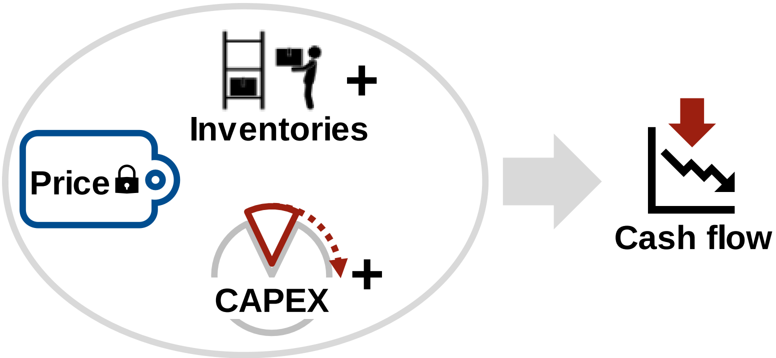
Corporates Outlook 2019/Retailing: Profitability expected to be under pressure

The 2019 credit outlook for European retail is negative. We expect squeezed profitability for retailers vulnerable to e-commerce growth or operating in countries with high e-commerce penetration, leading to an overall deterioration in credit metrics. Nonetheless, the deterioration in credit quality will be uneven across the sector considering the plurality of business models in Europe, though retailers will be operating in the context of slowing economic growth across the region.

The year ahead will see a continuation of the business trends that have dominated the sector in recent years rather than a turning point. E-commerce growth and the ability of retailers to diversify how they sell goods will remain central themes. As online sales appear to be maturing, growth in European e-commerce volume should vary among the sub-sectors and countries.

Figure 1: Squeezed profitability and higher investment needs create cash flow pressures



Source: Scope

Consumer electronics lead shift toward omnichannel sales

Legacy retailers are increasingly looking to develop their own online sales to prevent the inexorable drift towards e-commerce specialists. In Europe, some sectors have found this easier due to customer preferences and the relative ease in developing comprehensive online offers.

The consumer electronics sub-sector has had success in integrating online and physical sales channels. CEconomy, Dixons Carphone and Fnac Darty are examples of three European incumbents with bricks-and-mortar origins that have had strong online sales within a successful omnichannel mix. The subsector was one of the first to be affected by the emergence of e-tailers, forcing brick-and-mortar companies to master e-commerce to survive.

Other sectors have room to develop online sales in the short term, especially the food sector. Though one constraint is the high initial investment needed, which only few physical retailers have accomplished. Online food-delivery services face two hurdles:

1. The high density of supermarkets or convenience shops in cities often enable faster shipments; and

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Related research:

Of tortoises and hares: Retail segments in Europe have divergent online growth prospects - May 2018

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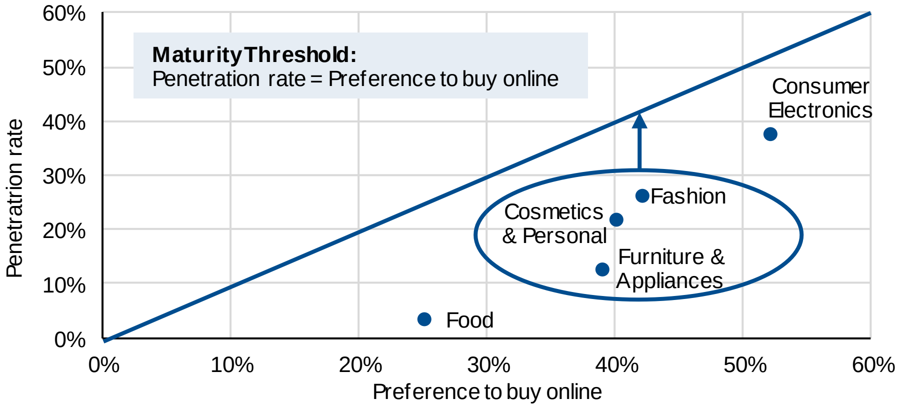
2. The need to deliver goods in an optimal condition (fresh, no damage) requires higher investment than for durable goods.

As consumers become more willing to buy groceries online, developing digital sales channels will be crucial for food retailers' future growth. (see 'Of tortoises and hares: Retail segments in Europe have divergent online growth prospects' (May 2018).

Figure 2: Consumers' online shopping preferences vary by sector



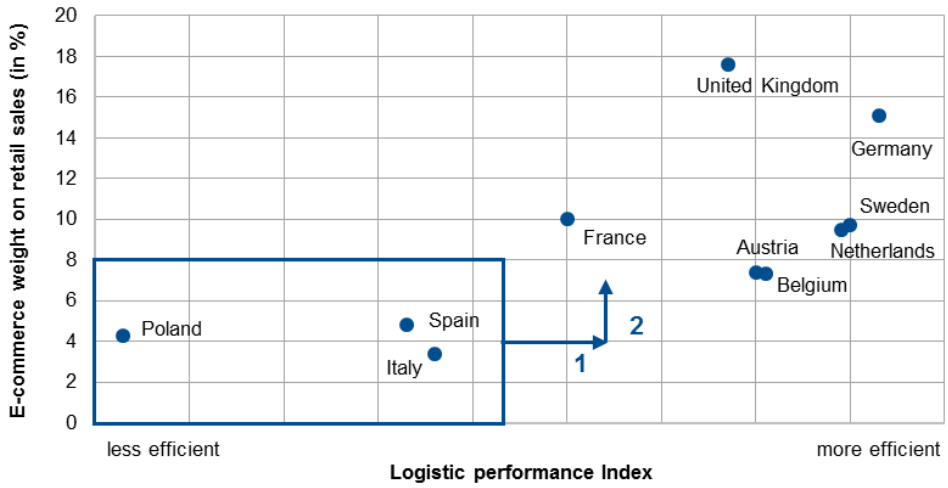
Source: Scope: "Of tortoises and hares: Retail segments in Europe have divergent online growth prospects"

Consumer habits vary widely across Europe

High-quality logistics infrastructure supports rise of e-tailers

For some countries, the gap is set to widen between firms that have adapted to the digital disruption—from cutting costs to developing efficient logistics—and those that struggle to do so.

Figure 3: Europe's biggest retail markets by e-commerce penetration rates and logistics quality



Source: Scope, World Bank, retailresearch

A Damocles Sword dangles over legacy retailers in the UK, Germany and the Nordics in the form of fierce competition from e-commerce rivals. The danger reflects consumers' strong preference in these countries for doing more shopping online and the existence of high-quality logistics infrastructure, without which e-commerce would be impossible.

The competitive situation in these countries is complex, regardless of whether a retailer is a bricks-and-mortar company or an e-tailer. Retailers can build market share quickly with the right concept, but lose it easily should they fall short of consumers' increasingly high expectations. Recovery can also be slow.

Retailers in southern and eastern Europe better protected against digital disruption

Retailers in southern and eastern Europe appear more protected from digital disruption. Poor logistics is one reason, with many countries in the region scoring poorly in the World Bank's efficiency index for the transport and delivery of goods across and within borders. In Italy, Spain and Poland, the nascent transport and logistics infrastructure is discouraging online entrants, even leading one major retailer to protect profits by charging customers for the return of goods. We expect this practice to spread to countries with poorer-quality logistics.

Changing consumer habits put a premium on cost control

As selling prices are locked, retailers focus on cost control with the help of …

According to many behavioural studies, price is by far the most important yardstick among millennials (those born in the 1980s until the early 2000s). This has led to a non-stop retail price war, aggravated by the added visibility over pricing afforded by the internet. To maintain margins, cutting costs has had to remain a top priority.

… retail alliances and the rising share of private labels …

As selling prices are essentially locked by competition, retailers have to optimise their gross margins to maintain profits. One way to is to strike commercial deals with rivals—hence the sharp rise in the number of alliances in 2018—to improve retailers' bargaining power over FMCG (fast moving consumer goods) suppliers or their sources of private-label goods. We expect the strategy to become more widespread. A good example is the alliance consisting of Fnac Darty, CEconomy and m.video. Private labels are also expected to become more prominent in sales and product mixes as their range and quality becomes comparable to those of branded products. This will lead to higher marginal profitability.

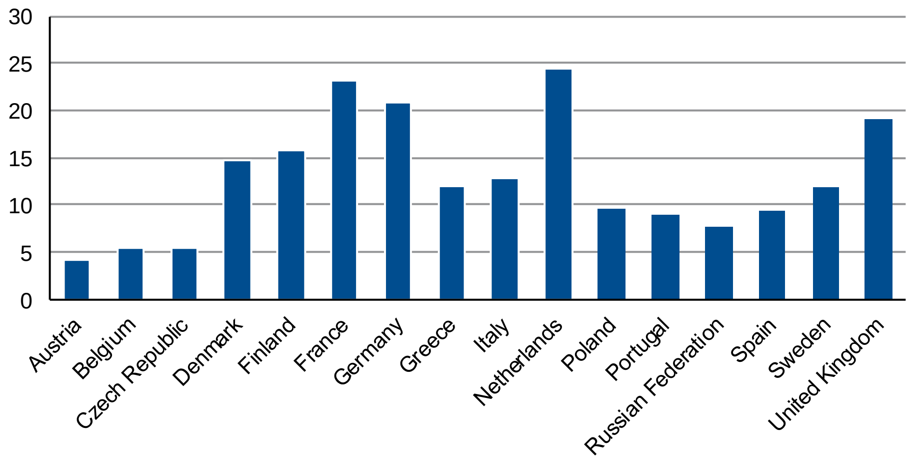
… as well as focus on core operations

Retailers are likely to continue to reshuffle portfolios of stores and business activities throughout 2019, partly by identifying and focusing on core operations. In 2018, UK-based Kingfisher sold most of its activities based outside of the UK and France. Retailers are also downsizing or rethinking physical selling space to optimise in-store EBIDTA. For instance, Tesco's new discount chain, Jack's, was launched to take on Aldi and Lidl. We hold a positive view of such initiatives as they provide a way for bricks-and-mortar retailers to bolster profitability. Downsizing, nonetheless, remains a delicate strategy. Management has to balance cost cutting with improving remaining shops to keep and attract customers. Margins are likely to remain under pressure and deteriorate overall, with the potential for slight deviations between retailers. While all retailers have started to move towards the omnichannel format, we have observed differences between companies, sectors and operating countries, with the likelihood that profitability will be sacrificed somewhat to maintain market share.

E-tailers exposed to uneven delivery prices across Europe

Not everything is perfect for e-tailers. There are still some constraints on growth beyond the fact that physical retailers are now catching up and developing their own e-commerce channels. In Europe, delivery prices remain elevated and uneven, as shown in the figure below. Average express prices on parcels—chosen to represent the closest possible to a day+1 delivery— are often high, limiting the price advantage from ordering online.

Figure 4: Express delivery costs in Europe remain uneven, hindering the development of e-commerce (in EUR)



Source: Scope, ecommercenews.

Credit profiles under pressure as squeeze on profit crimps cash flow

Profitability under pressure

The deterioration in the sector's credit quality will be driven by declining profitability among retailers that were slow to move towards omnichannel sales.

Rising interest rates rise will play a minor role, not least because most retailers in recent years have issued fixed-rate debt, providing some cushion against near-term rises in interest rates.

Profitability-related pressure on cash flows will affect retail strategies. Many companies will face a trade-off between maintaining market share and protecting cash flow, by divesting non-core businesses or exiting countries once considered important for expansion. Cash flow pressures will be due to three main factors: i) the decrease in profitability to save market share; ii) the burden on net working capital by the higher levels of permanent inventory called for by e-commerce; and iii) the high overall need for capital expenditure to support brand strength and differentiation.

Negative credit outlook

We believe cash flow pressures are likely to impair retailer credit metrics, especially for those which only recently became omni-channel players.

Regulatory risk another factor in assessing future cash flow

Regulatory changes in Europe could have diverse impacts on the cash flow of retailers:

- Ending geo-blocking to create a 'digital single market' will have a negligible effect as the law does not force retailers to deliver goods to countries they do not operate in.
- The unfair trade practices law proposed on 12 April 2018 could have a greater impact on the groceries sub-sector, as it would provide some protection to small operators against the stronger bargaining power of food retailers. If enacted, the law will focus on late payments, retroactive changes and last-minute cancellations. Provisions on late payments would have a direct impact on retailers' cash-conversion cycles and increase net working capital.
- IFRS 16, which supplanted IAS 17 in accounting for operating leases, will have some impact. Our October 2017 study mentioned the extensive use of operating leases in the retail sector, known for its thin profit margins, to minimise liabilities on the balance sheet. The new accounting standard will force retailers to capitalise operating leases as debt. On the income statement, rental charges will split into depreciation and finance costs. IFRS16 has no effect on the cash flow statement.

Figure 5: Impact of IFRS 16 on key P&L elements

Category	Transition to IFRS 16	Comment
EBITDA	↑	Rental charges will become either depreciation …
Finance costs	↑	… or finance costs
Net income	→	Will depend on the lifespan of the aggregated lease portfolio. If it is a company financing its expansion with leases, the finance cost is likely erode net income.

IFRS 16 will have a limited impact on our existing analyses as we already adjust for operating leases in terms of debt, depreciation and interest expenses.

In addition, many European retailers have reduced gross indebtedness in recent years. The median net debt to EBITDA multiple among retailers tracked by Scope is at its lowest level in five years, (decreasing yearly by ~4.5% since its peak in 2013), according to data from Bloomberg. Furthermore, the average maturity of issued debt implies it would have to be rolled over only in 2022, ensuring retailers have little need to refinance in the short term.

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