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Research Update:

Auchan Holding Downgraded To 'BBB-' On Weak Operating Performance And Elevated Leverage; Outlook Negative

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Rating Action Overview

- France-based food retailer Auchan Holding's trading performance for 2018 was weaker than anticipated. Like-for-like sales were negative, and reported EBITDA margins fell by 16%, in line with the first-half decline, because of continued intense price competition affecting retail operations, aggravated by restructuring costs, and negative foreign exchange effects. Coupled with high capital expenditures (capex), this resulted in a material breach of our leverage triggers.
- We expect pressure on credit metrics will persist in 2019 and 2020, as competition and the group's restructuring charges in particular will weigh on profitability and cash flows until the company reaps the benefits of its transformation plan.
- We are lowering our long- and short-term issuer credit ratings on Auchan to 'BBB-/A-3' from 'BBB/A-2' and our issue rating on its senior unsecured debt to 'BBB-' from 'BBB'.
- The negative outlook is driven by our expectation of prolonged pressure on the top line and margins, while the group's financial policy measures are only likely to provide a temporary relief to credit metrics.

Rating Action Rationale

The downgrade and negative outlook reflect our view of Auchan's weakened competitive standing in some of its most important markets, particularly in France, Russia, and Italy. It also reflects our anticipation that the group's transformation plan will take longer and entail larger restructuring costs than we anticipated. This adds to the pressure stemming from competitive and highly disrupted markets, and continuing significant leverage in spite of supportive financial policy measures such as disposals and an announced dividend cut.

In 2018, the group's revenues declined by 3.2% overall and by 1.3% on a like-for-like basis, and its reported EBITDA declined by 15.8%, in line with the first half of 2018, dragged down by the 20.5% decline in EBITDA of its retail operations. This marks the second consecutive year of a deep profitability decline, as reported EBITDA fell to under €2 billion in fiscal 2018 from €2.6 billion in fiscal 2016. This material erosion suggests a volatility in profitability typically higher than we expect for an investment-grade rating. While part of that underperformance stems from ongoing restructuring, foreign exchange (FX) trends affecting the Russian operations, and the so-called yellow vest protests in France, we believe this points to several weak spots in Auchan's positioning in some core markets. Auchan's weak operating performance, coupled with high investment to fund the development of its real estate arm, Ceetrus, and the need to adapt its supply chain to the omnichannel transition has resulted in a meaningful increase in debt, with leverage rising sharply above our 4x threshold to 4.5x on a proportional basis.

The rating action is also driven by our expectation of prolonged pressure on the top line and margin, while the group's financial policy measures are only likely to provide temporary relief to the group's credit metrics. Auchan announced materially reduced gross capex, down from €2 billion reported in 2018; a partial disposal of its captive finance arm Oney Bank; and no dividend payment to shareholders in 2019.

In fiscal year 2018, in the group's domestic and main market in terms of revenue contribution, France, Auchan's retail operations recorded a 33% EBITDA decline, excluding exceptional costs--up to 44% if we include them. In our view, the group's relatively high cost structure in comparison with its store format mix, which is highly skewed toward hypermarkets or out-of-town supermarkets, is more sensitive to price competition than proximity format, necessitating a leaner cost structure.

Auchan seems to have taken a different route than peers on its strategy regarding hypermarkets, with limited diversification. In contrast, Carrefour announced its intention to shrink its hypermarket selling space by 400,000 square meters. Casino is closing or selling some of its loss-making hypermarkets, and Leclerc is focusing on its food offering. Until this year, Auchan still had a material nonfood offering and put in place a strategy focused on developing strong private-label brands to attract traffic. We understand this may evolve somewhat under the new management team, as the group is exploring a collaboration with other Mulliez family-owned businesses, including Leroy Merlin, Boulanger, and Kiabi, to work on the nonfood offering.

The group's fairly strong diversification of revenues, with over 65% of sales generated abroad, is somewhat less beneficial than a few years ago. In Russia, the group's third-biggest geography, profitability declined by 33%, including FX headwinds. This is also related to a market positioning that appears to no longer appeal to consumer needs, as consumers are increasingly shopping through the convenience format, which is favored by Auchan's other competitors in Russia like X5 Retail. We understand that the restructuring of the Russian operations is underway and, in our view, somewhat easier to implement than in the group's domestic market. In Italy, the group's fourth-biggest geography with nearly €4 billion in sales, we understand the group is just about EBITDA break-even before restructuring costs, raising questions about the sustainability of its presence. Lastly, China's increase in profitability stalled in fiscal year 2018, with a decline in both EBITDA and margin, although it remains materially higher than in continental Europe. China contributed almost half of the group's consolidated profitability in 2018. While our proportional adjusted EBITDA margin was 4.4% in 2018, our fully consolidated margin (taking 100% of China) was 4.9%. Excluding China, it was 3.9%, somewhat comparable to Carrefour's 2018 adjusted EBITDA.

We believe new Auchan chairman Edgard Bonte's intention to restore profitability by streamlining the cost structure may prove difficult in a market characterized by a strong competition on prices. Carrefour, France's second-biggest retailer, has clearly indicated that part of its cost savings over the past few months will be reallocated to price investments. That is likely to offset the management team's efforts to optimize the cost structure. Furthermore, we understand that the group's restructuring plan is not yet finalized or quantified and may incur additional charges weighing on margin in 2019 and 2020, while the benefits would be felt 12-18 months after that. Because of the more pronounced pressure on profitability than what we initially anticipated and the new priorities set out by Mr. Bonte, the transformation plan will likely take longer than anticipated.

Despite the various challenges, Auchan's retail business benefits from a well-established drive format in France that generates over 9% of its revenues. The drive format is an innovation in the e-commerce channel that is typically more margin-friendly than last-mile delivery solutions. Auchan also engaged in buying partnerships with Casino, Dia, and Metro, making it the second-largest purchasing entity globally behind Walmart. In China, we expect Sun Art will resume with a positive growth trend in the next few months, driven by the effects of the partnership with Alibaba, while profitability should improve with greater integration between Auchan and RT-Mart.

The group has taken steps to preserve its creditworthiness, notably by reducing materially capex and cutting its dividend to shareholders. We believe, however, that this will only allow modest and temporary relief to leverage metrics because low capex is not sustainable. Furthemore, we note that over the last year a meaningful portion of capex was devoted to development of the real-estate arm, rather than to the core retail business.

That said, although the group faces increasing pressure, it has in our view multiple assets to mitigate it. Ceetrus contributes only 1.4% of revenues but over 20% to the group's consolidated EBITDA. Management estimates the market value of the group's real estate assets at €8 billion, even excluding the value of its Chinese operations. This is broadly comparable to the €8.2 billion of reported gross debt in fiscal year 2018. We also note that aside from its real estate subsidiary, Auchan owns most of its hypermarkets except in China, adding to the €8 billion of valuation reported for Ceetrus. Lastly, and setting the group's Chinese operations aside, the group will still have a 49% stake in Oney Bank, its captive finance entity, after the completion of the partial disposal to Groupe BPCE, a French bank.

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

- Macroeconomic factors that influence the grocery industry include GDP growth, consumer confidence, consumer price index (CPI) inflation, and the unemployment rate. Our assumptions for Auchan reflect economic scenarios for France, other Western European countries (especially Spain, Italy, and Portugal), Russia, and China, which together account for nearly 90% of the group's net sales in 2018.

- In Western Europe, we forecast the pace of GDP growth to slow to about 1.6% in 2019-2020, from 1.8% in 2018. However, ongoing recovery in the labor market supports consumption.
- Russia will have a more gradual recovery, with GDP growth of 1.5% in 2019, down from 1.7% in 2018, and 1.8% in 2020, with inflation at 4% in next couple of years.
- In China, GDP increases about 6.2% in 2019, down from 6.5% in 2018, but with inflation moving to 2.2% from 1.8%.
- In France, we expect a modest margin benefit from the new law imposing a minimum gross margin of 10% for each food item and putting a cap on promotions by food retailers. We consider that ongoing price competition and competitive activity would curtail meaningful upside in our forecasts. The increased penetration of discounters and still intense price competition should also mitigate the positive effects of measures taken by the government to stimulate purchasing power of lower income households following the yellow vest protests. This coupled with our anticipation of few stores openings in 2019 should mute growth.
- From a profitability standpoint, 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 product), which will likely increase costs. In particular, increasing online penetration likely will weigh substantially on margins, because physical retailers have to reshuffle their supply chains, ensure last-mile delivery, and maintain an important store network.
- We also expect the Auchan group to take additional cost saving measures in France in 2019 and 2020 to restore more sustainable profitability, while the purchasing alliance should help improve gross profit.
- In Russia, we expect a continued absolute revenue decline in 2019 from store closures, with gradually recovering like-for-like sales due to a redefined commercial strategy and footprint. We believe the group's intention to target a more premium positioning should help improve margins in the near future, although in 2019 restructuring costs related to network optimization should offset the positive impact on margins.
- In China, we forecast 1%-2% like-for-like growth in 2019, picking up in 2020, as the Alibaba partnership should attract additional traffic both online and offline. We believe the group's development plan in that geography will rely more on smaller proximity and convenience format, including the Auchan Minute concept. We expect moderate profitability gains, as the integration of support functions between Auchan and RT-Mart will be somewhat balanced by increasing delivery costs as part of the Alibaba partnership.
- Additional ongoing transformation charges of about €170 million-€230

million for the next 24 months are particularly related to the revamp or closures of hypermarkets and openings of more convenience formats. We expect Ceetrus' contribution to profitability will increase even further with the fast development of the subsidiary's activity, high investments in 2018, and inherently high margins.

- A reported EBITDA margin of about 3.9% in 2019 will be stable from 2018 and down from the 4.5% reported in 2017 and the 5.1% in 2016. This should translate to adjusted EBITDA margin of 4.5%-4.7% in 2019-2020 (down from 5.1% in fiscal year 2017 and 5.8% in 2016).

A slightly negative working capital contribution to free operating cash flow (FOCF) in 2019 is due to the supply chain reorganization. It's neutral thereafter.

- Gross capex of €1.3 billion-€1.4 billion in 2019 will pick up thereafter to about €1.7 billion, as we believe investments are critical in Auchan's effort to remain competitive on its digital capabilities and new growth formats such as the Pedestrian drive. We note, however, that the group's expansion plans on the convenience formats should be done essentially through additions of franchisees, limiting capex for this expansion.
- Cash proceeds related to the disposal of 50.1% of Oney Bank for about €1.2 billion-€1.3 billion, including the repayment of a €703 million intercompany loan.
- There is no dividend distribution to Auchan's direct shareholders in 2019, offset by share buybacks in relation to the employee's shareholdings of about €200 million-€250 million, in line with 2018.
- We also believe the group could consider disposing of other assets as part of its publicly stated goal of remaining investment grade.

We believe that full consolidation does not portray the group's real leverage as the group holds only 34.18% of economic stake in Sun Art, which it fully consolidates. Accordingly, we calculate our credit metrics using proportional consolidation. Based on these assumptions, we arrive at the following credit measures on a proportional basis:

- Adjusted debt to EBITDA of about 3.6x-3.7x, with adjusted funds from operations (FFO) to debt of 20%-25% in 2019, remaining broadly stable thereafter.
- Resuming positive FOCF generation in 2019, decreasing a bit in 2020.
- Adjusted discretionary cash flow to debt trending toward 5x.

Outlook

The negative outlook on Auchan reflects our opinion that the group may not quickly restore positive like-for-like revenues and sound profitability in France, Russia, and Italy following the marked EBITDA contraction there the past two years. The outlook also factors in the extremely competitive French food retail market, combined with rapid changes to customer behaviors, which are forcing Auchan to adapt its business model to preserve its market position and profitability. We see some execution risk in both the scope of the transformation plan and its speed of implementation.

We expect, however, the group's financial policy to support investment-grade ratings. In particular, we expect the group will primarily mitigate any negative financial impact on credit metrics by managing its balance sheet and investments, using a combination of dividend and capex cuts and disposal proceeds. Therefore, we anticipate that credit metrics will only moderately improve in 2019 and 2020, limiting the headroom under the rating, with adjusted debt to EBITDA of 3.6x-3.7x and FFO to debt of 20%-25% measured on a proportional basis.

Downside scenario

We could lower the ratings if the group fails to curtail the ongoing trends of a weak top line and earnings decline in Western Europe, particularly in its home market of France and in Russia. This could arise from the group's inability to execute its transformation plan effectively, realize cost savings from it, or enhance its hypermarket operations quickly enough within the very competitive French food retail market. Such a scenario could drop the group's adjusted EBITDA margins toward 4% and prompt us to lower our assessment of the strength of the group's business and competitive position.

If such a margin decline were not mitigated sufficiently by further ongoing financial policy measures such as additional disposals and continued capex or dividend cuts, the group's debt protection and cash flow measures would not improve from current levels. For instance, adjusted debt to EBITDA could remain higher than 4x, FFO to debt below 20%, and adjusted discretionary cash flow to debt could remain weak on an ongoing basis.

Upside scenario

We could revise the outlook to stable if Auchan restores earnings growth momentum such that adjusted EBITDA margin returns toward 5% on a sustainable basis, especially 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 expand on a local currency basis, with broadly stable or increasing profitability. In such a scenario, we would expect adjusted debt to EBITDA to sustainably reach about 3.5x and FFO to debt to exceed 25% measured on a proportional basis, supported by a prudent financial policy.

Company Description

With about €50.9 billion in reported revenues in 2018, France-based Auchan is the 12-largest food retailer in the world. It operates hypermarkets and convenience stores in 17 countries. It is the sixth-largest retailer in France, with sizable operations in both Eastern and Western Europe, and a notable presence in Russia, Ukraine, Italy, Spain, and China. Auchan operates China's largest food retailer through a 36.18%-owned joint venture called Sun Art. Auchan also owns and operates shopping centers through Ceetrus in 12 countries.

Auchan will still rely on Oney Bank, its captive finance subsidiary that serves more than 8 million customers in 11 countries. After selling a 50.1% controlling stake to Groupe BPCE, it will keep a 49% stake.

The Mulliez family owns about 95% of Auchan through Association Familiale Mulliez, while the rest is owned by eligible employees.

Liquidity

We view Auchan's liquidity as adequate and calculate that liquidity sources will likely exceed uses by more than 1.3x over the next 12 months. The amounts below are our estimates for the group's retail operations, excluding the China operations and Oney Bank.

Principal liquidity sources as of December 2018:

- €1.8 billion of cash and cash equivelent;
- About €1.1 billion of available credit lines expiring in more than 12 months, because meaningful portion of the group's committed line backs up the drawn part of the commercial paper program;
- About €1.1 billion in reported FFO forecast over the next 12 months; and
- €1.2 billion-€1.3 billion coming from the partial disposal of Oney Bank.

Principal liquidity uses as of December 2018:

- €2.8 billion of short- and long-term debt (including commercial paper used to fund working capital needs) that we expect will be rolled over;
- About €50 million-€70 million of working capital outflow;
- About €900 million-€950 million of maintenance capex and no expansionary capex (compared to the €1.3 billion-€1.4 billion of maintenance, including the Chinese operations); and
- No dividends to shareholders, but about €200 million-€250 million in share buybacks as part of the employee incentive program.

We also run an estimate of the group's liquidity with a proportional approach of Sun Art and a fully consolidated approach of China to conclude that the group's liquidity sources would materially exceed needs. This is given the high amount of cash in the Chinese operations and their material contribution to the group's cash flow.

Issue Ratings – Subordination Risk Analysis

Capital structure

Excluding debt issued by Oney Bank, Auchan's capital structure consists of about €8.2 billion of issued bonds and bank debt, essentially taken on by the group's financing vehicle company, Auchan Holding.

Analytical conclusions

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

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Negative/A-3

Business risk: Satisfactory

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

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

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)

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 | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Retail And Restaurants Industry, 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 Profitablity And Credit Metrics; Outlook Stable, March 16, 2018

Ratings List

Downgraded

	To	From
Auchan Holding		
Issuer Credit Rating	BBB-/Negative/A-3	BBB/Negative/A-2
Senior Unsecured	BBB-	BBB
Commercial Paper	A-3	A-2
Auchan Coordination Services S.A.		
Issuer Credit Rating	A-3	A-2

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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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.