Fnac Darty S.A.
France, retail

Corporate profile

Fnac Darty is a French retailer specialised in consumer electronics and editorial products. Despite a strong focus on France (about 80% of group sales), the retailer operates in five other countries: Switzerland, Spain and Portugal (Iberia), Belgium and Netherlands (Benelux). Fnac Darty came into existence in 2016 with the merger of two French retailers, Fnac and Darty. This resulted in a product palette combining Fnac's editorial products and brown goods with Darty's white goods.

Key metrics

			Scope estimates	
Scope credit ratios	2016	2017	2018F	2019F
EBITDA/interest cover (x)	8.6x	10.7x	9.2x	9.6x
Scope-adjusted debt/EBITDA	2.9x	1.6x	1.4x	1.7x
Scope-adjusted FFO/SaD	27%	45%	54%	46%
FOCF/SaD	13%	16%	11%	11%

Rating rationale

Scope Ratings assigns an initial issuer rating of BBB- to Fnac Darty, S.A. (Fnac Darty). Senior unsecured debt is rated BBB-. The rating for short-term debt is S-2. The Outlook is Stable.

Business risk profile

The rating is supported by Fnac Darty's market leadership and high brand recognition in its home market of France; thick shop network; good reputation for after-sales service; and excellent online traffic, with France's second most visited e-commerce website. We believe the group can maintain its market share going forward. However, traditional distribution of products via a physical network is facing substitution by e-commerce. The company is already addressing this by offering its own e-commerce service, including i) click and collect in any of the two brands' shops, increasing the catchment area; ii) a 'day + 1' delivery system, replicating those of competitors; and iii) initiatives to increase the appeal of physical shops via partnerships or complementary offers.

The situation differs in countries outside of France as only either one of the two brands is present (except for in Belgium). We do not expect Fnac Darty to expand activities abroad to any meaningful degree, meaning the lack of market share outside of France is unlikely to improve. This view is based on i) the lengthy time and high cost required to build brand recognition but with no guarantee that future revenues would justify such outlays; and ii) the markets' strong local and international competition, such as from Ceconomy (BBB- issuer rating; S-2 short term rating). Hence, we expect Fnac Darty to continue to be the French market leader but without expanding outside the country as peers have done (Dixons Carphone, Ceconomy).

Ratings & Outlook

Corporate ratings	BBB-/Stable
Short-term rating	S-2
Senior unsecured rating	BBB-

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Related methodology

Corporate Rating Methodology, January 2018

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The rating is held back by the lack of geographical diversification given the strong exposure to France. Nevertheless, the strength of online sales mitigates this as Fnac Darty is one of Europe's largest online sellers: direct sales from its own online platform is 18%, accompanied by 47% of omnichannel sales within this segment (click and collect). We view product segment diversification as positive, enabling the group to maintain market shares against e-tailers such as Amazon or Cdiscount, thanks to retail prices that are in line with or lower than peers. Besides the brown, grey, and white goods offered, Fnac Darty is also the largest bookseller in France, mitigating to some extent its large exposure to electronics goods (weak line-ups, etc.).

The status as France's largest bookseller also helps to stabilise group profitability, as book prices are legally controlled by publishers and not modifiable by retailers. Furthermore, the merger between the two entities have led to important costs synergies which impacted positively the profitability of the group. Hence given the relatively high profitability, with Scope-adjusted EBITDA margin increasing continuously from 2015. we expect the Confiance+ programme to reinforce the bond between the Fnac and Darty brands, which will also support group profitability. We anticipate EBITDA margin to improve, aided by partnership programmes aimed at increasing product and service palettes and by retail alliances (procurement and/or private labels).

Financial risk profile

Overall indebtedness is low based on our NPV for Fnac Darty's leasing obligations using a discount rate of 5%. Scope-adjusted debt (SaD), at only about EUR 930m at YE 2017, is net of the group's high historical cash levels (about EUR 800m in 2017). Fnac Darty benefits from a low overall SaD/EBITDA, with past metrics under 2.0x. Although we understand the likelihood of large acquisitions (above EUR 500m) to be low, we have nevertheless built in a EUR 400m cushion, reflecting the low external visibility on discretionary cash-based spending. We also understand that, in the absence of acquisitions, management will absorb some cash via deleveraging and/or dividend payments in the coming years.

This low overall leverage reflects the robust overall financial risk profile and investment grade metrics. This is especially the case for free operating cash flow (FOCF) relative to SaD, at 16% at YE2017, which we deem comparatively high in the retail industry and relative to competitor Ceconomy (3% at the same period). Despite our expectation of growing Scope-adjusted funds from operations (FFO), we expect FOCF/SaD to decrease over time due to higher capital expenditure; albeit the ratio is likely to remain relatively high in our forecasts, at ~ 10%.

Liquidity

Fnac Darty benefits from strong overall liquidity, with yearly coverage of short-term debt of above 10x, thanks to the very low short-term debt levels. The company has not stated an intention to issue new short-term debt over the next several years, except for CP program issuances. We consider liquidity strong enough to be able to opt for early debt repayment without resulting in a significant negative impact on the rating.

Outlook

The Outlook is Stable and incorporates our view of FFO/SaD of 35% and SaD/EBITDA of 2.0x on a sustained basis. The Outlook also takes into consideration a stable development of present key credit metrics and headroom for hypothetical acquisitions of EUR 400m.

A positive rating action may be taken if SaD/EBITDA falls and remains below 1.5x, on a sustainable level.

A negative rating action may be taken if SaD/EBITDA breaches and remains above 3.0x, on a sustainable level.

Rating drivers

Positive rating drivers	Negative rating drivers
• Top three player in Europe and dominant market share in France • Large range of products offered, cumulating consumer electronics, white goods and editorial products • Increase of the profitability, bolstered by a good mix of products sold and by the synergies stemming from the merger of the two groups. • Fast omnichannel transition due to high online sales • Relatively low leverage, leading to a good financial risk profile • High liquidity	• Inherent threat from e-commerce, due to the ease of substituting products offered • High seasonality of sales in Q4 • Less geographically diversified than its European competitors, leading to a significant exposure to the French market

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/EBITDA falls and remains below 1.5x on a sustainable basis	• SaD/EBITDA breaches and remains above the 3.0x on a sustainable level.

Financial overview

			Scope estimates	
Scope credit ratios	**2016**	**2017**	**2018F**	**2019F**
EBITDA/interest cover (x)	8.6x	10.7x	9.2x	9.6x
SaD/EBITDA	2.9x	1.6x	1.4x	1.7x
Scope-adjusted FFO/SaD	27%	45%	54%	46%
FOCF/SaD	13%	16%	11%	11%
Scope-adjusted EBITDA in EUR m	**2016**	**2017**	**2018F**	**2019F**
EBITDA	200.4	315.0	327.9	351.5
Operating lease payments in respective year	156.9	211.6	213.5	217.3
Scope-adjusted EBITDA	**357.3**	**526.6**	**541.4**	**568.7**
Scope funds from operations in EUR m	**2016**	**2017**	**2018F**	**2019F**
EBITDA	357.3	526.6	541.4	568.7
less: (net) cash interest as per cash flow statement	-18.5	-20.9	-32.0	-31.9
less: cash tax paid as per cash flow statement	-37.5	-98.3	-65.8	-74.0
less: interest component operating leases	-21.3	-24.5	-23.4	-23.7
add: others	-1.0	-3.7	-3.7	-3.7
Scope funds from operations	**279.0**	**379.2**	**416.5**	**435.3**
Scope-adjusted debt in EUR m	**2016**	**2017**	**2018F**	**2019F**
Reported gross financial debt	863.1	861.0	853.8	851.9
deduct: cash, cash equivalents	-656.0	-774.9	-838.5	-666.0
add: pension adjustment	93.2	89.9	89.9	89.9
add: operating lease obligation	513.7	465.9	470.0	478.3[1]
add: guarantees	205.4	196.3	196.3	196.3
Scope-adjusted debt	**1019.4**	**838.2**	**771.5**	**950.4**

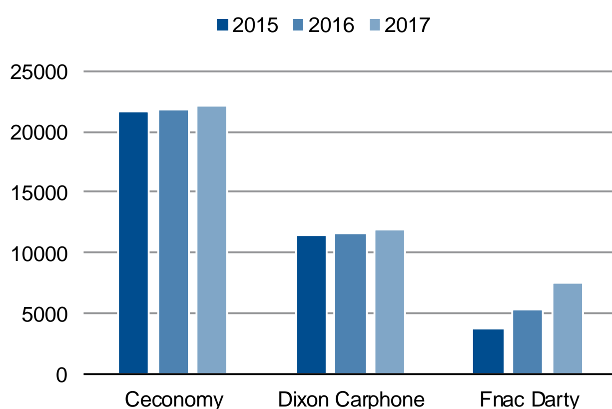
[1] See our detailed explanation on p.7 ('impact of the IFRS 16')

Business risk profile

Our assessment of the business risk profile consists of rating both the industry and the retailer's competitive positioning within this industry. We rate the industry risk profile at BBB, based on the cyclicality, entry barriers and substitution risk of a company operating in this sector. The competitive positioning includes an analysis of market share, diversification and profitability.

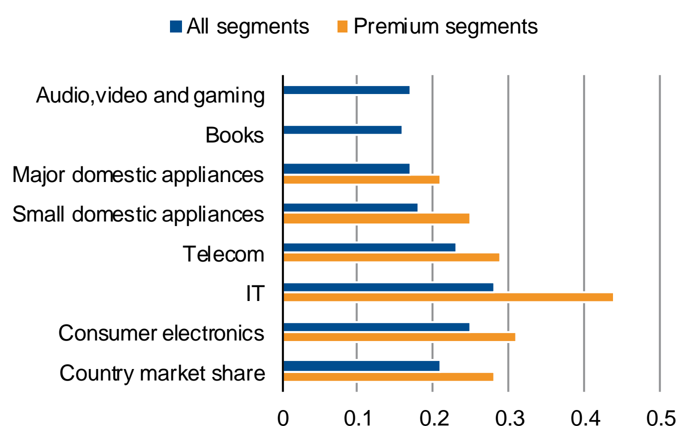
Fnac Darty is the third largest consumer electronics retailer in Europe, behind Ceconomy (latest rating on July 2018: BBB- issuer rating, S-2 short term rating) and Dixons Carphone. Whilst not as large as its competitors, Fnac Darty benefits from a higher annual growth rate, underlying the synergies created during 2016 merger of Fnac and Darty.

Figure 1: Size of Fnac Darty versus peers



Source : Scope estimates, Fnac Darty

Figure 2: Fnac Darty's market share on each product categories in France



Source : Scope estimates, Fnac Darty

France remains the key strategic market

With 79% of group sales, France remains Fnac Darty's main market by far. Other regions of operation are Benelux and Iberia. The longstanding establishment in France of both Fnac and Darty has resulted in high brand recognition for each, reinforcing the merged group's market shares. Despite a fragmented home market, Fnac Darty is the strongest retail player by market share, estimated at roughly 21% in the totality of its goods and 28% on premium products.

To counter the growth of e-tailers, Fnac Darty is actively capitalising on its differentiating factor: its shops. The group has launched numerous initiatives (partnership with other entities, shops in shops, exclusivity offers) over the last years to enhance the shopping experiences of customers. This strategy has borne fruit, with the retailer's merchant website becoming the second most visited in France. Furthermore, Darty has brought its know-how on after-sales services, resulting in the merged group becoming national market leader in this area as well. We view the market positioning in France as positive as we believe the strategy should protect market shares in the future.

Smaller sales generation abroad leading to low geographical diversification

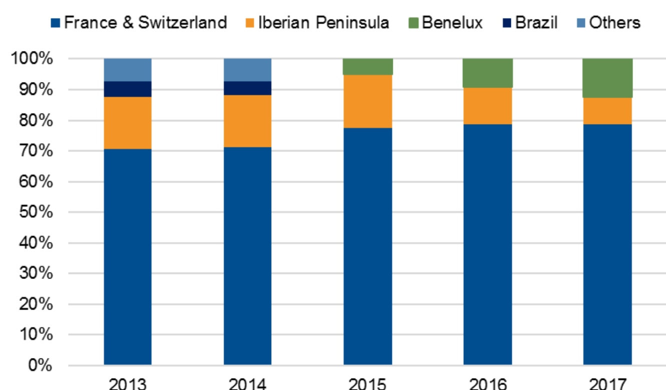
The situation differs slightly in the other countries in which the retailer is present. The group has only one of two brands implemented in all its countries of operation apart from Belgium. The absence of the other brand hinders the group's ability to crystallise on merger-related synergies in the same way as in France. The other brand's entry into these countries appears unlikely and risky as Fnac Darty would be confronted with either long-established local competitors or the European champions (Ceconomy or Dixons Carphone). We therefore do not expect these countries to provide enough growth to

offset any potential decline in the French market. This was particularly visible during the first three quarters of the year, when the drop in French market share (affected by strikes, the heatwave and a decrease of the purchasing power) caused the group's like-for-like growth to plunge while the other two regions remained more robust.

High product diversification decreasing consumer electronic risks

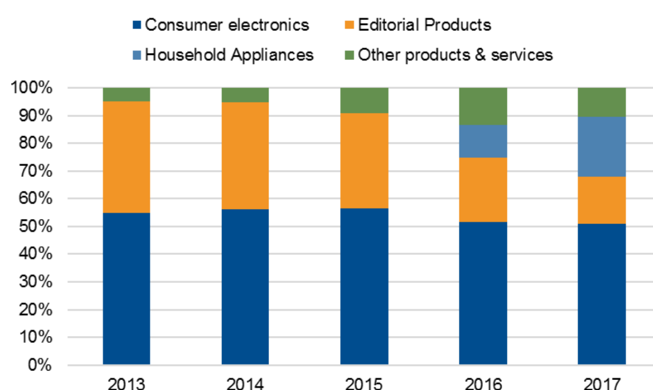
In terms of products offered, the retailer distinguishes itself by offering consumer electronics and editorial products, the latter including CDs, DVDs and books. This differs from Fnac Darty's European competitors, which solely sell consumer electronics. For editorial products, despite a gradual decrease in the segment's sales relative to overall sales – attributed to CDs and DVDs, either replaced by online content (Netflix and Spotify to name a few) or by the growth of online sellers in this segment – we consider the segment to be a key rating driver, as it helps to diversify against potential risks faced by electronic goods (weak technological line-up, for example).

Figure 3: Size of Fnac Darty versus peers



Source: Scope estimates, Fnac Darty

Figure 4: Fnac Darty French market share by product

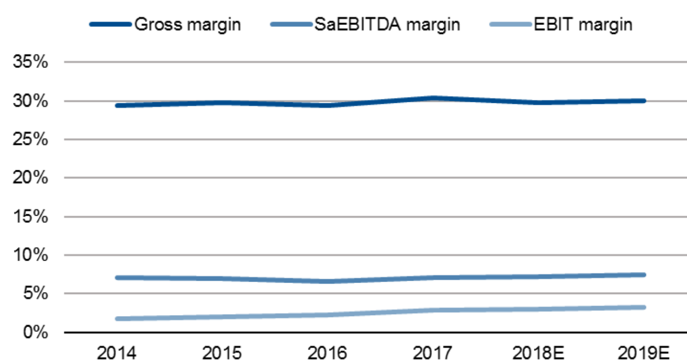


Source: Scope estimates, Fnac Darty

High online shares support the transition to omnichannel

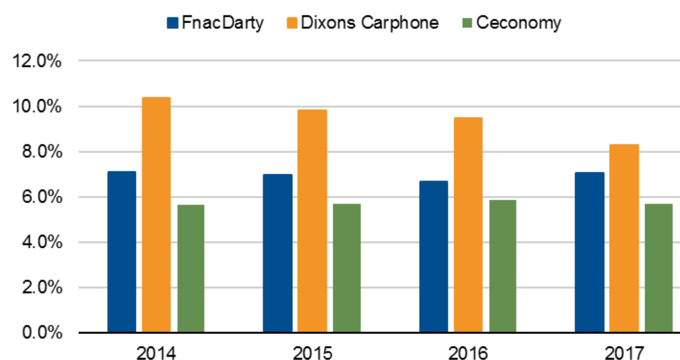
We attribute some weight to the diversification of the sales channels. Fnac Darty is performing well in its omnichannel expansion, reflected in a high share of online sales (18% as at YE 2017 versus 11% for Ceconomy in the same period). Furthermore, Fnac Darty's share of stores under franchise is close to 30%, which we view positively. In fact, by allowing the development of franchisee-owned and franchisee-operated (FOFO) stores, the retailer has limited financial downside as such entities are unconsolidated. At the same time, we understand that opening a new store can lead to 50% of "click & collect" orders being placed by customers who never ordered online in the said shop, boosting online sales but at little risk.

Figure 5: Fnac Darty's evolution of main margins



Source: Scope estimates, Fnac Darty

Figure 6: Fnac Darty profitability versus peers



Source: Scope estimates, Fnac Darty

Expectation of growing profitability due to initiatives and retail alliance

In terms of profitability, the retailer surpasses its peers slightly, with a high Scope-adjusted EBITDA estimated at 7.1% at YE 2017, versus 5.7% for Ceconomy over the same period. While both companies and the Russian m.video announced a retail alliance, - currently on hold -, we understand that Fnac Darty's higher profitability is supported by its editorial products and white goods. Indeed, in French law, book prices are fixed by the publisher, generating an important gain for retailers. We expect group profitability to increase slightly over the coming years, reflecting synergies realised from the merger. We estimate Fnac Darty's EBITDA margin to move to about 7.5% in the mid-term.

Financial risk profile

Impact of the IFRS 16

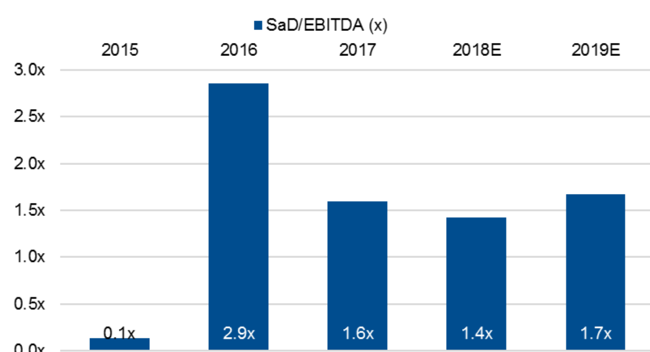
We consider Fnac Darty's financial risk profile as robust due to the limited amount of net financial debt in the group. With regard to the leasing debt adjustment, the new IFRS 16 is going to be implemented for the business year 2019, leading to the capitalisation of the operating leases in the balance sheet. As this still generates uncertainty in term of both impact and disclosure, we applied the Scope methodology (Net Present Value calculation with a discount rate of 5%) for our 2019 forecast. Nonetheless, in order to account for a potential appreciation of the leasing debt, we made a sensitivity analysis based on operating lease debt of EUR 600m and EUR 800m in 2019 (currently forecasted at EUR478m).

The impact on key credit metrics like SaD/EBITDA remains negligible, in our view (1.7x and 1.8x in 2019, compared to 1.7x in our base case). The resulting increase in SaD is offset by the appreciation of the Scope-adjusted EBITDA due to higher depreciation and operating lease payments. We therefore consider that the ratio remains anchored within our rating guidance.

Low debt leading to a robust financial risk profile

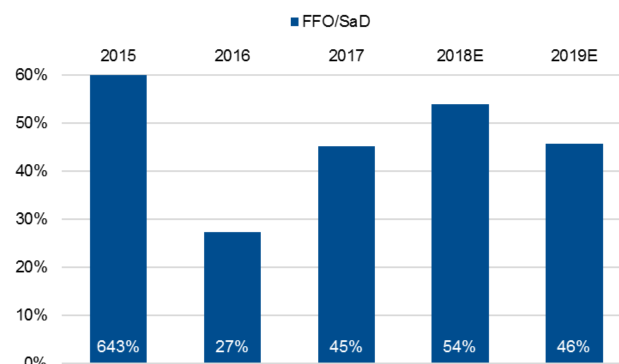
The company has only one sizeable long-term bond of EUR 650m (maturity in 2023, rated BBB-), which is completely offset by cash of EUR 775m at YE 2017, as well as no significant levels of short-term debt. It has to be noted that the cash position varies sensibly through the year due to the seasonality of the business (Q4 representing one third of the annual sales). The combination of the two factors leads to relatively low leverage in the context of the retail industry. Cash flow generation is also positive overall with a Scope-adjusted FFO of about EUR 380m at YE 2017, supported by low cash interest expenses. FOCF follows a similar trend, having reached about EUR 140m over the same period. In order to reflect some cash application in the future – and to account for our view on management's opportunistic financial policy - we modelled a hypothetical acquisition of EUR 400m, split over the years 2019 and 2020. Alternatively, should there be no sizeable acquisition, a full focus on deleveraging could lead the retailer to be almost debt-free in the short to mid-term.

Figure 7: SaD/EBITDA evolution of the group



Source: Scope estimates, Fnac Darty

Figure 8: FFO/SaD evolution of the group



Source: Scope estimates, Fnac Darty

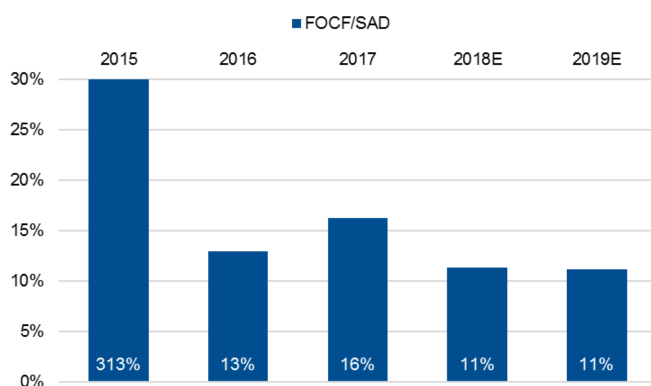
Low SaD/EBITDA and FFO/SaD

Leverage, as measured by SaD/EBITDA, is low at consistently below 2.0x. Fnac had a net cash position prior to the merger (in 2015) and financed the Darty acquisition in 2016 by issuing initial debt of EUR 850m supported by right issues of EUR160m. In 2017, the newly created group managed to swiftly decrease leverage from 2.9x in 2016 to 1.6x at the end of 2017, by integrating Darty. We do not expect SaD to grow rapidly over the short to medium term as no new debt issuances are planned. Meanwhile the cash level remains robust despite our forecast of a hypothetical acquisition, financed internally only. The latter is the sole reason we expect a small deterioration of the metric going forward (SaD/EBITDA increasing gradually).

The FFO/SaD ratio has been fluctuating within the investment grade category in the last few years. FFO has been continuously growing in the same fashion as EBITDA and has not been overly impacted by interest payments or tax payments (the latter saw an increase at YE 2017, viewed as a one-off). Overall the ratio reached 45% at YE 2017 and is expected to slightly deteriorate considering our assumption of a decrease in cash in 2019.

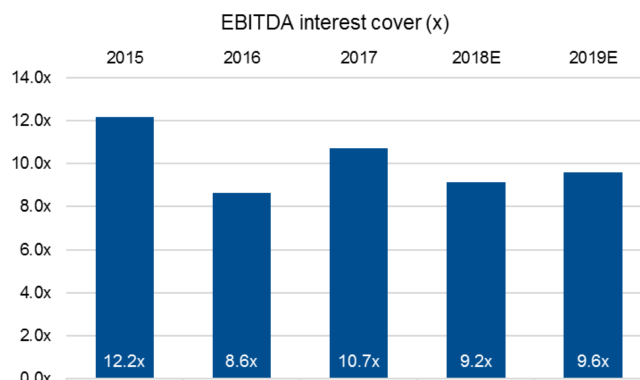
FOCF generation remains relatively high for a retailer, close to EUR 100m, carried by a high EBITDA and positive net working capital changes. This impacts FOCF/SaD positively, which stood at 16% at YE 2017. We expect a deterioration to 10% in the medium term, owing to higher assumed capital expenditure.

Figure 9: FOCF/SaD evolution of the group



Source: Scope estimates, Fnac Darty

Figure 10: Interest cover evolution of the group



Source: Scope estimates, Fnac Darty

High interest cover bolstered by low interest expenses

Lastly, interest coverage (interest expense/EBITDA ratio, Scope-adjusted) is well anchored at a high investment grade, well above 10x historically (YE2017, 10.7x). We expect interest expense to remain stable going forward as interest-bearing debt issuances are currently not planned. This leads to a forecasted interest coverage of between 9x and 10x; the figure was inflated by one-off interest expenses in 2017.

Liquidity above 10x

Fnac Darty benefits from strong liquidity, with yearly ratios above 10x. New issuance of short-term debt is not expected over the next several years. We consider liquidity strong enough to be able opt for early debt repayment without resulting in a significant negative impact on the rating.

Position	YE 2017		YE 2018E	
Unrestricted cash	EUR	774.9	EUR	838.5
Open committed credit lines (RCF)	EUR	400.0	EUR	400.0
Free operating cash flow (t+1)	EUR	87.2	EUR	106.5
Short-term debt (t+1)	EUR	7.2	EUR	1.9
Internal coverage		**>10.0**		**>10.0**

Outlook

The Outlook is Stable and incorporates our view of FFO/SaD of 35% and SaD/EBITDA of 2.0x on a sustained basis. The Outlook also takes into consideration a stable development of present key credit metrics and headroom for hypothetical acquisitions at EUR 400m.

A positive rating action may be taken if SaD/EBITDA falls and remains below 1.5x, on a sustainable level.

A negative rating action may be taken if SaD/EBITDA breaches and remains above 3.0x, on a sustainable level.

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