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## Research Update:

# Retailer Auchan Outlook Revised To Negative On Weaker Profitability; 'BBB' Ratings Affirmed

### Primary Credit Analyst:

Mickael Vidal, Paris + 33 14 420 6658; mickael.vidal@spglobal.com

### Secondary Contacts:

Solene Van Eetvelde, Paris (33) 1-4420-6684; solene.van.eetvelde@spglobal.com

Raam Ratnam, CFA, CPA, London (44) 20-7176-7462; raam.ratnam@spglobal.com

## Table Of Contents

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Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Issue Ratings--Subordination Risk Analysis

Related Criteria

Related Research

Ratings List

## Research Update:

# Retailer Auchan Outlook Revised To Negative On Weaker Profitability; 'BBB' Ratings Affirmed

## Overview

- France-based food retailer Auchan's trading performance during the first half of 2018 was much weaker than we expected. Like-for-like sales were negative and reported EBITDA margins fell by 16.7% because of continued intense price competition affecting retail operations, aggravated by high restructuring costs and negative foreign currency (FX) effects.
- The sharp drop in profitability tests our view on the resilience of Auchan's business because we expect these trends will prevail and weigh on the group's profitability and cash flows until it starts to reap the benefits of its transformation plan.
- We are revising our outlook on Auchan to negative from stable and affirming our 'BBB' ratings.
- The negative outlook points to strong pressure on the group's market position and profitability, shown by continued weak top-line performance and a sharp decline in EBITDA margins despite various strategic and cost-management initiatives.

## Rating Action

On Sept. 19, 2018, S&P Global Ratings revised its outlook on Auchan Holding, the holding company of France-based food retailer Auchan, to negative from stable. At the same time, we affirmed our 'BBB/A-2' long- and short-term issuer credit ratings on the company.

We also affirmed our, 'A-2' short-term issuer credit rating on Auchan's subsidiary, Auchan Coordination Services S.A.

Additionally, we affirmed our 'BBB' long-term issue rating on Auchan's senior unsecured debt, and 'A-2' short-term issue rating on the group's commercial paper.

## Rationale

The outlook revision reflects our expectation that it will be difficult for Auchan to restore positive like-for-like growth and margin improvements over the next 24 months. Overall, reported EBITDA declined by 16.7% during the first half of 2018, with EBITDA on retail operations dropping 22% (19% excluding FX). This is one of the most pronounced declines among other

European rated peers, including Carrefour and Dia. The group's profitability suffered as a result of continuing high restructuring costs of about €112 million in the first half of 2018, explaining about 60% of the EBITDA drop in retail operations. Another 17% was related to negative FX trends, mostly arising from the Russian operations. However, in our view the results mainly reflect continued difficult market conditions that are weighting on both top line and profitability for many of the group's operations. We believe, transformation-related expenses and FX charges aside, EBITDA has dropped by €35 million from the first half of 2017, partly because of a weaker top line.

We expect the market conditions will continue to remain very challenging in its main geographies, particularly France. This will make it difficult, in our view, for the group to achieve its top line and EBITDA targets because it will have to invest even more in prices to restore its price perception and market share. In addition, the transformation plan entails significant restructuring charges that will affect profitability further in 2018 and 2019, although, we expect cost savings from these measures will partly ease the pressure from 2019 onward.

This, combined with evolving spending habits, will likely result in structurally lower levels of profitability. In our view, Auchan, like other physical retailers, will have to bear additional costs stemming from customers' preference for more frequent and smaller basket purchases, with a high focus on quality of service and products. Whilst retailers will have to maintain their physical network of stores to a high quality, they will also have to increase investments for last-mile deliveries as consumers increasingly adapt to e-commerce. Secondly, the popularity of fresh and organic food and local sourcing of food products is likely to increase purchasing costs that retailers may find difficult to pass on to customers in such a competitive landscape.

In its home market France, Auchan (like its peers Carrefour and Casino) faces intense price competition from the market leader, E. Leclerc, which holds a 21.1% market share (Kantar WorldPanel) and benefits from a strong price perception. Auchan is most heavily skewed toward the hypermarket format, which is under greater pressure, because of declining traffic, as consumers are increasingly shopping through convenience stores and online channels. According to Kantar, from March 2018 to August 2018, Auchan slipped to sixth position from fifth, to a 10.3% market share from 10.7%.

In its international operations, the group has recorded another weak performance in both Russia and Italy, two of its very significant markets. Its Chinese operations, historically the second biggest contributor to sales on a consolidated basis, have grown at a slower pace because of heavy investments there during the first half of 2018 weighting on its profitability. Auchan's effort to consolidate its No. 2 position in the Chinese market, through a rapid expansion in convenience and a partnership with Alibaba, should bear fruit and drive rapid top line and EBITDA growth. In Russia, although we anticipate a challenging second half of the year, we expect the group will restore traffic thanks to a renewed commercial strategy. In contrast, the

potential for any near term improvements in Italy seems limited. Auchan is facing longer-term challenges, owing to a very localized Italian market and varying levels of wealth that make it difficult to apply a one-size-fits-all strategy.

The group's ability to turn around international operations will be critical, in our view. Historically, Auchan's solid market positions internationally have compensated for its declining position in its home market. We also believe the group's other geographies are not immune to increasing competitive pressures, in particular Spain, which could render the turnaround even more complicated.

That said, the group is currently implementing some measures aimed at turning around all of its poor performing geographies, including France, and has posted encouraging sales figures for the stores that have been remodelled or converted to the single Auchan banner. We expect 2018 will be a transition year and the results of the restructuring and repositioning of operations will be clear beginning in 2019.

We anticipate a flat 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.

We think the group's adjusted EBITDA margin should gradually recover from the first half of 2018 over the next 24 months to about 4.5% on the back of its transformation plan. However, we expect credit metrics will deteriorate in the next two years because of related additional debt-funded capital expenditure (capex). That said, we believe the group has some financial flexibility under our current assessment to roll out its expansion plan, assuming no further top line and margin erosion from levels during the first half of the year.

Auchan's transformation plan includes continued 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 omni-channel capability, in particular because 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 Auchan's new commercial strategy to expand its network of convenience stores in all large cities where it is present as a positive, given the structural shifts in consumer behaviors.

That said, results for the first half of 2018 seem to indicate that it is quite challenging for Auchan to significantly increase its share of proximity formats, because of its late entry into that segment, given some competitors' established positions, in particular in France and Spain, where Casino and Dia hold strong positions. Management is also focused on restoring traffic in

hypermarkets, through not only a more competitive price positioning, but also a renewed non-food strategy with the development of private-label offering deemed to be more margin accretive. We note, however, that this strategy tends to differentiate Auchan from that of peers that are generally trying to move away from non-food.

Lastly, the group dedicates an important portion of its investments to the fast-growing and high-margin real estate and property development business Ceetrus. This is the group's second-biggest EBITDA contributor after China's retail operations, with about €667 million of revenues generated in 2017 and €426 million of EBITDA (and the largest contributor if we only take into account the 36.18% stake Auchan has in Sun-Art).

After credit metrics deteriorated in 2017, (debt to EBITDA on a proportional basis weakened to about 2.8x from 2.3x in 2016), we expect the group's debt-funded expansion and transformation plan will weigh further on the group's credit metrics. In the context of weakening profitability, under our revised base-case scenario for 2018, we forecast Auchan will post funds from operations (FFO) to debt of about 23%-24% (down from 27%-29% in our March 2018 base-case) and adjusted net debt to EBITDA of about 3.5x (from about 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 International Financial Reporting Standards in 2014 to fully consolidate its Chinese operations. While not affecting our view of Auchan's credit ratios, we equally consider Sun-Art's robust and growing market capitalization of about €9 billion, only €3 billion below that of much bigger Carrefour (€12.6 billion as of Sept. 12, 2018).

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, and also because the vast majority of the group's debt is located in Western Europe and is euro denominated. That said, in comparison with in China, Auchan has more control of its Russian subsidiary because it fully owns it. We also expect the group will receive moderate but increasing dividends from its Chinese operations, which we expect will post healthy top line and EBITDA growth as well as moderate but increasing cash flow generation.

Our rating on Auchan also benefits from the group's fast growing and high margin real-estate subsidiary Ceetrus (previously Immochan). This business line is quite capex intensive, but it has so far translated into a portfolio of assets valued by third parties at €8.3 billion as of December 2017. This lends the group substantial operational and financial flexibility, which we consider a strong differentiating factor from its peers. We also note that Ceetrus assets are not hypermarkets and the rentals in these properties are

not linked to the same footfalls as Auchan's hypermarkets.

In our base-case scenario for Auchan, we assume:

- More muted GDP growth than initially anticipated in France of 1.7%, with inflation of 1.8% in 2018.
- The French government may adopt a proposed law imposing a minimum gross margin of 10% for each food item and put a cap on promotions by food retailers. The draft law aims to ease competitive pressures on prices for certain product categories. However, we consider ongoing price competition and competitive activity will curtail any meaningful upside in our forecasts. We also expect the competition will move on more qualitative grounds in France (next hour delivery, click and collect, or "Pedestrian Drive" development of a scarce organic offer), which are likely to incur more costs.
- Generally stable GDP growth rates in Western Europe of about 2% in 2018 and 1.8% in 2019 (2.8% in Spain and about 1.3% in Italy), with a pick-up in inflation to about 1.7%- 1.8%.
- A more gradual recovery in Russia, with GDP growth of 1.6% in 2018, from 1.8% initially anticipated and 1.7% in 2019 from 2.0% anticipated, with inflation declining from 3.7% to 3.1% in 2018.
- In China, GDP growth of about 6.5% in 2018, down from 6.9% achieved in 2017, with inflation, however, moving to 2.4% from 1.6%.
- Ongoing transformation charges of about €220 million for the next 18 months, in particular related to the revamp of hypermarkets stores and openings of more convenience formats.
- Increasing online penetration likely to weigh substantially on margins, because physical retailers have to reshuffle their supply chain, ensure the costly last-mile delivery, and maintain an important store network.
- These macroeconomic conditions, together with the store development plan above, should help to limit the top line erosion in 2018 and result in a 1.5% growth 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.
- In our base-case, we expect top line will stabilize gradually in Russia thanks to a redefined commercial strategy that should foster organic growth and profitability from 2019, and a 2%-5% growth in China stemming from store network expansion, but also from e-commerce growth, notably because of its partnership with Alibaba. While we expect EBITDA will increase in China, we believe the group's current strategy will result in structurally lower margins. In Italy, we believe the group will focus on adapting its commercial strategy and rationalizing its store network to regain top line momentum there and reduce the fixed costs base, but we don't expect any meaningful improvements in margins over the next two years.
- We expect Ceetrus' contribution to profitability will increase even further with the fast development of the subsidiary's activity and its

inherently high margins.

- A reported EBITDA margin of about 4.3% for 2018, down from the 4.7% 2017 reported level and the 5.1% in 2016. This should translate to adjusted EBITDA margin of 4.7% in 2018, slightly picking up to 5.1% in 2019 (down from 5.8% in 2016).
- Negative working capital contribution to FOCF in 2018 due to the supply chain reorganization, but that should translate into a modest but positive contribution by year-end 2019.
- Elevated capex of about €2.3 billion in 2018, climbing to almost €3.0 billion in 2019, from €1.7 billion in 2017. Against our initial forecast of March 2018, we have moderated our initial assumption for 2018 and 2019 but spread them over a longer period of time, as we believe these capex are critical to help Auchan catch up with digital capabilities.
- More contained shareholder remuneration from 2017.

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

- On a proportional basis, adjusted debt to EBITDA of about 3.5x, together with FFO to debt of 23% in 2018, deteriorating to 3.6x-3.8x and 20%-23% in 2019 as a result of debt funded capex.
- Negative FOCF in both 2018 and 2019 to fund the transition toward omni-channel 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, because 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 June 2018:

- €2.6 billion of cash;
- Almost €3 billion of undrawn credit lines expiring in more than 12 months; and
- €1.6 billion of reported FFO forecast over the next 12 months.

Principal liquidity uses as of June 2018:

- €1.3 billion of short-term and long-term debt (excluding commercial paper) that we expect will be rolled over;
- About €30 million-€35 million of working capital outflow;

- €1.2 billion of working capital seasonality;
- €1.0 billion-€1.3 billion of maintenance (and up to €2.6 billion overall capex); and
- €0.3 billion of dividends.

## **Outlook**

The negative outlook on Auchan reflects our opinion that the group may find it difficult to quickly restore positive like-for-like revenues and sound profitability levels in France, Russia, and Italy following the marked EBITDA contraction it has experienced in these countries over the past 18 months. We expect the group's financial policy will remain prudent despite high investments to further expand its omni-channel presence across geographies. In particular, we expect the group will primarily mitigate any negative financial impact on credit metrics by managing its balance sheet and investments, such that adjusted debt to EBITDA remains comfortably below 4x and FFO to debt in excess of 20% on a proportional basis. Under our base case, we anticipate that credit metrics will weaken in 2018 and limit the group's headroom under the current rating level, with adjusted debt-to-EBITDA ratio of about 3.5x, and a FFO to debt of about 23% measured on a proportional basis.

### **Downside scenario**

We could lower the ratings if the group fails to restore persistent revenue growth and resume EBITDA growth in Western and Eastern Europe over the next two years. Our view of Auchan's current credit risk is supported by the strong performance of its real estate subsidiary and its strong market positions in China. However, if retail operations in Europe weaken further, we would no longer see these differentiating factors as sufficient to meet the requirements of the current rating level.

Equally, we could also lower the rating on Auchan if, on the back of still-challenging market conditions, performance deteriorates further, the group adopts a more aggressive financial policy, adjusted debt to EBITDA moves closer to 4x, FFO to debt declines below 20%, or if the group's initiatives don't result in improved FOCF generation.

### **Upside scenario**

We could revise the outlook to stable if Auchan restored a positive EBITDA growth momentum such that adjusted EBITDA margin returns to over 5% on a sustainable basis, especially if this is achieved by restoring profitability in its French, Russian, and Italian operations and effective execution of the transformation plan. An outlook revision would also hinge on operations in China continuing to grow on a local currency basis with broadly stable or increasing profitability. In such a scenario, we would expect credit metrics to improve moderately from the current levels such that the adjusted debt-to-EBITDA ratio sustainable reaches about 3.0x, and a FFO to debt exceeds 25% measured on a proportional basis, supported by a prudent financial policy.

## Ratings Score Snapshot

Issuer Credit Rating: BBB/Negative/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 (+1 notch)

## Issue Ratings--Subordination Risk Analysis

### Capital structure

Excluding debt issued by Oney Bank, Auchan's capital structure consists of about €7 billion of issued bonds and bank debt, essentially taken on by the group's financing vehicle company, Auchan Holding.

Auchan capital structure's consists of senior unsecured debt primarily comprising bonds and notes.

### Analytical conclusions

We rate Auchan's debt '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, March 28, 2018

- 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

## Related Research

- Disruption: The French Food Market Gets No Respite From Tough Trading Conditions, July 4, 2018
- Auchan Holding, June 5, 2018
- France-Based Oney Bank Downgraded To 'BBB/A-2' On Similar Rating Action On Parent Auchan, Outlook Stable, March 19, 2018
- Research Update: Retailer Auchan Downgraded To 'BBB' On Weaker Profitability And Credit Metrics; Outlook Stable, March 16, 2018

## Ratings List

Outlook Action; Ratings Affirmed

	To	From
Auchan Holding		
Issuer Credit Rating	BBB/Negative/A-2	BBB/Stable/A-2
Senior Unsecured	BBB	BBB
Commercial Paper	A-2	A-2
Auchan Coordination Services S.A.		
Issuer Credit Rating	--/--/A-2	--/--/A-2

### Additional Contact:

Industrial Ratings Europe; [Corporate\\_Admin\\_London@spglobal.com](mailto: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 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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