Adapt or Disappear: E-commerce Transforms European Retail

SCOPE Scope Ratings

E-commerce is one of the fastest-growing sectors in Europe, averaging an annual growth of 13% against 2% for retail. And it hasn't even reached its full potential. In a new study, Scope examines how the 'e-tailers' are transforming retail.

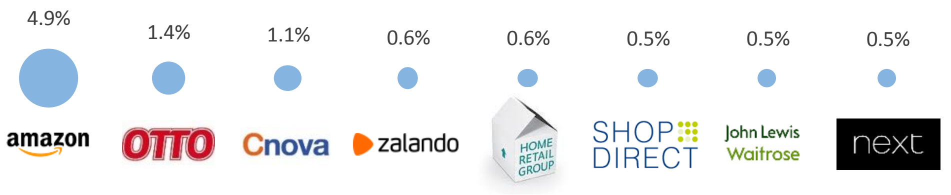
Benefiting from higher growth than traditional retailers, European e-commerce retailers – or e-tailers – are capturing the most interest from consumers, as well as massive capital inflows, both public and private. Bloomberg reports that the e-commerce sub-sector has accumulated over 50% of the retail industry's equity inflow between 2012 and 2015, despite representing just 9% of the overall market.

And Scope believes there is still room for the sub-sector's growth, based on three factors:

1. The penetration rate of currently 9% is still relatively low;
2. Demographics continue to move towards a more-connected population; and
3. Mentalities have changed to 'IWWIWWIWI' ("I want what I want when I want it", from Dr. Kit Yarrow, 2014).

Scope distinguishes between three different types of 'e-tailers': generalists, pure players and multichannel retailers. Each has different strategies and features in order to capture the highest growth possible. Figure 1 shows the market shares of the companies selected for Scope's study.

Figure 1: Market shares of selected e-tailers



Sources: Scope, public information of peer group

The main factors determining the success of an e-tailer are a high number of site views, an easy-to-use front-end, and excellent logistics. All of these factors result in a strong brand. However, even though the internet seems boundless, the sub-sector's growth in Europe is hindered by geo-blocking from unilateral decisions, and from the investment needed in logistics and advertising to create international brand recognition. The focus on e-tailers' national markets greatly limits international expansion – and therefore diversification and economies of scales – and, apart from a few exceptions, the establishment of truly pan-European incumbents.

Scope has found that e-tailers are much more efficient at revenue conversion, as they can implement new business models from scratch without the burdens of classic retail, for example, staff and operating-lease expenses. In addition, the agency believes that strong internal cash flow among established e-tailers should help finance investments to overcome geo-blocking in the medium term.

Hence e-tailers, armed with the ambition to challenge established markets, are expected to increase their penetration rate significantly, thanks to their high flexibility and ability to generate high free cash flows (improving financial risk profiles), bolstered by the anticipated collapse of geo-blocking barriers.

Scope therefore expects the European retail industry to see its own 'hunger games' over the next decade, where only the most robust and established companies will survive. After this, Scope foresees a consolidation of the market, with two to three main European incumbents per sub-sector of products. Scope assumes that Amazon and Zalando among others will remain dominant in their product categories, both protected by their size and current diversification.

As a result Scope expects the credit quality of classic retailers to weaken, leaving two options for survival: directly compete with e-tailers to stabilise market shares, at the cost of higher indebtedness; or dedicate just a small portion of activities to e-commerce, but lose market share in the process.

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With consumer behaviour becoming more pluralistic, and the persistently slow or negative growth in disposable incomes, the retail industry is undergoing a remarkable transition towards more product diversity, as well as multichannel delivery and marketing. This is supported by increasing digitalisation in the industry, which is also threatening traditional market participants. As a result, new e-commerce incumbents – so-called e-tailers – have emerged, such as Otto, Groupe Casino, Zalando and, foremost, Amazon. These companies have set entry barriers through cost advantages, cross-border activities and recourse to excellent logistics and distribution channels; all backed by massive levels of free cash flows.

Three different types of e-tailers

Scope generally identifies three different types of e-tailers and their respective business models.

1. **Generalists** sell goods in various sub-categories (Figure 7). These companies are well diversified by products and geographies, but may not develop high added value on marginal sales. Scope considers Amazon and Otto as examples.
2. **Pure players** can vary in terms of size, but all focus solely on selling one or two product classes (Figure 7). They are generally smaller in size and less diversified, leading to logistical networks that can be less efficient than those of generalists. However, their specialisations ensure large shares in their own markets as well as higher operating margins. Examples include Zalando and Shop Direct Group.
3. **Multichannel retailers** have networks of brick-and-mortar shops and offer original products on dedicated online platforms. Tangible shops generate economies of scale on logistical networks and initially high recognition among customers. However, their heavy cost structures may impede flexibility compared to e-tailers. Examples include Tesco, Carrefour, and Metro.

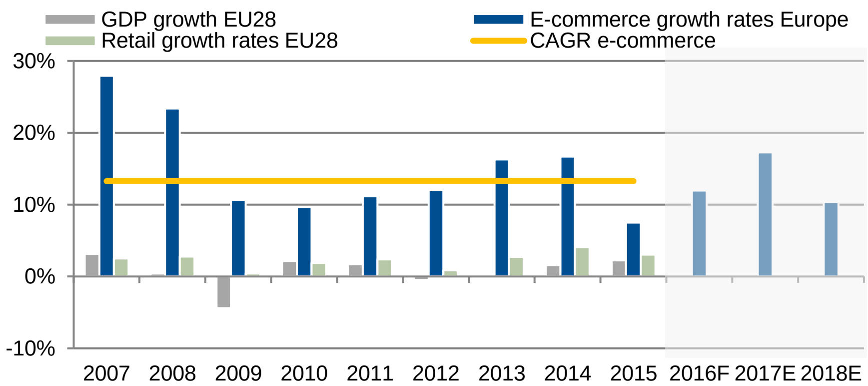
The e-commerce sub-sector shows solid industry characteristics, mirroring those of the total industry, namely with respect to cyclicality, entry barriers and substitution risk – the three main determinants in Scope's Corporate Rating Methodology for the industry analysis, a part of a company's business risk profile.

Cyclicality

Medium cyclicality

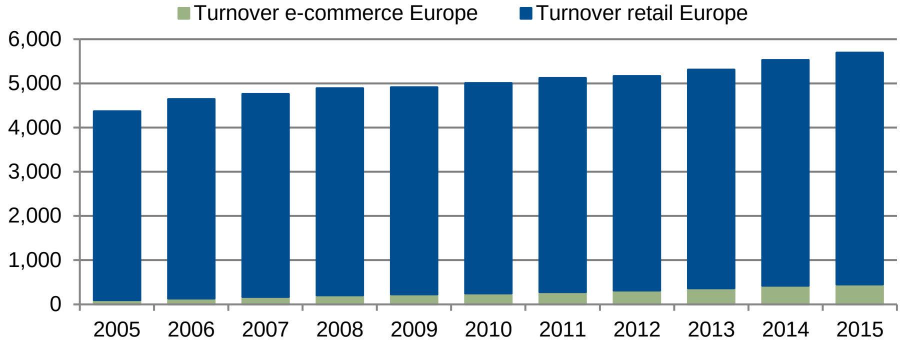
The e-commerce sub-sector, which has grown continuously since its inception around 20 years ago, benefits from a 10-year CAGR (2006-2015) at 13%, high against just 2% for the overall industry (Figure 2). However, average European growth is slower in western Europe as growth has already peaked. Southern and eastern Europe are still far from stable, too, but should display strong two-digit growth in the medium term.

Figure 2: Growth rates of EU28 GDP, retail sales, e-commerce sales



Sources: Ecommerce Europe, TNS Infratest, EUROSTAT, Scope Ratings

Figure 3: Composition of European retail turnover



Sources: Ecommerce Europe, TNS Infratest, EUROSTAT, Scope Ratings

Scope identifies the overall cyclicality of the retail industry as medium. However, depending on a company's product exposure, e-tailers and retailers alike can have strong intra-year cyclicality, with the bulk of annual turnover clustered around the end of the year (Christmas, Valentine's Day, Black Friday, and New Year).

Figure 3 indicates the European retail sector's growth, as well as its online version. The data indicates low penetration rates, at currently 9%, indicating room for improvement.

Barriers to entry

Medium barriers to entry

Scope deems market entry barriers for both e-tail and retail to be medium. There are only a few incumbents in the market, including amongst others:

Figure 4: The main incumbents of the e-commerce subsector:[1]

Corporate	Country of domicile	Product categories	Classification
Amazon Inc.	United States	Multiproduct	E-tail generalist
Tesco PLC	United Kingdom	Multiproduct	Re(e)-tail multichannel
Otto Group GmbH & Co KG	Germany	Multiproduct	E-tail generalist
Zalando S.E.	Germany	Fashion	E-tail niche player

These incumbents, together with other peers, dominate their respective sub-sector or region, and are protected by cost advantages, excellent access to capital, and distribution channels. However, Scope has also identified numerous small to medium-sized companies that operate with a national or regional focus.

Scope points out that entry barriers for e-commerce, which were low at the turn of the century, have risen in the last 17 years, and are now judged to be medium. This has been driven by two factors: i) consolidation, as traditional retailers are now also using e-commerce to widen distribution channels; and ii) massive capital inflows from venture capitalists, supporting the growth of todays incumbents.

Substitution risk

Low substitution risk

Substitution risk is deemed low as the retail industry could not easily be substituted, especially because it constantly adapts to be more convenient, flexible and price

[1] A detailed table presenting all the companies in this study can be found in the Appendix 1.

competitive. The potential competition from direct sales from consumer goods or wholesale is judged negligible by Scope.

Figure 5: Scope's industry risk assessment for retail industry

Cyclicality \ Barriers to entry	Low	Medium	High
High	CCC/B	B/BB	BB/BBB
Medium	B/BB	BB/**BBB**	BBB/A
Low	BB/BBB	BBB/A	AA/AAA

Source: Scope

Competitive positioning

Five general criteria to judge the three different kinds of e-tailers

Applying Scope's Corporate Ratings Methodology and introducing two new retail specific items, Scope looks at the following factors to determine competitive position as an element of business risk:

- Like-for-like growth (retail-specific)
- Market share
- Brand strength (retail-specific)
- Operating margin
- Diversification

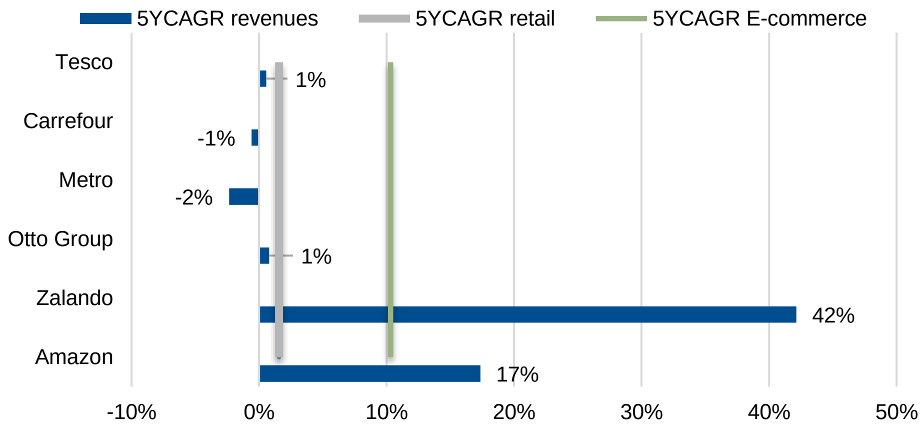
Like-for-like growth

Like-for-like growth compared to industry growth

Scope considers a company's development to be crucial for its position against peers, allowing a quantification of its development at industry level.

Like-for-like growth is compared with overall industry growth to assess the intrinsic strength of a company's business model. This is because high growth generally leads to increased market share. Scope differentiates between these two criteria as they both lead to different results. The like-for-like approach gives a temporally relative assessment whereas market share provides a global overview in absolute values.

Figure 6: Like-for-like growth of e-tailers and retailers in Europe



Sources: Scope, public information of peer group

Market share

Market share indicates a company's pricing power

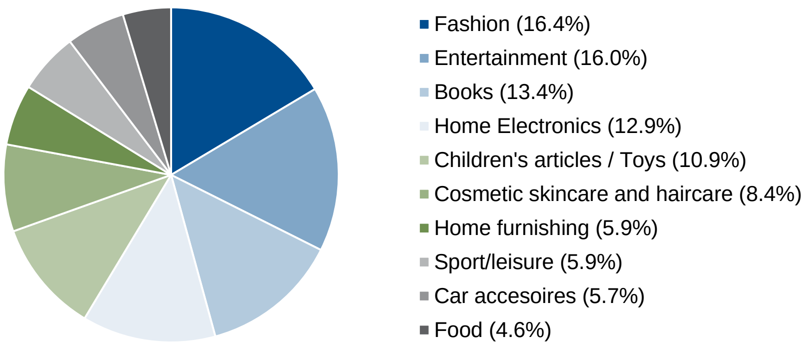
Scope does not focus only on market share in this analysis, but considers it together with like-for-like growth. The market shares of e-tailers are still extremely small and might give a misleading signal about the market position of a company. Scope considers this criteria important as it indicates monopolies or oligopolies, and thereby a company's pricing power. Market shares in e-commerce are generally small as the online product range now mirrors those of the 'offline' world. This is not only due to new market players looking to introduce 'offline' products to e-commerce, but also because 'old' retailers are widening point-of-sale structures to online.

Fashion, entertainment and books account for about 50% of European e-commerce sales

The largest e-tailer in Europe by far is Amazon, whose estimated market share[2] was 4.9% in 2015; followed by Otto (1.4%), Casino (1.1%), Tesco (0.9%) and Zalando (0.6%). However, as only few competitors offer nearly all types of products, Scope focuses on the companies' market shares in their respective product categories. The three main product categories in Europe are fashion (16% of e-commerce market), entertainment (16%) and books (13%). Scopes notes that the European e-commerce sector is well diversified, with no sub-sectors prevailing others in term of market share (no sub-sector holds more than 20%).

Fashion, Entertainment and Books account for about 50% of European e-commerce

Figure 7: Size of product categories in European e-commerce



Sources: eCommercenews.eu, Scope

The strongest player in fashion e-commerce is Zalando, with average sales climbing 37% p.a. over the past three years and a product-category-specific market share of 7.6%; followed by Amazon (estimated market share of 7.3%) and Otto (5.6%).

Amazon dominates the second- and third-largest European markets (respectively, entertainment and books). According to Retail Week, Amazon is the largest player in the entertainment sub-sector (comprising books and audio, video games, and video), with a total share of 26.5% in 2014. For music, Amazon leads with 27.0%; but Apple, with iTunes and the Apple store, comes close with an estimated market share of 21.6% (26% in 2014). Sainsbury holds 4.8%.

Regarding the market for books, Amazon dominates with more than 33.0%, far ahead of its next competitor, WHSmith (10.3%). Tesco ranks third with 3.3%.

Brand strength

Brand strength driven by high customer satisfaction

Scope estimates that an e-tailer's main source of income, in a vast majority of cases, is generated by sales of advertised products. However, supplementary income from digital advertising or service subscriptions are also good indicators when assessing an e-tailer's brand strength.

A strong e-commerce brand is one that offers an optimal service – from the online selection of the products to physical delivery –, ensuring high satisfaction and potential long-term loyalty. Thus, brand strength translates directly into qualitative results and, indirectly, into quantitative. Qualitatively, a company with a strong brand benefits from

[2] Percentage of total turnover in European-commerce 2015 measured in USD

high recognition and awareness, generally leading to a higher market share, as well as customer loyalty and satisfaction. Quantitatively, brand strength will indirectly stabilise sales, eventually enhancing profitability. The following criteria are deemed the most representative for the assessment:

- Internet visibility and conversion rate
- Logistical methods (including delivery and return) and amount of products returned

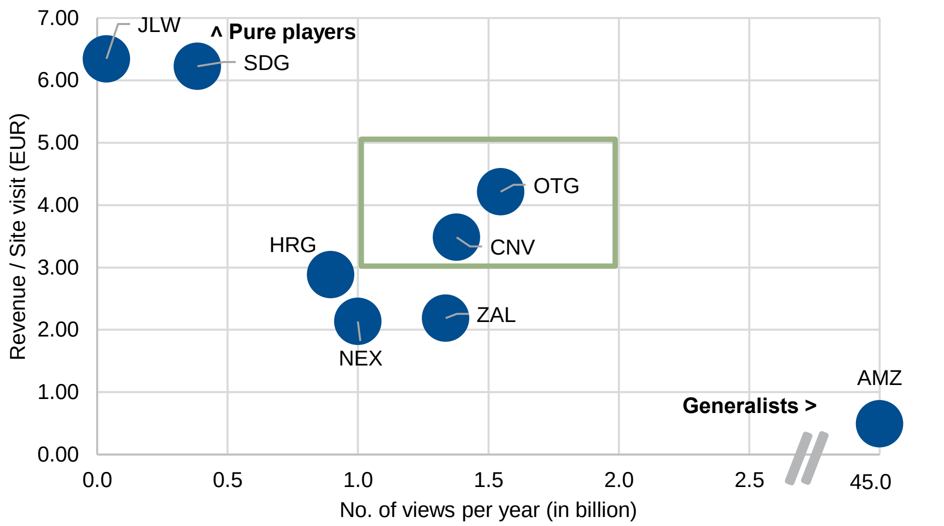
To fully assess an e-tailer's brand strength, Scope examines i) pricing power, customer loyalty and specific factors of a business model and ii) customer satisfaction. The former determines whether customer loyalty is possible as well as its impact on a company. The first aspect addresses a company's pricing power; ability to dictate prices to suppliers and customers; and the recurring aspect of the product. However, information on these two aspects are generally scarce; therefore, Scope assesses these factors case by case and not within this study.

Where all begins… 'Where to buy'?

Internet visibility and conversion rate

For the e-commerce sector, Scope considers essential a website's visibility (total views annually) and the company's ability to convert online traffic into sales. High traffic is seen positively: it demonstrates high brand recognition and, thereby, a diversified customer base, both geographically and socio-economically. A company's ability to transform traffic into sales, as represented by the conversion ratio, demonstrates how well it can position products and provide customer-friendly interfaces (ease of payment and logistics), both of which help to lure customers.

Figure 8: Matrix of conversion rate among a sample of e-commerce companies in selected western European countries (Germany, UK, France, Italy and Spain)[3]



Sources: Scope, hypestat.com, public information of peer group

Ideally the two ratios should be as a high as possible; however, Scope has established that they are often in opposition to each other. The two types of e-tailers below both have unique features:

- Generalist e-tailers offer a wider product range but generally create lower added value than the pure player's marginal sales. They distinguish themselves from competitors through sales or price discounts. Thus e-commerce generalists mostly tackle existing

[3] The e-tailers used in this sample are: JLW: John Lewis Waitrose I SDG: Shop Direct Group I OTG: Otto Group I CNV: Cnova (Cdiscount) I HRG : Home Retail Group NEX: Next I ZAL: Zalando I AMZ: Amazon

competition from multichannel retailers. While they benefit from a high level of website views, this does not translate into high conversion rates.

- Pure players offer a comprehensive, but small, range of specialised products online, providing in most cases guides for and comparisons between products. This allows buyers to benefit from expertise not always available in other platforms. Pure players also offer personalised or specialised niche products that are difficult to find in common brick-and-mortar shops; customers already have a specific interest in the product before visiting the website. Scope estimates that these websites are limited in growing beyond their products' boundary, as over-diversifying could result in losses in both reputation and know-how.

As seen on the Figure 8, the main European incumbents do not necessarily generate the highest conversion rates despite having the most visits on their online platforms. This is underscored, for example, by Amazon, which leads the amount of views by far (around 45bn views per year based on internal estimates) but has the lowest conversion ratio (EUR 0.5 per visit).

On the other hand, two companies buck this trend: John Lewis and Shop Direct Group. Both companies exhibit low traffic, as their markets are limited to the UK region (Ireland included); but offer numerous services (user-friendly websites; flexible pricing/ delivery/returns) that generate high customer satisfaction and, thereby, a high conversion rate. In Scope's sample, Otto performs the best, followed by Cnova. Both have significant geographical coverage and monetise website views well. In Scope's view, their high performance is attributed to having multiple websites, allowing highly specialised coverage (Otto) and high value-added products (CDiscount). Otto is a hybrid of a generalist and a pure player as it is composed of more than 30 pure-player websites (with high conversion rates) that give an overall product range similar to one of a generalist.

A high basket abandonment rate shows room for improvement

Scope expects room for improvement in future conversion rates as Europe's average basket abandonment rate is among the highest worldwide, ranging between 52% and 80% depending on the study (respectively Ecommerce Benchmark and Retail Report 2016, made by a consortium of entities, and Ecommercenews.eu's article from February 2016). This shows that while European online buyers and prospective clients are adding items to baskets, fewer than half actually finish the transaction. According to Baymard, the main reasons are extra costs (mainly due to logistics), and complicated processes around checkouts or account creation. While these justifications were based on a survey of US consumers only, Scope believes this translates adequately to the European market. The development of new payment solutions (via numerous European fintechs), and future innovations regarding deliveries and returns, should result in a steady development of e-commerce sales in Europe.

Shipping service is seen as a marketing tool

Product returns and logistics

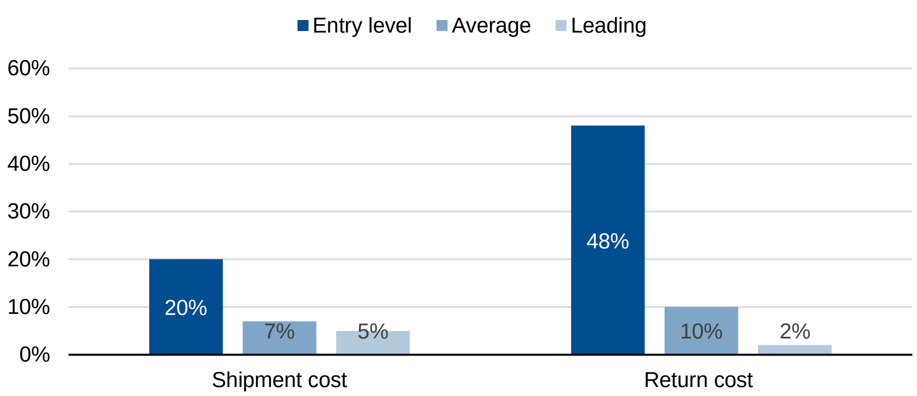
Scope's considers an e-tailer's delivery and return processes to be necessary for brand strength. Scope views integrated or efficient logistical processes – in terms of delays, geographical coverage and reliability – as positive credit drivers, while inefficient processes are considered a main cause for basket abandonment rates.

A 2016 study by communications firm Walker Sands found that free shipping determines the customer's choice of an e-tailer: 90% of customers surveyed said they would shop online more if shipping were free, up from 80% from the previous year. Delivery conditions are no longer considered just a service, but a marketing tool, forcing companies to constantly innovate in order to satisfy customers.

The three different business models of online retailers are facing different issues:

- Scope expects e-commerce incumbents, especially generalists such as Amazon, Otto and Zalando, to continue ramping up capital expenditure (capex) to provide the most effective and timely delivery methods. Major global e-retailers have even developed intra-hour delivery, as well as annual subscriptions (e.g. Amazon Prime) featuring free deliveries and returns, and additional services such as home or office delivery. Amazon, one of the market's main innovators, has even suggested 'drone deliveries' and Sunday deliveries for some markets.
- Small niche pure players are, as expected, suffering the most from the logistical aspects, as they do not have brick-and-mortar shops nor the investment to offer same (or next day) delivery as giant e-tailers can. Small pure players must therefore decide on either including shipping costs in the price (allowing them to offer 'free' shipping), but lose pricing competitiveness in the process; or charge an additional delivery fee, which could increase the basket abandonment rate. Scope forecasts that niche players, in order to provide an alternative, will develop shared warehouses, city-locker rental, or advance deliveries in denser areas.
- Multichannel retailers are already benefiting from an expanded network of shops, therefore only requiring minor additional investment on logistics, but there is still scope to build up current infrastructures. Free shipping often complements actual sales, by offering free delivery once a threshold is reached in a shop or as part of a subscription.

Figure 9: Logistical costs KPI at different stages of an e-tailer's development (in % of revenue)



Sources: Scope, Deloitte

Logistical costs are the main burden for nascent e-tailers

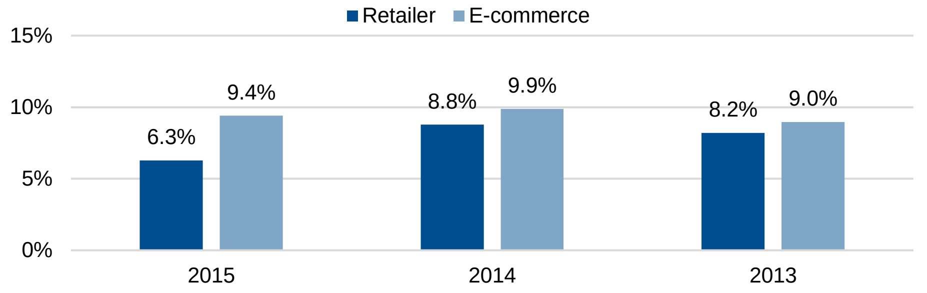
Logistical needs and potential solutions vary greatly among e-tailers, but represent a significant cost for all (Figure 9). This cost can lessen through economies of scale (as a company develops over time), long-term contracts with external providers, or internal logistical solutions, e.g. Hermes Logistic (Otto) or Amazon Logistics. Logistics can heavily burden a nascent e-tailer, impairing financial flexibility and contributing to geo-blocking in the European market (see 'Diversification').

Profitability

Profitability, as measured by a company's EBITDA margin, shows a company's ability to convert revenues into operating profits, and helps to establish an objective ranking of companies in the same sector. High profitability sends a clear message of financial strength to investors or potential debtholders, facilitating organic development or helping to attract more investors.

The classic retail strategies have been disrupted severely by e-commerce, through its often competitive pricing models, diverse shipping methods, and focus on customer satisfaction.

Figure 10: Median EBITDA margin (in %)[4]



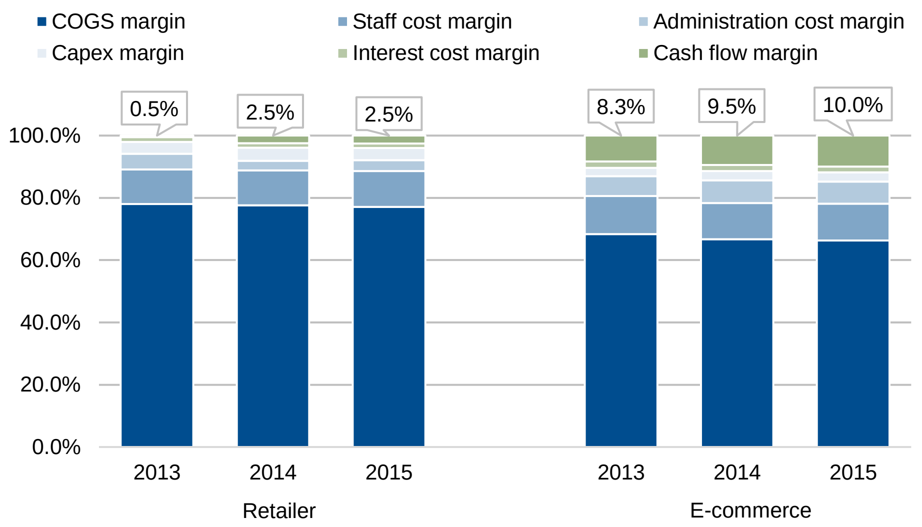
Sources: Scope, public information of peer group

In this section, Scope divides the previously studied sample of companies into two categories: i) retailers, including multichannel companies, and ii) e-tailers, including generalists and pure players. Figure 10 shows the profitability ratios of retailers and e-commerce companies, as defined by Scope-adjusted EBITDA margin.

A lighter cost structure provides a better flexibility

Scope has identified another reason for the rise of e-commerce: e-tailer's different cost structures (Figure 11).

Figure 11: Cost structure differences between e-tailers and retailers



Sources: Scope, public information of peer group

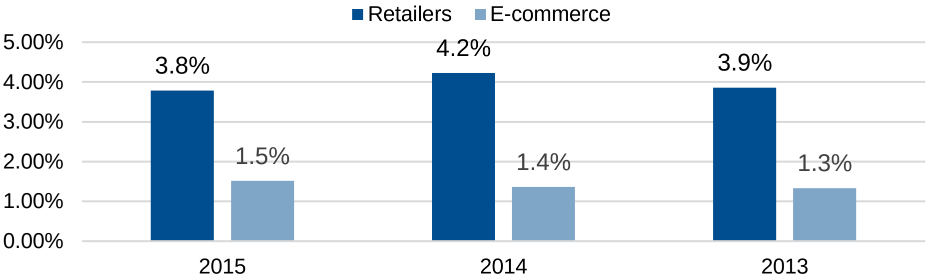
While large retailers have the ability to negotiate prices, Scope observes that cost of goods sold (COGS) is more important for retailers than for their online peers (more than 16% higher in 2015). This is because brick-and-mortar shops incur significant inventory costs. Traditional retailers are also burdened by higher operating-lease payments (Figure 12) from having to rent physical locations, but benefit from lower median administrative costs through global economies of scale.

Scope foresees that retailers will continue to suffer from high COGS (roughly 75% of revenue) as no innovative breakthroughs are expected, and these help to alleviate this aspect. On the other hand, e-tailers are more flexible cost-wise, meaning they can generate higher free cash flows, as evidenced by the cash flow margin of 10.0% in 2015 (excluding tax and working-capital changes) compared with the 2.5% for retailers. Scope expects this gap to widen, as 'offline' companies can generally increase capex, and can

[4] The retailers used in this sample are the following ones: Tesco, Carrefour, Casino, Metro, Sainsbury, H&M and Ahold.

continue to consolidate or pursue organic growth, financed by strong free cash flows. Retailers, on the other hand, have to become heavily leveraged to compete on similar levels of marginal capex.

Figure 12: Operating lease margin for e-tailers and retailers



Source: Scope, public information of peer group

Cost-related flexibility will accelerate sub-sector competition towards retailers. Scope estimates that traditional retail sub-sectors for which offline counterparts have limited coverage will continue to be attacked.

Scope believes that only the leading multichannel retailers will be able to cope with e-tailers, by continuing to increase the e-commerce share of their sales.

Diversification

E-commerce is no longer a nascent industry, but nevertheless faces important structural modifications in term of consolidation and market development. Scope assesses a company's strength of diversification through its ability to adapt to these changes. Scope considers diversification important for a company's business risk profile because it factors in overall risk. Indeed, strong diversification allows companies to capture new clients by offering a diverse range of products with new services, decreasing intrinsic risk to a more systemic risk level, and modifying the correlation of the company to a single element or geographical location. The e-commerce sector is no different, and its potential diversification will be studied from four distinct viewpoints:

- Geographies
- Channels
- Suppliers
- Products

Geographical diversification

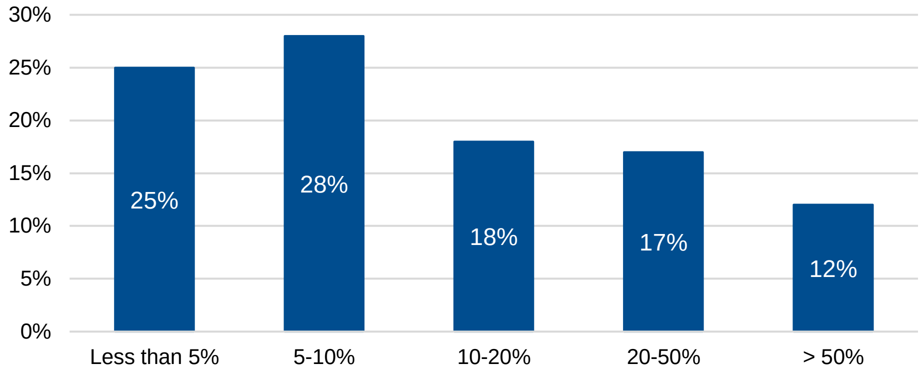
Geographical diversification – determines the future of European e-tailers

The European market is generally fragmented (see 'Market shares'). An e-tailer's entry into new markets is hampered by the investment needed in logistics, storage facilities or marketing in order to establish international brand recognition. And even though the internet seems boundless, European e-commerce is still dominated by domestic sales.

The difficulty to sell abroad affects all e-tailer business models (generalist, pure player, and multichannel), reflected in the small shares of international revenue. A survey from ecommerce-europe.eu points out that 53% of pure players realise less than 10% of revenues abroad (Figure 13).

In March 2016, the European Commission highlighted 'geo-blocking', i.e. constraints to cross-border selling, and stated numerous reasons from unilateral decisions (VAT costs, overly restrictive regulations, etc.) or contractual restrictions to sell abroad.

Figure 13: Percentage of non-domestic total turnover among pure players (in 2016)



Source: Scope, www.ecommerce-europe.eu

Scope expects that these geographical barriers will remain in the short to medium term, as no major measures to make European regulations uniform have been announced. Most e-tailers are poorly diversified, with mostly domestic coverage, and are correlated to the macro economies of their respective home markets.

This current geo-barrier is expected to be a key driver of change in Europe's e-commerce market. If the geo-blocking barriers collapse, Scope expects competition for the same products will increase among national and international e-tailers, ultimately leading to a drop in prices to allow companies to stabilise market shares and brand recognition.

Diversification of sales channels

Sales channel diversification – towards a new personal approach

Aware that some customers need to see products in person, some e-tailers have opened physical locations in select cities. Zalando, John Lewis and Amazon were among the pioneers of this in Europe. This diversification of sales channels suggests that basket abandonment rates become lower once customers are able to visit a brick-and-mortar shop.

Channel diversification also comprises the transition to an 'omnichannel': marketing, deliveries and payments are performed over multiple and interconnected channels (physical, e-commerce and mobile-commerce), which give the customer better and more personalised guidance. Scope judges this personalisation of the shopping experience as one of the most promising trends for classic brick-and-mortar retailers. However, the inherently high set-up costs constrain smaller companies from implementing this.

Supplier diversification

Supplier diversification – creating own brands

Scope highlights that e-tailers are now creating their own brands. While traditional retailers have been doing this for some time, this is relatively new for e-commerce, applying mostly to the fashion sub-market so far.

Zalando, Shopping Direct Group and Amazon have created their own online fashion labels, with the latter also establishing a label for household goods (Amazon Essentials). So far, this strategy has only been employed by a few e-tailers, but could become widespread. This has the potential to make e-tailers more profitable and independent by decreasing the exposure to suppliers. Scope has a positive view of the movement away from merely distributing products of other companies as this limits the dependency on third parties. On the other hand, this strategy does carry the risks in terms of reputation or keeping up to date with fashion.

Financial risk profile

For the assessment of the leading companies' financial risk profiles (FRP), Scope uses the figures disclosed in the annex 2. Scope has only used public information to compile this analysis, which differs from assessments for mandated, full corporate ratings because data excludes both contact with management as well as financial estimates. The numbers derived are thus mere snapshots based on the latest publications, and results should be interpreted as indications only.

Figure 14 below represents the median profitability and credit metrics of the assessed companies, split into retail and e-tail.

Figure 14: Median of Scope's key ratios

	2013		2014		2015	
industry	*retail*	*e-tail*	*retail*	*e-tail*	*retail*	*e-tail*
Profitability						
EBITDA margin	9%	8%	9%	10%	7%	9%
Debt protection						
EBITDA interest cover (Scope adj.)	6.1x	4.7x	6.2x	5.5x	6.1x	5.8x
Leverage						
SaD/EBITDA	3.2x	3.2x	3.3x	3.2x	3.1x	3.4x
FFO/SaD	24%	24%	23%	26%	21%	28%
FOCF/SaD	11%	25%	10%	13%	4%	26%
FRP	BBB/BB	BBB	BBB/BB	BBB/BB	BBB/BB	BBB

Source: Scope, public information of peer group

Financial risk profiles generally similar but differ in terms of development

The financial risk profiles of companies assessed in this study are generally similar, regardless of whether an e-commerce exposure exists. However, financial risk profiles differ between the sub-sectors in terms of development.

E-tailers seem to benefit from an improvement in their financial risk profiles, which is strongly linked to a greater ability to generate free cash flows, which enables deleveraging and/or enlarges headroom for further organic and dynamic growth. On the other hand, while retailers' overall financial risk profiles are still investment or high non-investment grade, this has been weakening slightly year after year. This is because revenues are growing modestly at best and high fixed capex limits the flexibility to generate organic or dynamic growth without debt levels rising.

As a result Scope expects the credit quality of classic retailers to weaken, leaving two options for survival:

- Directly compete with e-tailers to stabilise market shares, at the cost of higher indebtedness; or
- Dedicate just a small portion of activities to e-commerce, but lose market share in the process.

Outlook

Increasing penetration rates of e-commerce expected

The penetration rates of e-commerce are expected to increase significantly, thanks to the e-tailers' high flexibility; ability to generate high free cash flows; generally better financial risk profiles; along with the anticipated collapse of geo-blocking barriers. This will lead to a virtual "hunger games", where only the most robust and established companies will survive. After this, Scope foresees a consolidation of the market, with two to three main European incumbents per sub-sector of products. Scope assumes that Amazon and Zalando among others will remain dominant in their product categories, both protected by their size and current diversification.

While Scope firmly believes that e-tailers benefit from a competitive advantage in terms of business and financial risk profiles, Scope emphasises that mere digitalisation of sales will not be enough for retailers to distinguish themselves from competitors in the long term. The reason for e-tailers success is simply their ability to take risks by developing an alternative and disruptive business model.

Scope emphasises that the retail sector has reached a threshold. This has forced its players to take new business risks to counter the surge of new competitors and adapt to online markets to avoid disappearing.

ANNEX 1: Snapshot of companies analysed in this study:

	Ahold	Amazon	Carrefour	Casino	Cnova	Coop Group	H&M	Home Retail Group
Full name	Koninklijke Ahold N.V.	Amazon.com, Inc	Carrefour S.A.	Groupe Casino S.A.	Cnova N.V.	Coop Cooperative	H & M Hennes & Mauritz AB	Home Retail Group plc
Acronym used in figure 8	-	AMZ	-	-	CNV	-	-	HRG
HQ location	Netherlands	USA	France	France	Netherlands	Switzerland	Sweden	UK
Geographical outreach	Europe and USA	Worldwide	Worldwide	Worldwide	France, Africa and Brazil	Europe and Russia	Worldwide	UK
Main products category	Grocery	Multiproduct	Multiproduct	Grocery	Electronics specailty	Food	Fashion	Home and furnitures
E-tail / retail	Retail	E-tail	Retail	Retail	E-tail	Retail	Retail	E-tail
Type of e-tail (if applicable)	-	Generalist	-	-	Pure player	-	-	Pure player

	John Lewis Waitrose	Metro	NEXT	Otto Group	Sainsbury	Shop Direct Group	Tesco	Zalando
Full name	John Lewis Partnership	Metro AG	Next plc	Otto Group GmbH & Co KG	J Sainsbury plc	Shopping Direct Group Ltd	Tesco PLC	Zalando SE
Acronym used in figure 8	JLW	-	NEX	OTG	-	SDG	-	ZAL
HQ location	UK	Germany	UK	Germany	UK	UK	UK	Germany
Geographical outreach	UK	Europe and Asia	Worldwide	Europe	UK	UK	Worldwide	Europe
Main products category	Multiproduct	Electronics specailty	Fashion	Multiproduct	Grocery	Fashion	Multiproduct	Fashion
E-tail / retail	Hybrid	Retail	Hybrid	E-tail	Retail	E-tail	Retail	E-tail
Type of e-tail (if applicable)	-	-	Pure player	Generalist	-	Pure player	-	Pure player

ANNEX 2: Snapshot of Scope's key-metrics applied to companies in this study:

E-tailer

	Amazon (EURm) **		Cnova (in EURm)		HRG (EURm)[1] *		JLW (EURm)[3] *		NEXT (EURm) *		Otto Group (EURm)		SDG (EURm)[2] *		Zalando (EURm)	
	2015	3Y	2015	3Y	2015	3Y	2015	3Y	2015	3Y	2015	3Y	2015	3Y	2015	3Y
Revenue	98,546	▲	3,449	▲	7,750	►	13,166	▲	5,429	▲	12,057	►	2,421	►	2,958	▲
Revenue growth (2013 - '15)	*44%*		*19%*		*4%*		*15%*		*12%*		*2%*		*7%*		*68%*	
EBITDA (reported)	6,614	▲	-80	▼	344	►	1,083	►	1,257	▲	742	►	299	▲	124	▲
EBITDA (Scope-adj.)	7,627	▲	-53	▼	797	►	1,298	▲	1,257	▲	1,080	►	299	▲	152	▲
FFO	6,649	▲	-112	▲	628	►	1,059	▲	1,200	▲	1,145	▲	241	▲	138	▲
FOCF	602	▼	-57	▼	580	►	106	▼	1,078	▲	666	▲	423	▲	94	▲
Gross financial debt	7,885	►	147	▼	0	►	1,337	►	1,141	►	2,382	►	1,685	►	0	►
Scope-adjusted debt (SaD)	894	▼	Net cash	►	2,210	▼	5,249	▲	2,844	▲	4,261	►	1,667	►	Net cash	►
Profitability (3Y average)																
EBITDA margin	7%	▲	0%	▼	10%	▼	10%	►	28%	▲	10%	▲	11%	▲	3%	▲
Debt protection (3Y average)																
EBITDA interest cover (Scope adj.)	10.5x	►	0.0x	▼	5.5x	►	5.5x	►	10.7x	▲	4.8x	▲	3.7x	▲	6.1x	▲
Leverage (3Y average)																
SaD/EBITDA	0.3x	▼	Net cash	►	3.0x	►	3.7x	▲	1.9x	▼	3.7x	►	7.1x	▼	Net cash	►
FFO/SaD	463%	▲	Net cash	►	26%	▲	22%	▼	40%	▲	26%	▲	11%	▲	Net cash	►
FOCF/SaD	50%	▼	Net cash	►	22%	►	14%	▼	37%	▲	15%	▲	14%	▲	Net cash	►

[1] Home Retail Group
[2] Shop Direct Group
[3] John Lewis - Waitrose

*GBP:EUR FX-rate as 1.3572 at 31.12.2015
**USD:EUR FX-rate as 0.9209 at 31.12.2015
***SEK:EUR FX-rate as 10.918 at 31.12.2015
****CHF:EUR FX-rate as 1.0875 at 31.12.2015

Retailer

	Ahold (EURm)		Carrefour (EURm)		Casino (EURm)		Coop (EURm) ****		H&M (EURm) ***		Metro AG (EURm)		Sainsburry (EURm) *		Tesco (EURm)*	
	2015	3Y	2015	3Y	2015	3Y	2015	3Y	2015	3Y	2015	3Y	2015	3Y	2015	3Y
Revenue	38,203	▲	78,857	►	46,145	►	23,811	►	16,566	▲	59,219	▼	32,267	►	46,334	►
Revenue growth (2013 - '15)	*17%*		*3%*		*-4%*		*-4%*		*41%*		*-10%*		*2%*		*-1%*	
EBITDA (reported)	2,361	▲	3,915	►	2,342	▼	1,777	►	3,054	▲	2,176	▼	896	▼	-3,124	▼
EBITDA (Scope-adj.)	2,982	▲	4,950	▲	3,447	▼	2,402	►	4,936	▲	3,715	▼	1,694	▼	-2,029	▼
FFO	2,395	▼	3,231	▲	2,458	▼	1,932	►	3,918	▲	2,166	▼	1,044	▼	-2,354	▼
FOCF	1,627	▼	662	▲	504	▼	536	▼	3,368	▲	470	▼	-685	▼	-4,534	▼
Gross financial debt	2,812	►	7,628	►	11,734	►	4,322	►	0	►	7,572	►	3,754	►	9,327	►
Scope-adjusted debt (SaD)	7,497	▲	24,264	▲	11,902	▲	8,764	▲	7,992	▲	10,188	▼	10,161	►	25,015	►
Profitability (3Y average)																
EBITDA margin	8%	►	6%	►	8%	▼	10%	►	31%	▼	6%	▼	7%	▼	2%	▼
Debt protection (3Y average)																
EBITDA interest cover (Scope adj.)	6.5x	►	9.5x	►	5.3x	▼	7.7x	►	13.5x	►	5.2x	►	4.2x	▼	1.4x	▼
Leverage (3Y average)																
SaD/EBITDA	2.5x	▲	4.8x	▲	3.0x	▲	3.5x	►	1.6x	▲	3.0x	►	4.8x	▲	-3.5x	▼
FFO/SaD	35%	▼	13%	▲	26%	▼	23%	►	52%	▼	22%	▼	16%	▼	2%	▼
FOCF/SaD	23%	▼	1%	▲	7%	▼	7%	▼	44%	▼	10%	▼	1%	▼	-8%	▼

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