Retail Outlook 2021

The credit outlook for the European retail sector in 2021 is negative, unchanged from last year. Repercussions from the pandemic will continue to upturn the retailing landscape even if the economic recovery takes hold.

Retail, Scope Ratings GmbH, 28 January 2021

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| Bloomberg: RESP SCOP

Executive summary

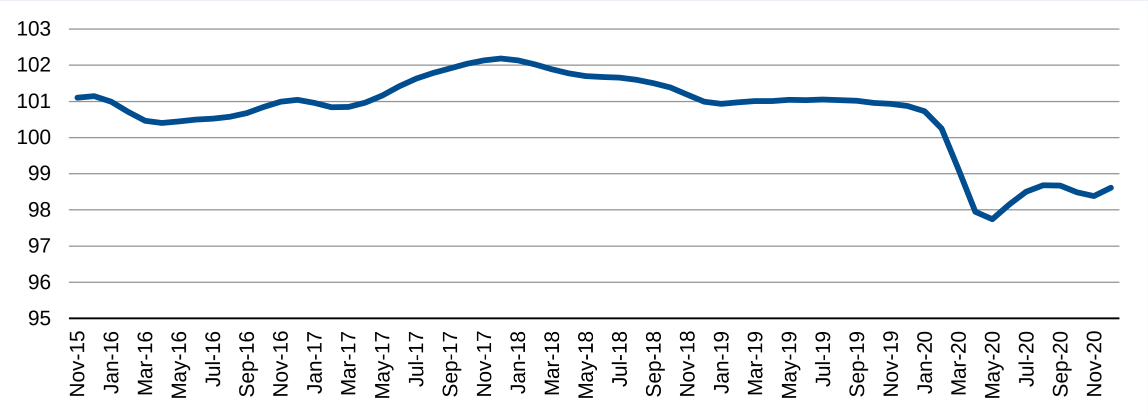
The credit outlook for the retail sector in 2021 remains negative.

Disparities within the retail sector will grow in 2021.

The main trends we expect for 2020 are:

- Food retailers and other purveyors of essential goods face the least downside business risk, particularly if the cocooning phenomenon persists, as the Covid-19 pandemic has led to more working and studying at home.
- Sellers of non-essential goods are likely to see an intense price war to maintain or win back market share lost due to the closure of shops last year through pandemic-related lockdowns and other restrictions as consumers do more shopping online.
- Clothing and wearables retailers and general merchandising shops face potentially the strongest recovery, having been particularly badly affected by the lockdowns and other economic constraints.
- In contrast, retailers specialised in DIY, consumer electronics and household products should see slower growth as their business turned out to be relatively resilient in 2020 due to the cocooning effect and growth in the integration of online and physical marketing and distribution or so-called omnichannel sales.
- Financial risk profiles are likely to remain under pressure in the short to medium term due to the pandemic-related squeeze on profitability and liquidity, limiting headroom under existing covenants for revolving cash facilities, capital-market debt, and bank loans.
- More retailers are likely to enter administration if the economic recovery disappoints and debt holders lose faith in some retailers' business models.
- These risks appear to be relatively modest in early 2021, but retailers' credit metrics will remain under pressure, despite the pledge of many companies to limit shareholder remuneration in the coming year.

Figure 1: Consumer confidence remains low (OECD standardised indicator 2015-20)



Source: OECD, Scope Ratings

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Scope Corporate Sector Ratings

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Key trends for 2021

Retailing is a diverse sector, including large international and small local players, sellers of cyclical and non-cyclical goods, in addition to physical shops and online stores – or owners of both. The Covid-19 pandemic has highlighted these differences. As the coronavirus spread last year, retailers also gained an important new qualification: 'essential' or 'non-essential'. While the credit outlook for the whole sector remains negative, the impact of the pandemic has proved highly uneven – and will remain so.

Pandemic changes consumer habits: are they temporary or permanent?

The status quo in Europe for much of the sector is a set of extremely difficult circumstances. Many retailers are stuck, their businesses locked down to one degree or another.

Only large-scale vaccination programmes seem likely to unlock the situation as they would trigger less constraining physical-distancing protocols and the return of consumer confidence toward pre-pandemic levels. That would likely lead to catch-up buying of non-essential goods which lend themselves to in-store shopping – such as higher-end fashion, luxury, and travel-related products.

Should these circumstances not materialise, it is likely that consumers will avoid bricks-and-mortar stores – if they are open at all – with a particularly heavy impact on retailers reliant on discretionary purchases and general merchandise.

A huge unknown is to what extent some changes in consumer behaviour in 2020 prove temporary, limited to the period of the Covid-19 pandemic, or long term, representing fundamental shifts in shopping patterns:

I) E-commerce: lockdowns and physical distancing restrictions have forced even reluctant users of the internet to embrace online platforms for buying a wide range of products and services. What percentage of shoppers will revert to in-store shopping when restrictions ease?

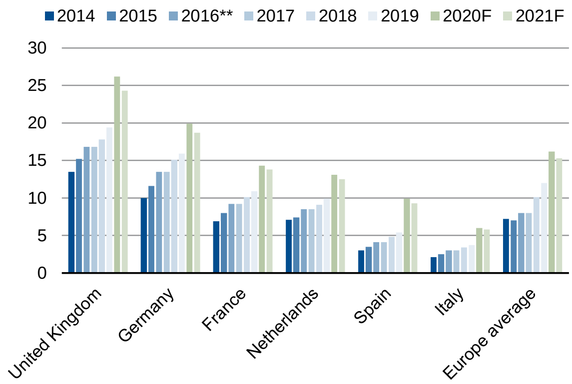
II) Cocooning: as the pandemic has restricted people's activities outside the home, it has triggered increased spending on household products, home electronics and home improvement. The effect might outlast the pandemic if working, socialising, and studying at home – and relying more on home entertainment – becomes more common, leading to declines in footfall in city centres and some malls, with more spending on home-related purchases (as opposed to hobbies, outdoor, fashion, and luxury).

A consequence of the pandemic which is less in doubt is the acceleration of the trend towards online shopping, well underway before the coronavirus outbreak and visible in the fast-growing e-commerce volumes and declining footfall for many, notably high-street retailers.

UK data show how dramatic the change was last year. The share of online grocery sales rose from nothing to 7% of the total in the 20 years before the pandemic but nearly doubled to 13% in the first eight weeks of the UK lockdown, according to the Financial Times.

Activity has risen sharply elsewhere in Europe. German and Italian online grocery sales have doubled during the pandemic and now account for 2.9% and 4.3% of national retail sales, respectively, according to Bain. Based on other survey evidence, Bain estimates that between 35% and 45% of the recent increase in online sales will be permanent. The reopening of physical stores expected at some point over 2021 will likely rub off on online consumption (see **Figure 2**) and temporarily break the momentum in e-commerce growth. However, we expect the share of e-commerce to at least hold steady at 2021 levels in the years ahead as the increased reliance on online shopping becomes the new norm.

Figure 2: Online retail trade in selected countries 2014-21F (in %)[1]



Source: retailresearch, Scope Ratings

The shift to online shopping is changing consumer habits profoundly. One trend that is likely to endure and become more common is customers' increased screening of possible purchases before making them, based on a growing range of criteria – health-related, environmental and ethical. Consumers today can review, compare and choose the products which best fit their expectations. Considerations such as product origin, manufacturing processes and health- or nutri-scores are likely to carry more weight in consumer decisions in the coming years. We expect relationships between retailers and consumer goods producers will change, with an increasing requirement for retailers to allow more flexibility in the consumer goods they offer.

[1] ** There was a break in the time series for 2016; figures may not reflect actual numbers but estimates for the year. Excluding vacations, autos, petrol and tickets. No exact survey date was given. The numbers are published annually in the first half of each year.

Contrasting retailing fortunes in 2021

Essential retailers

Grocers, and other sellers of essential products, are unlikely to record big changes in sales or profitability in the year ahead. What was lost in terms of frequency of consumers' shopping trips has been gained in higher basket size.

The pandemic may still have some residual favourable consequences. Before the crisis, shoppers in many countries were relatively reluctant to buy food, drink and other basic items online, though that began to change in Q2 2020. The estimated share of online sales for grocers rose to 13% in the UK in the 12 weeks to 20 November 2020, and was up to nearly 75% in Ireland, according to data from Kantar.[2] France's grocers are experiencing similar growth, with an increase of 43% in online sales from January through to September 2020 compared with the same period in 2019, according to data from a French e-commerce federation[3].

While some smaller and/or regional grocers might be crowded out, we don't expect important changes in national market shares. The fiercest competition will remain over price and the online tariffs for services. This is especially true given the trend among discount stores to improve their online offering and raise the quality of their private-label goods, adding a greater range of fresh, organic and vegan products.

Non-essential retailers

A wide range of sellers of non-essential goods and discretionary products – such as clothing, general merchandise, sports, leisure, and entertainment – face more intense pressure this year, with management eager for a quick recovery of the sales lost in 2020. Assuming that the roll-out of vaccines returns economic life to some degree of normality, the likely economic rebound will help, even though these retailers are the most vulnerable to changes in consumer behaviour.

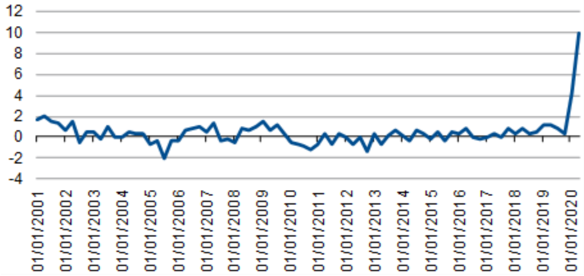
Most retailers in this category faced pressure from diminishing footfall in their physical stores before the pandemic struck. We expect that footfall will not return to the pre-Covid-19 levels – the scale of the decrease depends on retailers' locations and products – as shopping online becomes the norm.

The various sub-sectors in this part of the retailing industry will experience divergent growth in 2021. Clothing and wearables retailers and general merchandising shops face potentially the strongest recovery, having been particularly affected by the lockdowns and other economic constraints linked to the pandemic last year.

Such a catch-up could be high. European consumers have tended to save rather than spend through the Covid-19 crisis (see Figure 3), suggesting a release of significant pent-up demand once lockdowns and other restrictions are eased.

We expect a return to more normal traffic through airports and train stations as business and holiday travel recovers, which would boost sales for discretionary retailers (fashion, luxury, hobbies).

Figure 3: Euro area increase in private household savings (YoY %)



Source: ECB, Scope Ratings

In contrast, sellers of DIY, consumer electronics and household products should record slower growth as they were less impacted in 2020 due to the cocooning phenomenon and growth in omnichannel sales.

Good examples of companies benefiting from this trend include France's Fnac Darty (BBB-/Outlook under review for a possible downgrade) and Germany's Ceconomy (BBB-/Stable), whose online and click-and-collect sales have grown fast in the past year.

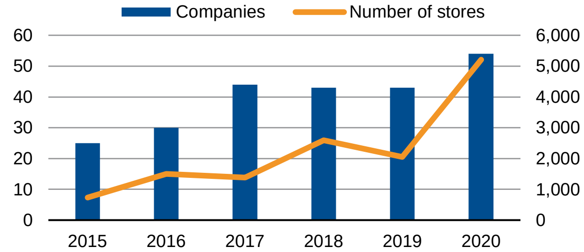
A la recherche des marges perdus [4]

The recession induced by the pandemic has inevitably forced management to focus on cost-cutting to shore up profit margins even as retailers benefited from government support, notably through short-time work programmes.

Retailers with physical stores will continue to look at optimising floor space, by reducing the number or size of shops, or rely more heavily on franchised outlets.

We foresee more shop closures by companies relying on physical rather than online distribution, exemplified by data from the UK (see **Figure 3**).

Figure 4: Going bust: retailer defaults and shop closures in the UK, 2015-20



Source: retailresearch.org, Scope Ratings

[2] https://www.kantar.com/uki/inspiration/fmcg/2020-uk-grocery-sales-spike-with-early-christmas-cheer

[3] https://www.fevad.com/bilan-du-e-commerce-au-3eme-trimestre-2020-266-milliards-deuros-de-chiffre-daffaires/

[4] "In search of lost margins"

Retailers' relationships with lessors are also likely to change. Retailers will push to renegotiate contracts by moving them to sales-based rent formulas with more flexible and shorter leases.

Supply chains will also come under growing scrutiny as management focuses on optimising costs – with a greater move toward private labels.

However, many retailers face a more profound logistics challenge as online shopping becomes the norm. In recent years, retailers have controlled costs by limiting product ranges with the goal of maximising product returns. At the same time, consumers have looked more and more for one-stop shopping, leading to the rapid growth of internet-based retailers, exemplified by Amazon, Otto, and Rakuten.

In 2021, retailers will have to balance holding enough stock in stores to remain competitive with minimising the range of products offered to remain profitable. The growth in the number of urban fulfilment centres across larger cities – allowing retailers to keep delivery times within a day – shows how retailers might in the future be able to continuously supply physical shops, allowing them to have much reduced and better-controlled on-site inventory. Online and offline sales and distribution channels are likely to have a much more intensely symbiotic relationship as this retailing model develops.

We also expect 'retail-tainment' (retail and entertainment) to remain one of the main questions for the year ahead. The pandemic has highlighted the difficulties that some formats (larger hypermarkets or retailers belonging to 'commercial zones', often outside city centres) were already facing in attracting shoppers amid the growth in e-commerce. Physical-distancing restrictions and an unwillingness among shoppers to congregate in large crowds have likely affected overall traffic through such stores, regardless of the entertainment options on offer. Retailers will need to rethink how to lure back consumers from shopping online. This may provide a further impetus for the transformation of less popular commercial zones into urban fulfilment centres.

Financial metrics

Overall, disparities within the retail sector will grow in 2021.

Food retailers and other purveyors of essential goods face the least downside business risk, particularly if the cocooning phenomenon of last year persists. Sellers of non-essential goods are likely to see an intense price war to maintain or win back market share lost due to the closure of shops last year and consumers' shift online.

Financial risk profiles are likely to remain under pressure in the short to medium term due to the decrease in profitability and liquidity, limiting headroom under existing covenants for revolving credit facilities, capital and bank market debt.

More retailers are likely to enter administration if sales do not recover to levels expected and debt holders lose faith in some business models. While these risks appear relatively modest in early 2021, we expect retailers' credit metrics will remain under pressure, despite the pledge of many companies to limit shareholder remuneration in the coming year.

Retailers are under pressure to invest, in online and logistics infrastructure in particular, but the economic climate remains sufficiently difficult that largescale M&A activity and heavy capital-spending programmes look unlikely, particularly for the majority of retailers in the non-essentials segment.

Annex I: Related research

"Rating Methodology: Retail and Wholesale Corporates", published December 2020 and calling for comments, available here

"The dark side of the store: French retailers reinforce 'drive' channel to boost out-of-town sales", published February 2019, available here

"Corporates Outlook 2019/Retailing: Profitability expected to be under pressure", published January 2019, available here

"Of tortoises and hares: Retail segments in Europe have divergent online growth prospects", published May 2018, available here

"Resisting the e-commerce whirlwind: A comparative study of the US and European retail sectors", published May 2018 available here

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