3 July 2019

Corporates

CECONOMY
Germany, Retail

BBB- STABLE

CECONOMY is the European market leader in consumer electronics retail, with about EUR 22bn of revenue generated in FY 2018 (fiscal year ending September). The group has two established brands, Media Markt and Saturn, and demerged from Metro Group in 2017. CECONOMY has a broad presence in Europe with more than 1,000 stores and leads the market in eight of its 14 countries of operation. The group's network of physical stores, combined with its online platform, allows it to record about 6 million customer contacts per day.

Key metrics

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	9	10	8	9
Scope-adjusted debt (SaD)/EBITDA (x)	2.2	1.7	1.9	1.6
Scope-adjusted FFO/SaD (%)	34	48	38	46
Free operating cash flow (FOCF)/SaD (%)	14	25	0	5

Fiscal year end: September 30

Rating rationale

Scope Ratings affirms the BBB- issuer rating of German consumer electronics retail group CECONOMY. The short-term rating is S-2. The rating Outlook is Stable.

The ratings continue to reflect CECONOMY's i) underlying market of consumer electronics retail, which exhibits inherently more stable trends than the macroeconomy; ii) position as Europe's clear leader in that industry; and iii) diversified product range with 'white' and 'brown' goods and telecommunications and entertainment equipment.

Relatively low operating margins continue to constrain the ratings. The recent change in management and the subsequently triggered restructuring are neutral for the ratings. The assessment also reflects the new management's continued conservative financial policy. However, we point out that execution risks are attached to the new management's restructuring programme and to the further development of the omni-channel and service activities, with the latter prompted by the ongoing transformation of the retail industry.

The ownership structure is still credit-neutral as Convergenta, the minority owner of MediaMarkt-Saturn Holding (21.6%) has no voting representation at the CECONOMY level.

The business risk profile continues to be bolstered by the group's clear lead in European consumer electronics retail. This was maintained during the last 12 months, in our view, with the group growing at least in line with the market and continuing to catch up in the online business. Many customers appear to endorse CECONOMY's hybrid status, which combines a physical presence via its stores – and the option to pick products up after an online purchase – with the convenience of e-commerce. We view the profit warnings in the last 12 months to be purely cost-driven, while the topline continues to develop well. Following poor profits in FY 2018, new management has now laid the groundwork for an expensive, but thorough, restructuring, in our opinion. Main points include the removal of double functions for the two brands, Media Markt and Saturn, and the set-up of a common procurement policy. The country portfolio was also further optimised during 2017.

Ratings & Outlook

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

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Related methodology

Corporate Rating Methodology

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Former 'problem' countries were addressed: France, entry via the 24.3% Fnac-Darty stake; Russia, sale of own activities and acquisition of a 15% stake in M.video; and a turnaround in Turkey and Italy. Measures are ongoing for Poland, Sweden and the Netherlands and recently a joint-venture was created in Greece with local partner Olympia Group. Given the present restructuring focus, we do not envisage market entry into the UK during FY 2019. Thus, we believe the above measures have improved geographical diversification since last year. The ratings continue to be held back by the group's profitability, but we believe there might be some upside from FY 2020, assuming restructuring efforts succeed.

The financial risk profile reflects CECONOMY's strong balance sheet, which arose as part of the Metro demerger and was maintained despite the Fnac-Darty and M.video transactions and the profit warnings in FY 2018. Credit metrics improved significantly at the end of FY 2018 in a year-on-year comparison. This was driven by an equity increase of more than EUR 270m (from new shareholder freenet AG) and by the positive release of about EUR 300m of cash due to working capital changes. The latter was caused by a jump in trade payables following strong Black Friday sales and high year-end demand. In particular, free operating cash flow (FOCF) to Scope-adjusted debt (SaD) improved to 25% in FY 2018, compared to 14% for the year before, thus far ahead of the BBB category for that metric.

In the current year, we expect working capital trends to normalise somewhat, given that the positive effect was so strong the year before. Cash absorption was negative EUR 295m for the first six months of FY 2019. While some catch-up in the second half of the year is likely, we still estimate about EUR -100m of cash consumption due to the expansion in working capital in FY 2019. Coupled with somewhat lower operating earnings due to the sizeable restructuring measures, which are likely to only affect FY 2019, credit metrics are expected to be lower this year but still in line with our ratio guideline for the ratings. The exception is FOCF/SaD, which is likely to reach around break-even in our base case scenario and below the level required for the ratings. However, this is also likely to be confined to FY 2019 and we expect some recovery by FY 2020 depending on actual working capital trends. Our assumptions on the future level of operating leases will increase slightly from FY 2019 due to the implementation of IFRS 16. We still consider management's financial policy to be conservative, as evidenced by the 2018 equity increase and the decision to cut the dividend to zero, signalling a firm commitment to the investment grade rating.

The liquidity policy continues to be sound, in our view. Limited short-term debt maturities are amply covered by a high cash balance and undrawn committed bank lines, each at EUR 1bn as of March 2019.

Outlook

The Stable Outlook reflects our expectations that the financial risk profile will not significantly deteriorate in the coming years. Specifically, we expect the company to maintain a Scope-adjusted FFO/SaD at 35%-40% and SaD/EBITDA at below 2.5x.

A higher rating could be triggered by an improved business risk assessment, for example, through better operating margins and free cash flow, or financial metrics sustainably exceeding aforementioned levels. A positive rating action is likely should the present level of credit metrics be sustained. A negative rating action could result from a more aggressive financial policy or a sustained, negative deviation from ratios commensurate with the present ratings.

Rating drivers

Positive rating drivers	Negative rating drivers
• Europe’s largest consumer electronics retailer • Diversified product range • Conservative financial policy • Continued strong balance sheet	• Company in transition for higher profitability • Lowest operating margins among peers • Significant restructuring underway

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Increasing margins and free cash flow • FFO/SaD of more than 40% on a sustained basis	• Change in financial policy • Inability to maintain FFO/SaD of 35% and SaD/EBITDA of below 2.5x

Financial overview

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	9	10	8	9
SaD/EBITDA (x)	2.2	1.7	1.9	1.6
Scope-adjusted FFO/SaD (%)	34	48	38	46
FOCF/SaD (%)	14	25	0	5
Scope-adjusted EBITDA in EUR m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	599	650	464	550
Operating lease payments in respective year	647	588	610	650
Other items	**0**	**0**	**0**	**0**
Scope-adjusted EBITDA	1,246	1,238	1,074	1,200
Scope-adjusted funds from operations in EUR m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	599	650	464	550
less: (net) cash interest as per cash flow statement	-3	-5	-20	-20
less: cash tax paid as per cash flow statement	-160	-119	-150	-160
add: depreciation component, operating leases	527	477	499	530
Scope-adjusted funds from operations	953	990	778	885
Scope-adjusted debt in EUR m	**2017**	**2018**	**2019F**	**2020F**
Reported gross financial debt	544	440	450	450
less: cash, cash equivalents	-861	-1.115	-1,370	-1,616
Cash not accessible	100	100	100	100
add: pension adjustment	640	547	519	520
add: operating lease obligations	2,369	2,084	2,343	2,443
Other items	0	0	0	0
Scope-adjusted debt	2,792	2,058	2,045	1,907

Business risk profile

Industry

Low cyclicality

In our view, the overall retail industry exhibits relatively stable characteristics, with turnover growing constantly, even in times of macroeconomic stress. The amplitude of annual growth generally ranges between -2% to 4% and has limited volatility. This growth includes more stable and 'low ticket' retail sub-segments like food, as well as slightly more cyclical sectors like electronics or DIY. Importantly, the overall retail segment has proven resilience to macroeconomic shocks. For example, in 2009, when European GDP declined by more than 4%, the retail industry's growth rate was slightly positive.

Medium to high entry barriers

A country's retail markets are usually highly concentrated and centre on a dominant player. For most European countries, this applies to food, DIY and electronics. We judge entry barriers to be medium to high, reflecting the comparatively concentrated markets, as well as the need for operators to have a national network, established relationships with manufacturers, and high-quality products. The importance of scale and diversified operations is supported by the comparatively low EBITDA margins in most large retail segments, and such levels are only financially viable upon reaching a critical scale.

The electronic goods retail market in Europe is rather fragmented: the top-five retailers often hold barely half of a country's market share. Even so, we do not consider this to be a threat to CECONOMY, because market leaders have continued to expand their shares over the years. Yet price competition is intensifying in each of CECONOMY's markets, against both traditional 'pure players' (based in physical shops; Euronics, CE Partners, Fnac) and e-commerce retailers (Amazon).

Medium substitution risk

We judge substitution risk to be low because the retail model has very few conceivable alternatives. The only possibility is direct distribution by manufacturers. An example is Apple Store, but we believe this is and will remain the exception, as such a strategy is costly and necessitates entry into a business segment in which few manufacturers have the requisite experience.

In our view, e-commerce does not constitute a different industry to retail, but is merely a different form of distribution and one which is increasingly adopted by classic 'brick and mortar' retailers.

The combination of the three industry risk drivers, according to our Corporate Ratings Methodology, results an industry risk rating for CECONOMY of BBB-.

Competitive position

Market shares

Clear European market leader

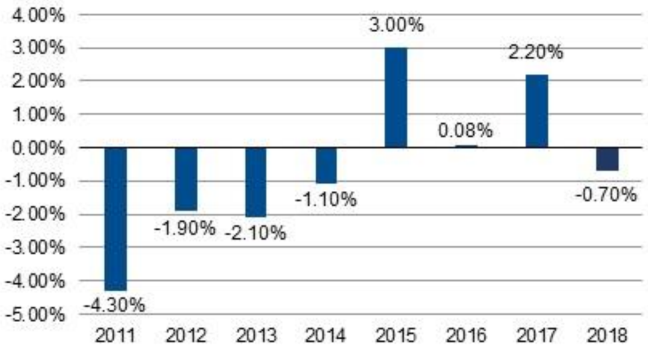
The group's ongoing market leadership in Europe continues to be the greatest support for the business risk profile. CECONOMY is Europe's leading consumer electronics retailer, with about EUR 21bn of revenue and EBITDA of EUR 650m in fiscal 2018. The group has over 1,000 stores in Europe and leads the market in eight of its 14 countries of operation.

Recovery in growth rates

Like-for-like growth rates generally recovered after 2014 for the group's two established sales channels, Saturn and Media Markt (see figure 1 overleaf). Same-store growth on a local currency basis declined slightly in FY 2018 compared to a year before, but was positive in H1 2019 at about 1%. CECONOMY appears to have entered a phase in which the online business is expanding and the shop business is declining – although this should be seen in the context of the group's hybrid status, which allows both channels complement each other. Thus, we believe high online growth rates would be difficult to achieve without offering the ability to physically inspect goods and/or collect them after an online purchase.

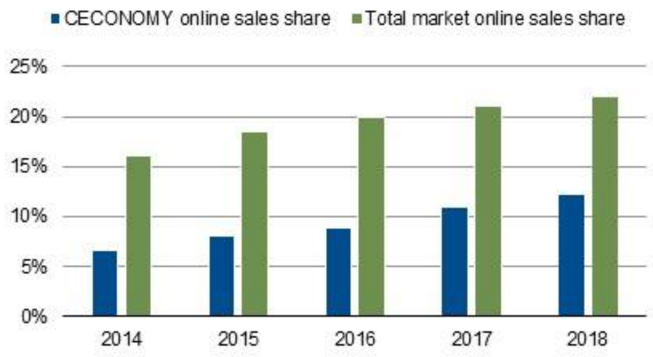
E-commerce continues to be crucial for CECONOMY, driving sales growth and boosting differentiation in its multi-channel strategy. (Its main online competitor is Amazon.)

Figure 1: Like-for-like growth rates



Source: Scope estimates

Figure 2: Improved online penetration



Source: Scope estimates

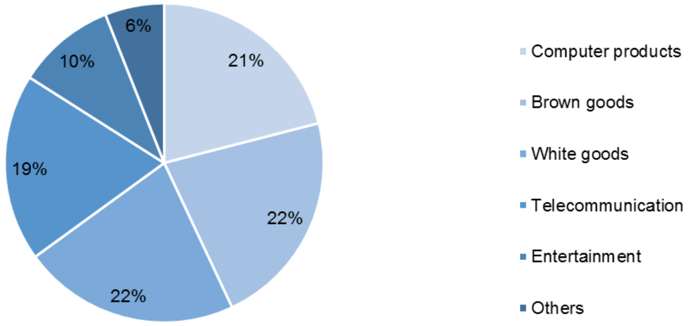
Nevertheless, the group's online revenues – despite substantial growth rates of 12.7% in FY 2018 and 13.4% in the first half of FY 2019, both on a year-on-year basis – remain substantially below the level in the total market (22%e, slightly less than twice the group's relative exposure).

In terms of online presence, the group has a major advantage over North American digital peers – its ability to interact in brick-and-mortar shops with buyers, who can purchase online and collect the product at a desired time. More than 40% of the group's online customers opt to pick up their purchases. We view this positively: not only does it capture customers' preference for online shopping, but also their desire to handle and collect products in person.

Diversification

In Europe, CECONOMY continues to cover all major segments in its core business of consumer electronics. In our view, this leads to high product diversification. The product range is diverse, from communications (telecoms, computers and brown goods) to white goods (figure 3). Thus, shifts in demand between product categories can be counterbalanced readily, for example, the recently declining share of photographic products and brown goods was offset by stronger demand for IT and telecommunications products.

Figure 3: Product category breakdown, FY 2018



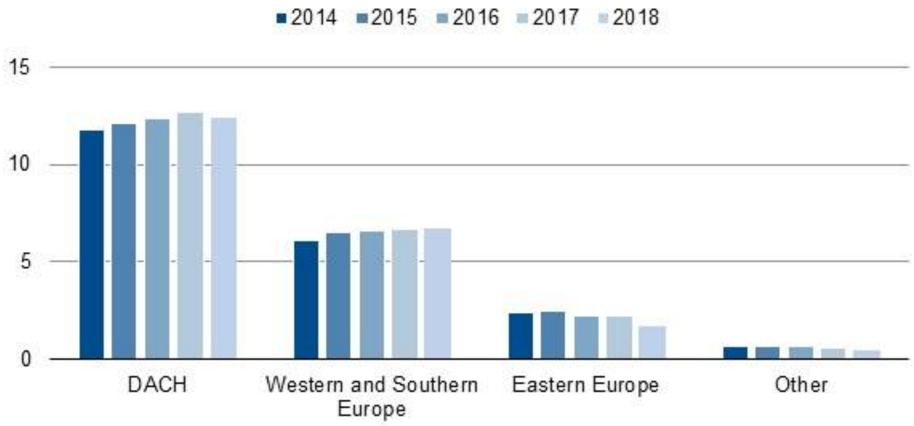
Source: CECONOMY, Scope

The product range is not only diverse, but also very extensive. For example, the group offers 160 different types of coffee machines. Within the sub-category of brown and white goods, CECONOMY has developed its own brand (named, 'ok'), which offers entry-level goods at competitive prices. The combination of these low-cost electronic goods with high-end products (Apple or Samsung) ensures the company appeals to different customer segments.

Geographically, CECONOMY focuses on Europe, with a clear strength among the so-called DACH countries (Germany, Austria, Hungary and Switzerland; figure 6). The group is the only one among its European peers to operate across the region (except for online players); most peers focus on home markets instead. The group is well diversified in Europe through its mix of mature and developing countries. However, the developing-economy exposure is a double-edged sword, potentially creating high cultural and political risks and operating losses at the early stage of exposure, while not being able to capture the markets' growth potential immediately.

While being a lower support to the ratings compared to market share, diversification has improved over the last 12 months, in our view. Former 'problem' countries, i.e. those with minimal critical market share and inadequate profitability, like France, Russia and Turkey, have been addressed. This will benefit management's profitability goal in the mid-term. However, the Netherlands, Sweden and the Poland remain an issue, with the group having no presence in those countries.

Figure 4: CECONOMY geographical diversification (in EUR bn)



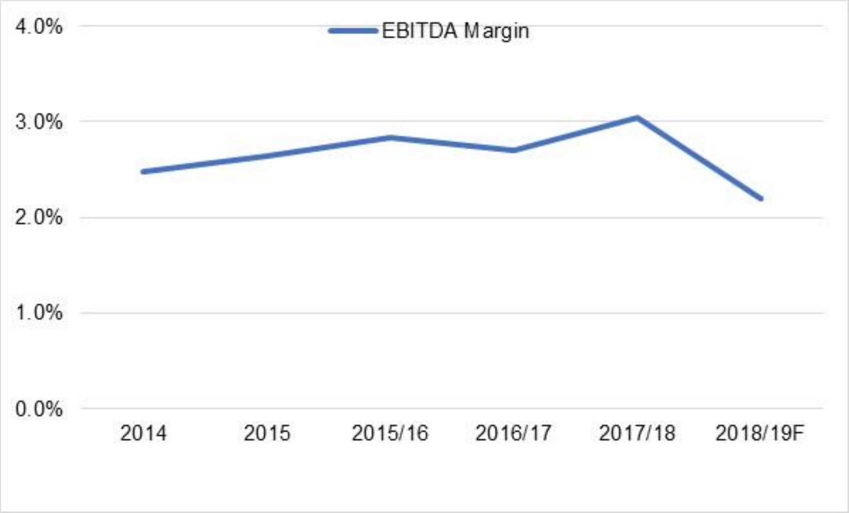
Source: CECONOMY

Operating margins

Comparatively low operating margins

Compared with peers, CECONOMY continues to have low operating margins, which is surprising at first glance given the company's size and market shares.

Figure 5: CECONOMY EBITDA trend



Source: Annual reports

The new management is targeting the three key areas to address the group's unsatisfactory profitability:

- Remove double functions at the group's two distribution brands, such as overheads and procurement;
- Standardise processes and streamline the organization; and
- Reduce costs and improve efficiency.

While it is surprising that Media Markt and Saturn had separate purchasing divisions, this was probably due to the former management of regional shops, who enjoyed a degree of flexibility. This has been addressed during the last six months and many key local decision-makers have meanwhile left the group. As a result, we believe profitability is likely to improve from FY 2020. The current year, however, will continue to be burdened by about EUR 200m of restructuring and redundancy payments. New management is upholding the former mid-term profitability targets (unadjusted EBITDA margin of 5%).

Our base case provides for a drop in EBITDA margins in FY 2019, for the reasons given above, followed by a gradual recovery in FY 2020.

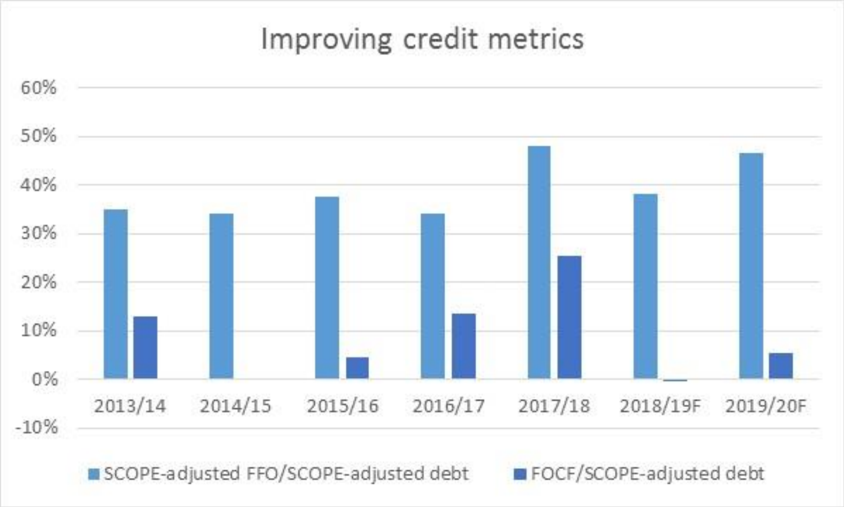
Thus, as execution of these measures is still somewhat in the future, we continue to view CECONOMY's profitability as the weakest contributor to the business risk profile.

Business risk profile rated BBB-

We continue to assess CECONOMY's business risk profile at BBB-. This includes the BBB- industry risk and our competitive positioning analysis (BBB). The latter considers CECONOMY's strong market shares and good diversification, though offset by the below-par operating margins.

Financial risk profile

Figure 6: Credit metrics on a high level



Source: Annual reports, Scope calculations

Strongly improved credit metrics

Key credit metrics have strongly outperformed projections for FY 2018. This is despite the Fnac-Darty and M.video transactions and the profit warnings in FY 2018. Credit metrics improved significantly at the end of FY 2018 in a year-on-year comparison. This was driven by an equity increase of more than EUR 270m (from new shareholder freenet AG) and by a release of cash of about EUR 300m from working capital changes, caused by a jump in trade payables following strong Black Friday results and high year-end demand. In particular, FOCF/SaD improved to 25% in FY 2018, up from 9% from the year before, and far ahead of the BBB threshold for that metric. CECONOMY's main debt constituents are the EUR 250m of Schuldschein issued in March 2017 as well as about EUR 200m drawn from the group's EUR 500m commercial paper programme, EUR 622m of pension obligations (not Scope-adjusted, as asset coverage of payments is less than 6x, our threshold for 50% consideration), and operating leases for the shops (about EUR 2.1bn).

The forecasts applied in our base case scenario involve the following assumptions:

- Comparable revenue growth of between 1% and 2% for FY 2019 and FY 2020
- A decline in EBITDA in FY 2019 due to about EUR 200m of identified restructuring charges followed by a gradual recovery in EBITDA margins for FY 2020
- No larger M&A in FY 2019
- Dividend payments to be gradually resumed in FY 2020
- Former operating-lease debt equivalents (to be capitalised in FY 2019) of EUR 2.3bn and EUR 2.4bn for FY 2019 and 2020, respectively

In the current year, we expect working capital trends to normalise somewhat, given that the positive effect was so strong the year before. Cash absorption was negative EUR 295m for the first six months of FY 2019. While some catch-up in the second half of the year is likely, we still estimate about EUR -100m of cash consumption due to the expansion in working capital in FY 2019. Coupled with somewhat lower operating earnings due to the sizeable restructuring measures, which are likely to only affect FY 2019, credit metrics are expected to be lower this year but still in line with our ratio guideline for the ratings. The exception is FOCF/SaD, which is likely to reach around break-even in our base case scenario and below the level required for the ratings. However, this is also likely to be confined to FY 2019 and we expect some recovery by FY 2020 depending on actual working capital trends. Our assumptions on the future level of operating leases will increase slightly from FY 2019 due to the implementation of IFRS 16. We still consider management's financial policy to be conservative, as evidenced by the 2018 equity increase and the decision to cut the dividend to zero, signalling a firm commitment to the investment grade rating.

The liquidity policy continues to be sound, in our view. Limited short-term debt maturities are amply covered by a high cash balance and undrawn committed bank lines, each at EUR 1bn as of March 2019.

Outlook

The Stable Outlook reflects our expectations that CECONOMY's financial risk profile will not significantly deteriorate in the coming years. Specifically, credit metrics are expected to stay at levels as indicated by a Scope-adjusted FFO/SaD of 35%-40% and a SaD/EBITDA of below 2.5x.

A higher rating could be triggered by an improved business risk assessment, for example, through better operating margins and free cash flow, or financial metrics sustainably exceeding the aforementioned levels. A positive rating action is likely should the present level of credit metrics prove sustainable.

A negative rating action could result from a more aggressive financial policy or a sustained, negative deviation from ratios commensurate with the present ratings.

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