Research Update:

Auchan Holding 'BBB-' Ratings Affirmed; Outlook Remains Negative Due To High Execution Risk For Transformation Plan

March 30, 2020

Rating Action Overview

- Auchan Holding's (Auchan's) full-year 2019 results showed still negative like-for-like retail operations growth of 1.2% but a partial recovery in profit following 2018's low.
- We believe this improvement should keep leverage within our outlook triggers, but its mid-term sustainability is yet to be demonstrated, in particular since the group operates in highly competitive and disrupted food retail markets.
- Auchan is also likely to incur significant restructuring costs as it implements its transformation plan, which we forecast will weigh on profits and cash flows until it starts reaping the benefits.
- We are affirming the 'BBB-' long-term and 'A-3' short-term issuer credit ratings on Auchan and our 'BBB-' issue rating on its senior unsecured debt.
- The negative outlook reflects limited ratings headroom since the group faces many operational challenges combined with material execution risk associated with its multi-year transformation plan, while we expect it to take tangible financial policy measures to mitigate any negative financial effect on credit metrics.

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Rating Action Rationale

The group's transformation plan is likely to weigh on profitability and cash generation in the next two years, while it is associated with high execution risk. The negative outlook indicates that we expect Auchan to find it difficult to implement its ambitious transformation plan while preserving its market positions and improving its cash flow generation. In 2019, Auchan announced a €1.1 billion cost-saving plan for its retail operations, corresponding to a targeted reported EBITDA margin of 6% in 2022 against 3% reported in 2018. We estimate this transformation plan will be associated with large one-off expenses of €700 million-€800 million spanning the next three years, with the majority for restructuring but also to incorporate investments aimed at reducing the cost base. Therefore, even if the transformation plan is successful, the group will only see profitability and cash generation improvements from 2022 onward.

The transformation plan still relies on turning around hypermarkets, which account for the majority of sales. We note the strategy to restore like-for-like growth under the transformation plan is somewhat different to measures taken by other market participants, since Auchan intends to build on its existing formats to recover growth and profitability. The group has no intention of reducing hypermarket selling space, like Carrefour S.A., and is not trying to diversify away from hypermarkets like Casino Guichard - Perrachon S.A. Auchan's strategy is centered on rejuvenating the hypermarket format by offering local market place services; building on strong and exclusive private-label products; introducing where possible a store-in-store concept with other Mulliez-held brands such as Leroy-Merlin, Decathlon, or Boulanger; and using hypermarkets as local distribution centers to reinforce the group's e-commerce and "drive" channels. In our view, this strategy seems ambitious and challenging in terms of execution and speed of implementation, considering market dynamics. Changing consumption trends in favor of convenience and proximity stores pose structural challenges to the hypermarkets that still dominate the French retail landscape. Hypermarkets also often record the lowest levels of growth, which exerts negative pressure on prices and consequently margins.

The group's long-term credit quality lies in its ability to durably restore its retail operating model and earnings. On an adjusted basis, EBITDA stood at €2.1 billion in full-year 2019, recovering somewhat against the €1.9 billion recorded in 2018 but still far from historical levels averaging more than €2.5 billion. The disposal of loss-making Italian operations has enabled the group to restore its adjusted EBITDA margin to 5.6% in 2019 from 4.4% in 2018, but at the cost of lower scale and very high one-offs related to the agreed recapitalization weighing on cash flow generation. We understand that the profit improvement last year came essentially from higher gross profit, in particular in France, which still represents 38% of consolidated revenue and about half of revenue on a proportional basis. Gross profit increased due to greater supply chain efficiency, which allowed for fewer breakage costs, and purchasing gains on cost items that are more variable in nature and hence might not be sustainable. Equally, like-for-like growth was negative again in 2019, questioning the sustainability of the group's performance given it will have to reinvest in price or at least price perception to resume growth. For a group that is largely focused on destination formats (hypermarkets and out-of-town supermarkets), price point and price perception is central in attracting traffic and various market surveys suggest Auchan is not well positioned against Leclerc and Carrefour in France. The group is also some way from returning to earnings growth in Russia, which remains its third-largest geography to date. We understand that Auchan is seeking major optimization of its fixed-cost structure, which is likely to be positive from a margin standpoint but may affect in-store experience and service quality.

The group's financial policy and asset-rich balance sheet provides it with resources to finance the transformation plan, but execution is critical. Last year, the group initiated several financial policy measures, which we understand will likely remain in force until reported net debt has decreased from €3.7 billion reported in 2019. These included an about €800 million reduction in capital expenditure (capex), cuts to dividends, and the disposal of a controlling stake in Oney Bank, the group's captive finance vehicle. It has also sold its loss-making Italian operations to retail group Conad and agreed to a recapitalization of the business. Supportive financial-policy measures will be sustained for at least the next couple of years, notably since shareholders have agreed to another dividend cut for this period. Similarly, the group is expected to initiate further asset disposals to reduce its gross debt and thereby its interest burden. In particular, we expect

Auchan to leverage its asset-rich balance sheet to do so. In full-year 2019, real estate subsidiary Ceetrus S.A. (BBB-/Negative/A-3) had €8.2 billion of assets, while numerous real estate assets related to retail operations are also held by Auchan Holding. More generally, we consider continuing shareholder support to preserve credit quality a cornerstone of the rating, particularly as Auchan embarks on the multi-year transformation and restructuring plan.

The COVID-19 pandemic is likely to have mixed effects on the group's operating performance but not translate to liquidity pressures. We understand that the effects of COVID-19 have been positive so far for retail topline growth. This is because food retailers are among the few stores to remain open in locked-down countries, hence capturing some traffic usually directed to specialized food or nonfood stores. However, some exceptional costs are likely to mitigate the topline benefits, including an extraordinary bonus to employees granted in March. Furthermore, we believe Ceetrus' earnings are likely to be affected in 2020, since it has already agreed to delay some rent payments.

Outlook

The negative outlook reflects limited rating headroom since the group faces many challenges. These include structural pressures in its main hypermarket format and in the nonfood segment, rapid changes in customer behavior, and aggressive price competition, particularly in the French food retail market. We view Auchan's multi-year transformation and cost restructuring program as necessary in the long run to mitigate and adapt to these changes, but we believe that the program will depress its operating margins and cash flow. Given the weakness in the hypermarket segment, we see Auchan's business strategy focused on the turnaround of hypermarkets as having material execution risks.

We expect the group to continue to take tangible financial policy measures and mitigate any negative financial effect on credit metrics through dividend and capex cuts and asset disposals. We also factor into our rating continuing support and commitment from the Mulliez family to maintain investment-grade ratings, through its vast holdings that are helping fund the transformation program. However, rating headroom remains very limited, given S&P Global Ratings-adjusted debt to EBITDA is expected to remain below but close to 4x measured on a proportional basis.

Downside scenario

We could lower the rating on Auchan if the group's adjusted EBITDA does not increase from levels reported in 2019 or its market share in France and topline performance continue to erode over time. This could arise from the group's inability to turnaround its hypermarket operations, execute effectively or realize cost savings from the transformation plan, or enhance its omnichannel capabilities quickly enough within a very competitive French food retail market. Such a scenario could prompt us to revise down our assessment of the group's business and competitive position.

If such a margin decline were not mitigated by further supportive financial policy measures, we could see the group's credit metrics weaken with, for instance, debt to EBITDA returning to 4x and funds from operations (FFO) to debt staying below 20%.

Upside scenario

We could revise the outlook to stable if Auchan restored earnings growth momentum such that S&P Global Ratings-adjusted EBITDA improves from current levels. This could especially stem from restored profitability in its French and Russian operations, on the back of sound transformation plan execution. 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 S&P Global Ratings-adjusted debt to EBITDA to sustainably reach about 3.5x and FFO to debt to comfortably exceed 20% on a proportional basis, supported by a prudent financial policy.

Company Description

With about €46.4 billion in reported revenue in 2019, France-based Auchan is the 18th-largest food retailer in the world, according to market research company Kantar. The company operates hypermarkets and convenience stores in 12 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, Spain, and China. Auchan operates China's largest food retailer through a 36.18%-owned joint venture called Sun-Art. The company also owns and operates shopping centers through Ceetrus in 12 countries.

Auchan will still leverage Oney Bank to offer consumer credit to its customer base after selling a 50.1% controlling stake to BPCE, and will keep its remaining 49.9% stake. In the medium term, assuming Oney benefits from the support of BPCE, we believe this transaction will likely increase the overall value of Oney Bank.

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

Our Base-Case Scenario

- EU GDP growth reduces by 0.8% in 2020 before increasing by 2.8% in 2021, from 1.5%-1.6% in 2019. However, given the evolving situation with regards to the spread of COVID-19, we expect GDP growth to be somewhat volatile against our base case.
- Negative real GDP growth in France of about 1.7% in 2020 before picking up in 2021. However, we expect inflation to cool down to below 1.0% versus about 1.3% in 2019.
- GDP growth in China slows to 2.9% in 2020, down from an expected 6.1% in 2019.
- More qualitative competition in France (next-hour delivery, click-and-collect, or Auchan's "Pedestrian Drive"), which will likely increase costs. In particular, increasing online penetration will likely weigh substantially on margins, because physical retailers have to reshuffle their supply chains, ensure last-mile delivery, and maintain their store network.
- Ongoing price competition and competitive activity curtail meaningful upside in our forecasts. However, we expect food retailers to benefit during 2020 from COVID-19-related lock downs as people venture out to purchase essential groceries and stock pile to some extent. The increased penetration of discounters and still-intense price competition should, to some extent, mitigate the effect of this surge in purchases. We also expect a limited number of store openings for the group as a whole during the year.
- Positive improvements in gross margin to continue, spurred by the same efforts in supply chain and breakage costs, combined with the benefits from the purchasing alliance with Casino, Metro, and DIA. Other cost-saving measures, including closures of loss-making stores in

France, should equally help to restore profitability.

- In light of the group's EBITDA margin objective for 2022, cost-saving measures will translate into important one-off expenses of €700 million-€800 million over the next three years, the majority of which will be restructuring charges.
- A continued absolute revenue decline in Russia related to store closures and the ongoing restructuring, while like-for-like sales should only pick-up from late 2020 due to a redefined commercial strategy and footprint. We believe the group's intention to target more premium positioning should help improve margins in the near future, although in the short term restructuring costs related to network optimization should offset the positive effect on margins.
- In China, 1%-2% like-for-like revenue growth in 2020, with additional online and offline traffic spurred by the Alibaba partnership. We believe the group's China development plan will rely more on the smaller proximity and convenience format. We expect moderate profitability gains, since the integration of support functions between Auchan and RT-Mart will be somewhat balanced by increasing delivery costs as part of the Alibaba partnership.
- Amid the lockdowns in various countries, we expect Ceetrus' profit contribution to decline in 2020 as most stores close and operators ask for rental waivers as a relief measure.
- Adjusted EBITDA margin to decline to about 5% in 2020 from 5.6% in 2019 as the group's transformation plans pick up pace and efficiency gains are to a large extent offset by a portion of the one-off costs related to business transformation However, we expect some pick-up in margins from 2021 onward, reaching more than 5.2%.
- Excluding one-offs related to the transformation plan, an adjusted EBITDA margin of about 5.5% over the next two years.
- About €160 million in working capital outflows in 2020, in-line with management's expectation, followed by neutral working capital effects on free operating cash flow (FOCF) from 2021 onward.
- Gross capex of €1.4 billion-€1.6 billion each year from 2020 since we believe investments are critical for Auchan's effort to remain competitive with its digital capabilities. Capex includes a portion of the transformation charges that will relate to automated and digital investments. We note, however, that the group's expansion plans for convenience formats have been toned down and will be essentially through new franchisees, limiting capex for this expansion. Equally, although we have stressed Ceetrus' earnings will reflect the likely effects of COVID-19, we have not assumed for now a reduction in real-estate capex.
- Cash proceeds of €750 million related to the disposal of Ceetrus properties during 2020.
- Alongside this, we expect outflows of about €130 million and €100 million respectively in 2020 and 2021 related to the recapitalization of operations in Italy disposed of in 2019.
- No dividend distributions to Auchan's direct shareholders in 2020 and 2021, offset by share buybacks in relation to employee shareholdings of €100 million each during the same period.
- The group may consider disposing of other assets or expand its more conservative financial policy as part of its publicly stated goal of remaining investment grade.

We believe that full consolidation does not portray the group's real leverage since it holds only a 34.18% 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 3.6x-3.8x, incorporating our expectations of one-offs, with adjusted FFO to debt of about 20% in 2020, exceeding 20% thereafter.
- Positive adjusted FOCF in 2020 before exceptional items. However, adjusted FOCF will still be negative €50 million-€150 million after these items, although we expect it to be funded by financial-policy measures.
- That said, an important consideration is the evolution of leverage and cash flow generation in the group's western operations, particularly France. Notably, both proportional metrics and consolidated metrics offer a favorable picture of the group's leverage since Chinese operations are almost debt free on a financial basis (excluding leases) and represent 45% of consolidated cash. In addition, the cash upstream from Sun-Art to Auchan Holding through dividends is historically quite low in comparison with cash volumes generated in China.

Liquidity

We view Auchan's liquidity as adequate and calculate that sources will likely exceed needs by more than 1.3x over the next 12 months. The amounts below are an estimate, starting from Dec. 31, 2019, of the group's immediate accessible cash excluding the Chinese operations and our expectation of its contribution to FFO, working capital, and capex, among others.

Principal liquidity sources include:

- Cash of €2.0 billion immediately accessible and available for debt repayment.
- About €2.7 billion of available credit lines expiring in more than 12 months, as a meaningful portion of the group's committed €3.5 billion line (€0.8 billion expires in the next 12 months) backs up the drawn part of the commercial paper program.
- About €1.1 billion in reported FFO forecast over the next 12 months.
- About €750 million stemming from disposal of real estate assets.
- Dividends of about €60 million from Sun-Art.

Principal liquidity uses include:

- Short- and long-term debt of €1.2 billion (including commercial paper used to fund working capital needs) that we expect will be rolled over.
- About €130 million of cash out related to the disposal of the Italian subsidiary.
- Yearly capex of €1.1 billion (including growth capex and capex related to the transformation plan).
- Working capital outflows of about €160 million in 2020 along with seasonal working capital requirements of about €1.2 billion.
- Dividends of €130 million to minority shareholders with no dividends to be distributed to AFM over the next 24 months.
- Share buybacks of €100 million as part of the employee incentive program.

We also run an estimate of the group's liquidity with a proportional approach for Sun-Art and a fully consolidated approach for China. We conclude the group's liquidity sources would materially exceed needs, given the high amount of cash at the Chinese operations, as well as its material contribution to the group's cash flow metrics.

Covenants

Some credit lines bear a financial covenant (debt to EBITDA at a maximum of 3.5x, as defined in the debt documentation), but Auchan has sufficient headroom.

Issue Ratings - Subordination Risk Analysis

Capital structure

Auchan's capital structure consists of about €7.7 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, since no significant elements of subordination risk are present in the capital structure.

As of year-end 2019, real estate subsidiary Ceetrus has taken some third-party debt on its own books. However, the amounts raised are not material, totaling about €1.4 billion. The debt comprises a bond, a private placement, and a corporate and asset financings. We understand that Ceetrus' intention is to rely less on intra-company funding and more on external funding, which could ultimately reinforce subordination risk (see "Retail Property Company Ceetrus Assigned 'BBB-' Rating; Outlook Negative," published Oct. 31, 2019, on RatingsDirect). However, we believe the portion of priority debt outstanding at subsidiary levels is still contained.

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

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Retail And Restaurants Industry, 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, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Retail Property Company Ceetrus Assigned 'BBB-' Rating; Outlook Negative, Oct. 31, 2019

Ratings List

Ratings Affirmed	
Auchan Holding	
Issuer Credit Rating	BBB-/Negative/A-3
Auchan Coordination Services S.A.	
Issuer Credit Rating	--/--/A-3
Auchan Holding	
Senior Unsecured	BBB-
Commercial Paper	A-3

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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. 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.