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## Research Update:

# Retailer Auchan Downgraded To 'BBB' On Weaker Profitability And Credit Metrics; Outlook Stable

### Primary Credit Analyst:

Mickael Vidal, Paris + 33144206658; mickael.vidal@spglobal.com

### Secondary Contacts:

Solene Van Eetvelde, Paris + 33144206684; solene.van.eetvelde@spglobal.com

Raam Ratnam, CFA, CPA, London + + 442071767462; raam.ratnam@spglobal.com

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## Research Update:

# Retailer Auchan Downgraded To 'BBB' On Weaker Profitability And Credit Metrics; Outlook Stable

## Overview

- Auchan, a French retailer with established market positions in several countries, has reported a substantial drop in profitability, resulting in a significant deterioration in the group's credit metrics.
- Trading conditions in Auchan's core markets are highly challenging, marked by intense price competition, structural shift away from hypermarkets, and increased digital penetration.
- The capital expenditure-intensive, profound transformation Auchan is undergoing to keep abreast of these trends could entail significant restructuring costs, and will increase leverage and further weigh on its credit metrics.
- We are therefore lowering our long-term issuer credit rating on Auchan to 'BBB' from 'BBB+'.
- The stable outlook reflects our expectation that the group's established market positions in various geographies, as well the rapid development of its real-estate subsidiary, will enable it to implement its turnaround plan to stem the decline in its profitability, in particular around the French hypermarkets, and in Russia.

## Rating Action

On March 16, 2018, S&P Global Ratings lowered to 'BBB' from 'BBB+' its long-term issuer credit ratings on France-based international retailer Auchan Holding. At the same time, we affirmed our 'A-2' short-term issuer credit rating.

In addition, we lowered the rating on Auchan's senior unsecured debt to 'BBB' from 'BBB+', in line with the issuer credit rating.

## Rationale

The downgrade primarily reflects the substantial EBITDA margin contraction that Auchan experienced in its key French, Russian, and Italian markets in 2017. This resulted in its S&P Global Ratings-adjusted EBITDA margin dropping by 70 basis points year-on-year to 5% in 2017, with the adjusted EBITDA declining by 11% in 2017 to €2.27 billion. The weaker earnings, alongside capital expenditures (capex) of about €1.7 billion and higher dividend

payments, resulted in an increase in adjusted debt by nearly €0.5 billion, to €6.3 billion.

Market conditions in France continue to be challenging, the group's performance in Italy has been consistently weak, and operating profitability in Russia strongly declined in the second half of 2017 because of continuing difficult macroeconomic conditions there. For Auchan, this has resulted in lower footfall and lower sales than anticipated, in turn weighing on operating margins. This was particularly the case in France, where the group's relatively high exposure to the very price sensitive hypermarket store formats led to a 30% decline in reported profitability and demonstrated a level of volatility considerably higher than what we had initially anticipated.

Equally, the group's underperformance in Russia contrasts with its record there in 2016, where it maintained healthy profitability in already challenging macroeconomic conditions. We expect, however, that the current modest economic recovery in Russia, as well as a repositioned commercial offer there, could help stabilize margins, thanks in particular to Auchan's strong No.3 market share.

In Italy, we believe Auchan is facing longer-term challenges, owing to a very localized Italian market, varying level of wealth that make it difficult to apply a one-size-fits-all strategy.

We anticipate moderate like-for-like sales performance for Auchan, as price competition in its key markets remains intense. In our view, despite its entrenched market position in several markets, the group will find it tough to reverse, on a sustainable basis, operating trends that are constraining its sales, market share, and profitability.

Although we think the group's adjusted EBITDA margin should stabilize and gradually improve from its 2017 level over the next 24 months to around 5.2% on back of its transformation plan, it is unlikely to result in improved credit metrics in the next two years. This is because we expect additional debt-funded capex to support the transformation plan over the next two years as it continues its diversification away from the hypermarket format and expansion into the convenience-store format, along with the related strengthening of its logistics platform.

The group's investments will also allow the expansion of its omnichannel capability, in particular as it aims to increase the share of digital sales in its offerings, expand into convenience retail, and also continue the expansion of its network in China and Russia. We view as positive Auchan's new commercial strategy to expand its network of convenience stores in all large cities where it is present, given the structural shifts in consumer behaviors. That said, we believe that Auchan might find it challenging to significantly increase its share of proximity formats, due to late entry into that segment, given some competitors' established positions there, in particular in France and Spain, where Casino and Dia hold strong positions.

Auchan has solid market positions internationally, albeit with a lower market position in its home market where it is the fifth-largest player with a 10.7% market share (as per Kantar Worldpanel). In particular, we also incorporate in our analysis the group's strong No.2 position in China, which we expect to strengthen further, thanks to the recently announced partnership with Alibaba, whereby Alibaba took a 36.16% stake in Sun-Art.

In our view, Auchan's Western and Eastern European operations are critical to our assessment of the group's credit quality, because Auchan has greater and more immediate access to cash and cash flows generated in these regions than to those in Russia and China. Auchan has more access to cash at its Russian subsidiary because it fully owns it. We also expect the group to receive moderate but growing dividends from its Chinese operations, which are posting healthy growth and margins as well as moderate but increasing cash flow generation.

The group's weakening free operating cash flow (FOCF), alongside increased dividend distribution, led to an increase in adjusted debt to €6.3 billion, causing a pronounced deterioration in credit metrics on a proportional basis: adjusted debt to EBITDA of about 2.8x and funds from operations (FFO) to debt of 29.7% in 2017, down from 2.3x and 36%, respectively, in 2016. Furthermore, the group's debt-funded expansion and transformation plan will ultimately weigh on the group's credit ratios. Under our base case for 2018, we forecast on a proportional basis that Auchan will still post FFO to debt below 30% and adjusted net debt to EBITDA of just below 3x. Auchan's relatively weak FOCF and discretionary cash flow-to-debt ratios continue to constrain its financial profile.

We continue to analyze Auchan's credit ratios on a proportional basis to better reflect our view of the group's limited access to cash originating from China, even though the group changed its reporting under IFRS in 2014 to fully consolidate its Chinese operations. While not affecting our view of Auchan's credit ratios, we equally also take into consideration Sun-Art's robust and growing market capitalization of about €9 billion, only €4 billion below that of much bigger Carrefour (€13.2 billion as of Feb. 28, 2018). That said, we deem a partial disposal very unlikely, as it would result in a loss of control to partner Alibaba.

Our rating on Auchan also benefits from the group's resilient and well-positioned property management portfolio through its fully owned subsidiary, Immochan. The assets in this portfolio have a market value of €8.3 billion based on third-party evaluation as of end-December 2017 and lend the group substantial operational and financial flexibility, which we consider a strong differentiating factor against peers. The group also intends to invest a large part of its capex in the development of Immochan's operations internationally, to help support its turnaround plan.

In our base case for Auchan, we assume:

- In France, we expect GDP to grow by 1.8% in 2018 and 1.7% in 2019, against 1.6% in 2016, on the back of higher private investment and the

better flexibility in the labor market introduced by the new government. We anticipate inflation of 1.3% in 2018 and 1.5% in 2019, compared with 1.2% in 2017.

- Pending adoption of new legislation in France that should impose a minimum gross margin of 10% on food retailers for each food item and put a cap on promotions. This new law could be relatively positive for the sector by easing somewhat the competitive pressures on prices for certain product categories. That being said, we remain cautious, as, in our view, ongoing price competition and competitive activity will likely curtail any meaningful upside in our forecasts.
- Generally stable GDP growth rates in Western Europe in 2018 and 2019 (2.7% in Spain and about 1.5% in Italy), with a pick-up in inflation to 1.2%-1.7%.
- A moderate improvement in Russia, with GDP growth of 1.8% in 2018 and 2.0% in 2019, but with inflation declining from 3.7% to 3.1% in 2018.
- In China, GDP growth of about 6.5% in 2018, down from 6.8% anticipated in 2017, with inflation, however, moving to 2.2% from 1.6%.
- Ongoing transformation of hypermarkets stores and openings of more convenience formats.
- These macroeconomic conditions, together with the store development plan above, should support the top line, with revenue growth rates of about 2% over the next two years, although in our view competitive conditions in the food retail market and potential for cost inflation could constrain any meaningful uplift to the group's margins.
- Top line is further supported by stabilization in Russia, thanks to a redefined commercial strategy that should foster organic growth and profitability, 2%-5% growth in China, stemming from store network expansion, but also from e-commerce growth, notably thanks to partnership with Alibaba. Price pressure in France and the still challenging market conditions and networking optimization in Italy will weigh on revenue generation.
- A reported EBITDA margin remaining at 4.7% for 2018, stable from the 2017 level, and down from 5.1% in 2016. This should translate to adjusted EBITDA margin of 5.2%-5.5% in 2018 and 2019, depressed by a still competitive environment in France, which may improve thanks to the new price regulatory framework which will likely take effect before the end of 2018. We also expect the impact of the transformation plan and of the expansion to further weigh on margins in the short term.
- Moderate working capital contribution to FOCF, stemming from tighter inventory controls, on the back of the supply chain reorganization.
- Elevated capex in excess of €2.5 billion annually in 2018 and 2019, with more contained shareholder remuneration, however.

Based on these assumptions, we arrive at the following credit measures:

- On a proportional basis, adjusted debt to EBITDA of about 2.8x-3.0x,

together with FFO to debt of 25%-30% in 2018 and 2019.

- Adjusted debt to EBITDA of about 2.3x and FFO to debt of approximately 35%, taking into consideration 100% of Chinese operations as reported.
- Negative FOCF in both 2018 and 2019 to fund the transition toward omnichannel and digital.

## **Liquidity**

We view Auchan's liquidity as adequate and calculate that liquidity sources will likely exceed liquidity needs by more than 1.6x over the next 12 months. While the amounts below reflect reported accounts, which consolidate 100% of Sun-Art, despite Auchan owning only 36% of the economic interest, we believe that our assessment is broadly reflective of actual cash flow circulation, as we estimate those operations and cash generated from China, while growing steadily, do not contribute meaningfully yet to the groups cash flow generation. Additionally, even deducting cash held in China and FFO and capex linked to Chinese operations, liquidity would remain commensurate with our adequate assessment.

Principal liquidity sources as of end-December 2017 include

- €2.6 billion of cash;
- €2.5 billion of undrawn credit lines expiring in more than 12 months; and
- €2.1 billion of reported FFO forecast over the next 12 months.

Principal liquidity uses as of end-December 2017 include:

- €1.3 billion of short-term and long term debt that we expect to be rolled over;
- €1.2 billion of working capital seasonality;
- €1.6 billion of maintenance and remodeling capex; and
- €0.3 billion of dividends.

## **Outlook**

The stable outlook reflects our expectation that, despite a highly challenging trading environment, the group will implement its turnaround plan to stem the decline in its profitability, in particular with regard to the French hypermarkets, and adopt a new commercial strategy in Russia. Taking into account Auchan's focus on the acceleration of growth capex to increase the number of its convenience stores, prop-up its supply chain capabilities, and develop Immochan real-estate portfolio, we expect reported FOCF will turn negative in 2018.

We anticipate that the group's margins will stabilize broadly at current levels, and that it will implement a financial policy that balances investment and dividends, consequently maintaining on a proportional basis adjusted debt to EBITDA at around 3x and adjusted FFO to debt at about 25%-30% in 2018 and

2019.

### **Downside scenario**

Although unlikely at this stage, we would consider a negative rating action if weak execution of management's operating plan, a lukewarm market environment in Russia or France, or highly competitive trading conditions resulted in further material deterioration of Auchan's operating performance, margins, or liquidity.

In such a scenario, the trend of like-for-like sales growth will become more significantly negative and squeeze reported EBITDA margins, triggering a further contraction of 100-120 basis points to less than 4%. In the absence of tangible financial policy measures to reduce debt under such conditions, on a proportional basis adjusted FFO to debt would likely fall toward 20% and adjusted debt to EBITDA of about 4x.

### **Upside scenario**

Owing to margin pressures, the high level of adjusted debt, and our forecast of negative free cash flow generation, we consider an upgrade of Auchan unlikely over the next two years. Auchan continues to invest, which will likely curtail any meaningful improvement in its credit metrics.

We might consider upgrading Auchan if the company built a sustainable track record of like-for-like growth and rising profitability in all its markets, notably in France, as well as in Italy and Russia. This would also be conditional on improving credit ratios on a proportional basis, with FFO to debt sustainably above 30% and adjusted net debt to EBITDA materially below 3x and free cash flow generation back to positive territory.

## **Ratings Score Snapshot**

Issuer Credit Rating: BBB/Stable/A-2

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: BBB-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)

- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Positive

## **Issue Ratings--Subordination Risk Analysis**

### **Capital structure**

Excluding debt issued by Oney Bank, Auchan's capital structure consists of about €5.1 billion of issued bonds and bank debt essentially taken on by the group's financing vehicle company, Auchan Holding.

### **Analytical conclusions**

Excluding Oney Bank-dedicated financing, Auchan capital structure's consists of senior unsecured debt primarily comprising bonds and notes.

We rate Auchan's debt at 'BBB', the same as the issuer credit rating, as no significant elements of subordination risk are present in the capital structure.

## **Related Criteria**

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Retail And Restaurants Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

### Downgraded

	To	From
Auchan Holding		
Long-Term Issuer Credit Rating	BBB/Stable--	BBB+/Stable--
Senior Unsecured	BBB	BBB+

### Ratings Affirmed

Auchan Holding		
Auchan Coordination Services S.A.		
Short-Term Issuer Credit Rating	--/--/A-2	
Auchan Holding		
Commercial Paper	A-2	

### Additional Contact:

Industrial Ratings Europe; Corporate\_Admin\_London@spglobal.com

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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