

Bankruptcy Is Blockbuster's Only Hope

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(Blockbuster bankruptcy article updated with additional analyst commentary on Blockbuster and Blockbuster stock movement.)

NEW YORK (TheStreet) -- Blockbuster's(BBI) warning that bankruptcy might be looming is a scare for investors who fear for the value of their stock -- but could ultimately be a smart move for the company.

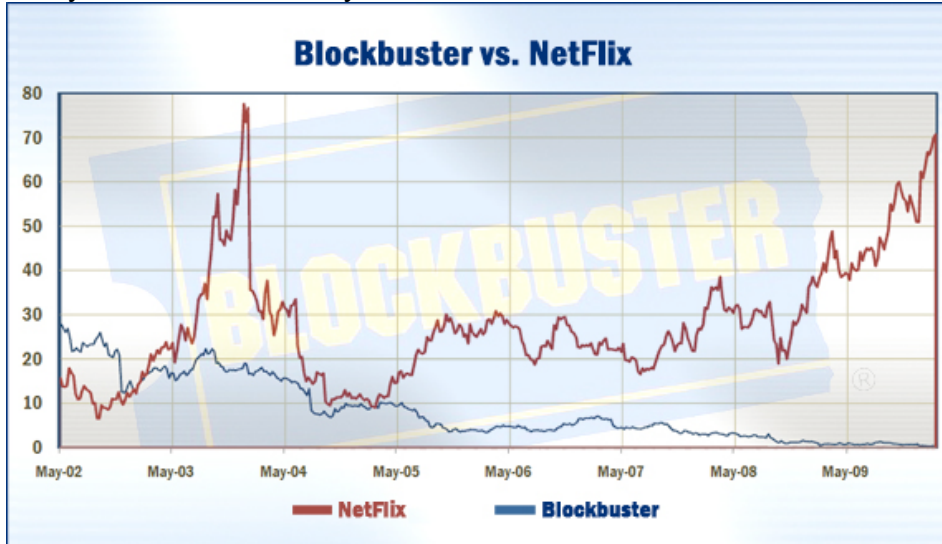


The video rental store declared in a Securities and Exchange Commission filing on Tuesday that it might be forced to file Chapter 11 if cash flows don't improve and it is unable to restructure its debt. Blockbuster's reportedly has about \$1 billion in debt.

"These factors raise substantial doubt about our ability to continue as a going concern," Blockbuster said in the filing.

As a result, shares of Blockbuster are tanking 32.7% to 27 cents in afternoon trading, with investors fearing that a Chapter 11 filing would render common shares worthless.

Still, a voluntary bankruptcy, while painful, may be its only way out, Needham analyst Charles Wolf says.



Blockbuster has provided little confidence that it will be able to recover on its own and its debt load isn't its only issue. Last month, the video rental company reported a fourth-quarter loss of \$434.9 million, or \$2.24 a share, as same-store sales fell almost 16%. This dour result came as a majority of the retail industry began to recover.

Bearing these numbers in mind, it should hardly come as a shock that Blockbuster is mulling filing Chapter 11. Yet, just two weeks ago CEO James Keyes told CNBC that the company has a "bright future," which sent the stock surging.

Still, no one can say Blockbuster isn't trying. Over the past several years, the company has shuttered underperforming stores, cut costs and rolled out kiosks in an effort to compete with Netflix(NFLX) and Coinstar's(CSTR) Redbox.

"There's a role for physical stores to play in video distribution," Wolf says. "And Blockbuster's plan to close underperforming stores is spot on."

Earlier this week Blockbuster also announced that it's in talks to divest its European unit.

The company has also said that it will reduce its costs by \$200 million this year.

Still, no matter what the company does, there is always the looming shadow of debt and interest burden, which was caused by the special dividend Blockbuster was forced to pay when it was spun out of Viacom(VIA) in 2004.

"A voluntary Chapter 11 would enable Blockbuster to reduce its debt burden and interest payments to manageable levels and [allow it] to implement its strategy

for closing underperforming stores and building a digital distribution business," Wolf says. "I can see why management is contemplating it."

Edward Neiger, bankruptcy attorney and founder of Neiger LLP, says the probability of Blockbuster filing for bankruptcy is about 75%. He expects the company is currently in frantic talks with their debt holders and if they don't agree on a resolution Blockbuster won't have any other choice. And even if the two parties do renegotiate the term of its debt agreement, there is still a chance Blockbuster could file Chapter 11.

Neiger expects a bankruptcy filing to come in the second or third quarter.

Blockbuster will likely use the filing as a platform to renegotiate terms with its existing senior debt holders, reject or renegotiate terms with a large number of its store landlords and liquidate non-core assets," says Kenneth Latz, director at Conway MacKenzie, a financial and operational consulting firm. "I would imagine that the holders of the existing subordinated notes will ultimately end up owning the majority of the business."

So if bankruptcy is imminent, what then will become of Blockbuster? Well, that all depends on the terms of the bankruptcy.

Latz does not think a pre-packaged bankruptcy is likely or there is any possibility of settling outside of court. "It would be unwise for Blockbuster to just deal with the debt holders and not address the vast store overhead or their operational issues," he says.

If they were to do this, it is likely Blockbuster will be staring at Chapter 22 down the road, Latz says, which often means liquidation.

-- Reported by Jeanine Poggi in New York.