Research Update:

Auchan Holding 'BBB-' Ratings Affirmed; Outlook Remains Negative On Slower-Than-Expected Deleveraging

September 10, 2020

Rating Action Overview

- Auchan Holding's half-year results show some advancement in the group's cost-saving program, but excessive leverage for its current rating level remains.
- The group also announced plans to reduce debt by €2.0 billion by 2022, mainly through asset disposals, but we view the disposal timeframe as longer than anticipated and further reducing limited rating headroom in an environment characterized by uncertainty from COVID-19, fierce competition, and the group's extensive restructuring.
- We are affirming our 'BBB-/A-3' long- and short-term issuer credit ratings on Auchan, and our 'BBB-' issue rating on its senior unsecured debt.
- The negative outlook reflects that we could downgrade Auchan in the next 12 months if the group does not demonstrate clear progress in deleveraging by lowering its S&P Global Ratings-adjusted debt to EBITDA well below 4.0x for 2020 and at least 3.5x by year-end 2021. To achieve these metrics, we believe that the group would likely need to front-load its real estate disposal program.

PRIMARY CREDIT ANALYST

Mickael Vidal

Paris

+ 33 14 420 6658

mickael.vidal
@spglobal.com

SECONDARY CONTACT

Solene Van Eetvelde

Paris

(33) 1-4420-6684

solene.van.eetvelde
@spglobal.com

ADDITIONAL CONTACT

Industrial Ratings Europe

Corporate_Admin_London
@spglobal.com

Rating Action Rationale

The group's deleveraging is taking longer than what we had initially anticipated, pressuring already low rating headroom. In our last review in March 2020, we expected deleveraging, through real asset disposals or exceptional shareholder support measures, to be already effective in 2020, in line with the group's repeated commitment to maintain an investment-grade rating. This would have translated, in our calculations, into S&P Global Ratings-adjusted debt to EBTIDA of close to 3.5x by year-end 2020. Due to COVID-19-related disruptions, these disposals initially factored in our base case have been put on hold, and we have limited visibility as to when they are likely to occur. Hence, in our preliminary calculations, we now see a risk that the group could post ratios of 3.8x-4.0x by end-2020 and, unless it undertakes significant asset disposals, we cannot rule out similar leverage levels in 2021, which would prompt us to lower the rating.

Auchan has announced a debt-reduction plan of about €2.0 billion by 2022, complementing the existing Renaissance plan, which aimed to generate €1.1 billion of cost reductions against 2018's levels. However, we believe that the expected one-off charges associated with the cost-saving program, combined with the impact on performance from the COVID-19 pandemic, and a very competitive landscape, are likely to weigh down EBITDA growth in 2020 and 2021. Additionally, alongside working capital improvements, so far Auchan has tempered the increase in debt by cutting down on capital expenditures (capex) for both 2019 and 2020, a strategy that may hinder its business positioning.

We view the timeframe set for deleveraging as longer than we had anticipated, and consider that this--combined with fierce competition, the continuing impact of COVID-19, and potential disruptions from the group's restructuring--heightens the risk that leverage could be out-of-line with the ratings in 2020 or 2021.

The execution risk associated with the group's transformation remains high in a market that we expect to be competitive and price focused. Auchan's transformation plan still relies on turning around its 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. Unlike other integrated peers in France, the group does not intend to reduce its exposure to hypermarkets. Rather, 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 click-and-collect 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 of stores pose structural challenges to 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 on margins. We expect the pressure will increase in a recessionary environment as consumers are expected to be more price sensitive. In particular, for France, Auchan's main market, the increasing penetration of German discounters, and continued strong momentum of independent retailers poses significant challenges to traditional integrated retailers, such as Auchan and Carrefour.

The pandemic has had a mixed impact on the group's operating performance in the first half of 2020, but should be somewhat less disruptive in the second half. We initially expected COVID-19 to boost Auchan's topline growth, considering food retailers are among the few stores that were allowed to remain open during lockdowns, hence capturing some traffic usually directed to specialized food or nonfood stores. However, that did not happen to the degree we anticipated, since during the strict lockdown period customers tended to favor closer, more convenient shopping locations to larger out-of-town stores. Additionally, the exceptional costs associated with COVID-19 have also mitigated further the positive topline impact that we anticipated initially.

Additionally, the crisis resulted in a significant underperformance of the group's real estate arm Ceetrus, with EBITDA declining by 42.6% due to rent cancellations granted during the lockdown and fair valuations dropping to €7.8 billion from €8.2 billion reported earlier in the year. However, we note that unlike peers, Ceetrus has accounted for the loss already in its first-half results given it decided to cancel about two months of rent, while peers have generally mainly offered deferrals, allowing them to smoothen the impact of the loss in earnings witnessed during the first half over the lease length. As a result, on a consolidated basis and in spite of the group's performance on the retail business, the group's reported EBITDA improved by just €49 million, before the employee bonus related to COVID-19 of €69 million.

That said, COVID-19 could still be a positive catalyst, since we expect more people will stay home in 2020 and even 2021, which should prompt increasing demand for food retailers, which is somewhat likely to mitigate competition exerting pressure on prices. We also expect fewer one-offs in the second half of 2020 due to COVID-19, since additional employee bonuses should come down. Lastly, while the risk of a second wave of COVID-19 remains high, which could ultimately hamper profitability of the real estate operations in particular, we expect the food business will remain resilient overall, as it did in the first half of the year.

Prompt and resolute progress in deleveraging, including through real estate asset disposals, is needed to maintain the current rating. Since Mr. Bonte's appointment as CEO, the group has embarked on a wide scale restructuring of its operations. It disposed of a controlling stake in its captive finance arm Oney Bank; cut dividends for 2020 on 2019's results; disposed of its Italian retail business, which has been loss making since several years; and reduced capex by about €800 million in 2019 to manage debt levels. Adding to that, it has now publicly committed to reduce debt by €2.0 billion and engaged in a €1.1 billion cost-reduction plan by 2022, with the aim of restoring the reported EBITDA margin to 6% by 2022. We consider that these measures, which have allowed the group to see some progress in its operating performance during the first half of 2020, somewhat mitigate the delay in the group's asset disposals that we had anticipated for 2020. Notwithstanding, for the group to maintain the current rating, it is critical that it is able to demonstrate clear progress in its deleveraging plan, by deleveraging well below 4.0x for the financial year 2020 and at least 3.5x by year end 2021.

Outlook

The negative outlook reflects that we could downgrade Auchan in the next 12 months if it fails to execute its deleveraging plan in a timely manner, such that its S&P Global Ratings-adjusted debt to EBITDA returns well below 4.0x for 2020 and below 3.5x by year-end 2021, in line with the rating expectations.

It also reflects structural pressures in its main hypermarket format and in the nonfood segment, aggressive price competition, particularly in the French food retail market, and a drop in profitability in its real estate arm as a result of the pandemic. We view Auchan's multiyear transformation and cost-restructuring program as necessary in the long run to mitigate and adapt to these changes, but we believe that the program presents the risk of depressing its operating margins and cash flows at a time were its leverage is high. Moreover, given the weakness in the hypermarket segment, we see Auchan's business strategy of turning around hypermarkets as having material execution risks.

Downside scenario

We will likely lower the rating on Auchan if it fails to rapidly execute financial policy measures and demonstrate clear progress in its deleveraging, which would consist of lowering its S&P Global Ratings-adjusted debt to EBITDA well below 4.0x for 2020 and below 3.5x by year-end 2021. We believe that the company will likely need to complement its cost-cutting plan by front loading its real estate disposal program to achieve these metrics.

We could also downgrade Auchan if 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.

Upside scenario

We could revise the outlook to stable if Auchan restores earnings growth momentum and, supported by a prudent financial policy, reduced debt such that S&P Global Ratings-adjusted debt to EBITDA improved sustainably below 3.5x and funds from operations (FFO) to debt comfortably exceeded 20% on a proportional basis. This could especially stem from restored profitability in its French and Russian operations, on the back of sound execution of its 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.

Company Description

With about €46.4 billion in reported revenue in 2019, France-based Auchan is the 18th-largest 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, Poland, 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, one of France's largest banks, 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 97% of Auchan through Association Familiale Mulliez (AFM), while the remainder is owned by eligible employees.

Our Base-Case Scenario

Assumptions

- Real GPD contracting in France by 8%-10% in 2020, before recovering by about 6%-8% in 2021.
- EU GDP shrinking by 7%-8% in 2020 before increasing by 5.4% in 2021. However, given the evolving situation with regard to COVID-19, we expect GDP growth will be somewhat volatile against our base case.
- Chinese GDP growth slowing to just 1%-2% in 2020, but returning to about 7%-8% in 2021.
- A continuing challenging market context in France, with intensifying price competition in the second half as a result of the recessionary context. The increased penetration of discounters and the renewed push from independents for market share gains will exert pressure on prices, only moderately compensated for by increased food demand due to COVID-19.

- Following a boom of online sales due to the pandemic, we expect a structural increase in online sales, which is also likely to weigh on margins, since physical retailers have to reshuffle their supply chains, ensure last-mile delivery, and maintain their store network.
- Modest improvements in gross margin will continue, spurred by the same efforts to improve supply chain efficiency and limit breakage costs as the witnessed in 2019 and the first half of 2020, 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 also help to restore profitability.
- One-offs associated with the restructuring plan of €500 million-€600 million, down from the €700 million-€800 million we had anticipated for the next three years.
- Real estate arm Ceetrus' profitability dropping by about one-fourth for the full year, due to the lockdown in various countries. We also expect more subdued profitability in future years, considering the exposure of its galleries to nonfood retail, which has been highly impacted by the pandemic.
- One-off costs associated with COVID-19 (employee bonuses, higher sanitary costs, etc.) weighing on the group's consolidated EBITDA generation.
- A continued absolute revenue decline in Russia related to store closures and the ongoing restructuring, while like-for-like sales only picking up in 2021 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, possibly rising to 5% thanks to store additions, 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 of stores. We expect moderate profitability gains, since the integration of support functions between Auchan and RT-Mart will be somewhat offset by increasing delivery costs as part of the Alibaba partnership.
- The group's adjusted EBITDA margin declining to about 5.0%-5.4% in 2020 and 2021 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, a more price competitive market, and COVID-19-related costs.
- Excluding one-offs related to the transformation plan, an adjusted EBITDA margin in excess of 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.
- Annual gross capex of €1.0 billion-€1.2 billion 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 be dampened by COVID-19, we have not assumed for now a reduction in real estate capex.
- Outflows of about €130 million and €100 million in 2020 and 2021 respectively, 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.

- No disposals over the next 24 months, in the absence of clearly identified assets.

We believe that full consolidation does not portray the group's real leverage since it holds only a 36.18% economic stake in Sun-Art, which it fully consolidates. Accordingly, we calculate our adjusted credit metrics using proportional consolidation. Based on these assumptions, we arrive at the following adjusted credit measures on a proportional basis:

- Adjusted debt to EBITDA of 3.8x-4.0x, incorporating our expectations of one-offs and delays in disposals, with adjusted FFO to debt of about 17%-23% in 2020 and 2021.
- Positive adjusted FOCF in 2020 by about €70 million, however turning negative after factoring in lease payments.

These leverage metrics are not commensurate with our expectations for a 'BBB-' rating.

Liquidity

We view Auchan's liquidity as adequate and calculate that sources will likely exceed uses by more than 1.2x over the next 12 months. The amounts below are an estimate for the 12 months starting from July 1, 2020, of the group's 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 €1.7 billion accessible and available for debt repayment;
- About €2.6 billion of available credit lines;
- About €1.0 billion-€1.1 billion in reported FFO forecast over the next 12 months (net of lease depreciation); and
- 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 €120 million-€130 million of cash related to the disposal of the Italian subsidiary;
- Annual capex of €1.1 billion-€1.2 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 the Association Familiale Mulliez, the majority shareholder, over the next 24 months; and
- 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 €8.1 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-', in line with the issuer credit rating, since no significant elements of subordination risk are present in the capital structure.

As of June 2020, real estate subsidiary Ceetrus has taken some third-party debt on its own books. However, the amounts raised are not material, totaling about €1.5 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 intracompany funding and more on external funding, which could ultimately reinforce subordination risk. However, the portion of priority debt outstanding at the subsidiary levels is still below the thresholds that could trigger subordination risks.

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
- 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
- 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

Related Research

- Auchan Holding 'BBB-' Ratings Affirmed; Outlook Remains Negative Due To High Execution Risk For Transformation Plan, March 30, 2020

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

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