American Apparel, Inc. – Saved from Bankruptcy but can it Sustain?

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This case has been compiled from published sources. It is intended for class room discussiona rather than to illustrate either effective or ineffective handling of a management situation.

Abstract

American Apparel, Inc, which was once the fastest growing retailer of America, is now striving to save its bleeding bottom line. With the possible bankruptcy looming on the American Apparel heads and huge pile of loans to pay, it is battling to get on the operating profits necessary for its very existence. The present case depicts the struggle of founder and CEO Dov Charney to revive the company with his recovery mechanism, inventory management, strengthening online & offline sales and crushing operating expenses to fight against the quarter by quarter losses, negative EPS and decreasing margins. This case gives an opportunity to the students to analyze and evaluate the financially troubled company's performance along with applying the Altman's Z score. At the end of the case students need to decide: whether the CEO Dov Charney's recovery plan is able to improve the financial performance of the company? What are the trends of growth and earnings? Does the company have sufficient liquidity and profitability to meet the requirements of massive debt and gather refinance options? Does the company survive bankruptcy?

Keywords: American Apparel, Bankruptcy, Z score, Profitability, Retails sector, financial performance, Ratio analysis

Introduction

With a cumulative loss of $41 million for the first three quarters in 2012, American Apparel, once the "Label of the Year: American Apparel", "The fashion sensation of 2008" (The Guardian, 2008) is struggling to stay afloat, after going into deep financial troubles in 2009 and was on the verge of bankruptcy in 2011**.** The company's net profit slipped to $1 million in 2009 from $15 million in 2007 and down to annual net losses of $86 million & $39 millions in 2010 and 2011 respectively. Dov Charney, the CEO and Founder of American Apparel, who built the company from a small retailer to a massive vertically integrated manufacturer, distributor and retailer, is now burdened with massive debt load, falling share prices and decreasing margins. Till now, Dov Charney's efforts have been able to sustain the company in spite of losses and pull up the investors for its sinking company, while enhancing the sales from $533 million in 2010 to $547 million in 2011 and further building up to $444 million (first three quarters in 2012) with effective inventory management and expansion plans. But, continuous losses pressurized him to improve the profitability and deliver the financial results or it will run out of options soon.

Figure 1 Stock Performance for 2006-2011

(Source: American Apparel, Inc., 2011)

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Case ID 040102

Company background

As of July 31, 2012, American Apparel had approximately 10,000 employees and operated 251 retail stores in 20 countries, including the United States, Canada, Mexico, Brazil, United Kingdom, Ireland, Austria, Belgium, France, Germany, Italy, Netherlands, Spain, Sweden, Switzerland, Australia, Japan, South Korea and China. American Apparel operates a global e-commerce site that serves over 60 countries worldwide at http://www.americanapparel.net. In addition, American Apparel also operates a leading wholesale business that supplies high quality T-shirts and other casual wear to distributors and screen printers. It is also one of the few clothing companies exporting "Made in the USA" goods. The American Apparel is headquartered in Downtown, Los Angeles, where, from a single building they control the dyeing, finishing, designing, sewing, cutting, marketing and distribution of the company's product. CEO Dov is very passionate about the company, and involved in every stage of manufacturing. He is known for the sexual controversies and various sexual lawsuits. The CEO Dov is also, famous for his use of provocative models for advertisements. Apart from these controversies, Dov is having a very strong fashion sense. In 2004, he was named Ernst & Young's Entrepreneur of the Year and Apparel Magazine's Man of the Year (www.americanapparel.net, 1997).

American Apparel's Mission statement

Company's Long-term goal: to become the #1 destination for basics – be the first name that fashion-conscious consumers think of for t-shirts, sweatpants, underwear, socks, and other basic apparel. (Americanapparel.net., n.d.)

The rise of American Apparel

The CEO Dov Charney with his vertical integration business model converted the company to America's fastest retailer in 2008. During the year, the company made wide spread expansion and launched stores across the globe with new launches in Australia, Belgium, Brazil, China, and Spain. The company expanded 78 net store openings and 3 store moves. The company got strong comparable store sales results: 22%, Achieved EBITDA of $70.1 million and EPS of $0.33 by significantly expanding the manufacturing operations. The company was basking on the glory of significant store growth and strong comparable store sales performance. By the end of 2008, the company has 260 stores in 19 countries, nearly 10,000 employees and $545 million in revenues and a five year compound annual growth rate of 46% (American Apparel, Inc., 2008). The company has a biggest competitive advantage of bringing the fashion changes quickly, as the entire process is governed in one building right from, cloth, cutting, and delivery of final product. By the end of 2008, the company was able to build a unique brand which was fashionable and low on prices.

Major setback to the profitability

In 2009, despite the company's ability to build a unique brand and having built a wide network of stores across the globe, the company started struggling to sustain. Although, year 2008 was good in terms of revenues and over all expansion, beginning 2009, the company faced several difficulties. The long run probe into the employment of illegal immigrants, and forced termination of bulk of its employees, brutally affected the performance of the company. Immigration crackdown forced American Apparel to fire 1,800 workers, most of whom are Latino immigrants (Daily 49ER, 2009). As a result, the company's profits reduced from $14 million in 2008 to $1 million in 2009, with EPS reduced from 0.33$ to 0.02$ in just one year and

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the operating margins decreased from 6.6% to 4.4%. The forced terminations of several employees impacted the performance of 2010 as well.

"We suffered the after-effects of a major labor disruption resulting from an immigration intervention in 2009. The disruption of our 2010 production schedule resulted in significantly higher production costs per unit and late deliveries of products to our stores and to our wholesale clients," said acting president Tom Casey. "In addition, we encountered extraordinarily challenging world-wide economic conditions. We also experienced higher yarn and fabric costs in the second half of 2010" (American Apparel, Inc., 2011).

Liquidity crisis and production losses

A significant decrease in the net cash flow from operating activities, was observed from December 31, 2009 ($45.2 million) to December 31, 2010 (- $32 million). Meanwhile, the revenue during the period fell nearly 5% as compared to previous year, with total retail sales fell just over 10%, wholesales sales dropped 6%, while online consumer sales shrunk by 4.4% (Proactive investors, 2009). In 2011 things became worse, when the company, with a long term mission of becoming the number one destination for garments, started to feel the difficulty even to stay afloat. In its annual report company specified that its operations are at risk and raised substantial doubt that the company may able to continue as a going concern. As the crisis grew, the company desperately looked for new investors.

“If the company is not able to timely, successfully or efficiently implement the strategies that the company is pursuing to improve its operating performance and financial position, obtain alternative sources of capital or otherwise meet its liquidity needs, the company may need to voluntarily seek protection under Chapter 11 of the U.S. Bankruptcy Code,” DealBook (2011).

Recovery plan

On the blink of bankruptcy, the CEO Dov Charney secured $14.9 million in additional financing and gave life line to the company. Dov, in his upbeat spirits, made an extensive plan for the recovery of the company through improving the operating performance, over hauling of the entire process of inventory management and severely trying to crush the cost while focusing on getting the required EBIT quarter by quarter in order to meet the requirements of heavy debt that it has taken.

According to Dov Charney, "We continue to make meaningful progress in improving inventory efficiency lower carrying costs and reduce working capital requirements over the long-term. These efforts, together with other operating performance improvements will assist in our near-term refinancing efforts" (Investors.americanapparel.net, 2012).

The expansion and renewed focus on sales enhancements resulted into total net sales increase by 15% to $56.3 million in December 2011. For the same period, comparable store sales increased 12% and wholesale net sales increased 25%. The Gross operating margin as well improved.

“Our sales exceeded plan in all channels and we saw good progress in our wholesale channel across a broad spectrum of customers. Our retail sales increases were also broad based with notably large increases in the US, in all Asian markets, and in Australia. Our product is

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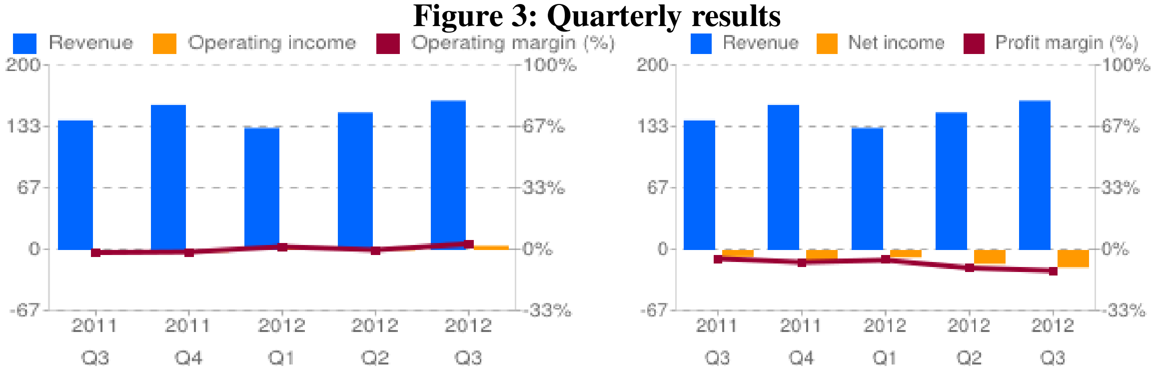
resonating well with our customers both in stores and online. During the quarter we opened three new stores in the UK, including one in Westfield, London and two store-in-store locations at the venerable Selfridges department store chain. We are excited about our progress in 2011 and expect to build on our recent successes in the coming year" said Dov Charney (American Apparel, Inc., 2012).

The strategy of building both online and offline stores was continued in 2012 as well. In April 2012, it launched a new online store, store.americanapparel.com.hk, serving Hong Kong, while continued to build brand offline and online.

Figure 2: Recent Stock Performance

(Source: Yahoo Finance, 2012)

Figure 3: Quarterly results



(Source: Google Finance, 2012)

Burdened under Debt

In spite of some improvements, the overall financial figures were still negative, making CEO Dov Charney to further increase debt or refinance, else it would go bankrupt. This time again Dov was able to arrange the investors and managed to get the major loans extended/refinanced till 2015 During July 2012, the company announced it has replaced its existing $75 million senior credit facility that was due to expire in July 2012 with a three year $80 million Senior Credit Facility also extended the maturity date of the Second Lien Loan by two years to December 31, 2015 (Americanapparel.net.,2012).

"I've never seen a company get so many lifelines. Dov must be very charming," said the retail analyst. (Retailgeeks.com, 2012)

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The growing liabilities, the high interest rates and inability to generate profits and once again resorting to the lenders for further loan, resulted into a total liabilities increasing to $ 319 million at the end of the third quarter of 2012 as compared to $13,877 in equity. But it seems Dov, is unshattered with the loans, all he wants to somehow keep the company floating. He believes that once the company is able to hit the numbers, the interest payment can be made easily.

Concern and challenges

"There's obviously a level of sexiness and excitement that (Charney) portrays, and passion for the brand" retail consultant said. "If the numbers aren't that positive, as they're not, investors are probably buying a vision and a promise that, things will get better" (Retailgeeks.com, 2012). Although the efforts of Dov Charney have managed to get investors till now, some analysts believe that the company has done nothing, except buying some time from its latest financing. With huge liabilities, the company has to show the results in numbers otherwise it may have to face the bankruptcy. No wonder, the company is having tough time to save its bleeding bottom line. With the sword of liabilities dangling on Dov Charney's head, he fears, whether the recovery plan will able to enhance the profitability of the company? What are the key financial indicators that need to be further emphasized, in order to pay back the liabilities, and generate further refinance, if required? Having survived on the blink of bankruptcy, would American Apparel be able to pass through the crisis or is it a sure short candidate of business failure?

Specific Assignment Questions

1. Has the recovery plan of Dov Charney able to improve the financial performance of the company?
2. Do you think company can survive? Apply the Atman Z –score to further strengthen your conclusions.
3. How good are the operating margins and EBIT of the company?

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Notes: 1 Altman's Z score

"Z" Score Component Definitions

1. **X1=Working capital/ total Assets**
2. **X2=Retained earnings / Total Assets**
3. **X3=EBIT/Total Assets**
4. **X4=Equity value/ total book debt**
5. **X5=Sales/Total Assets**

Z score is calculated to find out the future viability and chances of bankruptcy

Z = 1.2X1 + 1.4X2 + 3.3X3 + 0.6X4 + 1.0X5

Altman defined a "problematic area" which is between 1.81 and 2.99. Firms, with z-scores within this range, are considered uncertain about credit risk and considered marginal cases to be watched with attention. Firms with Z scores below 1.81 indicate failed firms. Although, the cut-off point was set at 2.675, Altman advocates using the lower bound of the zone-of-ignorance (1.81) as a more realistic cutoff Z-Score. So if Z < 1.81, then the company has a high probability of default. Altman, E., (1968)

When using this model Altman concluded:
Z-score < 1.81 = high probability of bankruptcy.
Z-score > 3.0 = low probability of bankruptcy.
Z-score 1.81- 3.0 = indeterminate. (Al- Rawi, K. et al., 2008)

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Exhibit 1: Annual Cash Flow statement for year ending 2011

American Apparel, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Amounts in Thousands)

	For the Years ended December 31, 2011	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES			
Cash received from customers	$ 542,930	$ 532,601	$ 559,089
Cash paid to suppliers, employees and others	(534,497)	(559,386)	(488,858)
Income taxes (paid) refunded	(866)	698	(16,901)
Interest paid	(5,535)	(6,456)	(8,609)
Other	273	173	482
Net cash provided by (used in) operating activities	2,305	(32,370)	45,203
CASH FLOWS FROM INVESTING ACTIVITIES			
Capital expenditures	(11,070)	(15,701)	(20,889)
Proceeds from sale of fixed assets	311	39	-
Net cash used in investing activities	(10,759)	(15,662)	(20,889)
CASH FLOWS FROM FINANCING ACTIVITIES			
Cash overdraft	(1,407)	(404)	1,307
(Repayments) borrowing under revolving credit facilities, net	(6,874)	50,852	(43,590)
Net proceeds from issuance of common stock and purchase rights	21,710	-	-
Payment of debt issuance costs	(1,881)	-	(5,003)
Proceeds from sale of treasury stock	-	1,650	-
Payment of payroll statutory tax withholding on stock-based compensation associated with issuance of common stock	(759)	(2,051)	-
Borrowings of subordinated notes payable to related party	-	-	4,000
Repayments under subordinated notes payable to related party	-	-	(3,250)
Borrowings under term loans and notes payable, net of $5,000 discount	-	-	75,074
Repayment of term loans and notes payable	(13)	(15)	(51,183)
Proceeds from equipment lease financing	3,100	-	-
Repayment of equipment lease obligations	(1,294)	(1,860)	(2,826)
Net cash provided by (used in) financing activities	12,582	48,172	(25,471)
EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH	(1,491)	(1,530)	(1,165)
NET INCREASE (DECREASE) IN CASH	2,637	(1,390)	(2,322)
CASH, beginning of period	7,656	9,046	11,368
CASH, end of period	$ 10,293	$ 7,656	$ 9,046

(Source: American Apparel, Inc. (2011) annual report on form 10-k for the year ended December 31, 2011)

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Exhibit 2: Annual Balance sheet as on 31st Dec, 2011

Consolidated Balance Sheets
(Amounts in thousands, except per share amounts)

	December 31, 2011	2010
ASSETS		
CURRENT ASSETS:		
Cash	$ 10,293	$ 7,656
Trade accounts receivable, net of allowances of $2,195 and $2,630 at December 31, 2011 and 2010, respectively	20,939	16,688
Prepaid expenses and other current assets	7,631	9,401
Inventories, net	185,764	178,052
Income taxes receivable and prepaid income taxes	5,955	4,114
Deferred income taxes, net of valuation allowance of $12,003 and $9,661 at December 31, 2011 and 2010, respectively	148	626
Total current assets	230,730	216,537
PROPERTY AND EQUIPMENT, net	67,438	85,400
DEFERRED INCOME TAXES, net of valuation allowance of $61,770 and $42,318 at December 31, 2011 and 2010, respectively	1,529	1,695
OTHER ASSETS, net	25,024	24,318
TOTAL ASSETS	$ 324,721	$ 327,950
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Cash overdraft	$ 1,921	$ 3,328
Revolving credit facilities and current portion of long-term debt, net of unamortized discount of $16,012 at December 31, 2010	50,375	138,478
Accounts payable	33,920	31,534
Accrued expenses and other current liabilities	43,725	39,028
Fair value of warrants	9,633	993
Income taxes payable	2,445	230
Deferred income tax liability, current	150	-
Current portion of capital lease obligations	1,181	560
Total current liabilities	143,350	214,151
LONG-TERM DEBT, net of unamortized discount of $20,183 at December 31, 2011	97,142	444
SUBORDINATED NOTES PAYABLE TO RELATED PARTY	-	4,611
CAPITAL LEASE OBLIGATIONS, net of current portion	1,726	542
DEFERRED TAX LIABILITY	96	260
DEFERRED RENT, net of current portion	22,231	24,924
OTHER LONG-TERM LIABILITIES	12,046	7,994
TOTAL LIABILITIES	276,591	252,926

(Source: American Apparel, Inc. (2011) Annual Report on Form 10-K for the Year Ended December 31, 2011)

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Exhibit 3: Consolidated Statements of Operations and Comprehensive (Loss) Income for year ending Dec, 2011.

American Apparel, Inc. and Subsidiaries
Consolidated Statements of Operations and Comprehensive (Loss) Income
(Amounts in thousands, except per share amounts)

	Years Ended December 31, 2011	2010	2009
Net sales	$ 547,336	$ 532,989	$ 558,775
Cost of sales	252,436	253,080	238,863
Gross profit	294,900	279,909	319,912
Selling expenses	209,841	218,198	198,518
General and administrative expenses (including related party charges of $919, $822 and $790 for the years ended December 31, 2011, 2010 and 2009, respectively)	104,085	103,167	93,636
Retail store impairment	4,267	8,597	3,343
(Loss) income from operations	(23,293)	(50,053)	24,415
Interest expense (including related party interest expense of $64, $266 and $271 for the years ended December 31, 2011, 2010 and 2009, respectively)	33,167	23,752	22,627
Foreign currency transaction loss (gain)	1,679	(686)	(2,920)
Unrealized (gain) loss on change in fair value of warrants and purchase rights	(23,467)	993	-
Loss on extinguishment of debt	3,114	-	-
Other (income) expense	(193)	39	(220)
(Loss) income before income taxes	(37,593)	(74,151)	4,928
Income tax provision	1,721	12,164	3,816
Net (loss) income	$ (39,314)	$ (86,315)	$ 1,112
Basic (loss) earnings per share	$ (0.42)	$ (1.21)	$ 0.02
Diluted (loss) earnings per share	$ (0.42)	$ (1.21)	$ 0.01
Weighted average basic shares outstand	92,599	71,626	71,026
Weighted average diluted shares outstar	92,599	71,626	76,864
Net (loss) income (from above)	$ (39,314)	$ (86,315)	$ 1,112
Other comprehensive (loss) income item:			
Foreign currency translation, net of tax	(188)	(1,085)	620
Other comprehensive (loss) income, net	(188)	(1,085)	620
Comprehensive (loss) income	$ (39,502)	$ (87,400)	$ 1,732

(Source: American Apparel, Inc. (2011) Annual Report on Form 10-K for the Year Ended December 31, 2011)

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Exhibit 4: Quarterly Reports - Balance Sheet

American Apparel, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(Amounts and shares in thousands, except per share amounts)
(unaudited)

		September 30, 2012		December 31, 2011*
ASSETS				
CURRENT ASSETS				
Cash	$	7,186	$	10,293
Trade accounts receivable		25,951		20,939
Prepaid expenses and other current assets		10,800		7,631
Inventories, net		180,879		185,764
Restricted cash		5,928		-
Income taxes receivable and prepaid income taxes		1,475		5,955
Deferred income taxes, net of valuation allowance of $12,003 at both September 30, 2012 and December 31, 2011		639		148
Total current assets		232,858		230,730
PROPERTY AND EQUIPMENT, net		65,959		67,438
DEFERRED INCOME TAXES, net of valuation allowance of $61,770 at both September 30, 2012 and December 31, 2011		1,559		1,529
OTHER ASSETS, net		33,269		25,024
TOTAL ASSETS	$	333,645	$	324,721
LIABILITIES AND STOCKHOLDERS' EQUITY				
CURRENT LIABILITIES				
Cash overdraft	$	2,625	$	1,921
Revolving credit facilities and current portion of long-term debt		71,586		50,375
Accounts payable		37,247		33,920
Accrued expenses and other current liabilities		38,750		43,725
Fair value of warrant liability		28,455		9,633
Income taxes payable		389		2,445
Deferred income tax liability, current		697		150
Current portion of capital lease obligations		1,017		1,181
Total current liabilities		180,766		143,350
LONG-TERM DEBT, net of unamortized discount of $29,959 and $20,183 at September 30, 2012 and December 31, 2011, respectively		103,964		97,142
CAPITAL LEASE OBLIGATIONS, net of current portion		1,083		1,726
DEFERRED TAX LIABILITY		108		96
DEFERRED RENT, net of current portion		21,597		22,231
OTHER LONG-TERM LIABILITIES		12,250		12,046
TOTAL LIABILITIES		319,768		276,591
COMMITMENTS AND CONTINGENCIES				
STOCKHOLDERS' EQUITY				
shares outstanding at December 31, 2011		11		11
Additional paid-in capital		173,787		166,486
Accumulated other comprehensive loss		(2,735)		(3,356)
Accumulated deficit		(155,029)		(112,854)
Less: Treasury stock, 304 shares at cost		(2,157)		(2,157)
TOTAL STOCKHOLDERS' EQUITY		13,877		48,130
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$	333,645	$	324,721

(Source: American Apparel, Inc. (2012) American Apparel, Inc. Reports Third Quarter 2012
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Exhibit 5: Quarterly Reports - Income Statement

American Apparel, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations and Comprehensive Loss
(Amounts and shares in thousands, except per share amounts)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net sales	$ 162,160	$ 140,889	$ 444,282	$ 389,760
Cost of sales	76,960	65,898	209,990	178,705
Gross profit	85,200	74,991	234,292	211,055
Selling expenses	58,017	52,283	168,258	152,536
General and administrative expenses (including related party charges of $332 and $177 for the three months ended September 30, 2012 and 2011, respectively, and $883 and $628 for the nine months ended September 30, 2012 and 2011, respectively)	22,566	24,552	71,792	77,025
Retail store impairment	-	784	129	2,436
Income (loss) from operations	4,617	(2,628)	(5,887)	(20,942)
Interest expense	10,454	8,832	30,274	23,715
Foreign currency transaction (gain) loss	(685)	1,855	141	780
Unrealized loss (gain) on change in fair value of warrants and purchase rights	13,312	(6,101)	15,340	(21,201)
(Gain) loss on extinguishment of debt	-	-	(11,588)	3,114
Other expense (income)	36	(186)	188	(240)
Loss before income taxes	(18,500)	(7,028)	(40,242)	(27,110)
Income tax provision	512	166	1,933	1,042
Net loss	$ (19,012)	$ (7,194)	$ (42,175)	$ (28,152)
Basic and diluted loss per share	$ (0.18)	$ (0.07)	$ (0.40)	$ (0.32)
Weighted average basic and diluted shares outstanding	106,248	102,279	105,960	88,614
Net loss (from above)	$ (19,012)	$ (7,194)	$ (42,175)	$ (28,152)
Other comprehensive income (loss) item:				
Foreign currency translation, net of tax	1,073	(1,279)	622	135
Other comprehensive income (loss), net of tax	1,073	(1,279)	622	135
Comprehensive loss	$ (17,939)	$ (8,473)	$ (41,553)	$ (28,017)

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Exhibit 6: Quarterly Reports: Cash Flow Statement

American Apparel, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations and Comprehensive Loss
(Amounts and shares in thousands, except per share amounts)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net sales	$ 162,160	$ 140,889	$ 444,282	$ 389,760
Cost of sales	76,960	65,898	209,990	178,705
Gross profit	85,200	74,991	234,292	211,055
Selling expenses	58,017	52,283	168,258	152,536
General and administrative expenses (including related party charges of $332 and $177 for the three months ended September 30, 2012 and 2011, respectively, and $883 and $628 for the nine months ended September 30, 2012 and 2011, respectively)	22,566	24,552	71,792	77,025
Retail store impairment	-	784	129	2,436
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Other comprehensive income (loss), net of tax	1,073	(1,279)	622	135
Comprehensive loss	$ (17,939)	$ (8,473)	$ (41,553)	$ (28,017)

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Exhibit 6: Quarterly Reports - Total Debts

Description of Debt	Lender Name	Interest Rate		September 30, 2012
Revolving credit facility	Crystal Financial LLC	(a) 90-day LIBOR of 0.47% plus 9.0% plus unused facility fee ranging (0.375% -1.00%) and for the brand name: (b) 90-day LIBOR of 0.47% plus 19.75%	$	35,576
Term loan from private investment firm	Crystal Financial LLC	90-day LIBOR of 0.47% plus 9.0% plus unused facility fee ranging (0.375% -1.00%)		30,000
Revolving credit facility (Canada)	Bank of Montreal	Bank's prime rate of 3% plus 4%		5,901
Term loan from private investment firm, net of discount and including interest paid-in-kind	Lion Capital LLP	From 15.0% to 18.00%		103,614
Other				459
Capital lease obligations	23 individual leases ranging between $1-$511	From 5.0% to 18.00%		2,100
Cash overdraft				2,625
Total debt including cash overdraft			$	180,275

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