Ratings Methodology – Organized Retail Companies

CareEdge RATINGS AFRICA
A subsidiary of CARE Ratings Limited, India

Mauritian Retail Industry

The Mauritian retail industry has emerged as one of the most dynamic and fast-growing industries due to the entry of several new players in the recent times along with rising income levels, growing aspirations, favourable demographics and easy credit availability. The Mauritian retail industry is a mix of both organized and unorganized sectors, though it is gradually shifting toward more organized formats.

Rating Methodology for Organised Retail Industry

CareEdge Africa (CRAF) has a standard methodology for credit rating of companies belonging to Service sector. It encompasses an assessment of the various risk factors which could potentially affect the credit risk of an entity such as: economy and industry risk analysis, business risk, financial risk and management quality. However, considering the size and diversity of the service sector, CRAF has specific parameters that it assesses with respect to various industries within the sector. These parameters attempt to point out factors, over and above those mentioned in the broader methodology, that are considered while analysing entities belonging to a particular industry.

Factors considered by CRAF, along with their analytical implications, while arriving at the rating of an entity that operates in the retail segment have been discussed below.

A. Promoter & Management Evaluation

Management Evaluation

The success of a retailer is largely dependent on its ability to win consumer confidence and ensure consumer loyalty. The management's ability to analyse consumer behaviour and changing preferences and quickly respond through innovation and formulation of appropriate strategies remains the key to success in this sector. Experienced management and continuance of senior executives with the organization are also critical to the success of retail players.

For detailed management analysis, please refer to CRAF' Rating Methodology-Service Sector Companies on our website www.careratingsafrica.com.

B. Industry Analysis

CRAF' analysis of the industry risk focuses on the current industry scenario, demand-supply factors, the size of the industry, key players in the industry and competitive factors, cyclicality and seasonality, if any, associated with the industry, any regulatory policies, etc.

C. Business Risk

Market positioning

Organised retailing is a consumer-centric business, hence positioning of the retailer is a crucial factor. The retailer can be positioned into 'Value Retailing' and 'Life style Retailing'. 'Value Retailing' caters to essential needs of the consumer and is relatively immune to economic downturns as against 'Life-style Retailing'.

Value Retailing is a high-volume but low-margin business. In contrast, Life-style Retailing is a high-margin and low-volume business and also fosters higher customer loyalty with relatively low substitutes. Furthermore, higher-margin private brands portfolio across segments contributes significantly to the profitability of the players in this segment. Nevertheless, the Lifestyle retailer needs to have a judicious mix of private labels so as not to dilute the offerings as regards other brands. Analysis of a retailer's business segment, and the mix adopted by the player and its cash flow impact assume prime importance in a rating exercise. Cash flows of a Value retailer tend to be relatively more stable while those of Life-style retailer are relatively seasonal in nature, leading to impact on working capital requirements. Cash flow volatility is particularly important in this sector given the significant fixed nature of operating cost. Furthermore, 'Value Retailer' is less susceptible to economic cycles on account of value proposition and less discretionary nature of product offerings as compared with 'lifestyle retailer'.

Geographical presence and competitive position

CRAF analyses the market position of the player, geographical presence and ability to cater to local tastes by right product mix, pricing and the level of competition. Large scale of operations results in economies of scale and provides a competitive advantage with respect to pricing. Size not only boosts the bargaining power of a retailer while accessing quality real estate or 'anchor tenant' status but also provides it with better bargaining power with its suppliers. Moreover, presence across different formats (specialty stores, department stores, supermarkets, hypermarkets) and multiple segments provides the retailer with a competitive advantage.

Store Level Analysis

Operating parameters like same-store sales growth, sales per square feet, footfalls and conversion rate, average selling price, average transaction size, share of private labels, proportion of sales under customer loyalty program and shrinkage are some of the key indicators for assessing the operating efficiency of retail companies.

Access to real estate/Store ownership model

One of the major input costs for a retailer is lease rentals/land acquisition cost. Retailers with access to low-cost, quality real estate enjoy a considerable competitive advantage, both in terms of saving of major cost components and also the ability to expand more quickly. Ownership of the stores ensures business continuity especially in case of strategic locations and reduces the uncertainties of renewing re-negotiating of lease contracts. However, own stores require higher initial capital cost per square feet and entail larger exit cost (compared to lease option). In case of lease or revenue-sharing contracts or franchise model, multi-year leasing contracts entails sharing of risk and reward are evaluated to assess its impact on future cash flows and its associated impact on the entity's risk profile. CRAF also analyses rental cost to total sales of the company vis-à-vis other players. CRAF analyses 'anchor tenant' status of the retailer as it enables access to quality real estate at relatively cheaper rates as well as mitigate to an extent lease renewability risk.

Supply Chain Infrastructure

CRAF evaluates the supply chain infrastructure in terms of the integrated distribution, warehouse and transportation systems, as these factors have a direct bearing on the operational efficiencies and hence the profitability of a retailer. CRAF also evaluates the operating synergies of the rated company with group in terms of the sourcing, logistics & distribution system, etc.

Presence in e-retailing segment

The e-retailing industry, although small in size compared to overall retail market is growing at a fast pace. Though brick and mortar continue to be dominant, the retail is moving towards omni-channel model with growing preference. In order to combat the impact from online players, majority of brick and mortar players have also entered into online channels. CRAF recognises the increase in competition from established e-commerce players and the company's strategy in this regard.

D. Financial Risk

Capital Structure and Financial Flexibility

Retailers require significant funds for expanding stores' network as well as for refurbishment of existing stores. CRAF evaluates the capital mix used to fund these assets. Low leverage and comfortable debt coverage indicators are viewed positively, and aggressive debt-funded expansion is considered adverse from a rating perspective. The company's ability to generate sufficient internal accruals and/or raise timely equity and/or debt, if required, to meet its capital expenditure is one of the key rating factors. Also, strong parentage would result in enhanced financial flexibility. CRAF also analyses off-balance sheet exposures of the company and adjustments are made to the accounts, wherever necessary.

Inventory and working capital management

As retail business is highly working capital intensive in nature mainly on account of high level of inventory required to be maintained to ensure ready availability of stock, inventory management assumes importance. Inventory management encompasses the ability to determine and maintain optimal inventory level, right offerings and minimizes shrinkage. Lifestyle retailers need even more working capital funds due to the big-ticket items held as stock. CRAF understands the management policy on stocking inventory on 'outright purchase' or 'sales or return basis'. Although the 'Private label portfolio' and 'outright model' have higher margins vis-à-vis other business models, they entail higher working capital requirements and also carry inventory obsolescence risk. Besides, quality of inventory in terms of its aging schedule (wherever critical) in the context of changing needs of the consumers is analysed.

Some of the retail units being a seasonal business, the retailers need to maintain higher stocks during certain part of the year. The liquidity with the retailer helps the company to maintain higher inventories as well as meet any temporary cash flow mismatch. CRAF analyses the liquidity available to a retailer in the form of liquid assets/unutilised bank limits.

Operating Cash flows and Debt protection measures

Cash flow analysis forms an important part of credit rating exercise. The ability of the company to generate healthy positive operating cash flows is very critical. Cash accruals vis-à-vis debt levels and other debt protection measures like interest coverage ratio, Debt/ EBITDA, Debt Service coverage and total debt/cash flow from operations are examined. Furthermore, analysis of sensitivity of these factors to adverse change in assumptions is also carried out.

Conclusion

The rating outcome is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CRAF analyses each of the above factors to arrive at the overall assessment of credit quality of the Issuer.

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About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and CRAF (Africa) Private Limited (CRAF) is the first credit rating agency to be licensed by the Financial Services Commission of Mauritius in May 2015. It is also recognized by Bank of Mauritius as External Credit Assessment Institution (ECAI) from May 2016. CRAF is also licensed by Capital Markets Authority of Kenya to operate as a Credit Rating Agency in Kenya. CRAF intends to expand across other geographies in Africa with Mauritius as its hub of operations. With an equitable position in the Mauritius capital market, CRAF (Africa) Private Limited provides a wide array of credit rating services that help corporates to raise capital and enable investors to make informed decisions backed by knowledge and assessment provided by the company.

CRAF's shareholders are CRAF Limited, African Development Bank, MCB Equity Fund and SBM (NFC) Holdings Limited.

CRAF gets its technical support in the areas such as rating systems and procedures, methodologies, etc. from CRAF Limited on an ongoing basis. CRAF Limited, with an established track record of rating companies over almost three decades, follows a robust and transparent rating process that leverages its domain and analytical expertise backed by the methodologies congruent with the international best practices.

CRAF's Rating Committee consist of full-time members comprising of Senior Rating officials from CRAF Limited and a panel of experienced professionals from Mauritius and African Development Bank.

CRAF has had a pivotal role to play in developing bank debt and capital market instruments including MMIs, corporate bonds and structured credit.