Leaner but meaner: Europe's retailers refocus

Asset sales continue as structural changes drive capex higher

Europe's retailers remain under pressure to sell assets to help finance e-commerce investment - even more of priority today than it was before the pandemic - without straining their finances. After recent geographic repositioning to focus on core markets and the natural reluctance to sell often increasingly important ancillary services businesses, retailing companies are keeping up sale-and-leaseback real estate deals to generate extra cash for investment. The overall impact is potentially credit positive for the sector.

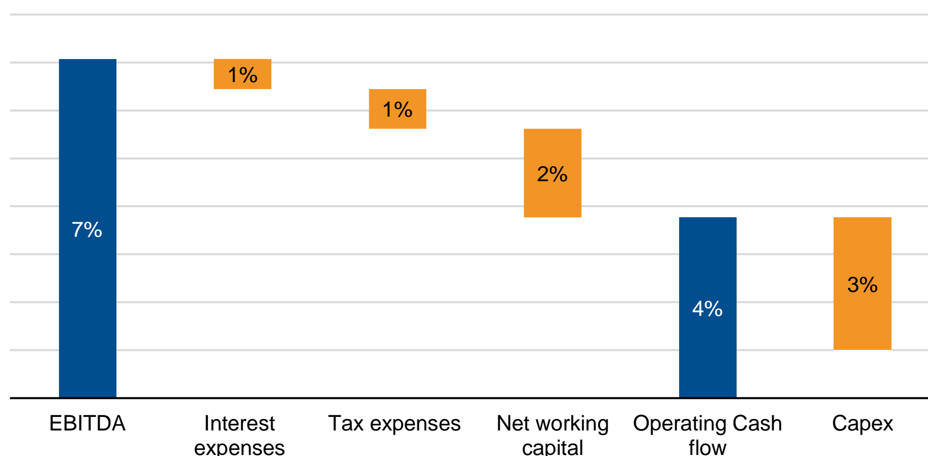
Extra competition in recent years from e-commerce and discount rivals amid changing consumer habits - all exacerbated by the lockdowns, travel restrictions and healthcare protocols imposed to contain the Covid-19 pandemic - have made Europe's retailers adopt a narrower view on what constitutes core business.

The growing propensity of European consumers to shop online and the increasing penetration of e-commerce across more retail segments were evident before the pandemic, as we argued in our 2018 report Of tortoises and hares: Retail segments in Europe have divergent online growth prospects

The pandemic has accelerated the two trends, forcing more retailers to modify their businesses and increase capital expenditure – notably in technology and logistics - to respond to customers' shifting shopping habits while seeking to protect market share from discounters or online specialists, notably Amazon.com.

Figure 1: Retailers have little room to finance any increase in capex internally

Median cash flow metrics for 20 European retailers 2016-2020 (% of revenue)



The industry's thin profit margins make it hard to rely only on internal resources for growth capex (**Figure 1**). Based on the past five years, using median data for 20 European retailers, room for internal financing for any increase in capex looks limited. Retailers' operating cash flow (4% of total revenue) barely covers existing capex (3% of revenue), making it difficult to either repay existing debt – financial or leasing - or to maintain cash positions (not shown in Figure 1).

Retail-sector executives will need to increase or least maintain current levels of capex to remain competitive in a post-Covid world where e-commerce is more dominant. UK supermarket operator Tesco PLC, for example, wants to develop at least 25 urban fulfilment centres to facilitate online grocery deliveries.

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French electronic-goods supplier Fnac Darty SA (BBB-/Stable) is investing to reduce fulfilment-centre unit costs by more than 20%. UK home products retailer Kingfisher is expanding its online presence in Poland while exploring new online marketplace models.

The capex squeeze: profitability under pressure

Retailers are left grappling with how to finance such investment. We expect profitability to remain under pressure in the coming years given the intensity of the competition that many traditional bricks-and-mortar retailers face from discount and e-commerce rivals in addition to the costs of the technology transition. Retailers have and will continue to issue debt to refinance the existing lines of credit or maintain adequate levels of liquidity. How to fund extra capex without relying too heavily on external debt that could put credit ratings at risk becomes the crucial question – hence the importance of selling assets to raise cash.

Asset sales help fund technology investment

Retailers such as France's Carrefour SA and Casino SA, Germany's Metro AG and Rewe Group, and the UK's Kingfisher and Tesco have typically cited the need to invest more in core businesses and bolstering their finances as reasons for the disposals. A survey by consultancy EY on retailers' strategy found that "three-quarters of European companies used funds raised from their latest divestment to invest in technology — slightly ahead of investing in new products, markets or geographies".

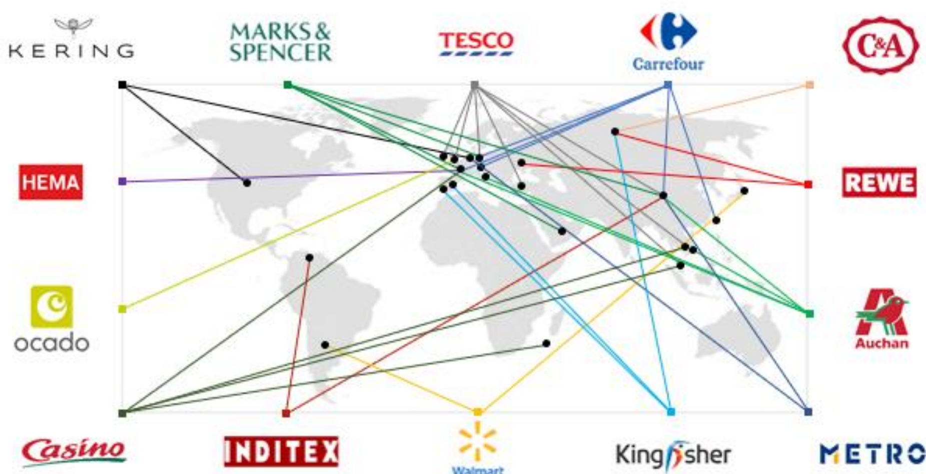
Meeting the e-commerce investment challenge: asset sale options

Narrowing the geographic footprint

Important geographic retrenchment

European retailers have reduced their geographic reach over recent years after a period of expansion in which they targeted what were at the time relatively fragmented, large emerging markets promising some political stability and good long-term growth potential. Over the years, as these markets in Asia, Latin America and Eastern Europe matured, the incentives for European retailers to pull outgrew as growth slowed while the investment required to maintain market share rose just as competition, particularly from online rivals, was intensifying in home markets.

Figure 2: Some of the world's leading retailers have reduced their global footprint in recent years by exiting foreign markets. (Lines link selected leading retailers to countries where they have recently fully or partially sold local operations.)



Some retailers kept a minority exposure

The withdrawal by European retailers hasn't necessarily been total. Some companies have preferred to retain some upside exposure through potential dividends by retaining minority stakes. Germany's Ceconomy CE (BBB-/Stable) retained a 15% share in

m.video following the sale of its MediaMarkt activities in Russia to m.video. Carrefour and Metro kept 20% stakes respectively in Carrefour China and Metro China.

Disposing of ancillary services

Lesser amount of sales of completementary acvtivities

European retailers have also sought to raise funds by selling stakes in non-core activities though we have seen only episodic transactions in recent years (**Figure 2**).

Figure 3: Examples of some of the activity divestures made by retailers over the past five years.

Retailer	Divestments
Tesco	Tesco Opticians
Auchan	49% Oney Bank
Metro	Real, Ceconomy
Carrefour	Dia France, Rue du commerce
Casino	Leader Price, Mercialys
Sainsbury's	Wholesale division

Source: Scope, public information

One of the reasons for only occasional disposals is that ancillary services – ranging from banking, delivery and repairs to online stores – have often become an integral part of the parent company's activities, providing some measure of competitive advantage rather than distracting from the core retailing activities. Take Netherlands-based retailer Ahold Delhaize NV's online shopping unit Bol.com, the Esserbella perfume unit of privately held Italian supermarket operator Esselunga SpA or the Hermes delivery-unit of Germany diversified retailer Otto Group, who nonetheless conducted some divestments within Hermes Germany and Hermes UK in 2020.

Even those companies which have sought to raise cash by selling out of such businesses, have done so only partially. French privately held supermarket group Elo (formerly known as Auchan Holding) no longer controls former banking subsidiary Oney but retains a 49.9% stake. French bank BPCE Group owns 50.1%.

Similar dilemmas face retailers with multiple brands, with much depending on the degree to which they can extract synergies through common online selling platforms and/or shop-in-shops possibilities, such as France's Fnac Darty with its eponymous brands. Running multiple brands can also help ward off competitors, in part by saturating the market, as Germany's Ceconomy aims to do in its home market by maintaining Saturn and MediaMarkt white-goods brands or targeting different groups of consumers as Ahold Delhaize does with various brands in the US. We see relatively few candidates for divestment of this sort among Europe's biggest retailers unless the ancillary businesses become unprofitable or fail to get sufficient market recognition.

Selling physical assets: real estate in focus

Sales of real estate ...

Disposing of physical assets is another indirect way to finance growth capex without stretching the balance sheet. To be sure, retailers continually juggle their portfolios of physical stores to maximise returns, but there are more strategic options they can pursue to reallocate capital with long-term, online-related growth in mind.

One is to spin off the retail real-estate assets into a separate commercial property unit, possibly through an initial public offering to create a real estate investment trust. The other is to enter sale and leaseback transactions for the physical stores they still own.

... either taking the form of spin-offs...

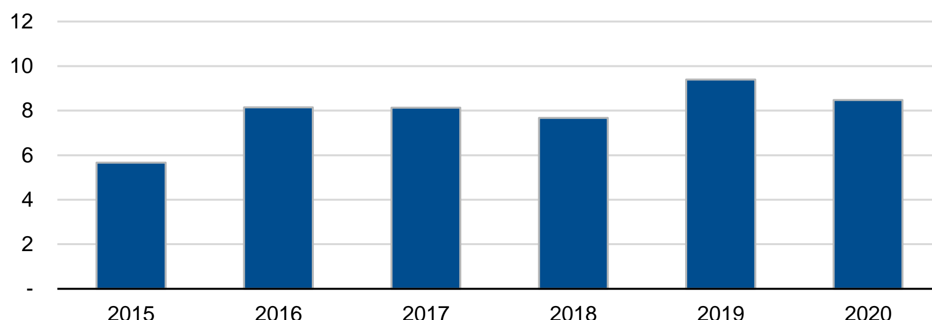
Many European retailers have historically owned large real estate portfolios which in recent years has to led spin-offs to create large commercial real estate companies in their own right as we have seen France with Carrefour spin-off Carmila SA, Elo spin-off Nhood and Casino spin-off Mercialys SA. The separated real estate companies have more leeway to use their existing expertise to develop new projects outside of pure retail investments such as revamping existing stores and logistic centres.

Such spin-offs bring several advantages for the core retailing business. First, there is cash inflow in the case of successful IPOs - more than EUR 500 m in the case of Carmilla - and the recurrent dividends. Secondly, retailers can jettison problematic assets – such as French operators have done with their hypermarkets in France – which have diminishing growth prospects and require significant maintenance and investment as environmental standards tighten.

... or sale and leaseback

Sale and leaseback transactions tend not to grab the headlines, but European retailers have proved enthusiastic adopters of the strategy in recent years. Typically, these transactions involve the retailer selling the title to shops to a real estate investor and signing leases for 10-15 years. The retailers benefit from a one-off cash inflow. In Europe, these transactions have picked up in frequency after falling to a low in 2015. Such transactions are inevitably relatively small in of themselves as a proportion of the retailers' overall capex but can make an important contribution to a company's funding.

Figure 4: Estimated sale and leaseback in Europe (in EUR bn)



Source: Scope estimates, Savills

Credit impact: continued divestments should be positive for outlook

Divestments set to continue

Divestments are likely to continue. Pressure on Europe's retailers to adapt to a fast-changing commercial environment, accelerated by the Covid-19 crisis and requiring significant investment in technology and infrastructure, comes in addition to upward pressure on costs amid tougher sustainability-related regulations. The EY survey found that 77% of European companies anticipate accelerating divestment plans.

Less room for non-core country, brand disposals

The type and size of assets put up for sale will change. Most food retailers have divested significant non-core activities in terms of location and business line in recent years. Europe's largest retailers operating physical stores have become less aggressive in entering new countries, preferring since 2018 to focus on optimising performance in home markets. Even if retailers have labelled some of their activities to be non-core, it might be difficult to find buyers in emerging markets able to take over the ownership and activities of large businesses.

Spread of franchising crimps room for portfolio juggling

Asset sales and shop portfolio optimisation will continue, though this has its limits given the spread of franchising. Most *new* shops are neither owned nor operated directly by

retailers in western Europe as the industry has been willing to sacrifice revenue in return for lowering business risk. The less-concentrated retail sector in eastern and southern Europe offers more room for portfolio adjusting - and mergers and acquisitions.

Theoretical impact on credit rating

The table in **Figure 5** displays the possible impacts of retailing-sector asset disposals, assuming proceeds are used *primarily* for financing capex with no change to company's commitments to maintaining leverage at current levels.

Figure 5. Pros and cons: weighing the potential credit impact of asset sales

Competitive positioning by:	Subcomponent	Short term impact	Long term impact	Comment
Market share	Size (revenue)	↓	↓	Divestments reduce revenue short term. Lost revenue is hard to recoup fast as divestment funds tend to be spent on enhancing remaining business rather than acquisitions.
	Market share (%)	↓	↑	Immediate of loss of share in one market can be offset longer term by investment in the retailer's existing markets to gain share in existing markets.
	Country retail strength	Depends on the relative positioning of retailer's operations in the country it has exited			
Diversification	Distribution channel	↑	↑	Exiting countries, segments with low e-commerce penetration can leave the retailer with relatively stronger multi-channel presence in core markets.[1]
	Product	↓	↓	Inevitable reduction in diversity of product, location
	Geography	↓	↓	
Profitability	Scope-adjusted EBITDA margin	=	↑	Selling low-margin or unprofitable activities has a neutral to positive impact on overall profitability. Moving to an asset-light business model can improve returns even if the impact on EBIDTA can be neutral. Judicious investment of sale proceeds, particularly if e-commerce is the target, should enhance returns.
	EBITDA return on assets	↑	↑	

Postive for ratings; use of proceeds under scrutinity

Retailers inevitably sacrifice revenue and market share when they exit countries and business segments. In return, they should record longer-term improvements in profitability assuming that sale proceeds – including those from sale-and-leaseback real estate deals – are invested wisely in enhancing the core business. Improved market share and profitability should lead to better cash flow and credit metrics. Our rating assessments will, however, keep a close watch on the balance retailers strike between remunerating shareholders, investing for long-term growth and satisfying creditors.

[1] European retailers in recent years have tended to pull back from emerging markets where their e-commerce activities were relatively limited, thereby artificially increasing the proportion of online sales in the remaining business.

Appendix

List of retailers mentioned in this paper	Scope ratings
C&A Mode GmbH & Co. KG	Not rated
Carrefour SA	Not rated
Ceconomy AG	BBB-/Stable
Elo SACA (ex-Auchan Holding)	ScopeOne
Esselunga SpA	ScopeOne
Fnac Darty SA	BBB-/Stable
Hema BV	Not rated
Industria de Diseño Textil, SA	Not rated
Kering SA	Not rated
Kingfisher PLC	Not rated
Koninklijke Ahold Delhaize NV	ScopeOne
M.video PJSC	Not rated
Marks and Spencer Group plc	Not rated
Metro AG	Not rated
Ocado Group PLC	Not rated
Tesco PLC	ScopeOne
Walmart Inc.	Not rated
Zalando SE	ScopeOne

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