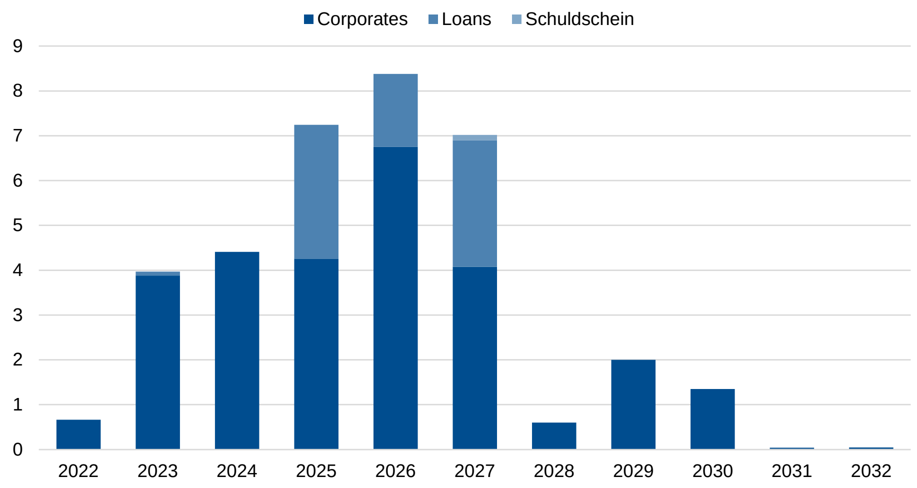
European retailers: sailing between Scylla of inflation, Charybdis of weak demand
Outlook still negative; refinancing risk low

Retailing companies are under pressure to protect profitability and cashflow as resurgent inflation, falling consumer confidence and residual supply-chain bottlenecks are setting back this year's rebound in household consumption. We maintain a negative outlook on the European sector as profitability comes under greater strain in the coming quarters. However, deteriorating credit metrics need to be set against the success many large retailers have had in refinancing borrowing at low rates in the past two years and extending bond maturities (Figure 1), thereby reducing short- to medium-term refinancing needs.

Macro-economic environment worsens as Covid recovery cut short

The squeeze on retailing revenues is mostly a result of the unfavourable macro-economic context, as Russia's war in Ukraine has exacerbated inflation and supply-chain disruptions to cut short the robust post-Covid economic recovery. Pent-up demand after the lockdowns in 2020 and 2021 had underpinned the rebound but that now looks increasingly exhausted. Even so, the impact on retailing revenues is likely to be uneven across the sector as consumers restrain spending on non-essential or discretionary goods as inflation erodes their purchasing power while maintaining spending on essential, non-discretionary items.

Figure 1: Debt schedule for a sample of European retailers (EUR bn)[1]



Sources: public information, Scope

Inflation has an adverse impact not only on demand but also on retailers' own costs, notably real estate leases which are often inflation adjusted. The aggravation of supply bottlenecks and blockages from the war in Ukraine, sanctions on Russia and

Russian retaliation and China's zero-Covid policy is another adverse factor squeezing profitability and cashflow as suppliers have to contend with soaring commodity prices while having to hold more inventory amid product shortages and supply-chain disruptions.

[1] Based on data of Carrefour SA, Auchan SA, Casino Groupe, Tesco PLC, J Sainsbury PLC, Koninklijke Ahold Delhaize NV, Metro AG, Esselunga SpA, H&M AB, Next PLC, Amer Sports Oy, Zalando SE, Kering SA, Ceconomy AG, Fnac Darty SA, AO World PLC, Kingfisher PLC, Tengelmann Warenhandelsgesellschaft KG, Maxeda DIY Holding BV, Hema BV, Plantasjen AS, El Corte Ingles SA, Marks & Spencer PLC, Otto GmbH & Co KG, Grandvision SA, Douglas GmbH, Calzedonia SpA, ASOS PLC, Travis Perkins PLC, Maison du monde SA, Frasers Group PLC

Analysts

Adrien Guerin
+49 1623923827
a.guerin@scoperatings.com

Daniel de Bruijn
+49 069 870027412
d.bruijn@scoperatings.com

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Scope Ratings GmbH

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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Passing on cost increases to customers is no panacea

Retailing company management has many ways to respond. Passing on cost increases to customers through high prices is the obvious option though it comes with the risk of damaging reputations for cost-competitiveness and losing market share. All in all, profitability will suffer, despite some initiatives started over the last years to diversify businesses and justify higher prices.

Capex requirements remain high

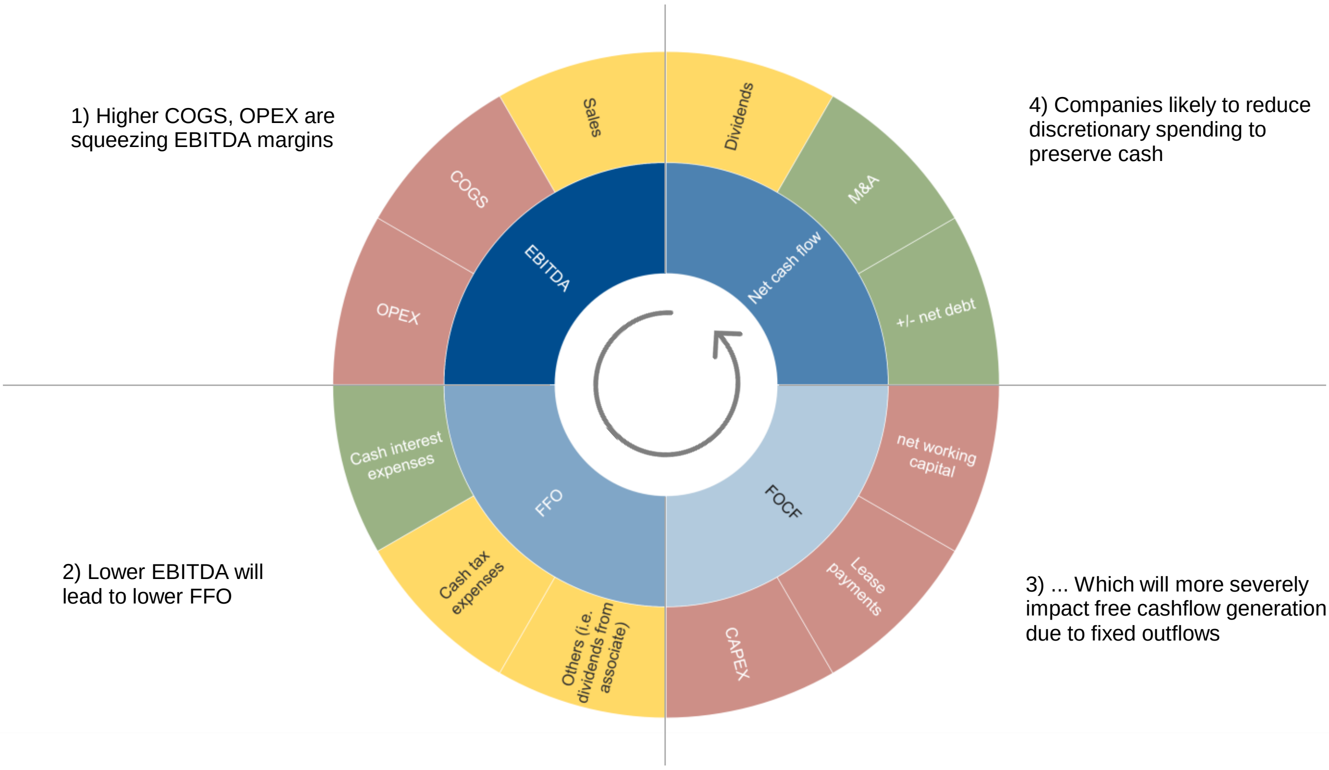
Such a strategy requires investment, ensuring that **capex-to-revenue** will remain relatively high for the majority of retailers at 3.5-4.0%, helped by the normalisation of post-Covid trading conditions which should increase business visibility. Capex demands will constrain retailers' ability to i) remunerate shareholders; ii) embark on ambitious M&A.

Inflation, supply-chain issues have multiple impacts on retail sector finances

Multifaceted impacts of cost increases supply disruptions

Inflation, supply bottlenecks, the economic consequences of Russia's war in Ukraine are all feeding through to the components of retailing company's profit and loss statements and cashflow, as the chart below shows. The outer ring of the chart shows the impacts – negative (red), green (positive), yellow (neutral) – on different aspects of company finances such as cost of goods and services (COGS) and operating expenditure (OPEX) and how they relate to the core measures of cash generation (the inner ring): earnings before interest, taxes, depreciation and amortisation (EBITDA); net cashflow; funds from operations (FFO); and free operating cashflow (FOCF).

Figure 2: Inflation, bottlenecks have broad impact on retailers' finances[2]



Source: Scope Ratings

[2] CAPEX stands for capital expenditures, M&A stands for Mergers and acquisitions

Feeling the squeeze: inflationary impact on retailers P&L

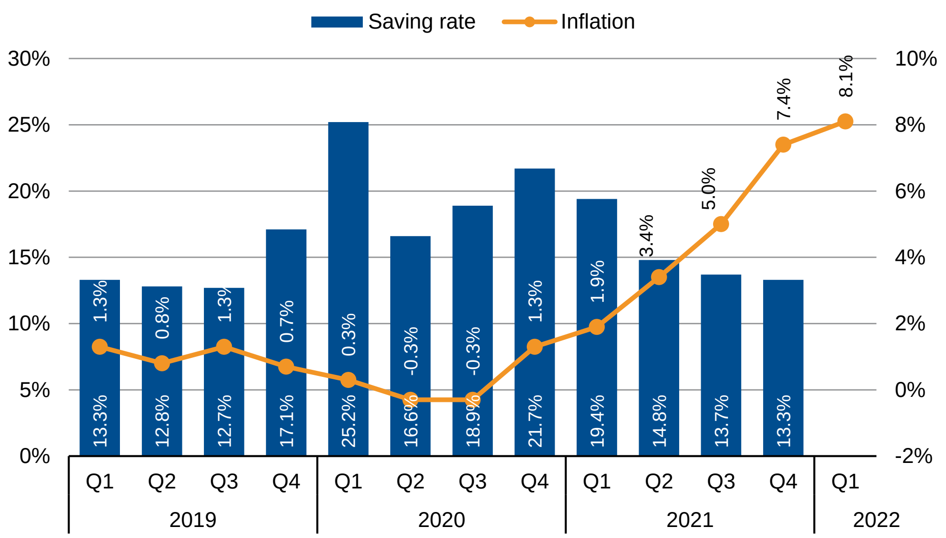
Economic headwinds will set back retailers' sales slightly…

Sales: Retailer revenues mirror household's financial health. While there are distinctions between products (see Scope Ratings' retail methodology and the distinction between discretionary and non-discretionary items), households are likely to reduce purchases, favouring non-essential items, as latest data showing subdued consumer confidence and low savings suggest.

Consumer confidence in the euro area has recently plunged to levels not seen since the outbreak of the pandemic in March 2020, driven by high inflation – particularly energy and food costs – and Russia's war in Ukraine and its severe economic and political repercussions for the rest of Europe.

The savings rate in the euro area stood at just over 13% at Q4 2021, also the lowest since the onset of the pandemic, having fallen steeply during 2021. Savings rates have fallen significantly during 2021, almost back to pre-pandemic levels (**Figure 3**). The argument that high savings accumulated during the lockdowns can support retail spending in the coming months no longer holds true, as savings are clearly not where they were a year ago. Combined, these two elements are squeezing sales.

Figure 3: Households wind down savings as inflation surges (euro area data Q1 2019 – Q1 2022)



Sources: Eurostat, Scope

... but more deeply impact retailers' cost base

COGS: Rising costs mainly reflect the consequences of the Russian war in Ukraine as well as China's zero-Covid strategy that has led to lockdowns in Shanghai and other cities which play important roles in global manufacturing and trade. Raw material prices – notably energy, metals and food – have risen fast in response to the war, international sanctions imposed on Russia and Russia's retaliation given the Russia and Ukraine are significant exporters. There are also knock-on effects as countries seek to protect domestic resources particularly grain. India, for example, has banned wheat exports. The longer the war in Ukraine goes one, the worse the impact will be. As for China's healthcare crisis – and the prolonged lockdown in the logistics hub of Shanghai – retailers are facing problems with the production and delivery of China-manufactured goods.

Operational expenditure: Inflation is a threat to the overall consumption in all countries. With sharp price increases in Europe, retailers are especially at risk as they will be the first sector impacted by changing consumer behaviour, even if that affects some products more than others. Inflation will also lead to an overall increase in operating expenses, in the form of inflation-indexed costs and/or general expenses. Operating margins will shrink in the next 12 months. Inevitably, this feeds through to EBITDA and profit margins.

Retailers respond -- pricing, product mix, cost control and ancillary services

Passing on price rises hard to justify as growth slows

Pricing: The simplest way for retailers to maintain margins in an inflationary environment is to pass price increases to customers. However, by doing so, they will have to tread carefully between balancing sales volumes with brand reputation and market share.

Tension between retailers, suppliers to grow in 2022…

Consumer goods companies typically agree annual pricing contracts with retailers towards the end of each year in many parts of Europe. In many cases, negotiations this time around have stretched into 2022, or have been re-opened after they had ended, according to Reuters. Negotiations are typically difficult due to the fragmented retailing sector numerous in each country) in comparison with a concentrated number of consumer goods manufacturers which have vastly consolidated numerous product segments e.g.: Nestlé, Unilever, Danone, P&G, etc).

Should retailers be not satisfied with gross margins, they can simply withdraw products from the shelves. For example, Ahold Delhaize's Albert Heijn chain – the largest Dutch supermarket chain – earlier this year removed Nestlé SA products, including Maggi, KitKat and Nescafé from its stores because the manufacturer increased prices. While this strategy is unlikely on a large scale as retailers could lose on brand perception, removing products is more acceptable than few years ago due to the change of perception of private labels (see below).

... which may lead to new retailer alliances...

Procurement: In response and following the principle that “the enemy of my enemy is my friend,” many retailers have developed procurement alliances to put pressure on suppliers which, in the current context, should help shore up profit margins. Shoppers at German supermarkets operated by Edeka Group paid around 12% less for products negotiated by the Agecore Food procurement alliance founded by Edeka in 2015 with France’s Intermarché, Switzerland’s Coop, Belgium’s Colryut and Spain’s Eroski, according to research by business school Insead. The danger is that such alliances attract antitrust scrutiny as Agecore did in France, prompting Edeka’s exit in 2021.

.. or more direct competition via private labels

Private label brands: Another increasingly common strategy is to control costs by relying on private-label or “own” brands. One reason is that consumers’ identification of private label brands as cheaper but inferior alternatives to branded products is changing. UK supermarkets' sales of branded items fell 1.0% over the four weeks year-on-year in mid-June while sales of own-label products rose 2.9%, boosted by strong performances from German-owned discounters Aldi and Lidl, which have extensive own-label ranges, according to Kantar. As consumer preferences change, retailers are making more headway in presenting private label goods as more affordable offering the same or better quality and health-benefits.

Latest data for the proportion of the market made up by private label brands suggests that retailers are successfully consolidating their supply chains. Private labels now make up 16.5% of FMCG sales by value, according to IRI. Private labels make up 35% of total FMCG sales in Europe, equating to EUR 194bn. The highest penetration is in Spain (44%) and Germany (38%). Germany records the highest absolute value (around EUR 60bn) followed by the UK (EUR 43bn).

Retailers will have to innovate in their offers to maintain footfall

Shop formats, new services: Shopping habits have changed enormously in Europe in recent years, albeit unevenly across the region. Long gone are the days when households just did a weekly shop at a supermarket or hypermarket for basic goods. With the surge in on-line shopping, accelerated during the Covid lockdowns, those retailers with physical stores which successfully adapted to e-commerce – are reinventing their bricks-and-mortar assets as hybrid retailing becomes the norm.

Hybrid strategies take centre stage

It would be hard to list all the experiments that retailers are undertaking to attract shoppers back to physical stores, but we have found several interesting examples of how management is trying to increase footfall and boost margins in new ways from a variety of international retailers[3]:

Other retailers are taking the hybrid concept to their stores when customers can examine goods or try on clothes in showrooms before ordering them online for home delivery, such as French furniture supplier Miliboo and stores recently opened by Inditex SA's Zara unit. Another strategy is to focus more on the product life cycle, offering subscriptions to maintenance and repair services as France's Fnac Darty SA has done much in line with the approach of Apple Inc. and Samsung Group.

Decline in share of online sales will support profitability

We are confident that some consumers have permanently switched their purchases to online platforms. E-commerce at times grew as fast in two months as in the past 10 years during the pandemic, according to McKinsey.

However, as the shopping restrictions have waned in Europe and look unlikely for now to be reimposed, footfall in physical stores should increase in the coming months albeit not to pre-Covid levels. UK retail footfall jumped by 3.4% in the latest four weeks (to mid-June 2022), while online sales fell to lowest proportion of the grocery market since May 2020 at 12.0%, according to Kantar. Digital orders fell by almost 9% in June over the same period and in constant decline for the last twelves months in a row. These figures should be seen in the perspective of the grocery sub-market where there is lower online penetration compared with other sectors where online shopping is increasingly entrenched.

This will have important consequences for retailers as a normalisation of high online sales during the peak of the pandemic should be beneficial for the margins. Online sales remain broadly margin dilutive for retailers, given the extra labour and transport costs involved, which have risen sharply this year. E-commerce also requires more careful inventory management and dedicated last-mile provisioning centres.

Feeling the squeeze: inflation's impact on retailer's balance sheets, cashflow

Long term debt expected to remain stable at current level

The liability side of retailers' balance sheets looks relatively robust. The sector's debt maturities are relatively long after refinancing during the pandemic. The debt schedule for a sample of 32 of European retailers shows little imminent refinancing risk. The sector has a couple of years to weather volatile financial markets before the bulk of the maturities come due starting in 2024.

Increase in short-term financing is however likely

That said, we expect an increase of short-term financing, taking either in the form of commercial paper or drawing on revolving credit lines for financing inventory especially towards the Q4 2022 which is often the busiest season for retailers. Nonetheless, absence of significant refinancing will help cash generation.

[3] Gaming: German electronic goods supplier Ceconomy AG / Beauty spa: German perfume retailer Douglas Holding AG / Design studio: Swedish home furnishing firm Ikea / Art galleries: South Korea sunglasses retailer Gentle Monster

We expect the **cash interest payments** to remain relatively stable or even improve should retailers decrease their debt exposure. On the asset side, deeper variations are likely. Cash holdings should decrease notably due to pressure on EBITDA margins.

Increases in inventory will affect net working capital

However, pressure is growing on **net working capital**. There are three main solutions to cope with the current supply chain bottlenecks, price inflation and product shortages: reshoring foreign production, diversifying supplier networks, and overstocking. While the first two solutions are long-term goals, the last one is the simplest most immediate response. Holding extra inventory can help guarantee product availability for increasingly fickle customers, quick to switch brands or retailers in case of out-of-stock products. In other words, retailers have switched from just-in-time inventory management to just-in-case inventory management. This strategy of inventory build-up is seen as relatively risky as discretionary goods tend to be exposed to changes in fashion and technological advances. Additionally, pressure on the net working capital also decreases the funds that companies can allocate to capital expenditure, which might delay important investments, putting retailers at risk of losing long-term market share and/or profitability.

Lease payments to prove important inflation-indexed cost

Another drain on cash is **lease payments**. Leases are typically indexed to local inflation in most European countries, with annual adjustments. Given the large weight of lease payments on cash flows, an increase of theses costs will have material impacts on retailer's cash, depending on the timing of the lease renegotiation and country of operation (i.e. UK has fixed-price leases with renegotiation at the termination of the lease term). Retailers with upcoming rent reviews with indexed-linked leases are likely to be especially vulnerable.

Greater reliance on franchised operations can help retailers too, at the expense of lower shop revenues.

Capex will remain high in search for greater footfall, online sales

The reinvention of in-store shopping will require significant investment while pressure remains on maintaining and improving e-commerce logistics, all requiring significant capital spending. The sector should maintain relatively high capex in a range of 3.5%-4% in the next 12 months. Most retailers will maintain high maintenance capex tailored toward refurbishment of existing stores and/or strengthening of their online capacities rather than expansion capex through M&A or expansion in new markets.

Our expectation is that the **gross debt** will remain at similar levels in 2022 compared with last year as we consider retail sector to be overall well financed over the last two years. **Scope-adjusted debt** will see a deterioration mainly given lower cash flow as well as negative cash contributions given increases in inventory and lease payments.

Discretionary outflows set to be modest in 2022

Retailers are likely to slightly scale back **M&A and dividends** to focus mainly on the resilience of their cash position. We cannot exclude the possibility that some retailers might use weaknesses of competitors to undertake more ambitious M&A or provide a bigger boost to dividends and share buybacks, but such action is more likely to be put off until 2023.

Appendix : Overview of our rated universe (selected names – data based on last monitoring)

	Koninklijke Ahold Delhaize N.V.	Zalando S.E.	Otto GmbH & Co. KG	Fnac Darty S.A.	Tesco plc	Ceconomy AG	Elo S.A.	Casino Guichard-Perrachon S.A.
Home market	Netherlands	Germany	Germany	France	U.K.	Germany	France	France
Status	Non-public	Non-public	Non-public	Public	Non-public	Public	Non-public	Public
Business risk profile	*	*	*	**BB+**	*	**BBB-**	*	**BBB**
Country retail strength	High	High	High	High	High	High	High	High
Market position	Strong with international market shares	Strong	Strong	Strong	Strong with international market shares	Strong with international market shares	Medium	Strong
Revenue size (in EUR bn)	75.6	8.0	14.8	8.0	66.6	21.4	31.1	31.9
Consumer good category	Non-discretionary	Discretionary	Discretionary	Discretionary	Non-discretionary	Discretionary	Non-discretionary	Discretionary
Online diversification**	High	SCD	High	High	High	High	High	High
Geographical exposure	USA = 60%	No countries >70% sales	No countries >70% sales	Immediate neighbours	One country	No countries >50% sales	No countries >70% sales	No countries >50% sales
Product diversification	Grocer	> 2 categories	> 2 categories	2 categories	Grocer	2 categories	Grocer	Grocer
Profitability assessment	Strong	Strong	Good	Strong	Good	Good	Moderate	Weak
Financial risk profile ***	*	*	*	**A-**	*	**BBB**	*	**B+**
Scope- adjusted Debt/Scope-adjusted EBITDA	2.2x	Net cash	1.6x	1.6x	3.4x	1.9x	2.8x	5.0x
FFO/SaD	39%	Net cash	66%	50%	21%	49%	25%	13%
EBITDA interest expense	12.2x	19.1x	5.8x	12.1x	5.0x	19.6x	5.4x	3.4x
FOCF/SaD	11%	Net cash	24%	11%	18%	7%	10%	5%
Liquidity	>2x	No short-term debt	>2x	>2x	>2x	>2x	>2x	>2x
Stand-alone rating	*	*	*	**BBB**	*	**BBB-**	*	**BB-**
Outlook	*	*	*	**Stable**	*	**Stable**	*	**Stable**

* Available on ScopeOne
** 'SCD' stands for 'Single channel distributor'
*** (average Y-1; Y; Y+1) - data based on last monitoring

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid
Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London
52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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