Thinking The Unthinkable

The current operations of retail leaders Guitar Center and Amazon.com call to mind the old adage, "unsustainable trends cannot be sustained." Guitar Center carries a debt burden that, absent some extraordinary event, it won't be able to repay. (Given the stock market's current lack of enthusiasm for brick-and-mortar retailing, a successful GC IPO would be "extraordinary.") Amazon has a decent balance sheet but operates without making a real profit. You don't have to be a CPA to recognize that these financials are "sub-optimal" and will need to be addressed at some point. These unsustainable situations are worth pondering, because the fixes that both companies adopt could have a significant impact on the music industry.

Guitar Center continues to struggle in the aftermath of an ill-fated 2007 private equity buyout, when Bain Capital bought the company for $2.1 billion, loading it up with $1.6 billion in debt. The leverage was based on projections that Guitar Center's revenues would rise to $3.0 billion from $2.0 billion, and that "better management discipline" would increase profits at an even faster rate. Unfortunately, events in the form of the 2008 financial crisis rudely intervened, causing sales to flatline and profitability to slip. Absent the $1.6 billion in debt, the retailer would have easily been able to manage through the slow growth period. However, with annual interest payments of $160 million that were slightly above cash flow, the company was in a precarious position.

Last March, Ares Capital gave Guitar Center a reprieve with a complex debt for equity swap that effectively cut its interest expense by about $70 million, and left Ares with a 60% ownership stake. The original Bain investors saw their stake wiped out. Since then, Guitar Center's finances are no longer publicly available, but there are indications that despite the lower interest costs, all is not well. A CEO was sacked due to a 33% decline in EBITDA (earnings before interest, taxes, depreciation, and amortization), bonds that were issued in March at $100 now trade at a deep discount—$83 for the five-year secured bond, and $64 for the ten-year unsecured—suggesting that investors are nervous. Topping it off, the new CEO has cut corporate staff. Collectively, this is not the kind of news that suggests that rapid growth is in the offing.

Absent the leverage, Guitar Center is still a viable business—think of it like a nice house with an underwater mortgage. The oft-published obituaries on brick-and-mortar are premature, and Guitar Center in particular still boasts viable locations and an organization rich in talent. To realize the potential of these assets, we suspect another round of "financial engineering" will probably be necessary. No one knows for sure how this would play out. The best hope is that bond and equity holders take another write-down and the trade creditors—which include most industry suppliers—are paid in full. The details of any reorganization are uncertain, but here's one thing you can bank on: Ares Capital and the bond holders are out to maximize the value of their investment and have no sentimental attachment to the music industry. If it's a choice between sustaining industry health by protecting trade creditors or squeezing out an extra 1%, there's no question which course they'll chose.

Over a two-decade span, Amazon has grown at a torrid pace, has been hugely disruptive, has invested heavily in plant and equipment, and yet has never been really profitable. The company posted losses in two of the past five years, and in its best year had a bottom line equal to a measly 0.5% of sales. This hasn't fazed growth-infatuated investors, who have given the company a stratospheric valuation. At a current quotation of $371 a share, Amazon is worth 163 times earnings, and 16 times book value. Wal-Mart, by contrast, fetches a comparatively earthbound 15 times earnings and 3.5 times book value.

So what does this mean for suppliers and retailers in the music industry? Amazon's lofty stock price allows it to acquire companies and pay employees in stock rather than cash. Being able to use currency you create yourself, rather than having to rely on Uncle Sam's greenbacks, is a great cost saver that contributes to Amazon's cash flow. Investor patience is not unlimited though, and at some point a rich valuation will have to be supported by reasonable profits. To achieve a more substantial bottom line, will Amazon have to raise prices, charge more for its Prime Service, or adjust its shipping charges? We have no particular insights, especially given that Amazon, for a large public company, reveals very little about its operations. However, maintaining a rich stock price while running a profitless operation is ultimately an unsustainable proposition. It doesn't take a lot of courage to predict that something's got to give.

A financially impaired Guitar Center and Amazon charging high prices are unthinkable, and we're not forecasting either now. However, in 125 years of chronicling the music industry, our columns have been filled with "unthinkable events." That American piano manufacturing, the mainstay of the industry for close to a century, would vanish? Impossible. That the accordion market, which once dwarfed the guitar business, would shrink to insignificance within a few years after Buddy Holly? Few thought it possible. That Chicago Musical Instruments Company, the industry's biggest and best-run company from 1950 through 1970, would be just a dimly remembered footnote? Once inconceivable. Considering the unthinkable can be a useful planning exercise. Try it sometime.

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