ARCHIVE | Criteria | Corporates | Industrials:

Key Credit Factors For The Retail And Restaurants Industry

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(***Editor's Note:*** *This article is no longer current. We have included relevant content in "Guidance: Corporate Methodology,"published on July 1, 2019.)*

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1. This article presents S&P Global Ratings' methodology and assumptions for rating retail companies, including restaurants, automotive retailers, and food distributors, on a global basis.

SCOPE OF THE CRITERIA

2. These criteria apply to all retail companies. We define retail companies as companies that sell goods or services directly to the individual consumer through stores, catalogues, or online operations--or a combination of these channels. We include restaurants, automotive retailers, and grocery wholesalers in this Key Credit Factors given that the fundamentals of operating these businesses are largely the same as general retailing with similar unit economics.

SUMMARY OF THE CRITERIA

3. This article presents S&P Global Ratings' criteria for analyzing retail companies, applying our general corporate criteria. We view retail as an "intermediate risk" industry under our new criteria, given its "intermediate" cyclicality assessment and "intermediate" competitive risk and growth assessment.
4. In assessing the competitive position of retail companies, we put particular emphasis on the companies' merchandising strategies, product differentiation, market position relative to peers, and operating efficiency.
5. If the preliminary cash flow leverage assessment is intermediate or stronger, we generally use discretionary cash flow (DCF) to debt or free operating cash flow (FOCF) to debt as the supplemental ratios. If the preliminary cash flow leverage assessment is significant or weaker, EBITDA to interest will be given greater importance as we focus more on their ability to service their interest burden.
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METHODOLOGY

Part I--Business Risk Analysis

Industry Risk

8. Within the framework of S&P Global Ratings' criteria for assessing industry risk, we view retailing as an "intermediate" risk industry (category 3). Our industry risk assessment for retail companies is derived from our view of the segment's intermediate degree of cyclicality (category 3), and our assessment that the industry's risk is intermediate (category 3) in terms of competitive risk and growth.

9. In our opinion, currently rated companies in the retailing industry usually have medium risk compared to other industries and sectors. Investment-grade issuers tend to operate in developed markets, have good market position with leading market share or well defined niche position in its subsector, or are focused on less discretionary product categories such as food and drugs. Conversely, it is difficult for a company operating in highly volatile and undeveloped markets, with narrow market presence and focused on growing its store base, to achieve an investment-grade rating, even with a conservatively leveraged capital structure.

10. There is a wide dispersion on the risk profiles of the subsectors within the retailing industry. Much of what rated retailers sell to consumers represents a highly discretionary purchase--especially over the short term. Subsectors that have similar traits and compete directly with each other can be grouped for purposes of industry risk analysis. We group the following subsectors for analytic purposes, ranked by the subsector's risk profile:

- Discounters, supermarkets, pharmacies, and convenience stores (including gas retailing operations);
- Department stores and specialty stores;
- Restaurants; and
- Automotive retailers.

11. We characterize the risk profile of the discount subsector as "strong" because of its good market share growth prospects, while we view the risk profile of the supermarket subsector as "satisfactory" to "fair" based on the relatively stable nature of food retailing. On the other end of the spectrum, we view the risk profile of specialty apparel retailing subsector as "weak" owing to the high discretionary nature of the product category in a very fragmented and competitive industry.

Cyclicality assessment:

12. We assess the cyclicality of rated retail companies as intermediate (category 3) based on our analysis of cyclical peak-to-trough (PTT) declines in revenue and profitability across sectors and over time. Key drivers of cyclicality include consumer confidence; unemployment rate; household indebtedness, consumer spending; gasoline prices; and availability of consumer credit. The effect of cyclicality is the main risk differentiator between subsectors. In general, we expect supermarkets, pharmacies, and general merchandise discounters to remain less cyclically affected by declining consumer spending because their broad product offerings are less

discretionary. Discounters also offer a good value proposition--they emphasize basics and consumables, and benefit from consumers trading down during times of economic slowdown. This is in contrast to discretionary categories such as home improvement, appliances, and especially apparel categories, which were weak throughout the recession in 2009.

13. In all subsectors, sales growth and volume are critical to profitability, because of the high fixed cost base and property intensity of these businesses (i.e., high operating leverage). The negative impact of merchandise missteps is compounded by this high operating leverage. Retailers also need to continually invest in new stores, undertake costly renovations of existing properties to maintain existing sales, and expand geographically to drive sales growth. This makes the business capital- and borrowing-intensive. Also, outdated and/or poorly maintained stores are susceptible to material sales erosion.

14. The retail industry has demonstrated a medium degree of cyclicality in revenue and profitability, which are two key measures we use to derive an industry's cyclicality assessment. Based on our analysis of global Compustat data, retailers experienced an average PTT decline in revenues of 0.6% during recessionary periods since 1968, and the steepest decline was 3.4% during the downturn from 2007 to 2009. Also since 1968, retail companies experienced an average PTT decline in EBITDA margin of 7.1% during recessionary periods and suffered the largest drop, a PTT EBITDA margin decline of 13%, during the 1972-1975 downturn. With an average drop in revenues of 0.6% and an average profitability decline of 7.1%, retail companies' cyclicality assessment calibrates to an intermediate (category 3) risk. We generally consider the higher the level of cyclicality in an industry, the more this factor will contribute to credit risk of entities operating in that industry. However, the overall effect of cyclicality on an industry's risk profile may be mitigated (or exacerbated) by an industry's competitive and growth environment.

Competitive risk and growth assessment

15. We view the retail industry as having an "intermediate" (category 3) competitive risk and growth assessment. To assess competitive risk and growth, we assess four subfactors as low, medium, or high risk. These subfactors are:

- Effectiveness of industry barriers to entry;
- Level and trend of industry profit margins;
- Risk of secular change and substitution by products, services, and technologies; and
- Risk in growth trends.

Effectiveness of retail industry's barriers to entry--Medium Risk

16. The retail industry is highly competitive and fragmented with few barriers to entry, although certain subsectors--such as food and drug retailing--are dominated by large players with significant market share and scale, while others have established strong brand recognition creating customer loyalty.

17. Industry consolidation and organic store growth created market leaders in food and drug retailing. Market concentration raises the barriers to entry as large chains with scale and efficiencies can invest in price to attract customers. In addition, much of the U.S. supermarket industry is unionized, which results in higher operating costs and a thinner profit margin.

18. Retailing is somewhat capital intensive given the need to continuously invest in store development. In the U.S., store renovation programs are highly important given the relative

maturity of the market, and a key factor in at least maintaining market share. Successful store renovation programs can drive store traffic and sales. A lack of store investment, conversely, can drive away customers and lose customer loyalty. Technology to support online operations and an efficient supply chain also require sizable capital investment.

19. Big-box retailers dominate specialty categories such as home improvement, electronics, and office supplies. This has created intense price competition for smaller or regional players. Those that are unable to compete on price need to differentiate themselves in order to succeed.

20. Auto retailers face higher barriers to entry given that automakers control the number and location of franchises. Automakers are generally prohibited from direct auto sales by dealer franchise laws and generally rely on auto dealers to reach the consumer. Given their role, auto retailers have gained effective territorial monopolies from their manufacturers. But an array of other vehicle offerings from competitors limits the benefits of this franchise structure.

Level and trend of industry profit margins--High Risk

21. Ongoing competition pressures retailers' profitability. The rapid growth of the discount segment, particularly in food retailing, has pressured gross margin for many traditional grocery operators as they need to lower prices to remain competitive. Big-box category killers with high volume sales per store also put intense pressure on smaller players.

22. While commodity cost increases could pressure profit margins in the short term, retail and restaurant operators have been nimble in passing part of the cost increase to consumers and adjusting their cost structure to absorb these increases. Through pricing, restaurants can direct customers to parts of the menu where margins are less exposed to commodity price rises. In Europe, however, weak trading coupled with increased competition have recently resulted in many retailers absorbing or unable to pass input cost increases.

23. Successful inventory management can help limit markdown risk for specialty retailers. Retailers can generally rebound from a single weak selling season by fixing merchandising issues and achieving better margins in the next selling season. For example, during the most recent recession, retailers reduced inventory purchases and enhanced cash flow, reducing markdown risk and lowering their overall costs in light of weak sales.

24. Auto retailers have a diverse revenue stream that includes a high-margin parts and service business, which affords the potential for consistent cash generation despite economic swings that can reduce the volume of vehicle sales and/or lower margins on new and used vehicles. Parts and services can generate 40% to 50% of profit, which can cover about 50% of selling, general, and administrative (SG&A) expenses.

25. Auto retailers are dependent on automakers' captive finance companies or third-party lenders to provide credit directly to consumers for the vehicle purchase. The cost and availability of credit can constrain/drive sales, as can manufacturer incentives to the consumer.

Risk of secular change and substitution of retailing by products, services, and technologies--Medium Risk

26. We view the risk of secular change and substitution by products, services, and technologies as "medium." While the risk from outside the industry is low, there is increasing risk within the industry as online sales are rising at a faster pace than brick-and-mortar retail sales.

27. While there is a well-established consumer trend favoring shopping online, brick-and-mortar retailers continue to be the primary distribution channels. Further, many retailers are blending

their brick-and-mortar stores with their online operations and, in the process, growing their multichannel sales.

28. Some manufacturers have developed their own distribution channels to sell to consumers directly, but this has had limited impact on retailing.

29. Substitution risk for auto retailers is relatively low as well. Only a relatively small portion of the U.S. population has accessible, reliable public transportation. Therefore, the vast majority is reliant on a private vehicle. This is by design. In the U.S., the vast majority of roads and interstate highways were designed and constructed for the modern automobile. In Asia, although public transportation is more widely available given a higher density of population, private vehicle penetration is still very low and has more room to grow.

Risk in retail industry growth trends--Low Risk

30. Retail industry sales trends are closely correlated with macroeconomic trends. In mature developed markets, GDP growth in itself is sometimes not a good proxy for retail sales. Same-store or like-for-like sales can be much more sensitive to consumer confidence and expectations about unemployment and discretionary income. This is evidenced by a modest retail sales decline in the recent economic downturn in the U.S. and eurozone during 2009. In Asia, we tend to see retail sales grow faster than or in line with GDP growth.

31. A retailer's strategy to achieve top-line growth from its store expansion strategy can also have a significant impact on its operating profile. Large multinationals, including many European retailers, have expanded their footprint to emerging markets where there is higher growth potential compared to the core developed markets.

32. The U.S. retail landscape is mature and overstored (another way of saying "excess capacity") and exhibits low growth rates. Sales growth largely comes from the existing store base or same-store sales. Macro trends affect same-store or like-for-like sales, predominantly. If retail sales grow, they grow through expansion--especially retailers that are internationally present, but also retailers who expand their distribution channels (for example, to online).

33. We view European retail markets as very diverse with varying operating and competitive dynamics, which vastly influence the growth patterns. That said, we would assess retail markets, particularly in Western Europe, as largely mature but suffering less from excess capacity than in the U.S. Competition from both established retailers and new entrants remains fierce, and low to moderate increase in same-store sales growth can be largely attributed to improved consumer spending trends or better operational execution. Continued online and multichannel growth should also aid the top line, together with moderate contribution from store expansion strategies.

34. The Asian retail market is highly fragmented and competitive but thinly penetrated and experiencing rapid growth, mainly driven by increasing disposable income, price inflation, urbanization, and higher population. Retailers are expanding their store networks aggressively to increase coverage.

35. Retailers selling less-discretionary products, such as food and drugs, are less susceptible to economic downturns than those in home improvement and apparel, where consumers can postpone purchases when times become tough. The restaurant sector is also highly discretionary. The consumer can eat at home.

36. The effect of cyclicality is the main risk differentiator between subsectors in retail. We expect specialty retailers selling more-discretionary products to exhibit more pronounced swings in sales based on changes in economic activity in their markets.

Country risk

37. We define "country risk" as the broad range of economic, institutional, financial market, and legal risks that arise from doing business with or in a specific country and can affect a non-sovereign entity's credit quality. The credit risk for every rated entity and transaction is influenced to varying degrees by these types of country-specific risks.

38. In assessing country risk for a retail company, our analysis uses the same methodology as with other corporate issuers (see the corporate criteria).

Competitive position (including profitability)

39. Under our corporate criteria, a company's competitive position is assessed as (1) excellent, (2) strong, (3) satisfactory, (4) fair, (5) weak, or (6) vulnerable. In assessing the competitive position for retailers, we review an individual company's

- Competitive advantage;
- Scale, scope, and diversity;
- Operating efficiency; and
- Profitability.

40. The first three components are independently assessed as either (1) strong, (2) strong/adequate, (3) adequate, (4) adequate/weak, or (5) weak. Profitability is assessed through the combination of the level of profitability and the volatility of profitability.

41. After assessing competitive advantage, scale, scope, diversity, and operating efficiency separately, we determine the preliminary competitive position assessment by ascribing a specific weight to each component. The applicable weightings will depend on the company's competitive position group profile (CPGP). The CPGP assigned to retailers is "Services and Product Focus" as retailing is consumer facing and operates based on reputations for its products and services. While the industry is also somewhat capital intensive, most retailers lease their stores and therefore do not need to commit substantial amount of capital. We apply a CPGP with a weighting of the three components as follows: competitive advantage (45%); scale, scope, and diversity (30%); and operating efficiency (25%). Profitability is assessed through the combination of level of profitability and volatility of profitability, and we assess profitability based on a matrix (refer to our corporate methodology, "Profitability Assessment Matrix").

42. When analyzing a retailer's competitive position, we put particular emphasis on the company's competitive advantage. In our view, the company's market position against its peers, its merchandising strategy, and its track record in growing its sales base are key factors that may mitigate sales pressure during a cyclical downturn or highly competitive environment. Large scale can command pricing power and ability to leverage cost. Matters of operating efficiency--including cost structure, working capital management, and technology--are generally secondary considerations.

Competitive advantage

43. Our assessment of a retailer's competitive advantage is based on the following subfactors:

- Merchandising strategy. Whether the strategy is focused on a niche or on a category, successful merchandising is clear, focused, and consistent enough to maintain customer

loyalty.

- Differentiation of concept/product/shopping experience, and positioning versus competitors can effectively target a specific customer segment.
- Brand reputation and marketing. Strong private or exclusive brands can command price premiums and allow for above-average margins while building customer loyalty.
- Product/service-level quality. Retailers that offer the right balance of quality and price provide a compelling value proposition.

44. Whether the strategy is broad or narrow, a retailer's merchandising strategy and brand management are critical aspects of the business risk analysis as these can set the foundation for overall competitive position.

45. A retailer with a strong or strong/adequate competitive advantage assessment has a combination of:

- Consistently successful merchandising strategy;
- Compelling value proposition of its products or services;
- Highly differentiated concept or products;
- Successful product/brand positioning;
- A strong consumer franchise;
- Successful online strategy and a platform to support future channels;
- Strong store development with attractive store locations; and
- For auto retailers, operation of a variety of desirable franchises with diverse brand exposure.

46. A retailer with a weak or adequate/weak assessment of its competitive advantage typically has a combination of:

- Little concept/product differentiation;
- Weak brand positioning relative to peers;
- Low value proposition of its products/services;
- Weak track record of store development, or exits from certain markets due to failed expansions;
- Lack of significant online presence to supplement its retail operations; and
- For auto retailers, concentration of franchises and brand exposure.

47. Merchandising success can be achieved through a variety of methods. Most retailers focus on a distinct niche, product category, or convenience. Whether the strategy is niche or category-dominant, the merchandising strategy needs to be clear, focused, and consistent because deviations can lose customer loyalty and market share to competitors.

48. A strong consumer franchise is the result of long-term merchandising success and brand management that create high consumer acceptance and loyalty. From a credit analysis perspective, a strong consumer franchise supports consistent healthy sales and profit growth.

49. Successful retailers provide a compelling value proposition. Retailers that offer the right balance of product quality and price provide a convincing reason to shop at their stores, and generally have a strong or strong/adequate assessment. Selecting appealing products and effectively displaying and marketing them will attract high customer traffic. Introducing new items and moving into new

categories and price points can reinvigorate sales and image. However, stocking merchandise and assortments that differ from customers' expectations or image of the store can lead to subpar sales and generally results in a weak or adequate/weak competitive advantage assessment.

50. Retailers differentiate themselves by offering unique product design, quality products, good service, compelling assortment, and appealing presentation. Differentiation is often the key to success in a crowded market. Given the intense competition from big-box players in almost every product category, a small regional or niche retailer that is unable to compete based on price will need a high degree of differentiation to receive an assessment of strong or strong/adequate.

51. To prevent discounters from gaining market share or to improve price-perception among customers, retailers have been expanding their private-label and exclusive offerings. These products, when successful, typically boost volume growth as customers can afford to purchase more. In addition, private-label goods carry higher margins than branded products as they are tailor-made for the retailer, produced in lower stock-keeping units (SKUs), and carry lower marketing costs. Grocers and drug chains that increase the penetration of their private-label programs generally get a strong or strong/adequate assessment.

52. Specialty retailers have also developed private brands targeting a niche market that competes against national brands. Some specialty retailers have also achieved a highly differentiated product mix and store experience targeting specific customer segments. We view these developments favorably, as they represent a competitive advantage that allows for above-average gross margins while building customer loyalty.

53. Retail companies must regularly reinvest in their properties, or build new properties to increase sales and maintain the relevance of the store concept. Investment beyond normal maintenance spending is often required to periodically reinvigorate a property, especially in more competitive markets. Store remodeling programs are critical to attract customers and maintain competitiveness. A well maintained store base with an attractive store layout can be a competitive advantage. Outdated and/or poorly maintained stores, on the other hand, are susceptible to material sales erosions, can be a competitive disadvantage, and will generally be assessed as weak or adequate/weak.

54. Online sales remain a small percentage of overall retail sales, but are growing at a much faster pace. In response, retailers have increased their investments in the online channel. In our business risk assessment, we view investment in the online channel favorably. We do not necessarily view a lack of online investment unfavorably as long as overall growth prospects remain healthy and the retailer is expanding its "brick and mortar" store base. We believe retail subsectors, such as discount stores, maintain good store growth potential and, therefore, significant online investment is not critical. For other more mature sectors, such as department stores, in contrast, broadening the online channel is important to sales growth given the lack of store growth potential.

Scale, scope, and diversity

55. Retailing is generally fragmented, but in certain subsectors, such as supermarkets and drugstores, large retailers can command a very significant share of the overall market. Other sectors, such as specialty apparel or hard goods are highly fragmented and even the largest players only account for a very small portion of the overall market.

56. Size alone does not ensure profitability and growth; however, large scale allows companies to spread out costs and enjoy more economies of scale than their competitors. Size can provide economies of scale in distribution, advertising, overhead, and information systems. Important market share leadership also creates clout with suppliers to obtain purchasing discounts.

57. Our scale, scope, and diversity assessment incorporates:

- Diversity of product or service range.
- Geographic footprint of store base and prospects of core markets. For European retailers, a presence in emerging markets offers higher growth prospects than the mature home markets.
- Volumes, size, market share, or niche position in chosen segment.
- Relative attractiveness of the markets (i.e., size, demographics, expected growth, and intensity of competition).

58. A strong or strong/adequate assessment of scale, scope, and diversity typically combines:

- Sizable market share leadership in the retailer's core markets or industry subsector.
- Large scale that commands strong bargaining power with suppliers.
- Ability to leverage marketing and other operating costs.
- A successful niche position within a subsector; a category leader.
- For European and Asian retailers, geographic diversity with presence in higher-growth emerging markets given the limited size of the domestic market, or exposure to different regions with different consumption trends, helping to mitigate volatility.
- For large auto retailers, growth through successful acquisitions, with the scope and scale for technology that enables more efficient operations.
- In the restaurant industry, company-operated and franchised restaurants generally contribute a significant percentage of revenue to advertising funds. As a result, large brands tend to have large advertising budgets and can market their products and promotions more aggressively than smaller brands.

59. A weak or weak/adequate assessment of scale, scope, and diversity typically is characterized by:

- Weak market position in a crowded sector.
- Lack of scale and low bargaining power with suppliers.
- Presence of significantly stronger players in core markets.
- Market share loss to stronger players in its core markets.
- For European and Asian retailers, lack of geographic diversity, little or no presence in higher-growth emerging markets, or little or no diversity in different regions with different consumption trends to mitigate volatility.
- For auto retailers, lack of growth through acquisitions and lack of scale and scope for technology to enable more efficient operations.
- For restaurants, smaller or regional brands lack scale and scope that could result in small advertising budgets that hinders the ability to promote products.

60. In terms of geographic diversity, we believe retail companies should operate in multiple regions around the world holding leading market positions; or be well spread across one sizable market (for example, the U.S. or China) with little concentration in any particular state or region. However, geographic diversity that lacks good profitability is not meaningful, and well diversified retailers can struggle because of poor store or merchandising execution. Likewise, significant concentration in one state or region can be viewed as unfavorable; however, numerous regional retailers have achieved strong regional market share despite limited geographic diversity.

61. Generally, brand diversity does not play an important role in our ratings process. A retail company may operate or manage multiple concepts, and these may be in different subsectors or have quite divergent product offerings and price points. But in fact, development and management of smaller brands can occupy management's time and resources so that the primary brand operations may suffer. Still, we would view a singular concept that is weakly positioned as unfavorable.

62. In terms of concept diversification, we believe the retailer should have brands that have dominant positions in the niche segments they serve and account for a significant portion of operating income. Ideally the multiple concepts target distinct customer or product segments and the growth of one does not cannibalize on the sales of another.

Operating efficiency

63. Retail comprises diverse sectors, and operating metrics for each sector can vary widely. Therefore, comparison should be made with peers in the same subsector with similar product mix, cost structure, and geographical operations. To assess operating efficiency we typically track:

- Same-store sales or like-for-like sales;
- Gross margin;
- SG&A to sales;
- Sales per square foot;
- EBITDA margin;
- Inventory turnover;
- Accounts payable days;
- Cash conversion cycles; and
- For auto retailers, we look at the ratio of SG&A to gross profits.

64. Strong or strong/adequate operating efficiency is characterized by:

- A consistent positive trend of same-store sales growth that leverages a growing fixed cost base.
- Higher-than-average unit-level productivity compared to peers, such as sales per square foot for retailers and average unit volume (AUV) for restaurants.
- A consistent trend of gross margin indicates strong working capital management. This is particularly more important for seasonal retailers.
- A competitive cost structure (SG&A as a percent of sales) and ability to adjust cost structure in periods of falling sales.
- Above-average profit margin (EBITDA margin) from consistent sales growth to leverage a highly fixed expense base.
- Efficient working capital management leading to higher inventory turns and limited markdown risk
- For auto retailers, a high degree of automation integrating operations and sales, providing current market data to the sales floor for better pricing, and gathering customer information to drive sales for the parts and service segment of the business.
- Also for auto retailers, excellent relationships with profitable automakers, knowing that these automakers typically provide floor plan financing for the vehicle inventory and have veto power

over the awarding of franchises to operators.

- For restaurants, a higher mix of franchised units results in less exposure to commodity cost fluctuations and packaging and labor costs, and thus offers a more predictable cost structure.

65. Weak or adequate/weak operating efficiency combines:

- Same-store sales trends that lag peers or or are declining consistently, indicating market share loss.
- Profitability consistently below peers due to subpar sales trends or less competitive cost structure.
- Less competitive ratio of SG&A to sales because of higher rent or labor expenses.
- High volatility of gross margin, indicating poor inventory management.
- Lower-than-average sales/sq. ft. indicating underutilized assets.
- Lack of a comprehensive online strategy or little presence in this growth channel.
- Weak working capital management resulting in greater inventory investment, lower inventory turns, and a higher-than-expected level of markdowns.
- For auto retailers, volatile same-store sale growth trend, less variable cost structure, and inconsistent inventory control due to less sophisticated systems automation.
- For restaurants, inconsistent sales and greater exposure to cost fluctuations due to the larger portion of company operated units versus franchised units.

66. Store productivity is an important measure of a retailer's overall operating efficiency. In our analysis of store productivity, we generally look at the following key metrics:

- Same-store sales (also referred to as comparable-store sales or like-for-like sales). We view a consistent trend of same-store sales growth favorably in our assessment and believe it indicates the company is using its assets efficiently to leverage its largely fixed cost base, which primarily consists of rent expense and labor cost. Furthermore, same-store sales trends that rank ahead of peers may indicate that the retailer is gaining share. Conversely, same-store sales trends that lag peers or are declining consistently may indicate market share loss versus its peers or to other retail formats.
- Sales per square foot or sales density. Retailers can demonstrate above-average store productivity by selling more per square foot than peers, which we view favorably in our assessment. Lower sales per square foot than peers may indicate underutilized assets and subpar operating performance. However, retailing is a very diverse sector and this measure can vary widely depending on the product mix or store format. Therefore, the comparison should be made with peers in the same subsector with a similar product mix, cost structure, and geographical operation.
- Gross margin trends can provide insights into how well a retailer is managing its inventory purchases, cost increases, and pricing strategies. Inventory planning is critical in retailing as too much excess inventory usually leads to steep markdowns, hurting overall profitability. In periods of high inflation, retailers able to pass on cost increases can maintain gross margins. We view favorably a retailer that outperforms its peers in maintaining or growing its gross margin. We view unfavorably a retailer that underperforms its peers with a steady decline in gross margin or highly volatile gross margin trends. These trends heavily depend on global commodity prices (both food and nonfood) and labor cost inflation levels, due to the heavy dependence on Asian manufacturing (Chinese manufacturing in particular).

- EBITDA margin. While sales metrics are useful, we also consider the operating margin as another measure of operating efficiency. We look at a retailer's SG&A expenses as a percentage of sales and compare it to its peers. SG&A expenses are typically fixed costs that a retailer needs in order to grow profitability. Depending on the degree of operating leverage, a retailer may need to increase same-store sales at a different pace than its peers. Therefore, we view favorably the ability of a retailer to turn fixed costs into sales growth to drive margin expansion. Generally, mall-based operators have higher rent expenses than off-mall operators in lifestyle centers.

67. Working capital management is important in our evaluation of operating efficiency because of the use of liquidity to fund inventory investments ahead of sales, particularly in the important holiday season. In general, a retailer with strong working capital management skills exhibits lower levels of working capital investment compared to its peers, and often has fewer markdowns. Growing companies need to invest in inventory to support store growth, resulting in a use of cash, while mature companies can reduce inventory investments, resulting in a source of cash. Given that inventory typically represents the bulk of a retailer's current assets, achieving higher inventory turnovers generally results in lower levels of inventory investment and reduces financing costs. On the other hand, poor working capital management can stress a retailer's liquidity if the company's inventory position is too high while vendors demand shorter payable terms.

68. Characteristics of successful working capital management include:

- Higher level of inventory turnover than peers. This reflects the retailer's ability to stock sufficient types and quantities of inventory in order to meet customer demand on a timely basis without tying up excess capital;
- Account payable levels that minimize net inventory investment, such as extending the number of account payable days (stretching of A/P days); and
- Lower cash conversion cycles. These demonstrate a company's stronger position in the supply chain (for example, requiring suppliers or dealers to hold more of its inventory). Relative to peers, this allows a company to direct more capital to other areas of investment.

69. Many retailers, and particularly speculative-grade issuers, rely on revolving credit facilities to fund seasonal inventory purchases during the months leading to the critical selling period. High seasonality leaves little room for error in the important selling quarters. An unfavorable assessment of seasonality risk could manifest from the inability to lower the impact of seasonal risk factors on business performance (say, a DIY retailer that is unable to arrest sales decline due to a poor summer). Underperforming peers in achieving sales targets and managing inventory investments during seasonal peaks could lead to heavy markdowns, hurting profitability.

Profitability

70. The profitability assessment can confirm or modify the preliminary competitive position assessment. The profitability assessment consists of two components: 1) the level of profitability, and 2) the volatility of profitability. The two components are combined into the final profitability assessment using a matrix. To assess volatility, we require several years of historical data. In cases in which we do not have such historical data, we perform the volatility assessment based on peer analysis.

71. Profit potential is a critical determinant of credit protection. A company that generates higher returns on capital and strong margins has a greater ability to generate cash to redeploy for investment and withstand business adversity.

72. A retailer that warrants a favorable assessment of profitability generally can successfully increase profitability by consistently growing sales, and drive return on capital by efficiently using its assets. Higher profitability also serves as a reliable gauge of a retailer's competitive strength, market positioning, and its brand identity. In our analysis, we consider a retailer's sales growth track record and try to forecast a sales trend based on the company's competitive position, growth plans, and industry prospects. An unfavorable assessment can result from persistent sales declines leading to profit erosion despite cost reduction efforts.

73. We analyze profitability measures in absolute and relative terms, focusing on the volatility, trends, and prospects of the measures. Profitability is also ultimately a key performance indicator, allowing comparisons to peers inside and outside of the retail industry. A company that generates higher operating margins and returns on capital also has a greater ability to fund growth internally, attract capital externally, and withstand business adversity. Earnings power ultimately attests to the value of the company's assets and the success of management strategies. In fact, a company's profit performance offers a litmus test of its fundamental health and competitive position.

Level of profitability

74. EBITDA margin is the primary metric that we use to evaluate profitability for retail companies. We also consider return on capital in some cases, but this measure can be distorted if there is a significant amount of goodwill or intangibles from a leveraged buyout of acquisitive history. The EBITDA margin used is adjusted for leases based on our lease adjustment methodology.

75. Retailing comprises diverse sectors each with a different margin profile. As such, we compare each retailer's profitability against its peers in the same subsector and in most cases within the same region. For example, food and drug retailers generally have a lower margin profile than apparel and department stores given the low margin nature of food and drugs. Profitability is determined on a three point scale: above average, average, and below average.

Table 1

Retailer Profitability Scale

	Dept stores/specialty retailers	Discounter/Food retailers/drugstores/C-stores	Restaurants	Auto retailer
Above average	over 16%	over 10%	over 23%	over 4%
Average	10%-16%	5%-10%	14%-23%	3.5%-4%
Below average	below 10%	below 5%	below 14%	below 3.5%

76. We assess a company's profitability ratios relative to those of its peers with similar business mixes or merchandising focus and in the context of its strategy. While we generally assess profitability using the above table, in cases where a company does not fit clearly into the above categories, we would assess profitability using other, more-relevant benchmarks.

Volatility of profitability

77. Volatility of profitability is determined using the standard error of regression (SER), in accordance with our corporate criteria. We use EBITDA margin to determine the SER for retail and restaurant companies. We only determine SER when companies have at least seven years of historical annual

data to ensure the results are meaningful.

78. We generally use EBITDA to determine the SER for retailers and restaurants only if there are at least seven years of historical annual data to ensure meaningful results.

79. As with the level of profitability, we evaluate a company's SER in the context of its industry group. We establish a six-point scale with the '1' category capturing the least volatile companies (i.e., those with the lowest SERs) and the '6' category capturing the most volatile companies (i.e., those with the highest SERs).

Part II--Financial Risk Analysis

Accounting and analytical adjustments

80. Our analysis of a company's financial statements begins with a review of the accounting to determine whether the statements accurately measure a company's performance and position relative to its peers and the larger universe of corporate entities. To allow for globally consistent and comparable financial analyses, our rating analysis may include quantitative adjustments to a company's reported results. These adjustments also enable better alignment of a company's reported figures with our view of underlying economic conditions. Moreover, they allow a more accurate portrayal of a company's ongoing business. Adjustments that pertain broadly to all corporate sectors, including this sector, are discussed in "Corporate Methodology: Ratios And Adjustments."

81. This paragraph has been deleted.

82. This paragraph has been deleted.

83. This paragraph has been deleted.

84. This paragraph has been deleted.

Cash flow/leverage analysis

85. The pattern of cash flow generation, current and future, in relation to cash obligations is often the best indicator of a company's financial risk. Cash flow/leverage analysis is the foundation for assessing an issuer's financial risk profile. The assessment of a corporation's cash flow/leverage is assessed on a scale of 1) minimal, 2) modest, 3) intermediate, 4) significant, 5) aggressive, and 6) highly leveraged.

86. We use the same methodology as with other corporate issuers (see our corporate methodology) for rating retail companies when assessing cash flow/leverage.

Core ratios

87. We determine core ratios in accordance with S&P Global Ratings' ratios and adjustment criteria. In assessing the cash flow/leverage of retail companies, we utilize FFO to debt and debt to EBITDA.

88. We consider most retail and restaurant companies as having "standard" volatility.

Supplemental ratios

89. In addition to a company's core ratios, we consider supplemental ratios in order to develop a fuller

understanding of a company's credit risk profile and fine tune our cash flow analysis. We generally include EBITDA to interest coverage, FOCF to debt, and DCF to debt in our analysis.

90. Retailers often carry a high adjusted debt burden and their ability to meet cash interest and lease payments is critical. For retailers with core cash flow and leverage ratios indicative of a financial profile of intermediate or better, the ability to generate free cash flow after investing in their business enables them to lower leverage or fund shareholder returns, such as share repurchases or dividend payments. Therefore, we generally use DCF to debt or FOCF to debt as the supplemental ratios. However, for retailers whose FOCF generation is constrained by significant capital expenditures, we will use cash flow from operations (CFO) to debt as the preferred supplemental ratio. For retailers whose core cash flow and leverage ratios are indicative of a financial profile that is "significant" or weaker, we generally use EBITDA to interest coverage as the supplemental ratio as we focus more on their ability to service their interest and lease burden. In some cases where we believe lease-adjusted EBITDA interest coverage or other cash flow coverage ratios (because of our lease adjustment) overstate the company's ability to cover fixed costs, including rent, we may use an unadjusted EBITDAR to interest plus rent ratio instead. We believe this ratio more accurately reflects the lease-related obligation by capturing actual rent versus minimum contractual rent. This ratio also helps distinguish companies with higher property ownership versus companies that lease most of their properties.

Table 2

EBITDAR Coverage Ratio Scale

Minimal	>8.0x
Modest	>5.0x-8.0x
Intermediate	>3.0x-5.0x
Significant	>2.5x-3.0x
Aggressive	=>2.2x2.5x
Highly leveraged	<2.2x

Part III--Rating Modifiers

Diversification/portfolio effect

91. In assessing diversification/portfolio effect analysis for a retailer, our analysis uses the same methodology as for other corporate issuers (see our corporate methodology).

Capital structure

92. In assessing capital structure on a retail company, our analysis uses the same methodology as with other corporate issuers (see our corporate methodology).

Liquidity

93. We use the same general methodology as with other corporate issuers.

94. Auto retailers' inventory borrowing requirements may be met by floor plan financing from automakers and sometimes third-party lenders. This arrangement stabilizes liquidity for the

retailers and is not considered to be a use of liquidity.

Financial policy

95. In assessing financial policy on a retail company, our analysis uses the same methodology as with other corporate issuers (see our corporate methodology).

Management and governance

96. In assessing management and governance on a retail company, our analysis uses the same methodology as with other corporate issuers (see our corporate methodology).

Comparable rating analysis

97. In assessing the comparable ratings analysis on a retail company, our analysis uses the same methodology as with other corporate issuers (see our corporate methodology).

REVISIONS AND UPDATES

This article was originally published on Nov. 19, 2013. These criteria became effective on the date of publication.

Changes introduced after original publication:

- On June 30, 2016, as part of our annual review of the criteria, we removed paragraphs 6-7, which were related to the original publication of the criteria and no longer relevant.
- Following our periodic review completed on June 30, 2017, we updated the contact list.
- Following our periodic review completed on June 29, 2018, we updated the contact list.
- On April 1, 2019, we republished this criteria article to make nonmaterial changes. We deleted paragraphs 81-84 were because they were superseded by "Corporate Methodology: Ratios And Adjustments," published April 1, 2019 (Ratios and Adjustments). The sector-specific accounting and analytical adjustments previously included in those paragraphs are now included in the Guidance supporting the Ratios and Adjustments criteria.
- On Aug. 14, 2019, we republished this criteria article to make nonmaterial changes to the contact information.

RELATED PUBLICATIONS

Superseded Criteria

- Key Credit Factors: Business And Financial Risks In The Retail Industry, Sept. 18, 2008

Related Criteria

- Corporate Methodology: Ratios And Adjustments, April 1, 2019

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Corporate Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Principles Of Credit Ratings, Feb. 16, 2011

Related Guidance

- Guidance: Corporate Methodology: Ratios And Adjustments, April 1, 2019

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