FitchRatings

Corporates
Retailing
EMEA

What Investors Want to Know: European Retail Companies and Coronavirus

Non-Food Retailers Exposed to Greater Stress While Food Retailers Could Increase Online Efficiency

"All retailers need flexible supply chains, cost structures and capital allocation to weather the pandemic, whether they're fighting for survival or looking to emerge stronger. The crisis is also creating a divergence in the performance of traditional food retailers and discounters due to their differing approaches to online sales."

Manuel Gutierrez, Associate Director, Fitch Ratings

The Pandemic Reshapes Retail

The performance of European retail sub-sectors has diverged sharply since early March 2020 due to the widespread lockdowns and subsequent, gradual reopening since June. Revenue has grown quickly for food retailers and contracted sharply for most non-food retailers, as those deemed non-essential were forced to close their stores, with the exception of "do it yourself" (DIY) stores.

Non-food retailers have started to recover in 3Q20 as lockdowns and social-distancing measures ease. However, the pace of recovery will depend on consumers' willingness to return to stores and could vary significantly between sub-sectors. Food retail growth will remain fairly stable.

In addition, downward pressure on disposable incomes and higher unemployment will lead to delayed recovery prospects on the most cyclical retail categories and purveyors of high-ticket items, such as electricals or furniture.

Related Research

Global Economic Outlook – September 2020 (September 2020)

The Road Back: Post-Lockdown Assumptions for Global Corporates (June 2020)

Coronavirus Spurs Retail Re-Engineering, Store Property Changes (May 2020)

European Food Retailers' Coronavirus Costs Offset Higher Sales (April 2020)

What Investors Want to Know: Coronavirus and EMEA Retail Property Portfolios (June 2020)

Analysts

Manuel Gutierrez
+34 91 076 1980
manuel.gutierrez@fitchratings.com

Edoardo Danieli
+44 20 3530 1830
edoardo.danieli@fitchratings.com

Sophie Coutaux
+33 1 44 29 91 32
sophie.coutaux@fitchratings.com

Pablo Mazzini
+44 20 3530 1021
pablo.mazzini@fitchratings.com

Are All Retail Segments Equally Exposed?

Fitch Ratings has had a negative outlook on the non-food retail sector since 2016 due to challenges including e-commerce competition, evolving consumption patterns, and distribution and delivery issues. The pandemic has magnified all of these factors and caused a collapse in demand for some sub-sectors. Store-based retailers in areas whose governments imposed strong lockdowns have been most affected. However, the impact has been broad and has resulted in several negative rating actions across the sector.

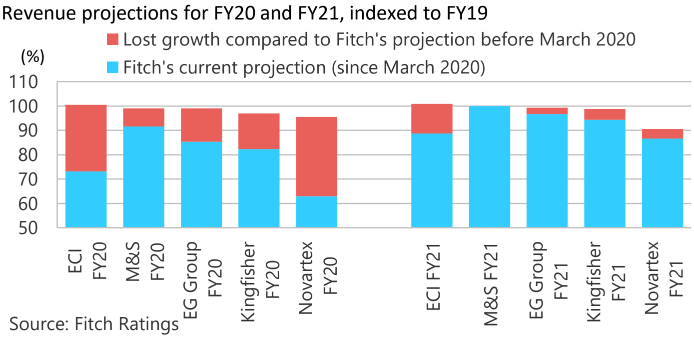
That said, there are clear differences in the scale of the impact and the pace of recovery between segments. More discretionary retailers, particularly clothing, are likely to have seen the sharpest drop in sales and will take the longest to recover. This segment was already facing the most disruption from e-commerce, with several ratings at low sub-investment-grade levels. In August 2020, New Look Bonds Limited (C) announced a comprehensive new financial restructuring and company voluntary arrangement (CVA) on its lease portfolio and other creditors.

Pharmacies and fuel distribution will experience a smaller impact as they are less discretionary, especially as people resume long-distance driving. Home furnishings and DIY retailers also appear less affected for now and will experience some offsetting demand as many people continue to spend more time at home. Across all segments, retailers with strong e-commerce capabilities have outperformed peers in lockdown and are better-placed for growth as economies reopen.

The chart below shows our predicted revenue impact for selected non-food retailers. We expect 2021 revenue to remain below 2019 levels in almost all cases.

Rating-Case Projections Before and Since March 2020

Revenue projections for FY20 and FY21, indexed to FY19

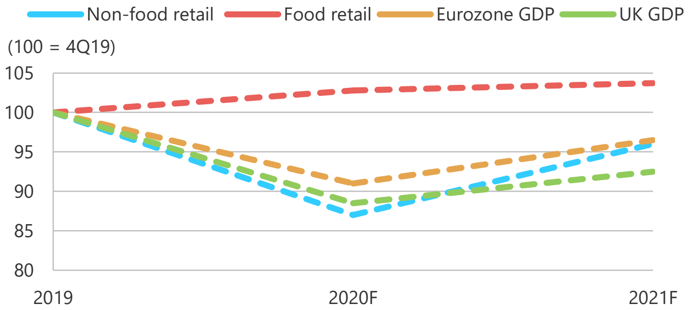


Source: Fitch Ratings

What Will Drive Revenue in 2H20 and 2021?

We expect 2Q20 results to have been the worst ever experienced by non-food retailers due to the unique nature of the crisis (including forced lockdowns) compared to a more normal recession. We expect this will be followed by a weak rebound due to higher unemployment and weak wage growth.

GDP versus Retail Revenue



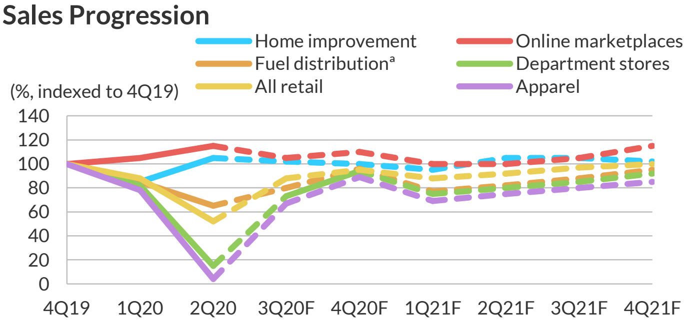
Source: Fitch Ratings

The relaxation of lockdowns and reopening of stores means there should initially be a sharp recovery in 3Q20. However, the pandemic will continue to weigh heavily on the sector, meaning a recovery to 2019 levels will not happen before 2022 in most segments.

Consumer spending will be hit by lower incomes and job losses in many sectors. Consumer behaviour will also be a big factor as some people will not be comfortable returning to stores. The scale of this impact may also vary between locations. For example, customers may be quicker to return to less densely-packed high street shopping centres while avoiding large destination malls, especially those served by public transport. We expect non-food retail revenues in 2021 to be 5%-10% below 2019 levels (excluding online). Apparel will be the most affected sub-sector, with sales in 2021 likely to be 15% below 2019 levels.

However, we expect e-commerce to continue to capture some of the lost demand. Depending on platform efficiency, e-commerce operations will yield double-digit growth in 2020. Retailers could also experience short-term benefits from inventory sell-offs and postponed purchases, although this is unlikely to offset the overall revenue decline compared to 2019.

Sales Progression



[a] Sales measured by fuel volume
Source: Fitch Ratings

How Will Profits Evolve for Non-Food Retailers?

Profit evolution will depend on post-lockdown measures and will vary by country. Yet again, however, pressure will be greatest in sectors already disrupted by online competition.

Social-distancing measures, including cashier closures and the need to maintain space between customers, will effectively limit the capacity of stores, reducing physical sales density and dampening efficiency levels. This will take its toll on profit margins unless retailers can take advantage of online sales. Generally, margins in brick-and-mortar stores will be lower in almost all sectors, with the exception of fuel retail (where higher fuel margins could offset falling retail profits).

We expect that the profit margins of clothing and accessory retailers will be most affected. However, the magnitude will differ greatly depending on the flexibility of issuers' cost structures including, but not limited to, the renegotiation of lease structure.

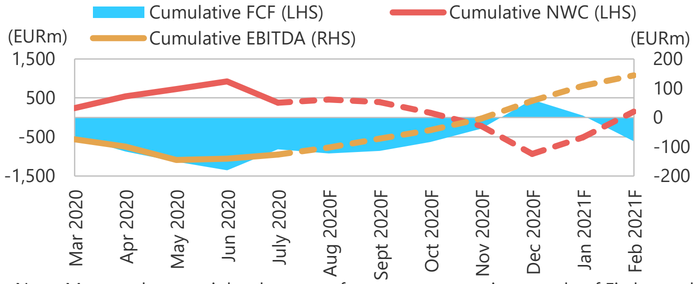
E-commerce operators, despite enjoying top-line growth, are not insulated from profitability challenges. Logistics costs are likely to grow faster than revenue, especially for those companies with limited capacity headroom. Further margin compression could come from higher customer returns (including returns of purchases made during lockdown). E-commerce retailers could also see a shift in sales mix away from high-end products as consumer spending deteriorates, which would put further pressure on margins.

Can Cash Flow Cushion the Impact?

All Fitch-rated retailers have demonstrated some flexibility in their capital-allocation policies due to the current extraordinary circumstances. Measures have included the suspension of shareholder distributions and reductions in capex. We have cut our 2020 capex assumptions by around 50% compared to pre-pandemic assumptions, other than spending related to e-commerce or logistics development.

However, many retailers, such as El Corte Ingles, S.A. (ECI; BB+/Negative) or the clothing and home division of Marks and Spencer Group plc (M&S; BB+/Stable), will also face a significant working-capital impact and may have less ability to respond. Some segments, critically clothing retailers, usually have to place committed orders two to three months in advance. They have therefore been in the position of having to pay for merchandise while their revenues are collapsing, or had to be quick to renegotiate payment terms and timing with suppliers. Those with agile logistics and rapid inventory turnover will be able to manage the situation better. However, we expect intra-year net working-capital fluctuations to be the main driver of these companies' cash burns.

Cumulative Intra-Year Free Cash Flow to be Funded



Note: Measured as a weighted average from a representative sample of Fitch-rated entities. NWC = net working capital. Source: Fitch Ratings

Companies whose stock is not seasonal, such as furniture retailers, have more flexibility to respond as they can cancel purchase orders for the next few months and sell their inventories with some delay.

What Are the Implications for Liquidity and Leverage?

Non-food retailers moved quickly to shore-up their liquidity in the early days of the crisis. Higher-rated investment-grade retailers and stronger sub-investment-grade retailers, such as ECI, were able to strengthen their liquidity in March via new revolving credit facilities or short-term loans.

Retailers that had challenged business models and fundamentally weak credit profiles entering the crisis have much more stretched liquidity, reflected in rating actions in the past few months. These include the downgrade of New Look in April 2020 to 'CC' from 'CCC+' due to near-term liquidity concerns and the subsequent downgrade to 'C' in August 2020 on the company's news of a comprehensive new debt restructuring. We also downgraded Novartex SAS to 'C' from 'CC' in April due to its announcement of a safeguard procedure that we treat as a distressed debt exchange.

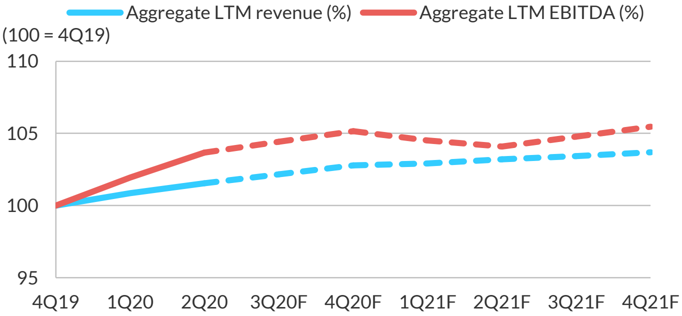
The sharp decline in revenues, weaker margins and higher debt will together push leverage higher in 2020 for all non-food retailers, to various degrees. It will probably take two to three years for leverage metrics to return to their previous paths.

How Will Food Sales Evolve After a Strong 1H20 and Are Profit Margins Structurally Affected?

Food retailers' strong performance in 1H20 is in marked contrast to the non-food sector. Record sales in the period were driven by stockpiling and reduced eating-out. However, the profitability of many food retailers will be diluted by extra expenses and a greater share of online sales, which have structurally lower margins.

Typical pandemic-related incremental costs include extra personnel, the emergency roll-out of online capabilities, cleaning, disinfection, cashier-protection and extra packaging.

Aggregate Metrics of Tesco, Ahold and X5



Source: Fitch Ratings

We expect sales growth to normalise in 2H20. In particular, the UK government's "Eat Out to Help Out" subsidy scheme, which was implemented for a few days a week throughout August to help revive consumer confidence in eating out in restaurants and pubs, will lead to weaker normalised (or like-for-like) food retail sales in comparison with August 2019 figures.

Sales in 1H21 are likely to show some correction due to the high base effect, but overall we believe that part of the sales gained by the food retail channel (due to the decline of the restaurant sector) will be retained as consumers are likely to continue to eat out less often in 2021. Pressure on margins will probably continue in 2021 but the scale will depend on how long social-distancing measures remain in place and whether the rise in online sales is permanent.

How Would a Second Wave of the Pandemic Affect Retail?

Our forecasts do not assume a second wave of infection that leads to widespread (or nationwide) lockdowns. If this were to happen, 2H20 retail revenues in affected countries could collapse again, potentially showing no recovery from 1H20 depending on the measures taken by authorities. The subsequent recovery would also probably be substantially slower due to even weaker consumer spending and more cautious behaviour.

The financial impact on retailers would depend on whether governments would extend or reinstate support programmes. However, a further significant round of rating actions would seem likely considering the impact on ratings from lockdowns in 1H20.

Localised lockdowns to combat a virus flare-up in individual towns or regions would have a much more limited impact. They would be unlikely to significantly change our forecasts, especially as most Fitch-rated retailers are geographically diversified within their countries of operation.

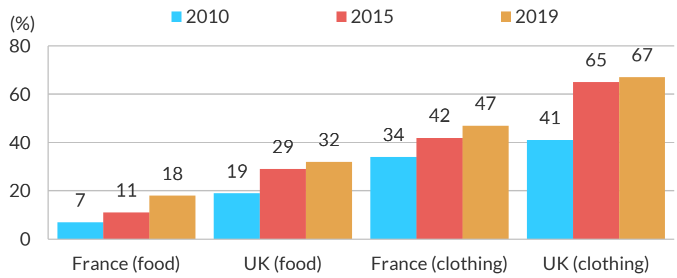
How Will the Pandemic Affect the Trend of Declining Retail Space in Europe?

Many retailers had already begun to close down excess space in less productive malls and stores prior to the pandemic. This trend of reducing physical retail space will broadly continue, although the consumer response to the pandemic could reshape retailers' plans.

In particular, consumers may begin to prefer more convenient retailers in less densely-packed locations, especially if a vaccine takes a long time to be developed. In this situation, high street stores would get a boost compared to destination malls and more affluent shopping destinations, slowing or reversing the trend of the past few years.

Store closures are likely to be most prevalent in sectors where online competition is already most entrenched, including clothing, footwear and electronics. The transition will be more measured in other segments. Retailers that are not under significant financial pressure may wait until they have a clearer view of the competitive landscape in 2021 before making big changes.

Share of Individuals Who Have Used Internet for Online Purchases in the Last Year



Source: Fitch Ratings, OECD

Will the Pandemic Have a Long-Term Impact on Food Retail Trends?

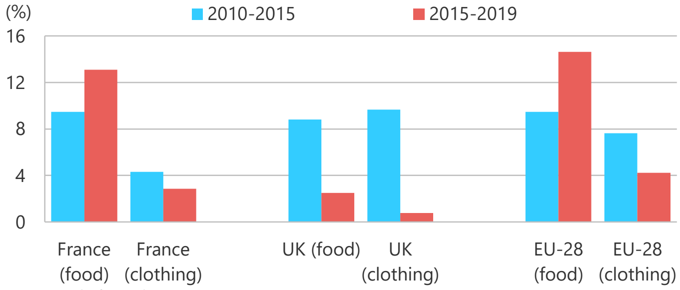
The large number of first-time online shoppers is likely to provide a significant boost to e-commerce sales penetration in the food retail sector. While growth has accelerated in the last few years, penetration is still much lower than other sectors.

The cost and complexity of e-commerce systems in food retail means companies that have already invested heavily, such as Tesco PLC (BBB-/Stable), Ahold Delhaize NV (BBB+/Stable) and Carrefour SA, have a significant advantage. Most discounters, on the other hand, don't have these services insourced. We therefore believe that after years of narrowing differentiation between traditional food retailers and discounters, the pandemic could create divergence in their outlooks due to their differing approaches to online operations.

Even retailers that have invested heavily have struggled to boost capacity during the crisis, with delivery slots often fully booked for days or weeks. The sustained success of retailers' platforms will therefore depend on their ability to adapt to record sales volumes through the online channel. The latest news that Tesco will create 16,000 jobs and utilise some of its large superstores as fulfilment centres for its online orders is testament to this trend.

The increase in online sales, if consolidated, could finally turn these largely dilutive operations profitable. Online sales have a strong proportion of variable costs if they are not automated, due to the high cost of store-picking solutions. Investment in automated warehouses, small fulfilment centres or other solutions, paired with increases in sales volumes, are therefore fundamental to drive this channel's profitability. This is especially important in light of the trend of decreasing basket sizes for online grocery orders, as experienced by some retailers such as Ocado Group Plc (B+/Stable) in the UK.

CAGR Relating to Individuals Who Have Used Internet for Online Purchases in the Last Year



Source: Fitch Ratings, OECD

Who Will Win and Lose in 2020 and 2021?

Non-Food Retailers

There are no clear winners in the non-food sector, although fuel is likely to be least affected as profits from higher fuel margins (as long as oil prices remain low or decrease further) should offset lower retail profits. Home improvement and DIY retailers also appear less affected for now, while electronics are moderately affected and apparel is the most severely affected.

Department stores in countries with the greatest online competition, such as the UK, will be greatly challenged by online alternatives, people's reluctance to return to shops, or their preference to spend money more wisely when buying products, either through the discount or outlet channel, or through consumer platforms, such as eBay Inc. (BBB/Stable). M&S continues to rapidly streamline its non-food store base – a trend already in place before the pandemic – with large exceptional charges related to staff redundancies. It is also redeploying resources more flexibly across its other divisions, mainly in food (post-partnership with Ocado) and online. A fast shift to food retail, away from higher-margin non-food categories, will structurally reduce M&S's profit margins, yet not necessarily affecting its cash flow generating capabilities.

The less-affected segment in non-food retailing relate to pure-play online retailers such as THG Operations Holdings Limited (The Hut Group; B+/Rating Watch Positive) or The Very Group Limited (B-/Stable) as they have been able to recruit new customers at lower costs during lockdown, thereby generating greater throughput that optimises logistic costs, which in turn protects their margins (excluding any fluctuations caused by changing business mix). However, The Very Group's highly leveraged balance sheet, leading to increased refinancing risks by 2022, and headwinds from potential asset impairments from its consumer book, led to the one-notch downgrade to 'B-' in May 2020.

Food Retailers

The impact is broadly neutral in food retail. Supermarkets and proximity (or convenience) stores will perform better than hypermarkets, although the divergence in their outlooks will be less clear than in the past five years.

Supermarket chains with well-entrenched online platforms, such as Tesco, are due to regain some market share from hard discounters (such as Lidl and ALDI) given their lack of online presence, although their continuing focus on low prices and ruthless cost management will still create a big competitive advantage over big chains. We expect Iceland Topco Limited (B/Stable) to benefit from a recessionary environment given its specialist and convenience-type profile. We therefore assume dynamic sales – 8% like-for-like sales growth in the financial year ending end-March 2021 (FY21) – and EBITDA progression. We see, however, some uncertainty on future sales growth due to its announced reduction of its capex programme.

Purely online food retailer Ocado will also perform well, following the establishment of a JV between its food distribution business and that of M&S. We expect the JV's profitability during lockdown to have been more protected than that of multi-channel peers.

Ocado's "Solutions" business has raised additional equity financing (up to GBP1 billion in June 2020) as it becomes a technology partner for food retailers globally. This will improve Ocado's financial flexibility and rating headroom under the 'B+' rating, against largely unchanged execution risks. We continue to project that Ocado's solutions business will achieve its EBITDA breakeven in 2023 at the earliest.

Proximity Stores and Medium-Sized Supermarkets Are Winning

	Footfall	Exposure to non-food	Online	Store location	Cost flexibility	Global view
Hypermarket	Negative	Negative	Positive	Negative	Negative	Negative
Supermarket	Positive	Neutral	Positive	Positive/ Neutral	Neutral	Positive
Proximity store	Positive	Positive	Negative	Positive	Neutral	Positive
Discounter	Neutral	Neutral	Negative	Neutral	Negative	Negative

Source: Fitch Ratings

Rating Actions in 2020

	Rating as of 29 February 2020	Current rating	Overall change
Ahold Delhaize	BBB/Pos	BBB+/Stable	Pos
Migros Ticaret A.S.	A+(tur)/Stable	AA(tur)/Pos	Pos
THG	B+/Stable	B+/RWP[a]	Pos
Iceland Topco	B/Stable	B/Stable	Neutral
Puma Energy Holdings Pte. Ltd	BB-/Stable	BB-/Stable	Neutral
Vivo Energy plc	BB+/Stable	BB+/Stable	Neutral
X5 Retail Group N.V.	BB+/Stable	BB+/Stable	Neutral
ECI	BB+/Pos	BB+/Neg	Neg
EG Group Limited	B/Stable	B-/Stable	Neg
Kingfisher plc	BBB/Neg	BBB-/Stable	Neg
M&S	BBB-/Neg	BB+/Stable	Neg
Mobilux 2 SAS	B/Stable	B/Neg	Neg
The Very Group	B/RWN[b]	B-/Stable	Neg
New Look	CCC+	C	Neg
Novartex	CCC	C	Neg

[a] Rating Watch Positive. [b] Rating Watch Negative. Source: Fitch Ratings