99 Problems But the Price Ain’t One

 Unsustainable Capital Structure at Ares Management’s 99 Cents Only Stores

As Ares Management looks to deploy capital from its newly-raised Ares Corporate Opportunities Fund V (ACOF V), the firm’s troubled $6 billion buyout of struggling luxury retailer Neiman Marcus has drawn headlines amidst a potentially conflicted exit.¹ But the firm’s lesser-known acquisition of discount retailer 99 Cents Only Stores has also been plagued with heavy debt, slim margins, and an unclear exit strategy. Is Ares striking out on retail?

Ares’ ACOF III and the Canada Pension Plan Investment Board bought dollar-store retailer 99 Cents Only Stores for $1.6 billion in 2011, two years before their purchase of Neiman Marcus.² While Neiman Marcus executives have blamed low oil prices and online options for lagging sales, similar financial problems at 99 Cents Only Stores suggests Ares may be poorly managing retailers on both ends of the price spectrum.³

Unlike high-end retail, the dollar store industry has seen continued growth.⁴ 99 Cents Only Stores’ low margins and poorly planned expansion have driven up its debt, putting the company at risk to be uniquely unable to benefit from industry growth relative to peers.

Key Points

- In the last three years, 99 Cents Only Stores more than quadrupled its long term debt to Adjusted EBITDA ratio.

- 99 Cents Only Stores’ EBITDA margin and gross margin are significantly lower than those of its peers.

- 99 Cents Only Stores has $845 million in debt maturing in 2019. Poor financial results have been followed by multiple rating downgrades.
Over-Expansion Drove Debt Up and Sales Down

<table>
<thead>
<tr>
<th>99 Cents Only (in thousands)</th>
<th>1/29/2016</th>
<th>1/30/2015</th>
<th>1/31/2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue Total Sales</td>
<td>$2,003,995</td>
<td>1,926,949</td>
<td>1,528,743</td>
</tr>
<tr>
<td>COGS</td>
<td>1,441,631</td>
<td>1,308,849</td>
<td>946,048</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>562,364</td>
<td>618,100</td>
<td>582,695</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>65,653</td>
<td>62,734</td>
<td>50,820</td>
</tr>
<tr>
<td>Adjusted EBITDA</td>
<td>39,493</td>
<td>143,714</td>
<td>155,100</td>
</tr>
<tr>
<td>Long Term Debt</td>
<td>887,388</td>
<td>901,395</td>
<td>749,758</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>1/29/2016</th>
<th>1/30/2015</th>
<th>1/31/2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long Term Debt to Adjusted EBITDA Ratio</td>
<td>22.46</td>
<td>6.27</td>
<td>4.83</td>
</tr>
<tr>
<td>Interest Coverage Ratio</td>
<td>0.60</td>
<td>2.29</td>
<td>3.05</td>
</tr>
<tr>
<td>Gross Margin</td>
<td>0.28</td>
<td>0.32</td>
<td>0.38</td>
</tr>
</tbody>
</table>

99 Cents Only Stores’ long-term debt to Adjusted EBITDA ratio more than quadrupled from 2014 to 2016. At the same time, the company’s interest coverage ratio dropped by 80% and its gross margin declined by 26%.

99 Cents Only Stores has expanded rapidly, adding over 35% to its store base over the last five years. This rapid growth stressed the company’s operations with higher capex and growth in inventory associated with the new store growth, resulting in increased borrowings, according to a Fitch analysis. Sales cannibalization by new stores, inventory problems and poor in-store execution resulted in weak traffic and same-store sale declines, causing double-digit declines in EBITDA and negative same store sales for three straight quarters in 2015. By the third quarter of 2016, the company had cut back its new store openings to focus on stabilizing its operations and results.

Hoovers reported in December 2016 that “net profit margins have been usurped by losses on debt extinguishment, interests expenses on long-term debt, and capitalized and financing leases.”

![Quarterly EBITDA Margin](image)
Discount retailers have very tight profit margins.\textsuperscript{13} 99 Cents Only Stores’ quarterly EBITDA and quarterly gross margins remained below its main competitors.\textsuperscript{14} As of the most recent financial quarter, Dollar Tree and Dollar General had EBITDA margins six percentage points higher and gross margins one percentage point higher than 99 Cents Only Stores. In an industry with such small margins already, 99 Cents Only Stores’ disadvantage compared to its competitors is significant.

**High Debt Exposes 99 Cents Only Stores to Downgrades**

As of January 2016, 99 Cents Only Stores reported a total indebtedness was $893.5 million.\textsuperscript{15} In recent years, the company has seen repeated credit downgrades.

<table>
<thead>
<tr>
<th>Debt Name</th>
<th>Amount (in millions)</th>
<th>Maturation Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Lien Term Loan Facility</td>
<td>$595.7</td>
<td>January 13, 2019</td>
</tr>
<tr>
<td>Senior Notes</td>
<td>$250.0</td>
<td>December 15, 2019</td>
</tr>
<tr>
<td>ABL Facility</td>
<td>$47.8</td>
<td>April 8, 2021</td>
</tr>
</tbody>
</table>

In January 2016, Moody’s downgraded 99 Cents Only Stores’ corporate family and probability of default ratings to Caa1 and Caa1-PD and its senior secured term loan to Caa1 from B3 and its senior unsecured notes to Caa3 from Caa2. Moody’s Senior Analyst Mickey Chadha said “99¢ Only Stores’ liquidity profile is weak and operating performance continues to be challenged with declining same store sales, margins and earnings.”\textsuperscript{17}

In May 2016, S&P Global Ratings lowered its corporate credit rating on 99 Cents Only Stores to CCC+ from B-, its term loan facility to CCC+ from B- and its $250 million senior notes to CCC- from CCC. “The downgrade reflects our expectation that 99 Cents Only Stores’ weak operating performance trends, which have caused liquidity to weaken and credit protection measures to erode, will persist as it continues to address executional issues that have led to lower customer
traffic amid increased competitive headwinds,” said S&P analyst Declan Gargan. “Given our expectations for operating performance in the next year, we believe the company’s capital structure is unsustainable.”

In May 2016, Steve Gelsi of Buyouts Insider said that 99 Cents Only Stores “faces an unsustainable capital structure.” In its most recent 10-K, 99 Cents Only Stores admitted its high indebtedness could impair growth. Moody’s warned that a poorly timed debt maturity could “quickly trigger default” for a company that has limited financial flexibility.

In February 2016, Standard & Poor’s included 99 Cents Only Stores in a report on a predicated increase in retail defaults, writing that the company’s “further deterioration in operating performance…strains liquidity and results in financial commitments that appear unsustainable in the long term.”

In September 2016, Fitch identified 99 Cents Only Stores as one of seven retailers with “significant default risk within the next 12–24 months.” In February 2017, Moody’s put 99 Cents Only Stores on a list of 19 companies with “very high credit risk”, citing its weak credit metrics and overly leveraged debt structure.

<table>
<thead>
<tr>
<th>Growing Analyst Consensus: Trouble Ahead for 99 Cents Only Stores?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Report Name</strong></td>
</tr>
<tr>
<td>Ratings Downgrade</td>
</tr>
<tr>
<td>Ratings Downgrade</td>
</tr>
<tr>
<td>Retail Bankruptcy Enterprise Value and Creditor Recoveries</td>
</tr>
<tr>
<td>Distressed Retail and Apparel Companies Are on the Rise. Who’s Next?</td>
</tr>
</tbody>
</table>

Rising US interest rates could limit the ability of retailers like 99 Cents Only Stores to restructure. “If interest rates do go up it’s going to be harder for them to find more favorable options,” Murali Gokki, a managing director in AlixPartners’ retail practice, told CNBC. “The clock is ticking.”

**Conclusion**

The dollar store industry has performed strongly over the last five years. Even with an improving economy, low-cost products remain popular with cash-strapped customers. While the industry has historically targeted exclusively low-income earners, this consumer pool has expanded in recent years to include middle-class shoppers and even some high-income earners.
Over the next five years, analysts expect the industry to fully transition into a mature industry. Dun & Bradstreet forecast the dollar store industry will continue to grow at an annual rate of 4% between 2017 and 2021. Dollar stores’ share of overall retail sales remains below 2%. The industry could be poised for rapid sales growth if it can leverage value and product relevance to attract new consumers.

Ares Management has held 99 Cents Only Stores for six years—two years longer than Neiman Marcus—yet Ares lacks a clear plan for exit. 99 Cents Only Stores faces an impossible dilemma: the rush to open stores damaged the company’s finances, potentially jeopardizing its debt restructuring and impairing future borrowing to grow the company. Will looming debt maturity and grim finances be an obstacle for potential buyers?

**Question for Limited Partners**

- Ares has held 99 Cents Only for six years. What is the exit plan?
- Can 99 Cents Only Stores refinance on favorable terms given current margins? How do looming maturities affect a potential exit?
- How will Ares improve 99 Cents Only Stores’ margins without increasing the company’s debt burden?

**Endnotes**


11 Dollar Tree and Dollar General EBITDA margin data obtained from https://ycharts.com/. 99 Cents Only Stores quarterly EBITDA margin data obtained from quarterly earnings press releases.
12 Dollar Tree and Dollar General gross margin data obtained from https://ycharts.com/. 99 Cents Only Stores quarterly gross margin data obtained from quarterly earnings press releases.