ACRA

Principles of Assessing Industry Factors in the Rating Analysis of Non-financial Corporations

Retail

This document is part of the Methodology for Assigning Credit Ratings to Non-financial Corporations under the International Scale (hereinafter, the Methodology) and describes the specifics in conducting rating analyses of the operational and financial profiles of retail industry corporations.

The document provides lists of indicators used, factor weights, assessment score boundaries for quantitative factors, and the principles of assessing qualitative factors for companies in the industry.

1 Industry Companies

The assessment approaches described in this document are applicable to companies whose core business is selling general use products to end consumers.

2 Rating Factor Structure

Creditworthiness analyses of rated entities in the retail industry are based on assessing eight indicator blocks, which are combined in two profiles and have their own weights totaling 100%. The weights presented in Table 1 are base weights, i.e., they may change depending on the assessment scores derived for indicator blocks (see Subsection 4.1.3 of the Methodology for a description of the floating weights concept).

Table 1. Scorecard for the retail industry

Profile	Factors	Factors weighting	Sub-factors
Operational profile	Business profile	25%	Market position and its stability
			Product and geographic diversification
	Financial policy and corporate governance	15%	Financial policy
			Corporate governance
Financial profile	Size	20%	Revenue (USD bln)
	Profitability	10%	Funds from operations (FFO) margin before fixed charges and taxes
	Leverage	10%	Adjusted gross debt to FFO before fixed charges
			Qualitative leverage assessment
	Coverage	10%	FFO before fixed charges to fixed charges
	Liquidity	5%	Liquidity ratio
			Qualitative liquidity assessment
	Cash flow	5%	Free cash flow (FCF) margin
			Qualitative assessment of FCF stability

Source: ACRA

3 Operational Profile

The following describes the basic factors in the rating analysis of the operational profile, the degree of their influence when determining the credit rating of a non-financial corporation, and assessment specifics.

To assess operational profile qualitative indicators for rated entities in the industry, ACRA uses a set of characteristics specific to the industry that translate into a qualitative assessment category.

Operational profile indicator weights are shown in Table 4.

3.1. Business Profile

Retailers differ considerably from each other depending on the segment in which they operate (food, cars, clothing, shoes, electronics and home appliances, etc.), the format (large scale, local stores, online trade), and type of business model.

Assessing the business profile of companies in the industry involves taking into account the market position of a company, its ability to retain its market share (volatility), and product and geographic diversification.

The retail industry depends on the level of economic development in the regions of presence and changes in consumer preferences, and exhibits varying degrees of demand elasticity and high competition. Companies may operate in a certain market segment or have a wide product diversification. In addition, awareness and strength of a company's brand matter.

The business profile is assessed taking into account the following subfactors subject to qualitative assessment.

3.1.1. Market position and its stability

Market position is determined by a company's share both in the market as a whole and in its individual segments. Companies with a dominant position in the market generally enjoy high brand awareness, significant competitive advantages, and advantageous locations of key stores.

The higher the market share of a company, the more stable its financial position and customer base. Market share may be expanded or retained either through organic growth or by acquisitions of other players, or via aggressive pricing. At the same time, despite the fact that such policies can ensure rapid market share growth, they may also undermine the financial and operational stability of a company.

A declining market share, in turn, may result from either structural changes or increased competition from new players, the appearance of which may lead to a gradual decline of margins in the industry.

The qualitative assessment category for the market position and its stability is determined according to Table 2.

Table 2. Qualitative assessment of the market position and its stability

Assessment category	Main features
I	Leading market position in several countries, maximum brand awareness, significant competitive advantages; market share is growing steadily without sacrificing margins; online trade (where applicable) is successfully growing and well integrated into the core business; multichannel player
II	Leading market position in one country (or key market player in several countries), high brand awareness, competitive advantages; market share is growing, but in some market segments, increase in market share is accompanied by a decrease in margins; online trade (where applicable) is growing and becoming integrated into the core business; multichannel model is under development
III	Key player in the market in one country, moderate brand awareness, no significant competitive advantages; a slight decrease in the market share amid increasing competition or structural changes, leading to a slight decrease in margins; online trade (where applicable) is gradually developing, with integration at an early stage; foundations are being laid to create a multichannel model
IV	Player in the market in one country, low brand awareness, no competitive advantages; moderate reduction in market share due to increasing competition or structural changes, falling margins across the whole business; online trade (where applicable) is in its infancy; no obvious ability to become a multichannel player
V	New player in the market, no well-established business model or recognizable brand; market position is highly vulnerable, there is a risk of loss in market share even in the event of a minor increase in competition,; online trade is in the inception stage; development opportunities are limited

Source: ACRA

3.1.2. Product and geographic diversification

Geographic diversification is assessed both in terms of business concentration in a single region and in terms of the level of economic development of the region of presence.

Concentration on one market segment increases a company’s exposure to the business cycle and other supply and demand features of the market for a particular product, while a diversified product line helps reduce the risks of individual price and consumer shocks for products.

The analysis also involves assessing the historically proven elasticity of demand for products (from essential items (medicines and the minimum monthly groceries) to goods the acquisition of which may be postponed due to adverse macroeconomic and cyclic events), which is crucial in assessing the sustainability of a company’s business model.

The qualitative assessment category for product and geographic diversification is determined according to Table 3.

Table 3. Qualitative assessment of product and geographic diversification

Assessment category	Main features
I	Wide geographic footprint in a country or presence in several jurisdictions with a high level of economic development; product line is composed of goods with low elasticity of demand (essential items), not exposed to adverse macroeconomic or cyclic factors; minimal risk of changes in consumer preferences or technological obsolescence
II	Presence in several regions within a country or in several jurisdictions with a good level of economic development; product line is composed of goods with moderate elasticity of demand, deferred demand is possible as a result of certain macroeconomic and cyclic changes; moderate risk of changes in consumer preferences or technological obsolescence
III	Presence in several regions with a moderate level of economic development; product line is composed of goods with elastic demand, deferred demand is observed during periods of economic instability; demand depends on changes in consumer preferences and technical obsolescence; high risk of fundamental changes in preferences
IV	Local presence in one country, level of development of the region of presence is below average; highly elastic product line exposed to fluctuations in demand during periods of economic instability; high risk of changes in consumer preferences or technological obsolescence, easily replaced by other goods
V	Local presence in one country, low level of development of the region of presence; highly elastic product line prone to adverse changes in the event of even a moderately negative economic situation; product line is composed of goods that recently appeared in the market or those that are being gradually withdrawn from the market

Source: ACRA

3.2. Financial Policy and Corporate Governance

To assess the financial policy and corporate governance of rated entities in the retail industry, ACRA uses a common set of characteristics that translate into a qualitative assessment category for all industries (for a general description of the concept of the corporate governance qualitative assessment, see Section 5 of the Methodology). The assessment of financial policy and corporate governance is carried out according to Table 4.

4 Financial Profile

The following describes the basic factors in the rating analysis of the financial profile, the degree of their influence when determining the credit rating of a non-financial corporation, and assessment specifics.

To assess the qualitative indicators in the financial profile of rated entities, ACRA uses a common set of characteristics that translate into a qualitative assessment category for all industries (for a general description of the qualitative assessment of financial profile indicators, see Section 6 of the Methodology).

Quantitative indicators in the financial profile are assessed in scores based on being part of a particular range, with qualitative indicators based on qualitative assessment categories according to Table 5.

4.1. Size

To assess the business scale of companies in the industry, ACRA uses the size of their revenues, which is important for assessing the creditworthiness of rated entities. The volume of revenues of a company reflects the size of its customer base and market share, and is a key indicator in assessing business growth. In addition, ACRA analyzes revenue dynamics: companies where this indicator exhibits stable growth generally receive a higher score than those whose revenues are stagnating or not exhibiting high growth rates.

4.2. Profitability

To assess profitability, ACRA uses the FFO margin before fixed charges and taxes. This allows ACRA to make a correct comparative analysis of companies using their own infrastructure versus those who rent it.

4.3. Leverage

To assess leverage, ACRA uses the ratio of adjusted total debt[1] to FFO before fixed charges. Qualitative characteristics are also used to assess leverage.

4.4. Coverage

To assess coverage, ACRA uses an indicator calculated as the ratio of FFO before fixed charges to fixed charges. This allows for a more correct comparative analysis of companies using their own infrastructure versus those that rent it.

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[1] Given the currently established practice of assessing the cost of infrastructure rent for retail companies, ACRA uses a multiplier of operating lease capitalization equal to 4x to adjust the size of debt.

4.5. Liquidity

To assess liquidity, ACRA uses the short-term liquidity ratio and qualitative characteristics.

4.6. Cash Flow

To assess cash flow, ACRA uses the FCF margin, as well as the qualitative assessment of FCF stability.

If a company has its own retail floor space, it needs to maintain a sufficient level of capital expenditures and finance them with operating cash flow. Significant changes in the global retail market push companies to fund the installation and implementation of innovative logistics systems, as well as accounting and CRM systems. Dividend payouts made by a company are analyzed separately. Amid high capital costs, high dividend payouts can exert significant pressure on FCF.

Table 4. Operational profile factors

Factors	Sub-factors	Sub-factors weighting	Sub-factors score				
			5	4	3	2	1
Business profile	Market position and its stability	50%	V	IV	III	II	I
	Product and geographic diversification	50%	V	IV	III	II	I
Financial policy and corporate governance	Financial policy	50%	V	IV	III	II	I
	Corporate governance	50%	V	IV	III	II	I

Source: ACRA

Table 5. Financial profile factors

Factors	Sub-factors	Sub-factors weighting	Sub-factors score				
			5	4	3	2	1
Size	Revenue (USD bln)	100%	[0; 3)	[3; 10)	[10; 25)	[25; 50)	[50; ∞)
Profitability	FFO margin before fixed charges and taxes	100%	(−∞; 3%)	[3%; 7%)	[7%; 15%)	[15%; 25%)	[25%; ∞)
Leverage	Adjusted gross debt to FFO before fixed charges	70%	(8; ∞)	(5; 8]	(3; 5]	(2; 3]	[0; 2]
	Qualitative leverage assessment	30%	V	IV	III	II	I
Coverage	FFO before fixed charges to fixed charges	100%	(−∞; 1)	[1; 3)	[3; 6)	[6; 10)	[10; ∞)
Liquidity	Liquidity ratio	50%	(−∞; 0.8)	[0.8; 1)	[1; 1.25)	[1.25; 1.5)	[1.5; ∞)
	Qualitative liquidity assessment	50%	V	IV	III	II	I
Cash flow	FCF margin	50%	(−∞; −10%)	[−10%; 0%)	[0%; 5%)	[5%; 10%)	[10%; ∞)
	Qualitative assessment of FCF stability	50%	V	IV	III	II	I

Source: ACRA

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