2020 Retail Outlook

The credit outlook for the European retail sector in 2020 is negative, unchanged from last year. Europe's retailers will have to make more heavy investment in their operations to remain competitive, but they face a continuing squeeze on profit margins.

Corporates, Scope Ratings GmbH

Executive summary

The credit outlook for the European retail sector in 2020 is negative, unchanged from last year. Europe's retailers will have to make more heavy investments in their operations to remain competitive. With debt back near levels not seen since the global financial crisis, profit margins remain under pressure amid fierce competition and slowing growth.

The capacity of retailers to enhance the shopping experience for customers, online and in their bricks-and-mortar shops, will be the theme of 2020. Proposing distinctive but sought-after products at affordable prices while raising the satisfaction rate of in-store shopping and gaining customer loyalty will be the big test for the sector.

The main trends we expect for 2020 are:

- Restructuring will continue, with the transformation of shopping networks through asset sales and/or enhanced shopping experiences with more "retailtainment", showrooms, shops-in-shops.
- Companies will consider more industrial alliances to increase bargaining power and better control procurement costs.
- Disposals of non-core assets – by location or activity – are likely as management seeks to improve profitability at the risk of losing market shares and/or revenue.
- Franchises will be the main vector for expansion, allowing retailers to lower operating expenses albeit by foregoing potential revenue.
- Pricing pressure risks further compressing profit margins.
- Capital expenditure will limit retailers' ability to generate free cash flow.
- Fast-moving consumer goods (FMCG) companies are increasingly developing their own distribution channels.

Scope Corporate Ratings

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Key themes for 2020

Profit and capex: retailers' delicate balancing act continues

Increasing profit margins is the central challenge Europe's retailers face in 2020. Companies across the sector have undertaken many cost-saving programs over recent years – covering purchasing as well as operating expenses – but consumer expectations of ever lower prices and higher-quality services continue to rise, compounding the impact of already fierce competition for market share. Retailers are taking advantage of low interest rates to refinance debt more cheaply, but retailer debt is increasing, getting back toward levels in 2008 at the onset of the global financial crisis (Figure1).

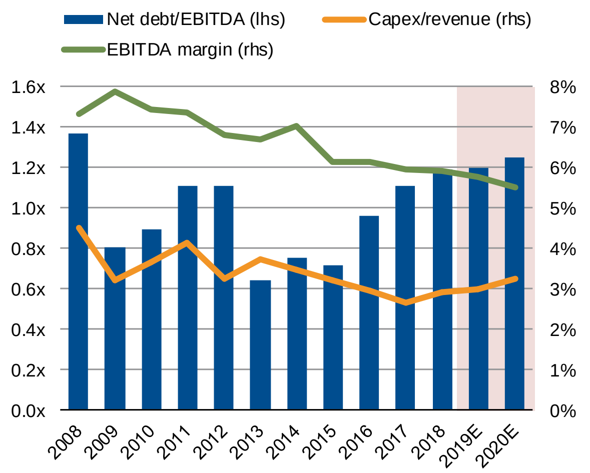
We believe there is limited room for manoeuvre for retailers to gain greater market share through mergers and acquisitions. Most national retail markets in western Europe are tightly consolidated. Retailing chief executives are increasingly focused on maximising the sales and cost-saving potential of individual markets where their companies are already present rather than seeking gains in market share in new countries.

The pressure is therefore on management to innovate – through shop refurbishment, new payment methods, new products and services – to enhance the shopping experience, ensure customers' loyalty and increase sales.

Generating extra cash flow will prove difficult given the pressure on prices and need to invest first and then wait for returns to improve. Capex-to-sales ratios are likely to remain between 2.5% and 3.0%, putting pressure on the free operating cash flow due as margins shrink.

Several trends will determine the performance of the sector in 2020 as retailers try to lower operating costs and keep margins high enough to support investments.

Figure 1. Rising debt multiples as profit margins narrow; capex requirements stable



Source: IMF, Scope Ratings

Rethinking shopping networks and the retail experience

Efforts to reorganise retailers' bricks-and-mortar shops will intensify in a variety of ways. We expect the shift to smaller, convenience-style formats to continue. Companies will increasingly turn to franchising to reduce development and operating costs, signing agreements where the franchisee takes charge of the ownership and operation – so-called "FoFo" formats – of the stores. In such deals, retailers earn fees indexed on the sales generated by the franchised stores.

We expect spending on new store concepts to rise too, as companies experiment with a wider variety of formats. Development "shop-in-shop" concepts, where fast moving consumer goods' companies take space within an operator's larger store, will increase, with a focus on innovative services and trending or curiosity products.

Footfall in some types of shops, such as large hypermarkets often located outside of cities, has fallen in recent years with growing consumer preference for convenience stores. Rather than rely on hypermarket refurbishment to win back customers, retailers and landlords have tackled this issue by trying to offer ancillary services. This might take the form of entertainment (cinema, bowling alleys, or other family activities), services (supervised children's playgrounds, repair shops, "click and drive" collection) or simply bars and restaurants – leading to the neologism "retailtainment."

We expect online retailers to continue to innovate. Among recent developments that have caught our eye is UK online clothing retailer ASOS plc trial of augmented reality to simulate how pieces of clothing look in different sizes fitted to different body types.

Online vs offline? Retailers will continue to develop multiple distribution channels

Retailers will continue to diversify how they get their goods to customers, with further multiplication of order and delivery possibilities, typically varying according to shopping habits in different countries. In this "omnichannel" world, the click-and-collect model has advanced rapidly across Europe, predominantly in the consumer electronics sub-sector and led by companies such as Germany's Ceconomy AG (BBB-/Stable) and France's Fnac Darty (BBB-/Stable). Among supermarket operators, the "drive" option – where customers order online and use their own vehicles to pick up goods from retailers' depots – is gaining ground.

The line between bricks-and-mortar and online retailing is increasingly blurred, as the example of Made.com illustrates. Its outlets operate purely as showrooms with purchases restricted to its online platform. Made.com argues that the advantages are those of better service, as sales staff can devote themselves solely to showcasing and explaining its products, smaller shops and the curiosity effect.

At the same time, the pressure on companies – retailers and FMCG suppliers – with large networks of physical stores will persist. US high-end musical-equipment supplier Bose plans to close its remaining 119 retail stores across North America, Europe, Japan and Australia in the months ahead, citing consumers' shift to buying its products online in those markets.

Downward pressure on prices remains intense

Retailers will find it hard to regain much pricing power in world of intense retail competition and the ease at which consumers can compare prices online. We expect retailers to extract extra profitability by squeezing their cost of goods sold. Large retailers notably in the food sector retain bargaining power over smaller and fragmented producers. For other consumer goods, bargaining power is often lower. One response is likely to be growth in the number of retail alliances to improve product procurement and sourcing beyond the grocery sector where they are already common. These initiatives might bear fruit with small- to medium-sized FMCG companies, though retailers will struggle to extract price concessions from larger incumbents. Such alliances can enhance bargaining power as the Agecore alliance made up of European retailers Colruyt, Edeka, and Intermarché showed last year. But there are also regulatory and reputational risks for companies if there is suspicion of anti-competitive behaviour on the part of such alliances.

Balance of power in online marketplace is shifting

Amazon.com remains the world's dominant online retailer, but its business model and market share are more under pressure in Europe than they have been for some time. Swedish furniture and home-products supplier IKEA and sports-goods company Nike both want to get their products out of Amazon's marketplace to retain better control of their brands. For now, IKEA and Nike are outliers, but their plans suggest that companies with brands of significant size and consumer recognition can bypass the online middleman by selling directly to the end-customer. Alibaba, the Chinese-based online retail group, has approached some big-name brands through its European platform AliExpress with lower commission fees – said to be between 5-8% – than Amazon's whose fees range from around 7% to 15%. Amazon's leading position is far from being in danger, but growing alternatives for the end-customer in e-commerce in the past year suggest competition is heating up for the US giant.

Long lead times for retail sector capex puts premium on balance-sheet management in interim

Investment in multiple new formats and services could boost overall profitability in Europe's retail sector but only in the longer term. In the short term, the time-lag between developing, rolling out to new retail concepts and customers' reacting positively to them is matter of quarters, if not years, not weeks and months. Retailers' financial risk profiles are expected to remain under pressure given the pressure on margins and high investment needs.

Chief financial officers are likely to examine even more closely what constitute core assets and activities, disposing those which do not pass muster as the year progresses. Asset sales could free up funds for the capex needed to boost longer-term profitability. Several deals have been completed recently or are in the works: the UK's Kingfisher PLC's sale of its Iberian and Russian activities; France's Casino SA selling discount unit Leaderprice to Germany's Aldi, UK food retailer Tesco's divesture of its Asian activities.

A gap may open up between those deep-pocketed retailers willing to enter new markets - as privately held German discount-supermarket operator Lidl has done across Europe and more recently the US - and those under pressure to cut costs and reduce debt, typically through selective asset disposals to local players.

Financial risk-profiles under pressure: low interest rates help but debt is climbing higher

Accommodative monetary policy across Europe, notably the euro area, is supporting the financial risk profile of the retail sector as companies can refinance at often record low interest rates and extend repayment periods – hence buoyant activity on debt capital markets.

The catch is that such favourable refinancing conditions has dissuaded management from the more challenging task of selling assets to reduce borrowing so that the sector's level of net debt is rising, now not far from where it was in 2008 as a percentage of earnings before interest, taxes, depreciation and amortisation.

Making an overall appraisal of the financial risk profile for the whole industry remains difficult due to the large differences between individual retailers: varying degrees of reliance on operating leases or franchises, different degrees of omnichannel development, and strategies tailored to national customer habits.

Nonetheless, we retain our negative credit view on the overall industry as we expect further deterioration in profitability to put pressure on cash flow through 2020, thereby accentuating the gap between the high and less leveraged and the comfortably and marginally profitable retailers in Europe.

Annex I: Related research

"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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