Rating Methodology - Organised Retail Companies

[Issued in December 2022]

Indian retail industry

The Indian retail industry has emerged as one of the most dynamic and fast-growing industries due to rising income levels, growing aspirations, favourable demographics and easy credit availability. The Indian retail industry is one of the top five retail markets in the world. The Indian retail market continues to be dominated by the unorganised retail (mom-and-pop stores and traditional kirana stores).

Rating methodology for organised retail industry

CARE Ratings Limited (CARE Ratings) has a standard methodology for credit rating of companies belonging to the service sector. It encompasses an assessment of the various risk factors which could potentially affect the credit risk of an entity such as: economy and industry risk analysis, business risk, financial risk and management quality. However, considering the size and diversity of the service sector, CARE Ratings has devised methodologies specific to various industries within the sector. These methodologies attempt to point out factors, over and above those mentioned in the broader methodology devised for the service sector, which are considered while analysing entities belonging to a particular industry.

Such additional factors considered by CARE Ratings, along with their analytical implications, while arriving at the rating of an entity that operates in the retail segment have been discussed below.

A. Promoter & management evaluation

Management evaluation

The success of a retailer is largely dependent on its ability to win consumer confidence and ensure consumer loyalty. The management's ability to analyse consumer behaviour and changing preferences and quickly respond through innovation and formulation of appropriate strategies remains the key to success in this sector. Experienced management and continuance of senior executives and skilled personnel with the organisation are also critical to the success of retail players.

For detailed management analysis, please refer to CARE Ratings' Rating Methodology-Service Sector Companies on our website www.careedge.in.

B. Industry analysis

CARE Ratings' analysis of the industry risk focuses on the current industry scenario, demand-supply factors, the size of the industry, key players in the industry and competitive factors, cyclicality and seasonality, if any, associated with the industry, any regulatory policies, etc. Government policies such as foreign direct investment (FDI) can have major implications for retail companies.

C. Business risk

Market positioning

Organised retailing is a consumer-centric business, hence brand equity/ loyalty and positioning of the retailer is a crucial factor. The retailer can be positioned into 'Value Retailing' and 'Life style Retailing'. Value Retailing caters to essential needs of the consumer and is relatively immune to economic downturns as against Life-style Retailing. Value Retailing is a high-volume but low-margin business. In contrast, Life-style Retailing is a high-margin and low-volume business and also fosters higher customer loyalty with relatively low substitutes and high entry barriers. Furthermore, higher-margin private brands portfolio across segments contributes significantly to the profitability of the players in this segment. Nevertheless, the Lifestyle retailer needs to have a judicious mix of private labels so as not to dilute the offerings as regards other brands. Analysis of a retailer's business segment, and the mix adopted by the player and its cash flow impact assume prime importance in a rating exercise. Cash flows of a Value retailer tend to be relatively more stable while those of Life-style retailer are relatively seasonal in nature, leading to an impact on working capital requirements. Cash flow volatility is particularly important in this sector given the significant fixed nature of operating cost. Furthermore, 'Value Retailer' is less susceptible to economic cycles on account of value proposition and less discretionary nature of product offerings as compared with 'Lifestyle retailer'.

Diversification and competitive position

CARE Ratings analyses the market position of the player, product diversification, geographical presence and ability to cater to local tastes by right product mix, pricing and the level of competition. Diversification by way of geographies, offerings, demographic groups and sales channels mitigates the impact in a particular geography, brand or sales channel and provides edge to the retailer over competitor. Additionally, CARE Ratings also analyse the revenue share from online sales apart from specialty stores, department stores and supermarkets/ hyper markets. Furthermore, CARE Ratings also analyse the share of revenue from food and grocery products and non-food products to see stability of cash flows.

Moreover, supplier diversification along with reputation of supplier is also critical. Although, retailer can get volume discount and favourable credit terms by procuring from limited suppliers, diversified supplier base is preferable to ensure smooth operations in the event of failure at supplier's-end.

Large scale of operations results in economies of scale and provides a competitive advantage with respect to pricing. Size not only boosts the bargaining power of a retailer while accessing quality real estate or 'anchor tenant' status but also provides it with better bargaining power with its suppliers. .

Store-level analysis

The operating parameters like same-store sales growth, sales per square feet, footfalls and conversion rate, average selling price, average transaction size, share of private labels, proportion of sales under customer loyalty program and shrinkage are some of the key indicators for assessing the operating efficiency of retail companies.

Access to real estate/store ownership model

One of the major input costs for a retailer is lease rentals/land acquisition cost. Retailers with access to low-cost, quality real estate enjoy a considerable competitive advantage, both in terms of saving of major cost components and also the ability to expand more quickly. Ownership of the stores ensures business continuity especially in case of strategic locations and reduces the uncertainties of renewing re-negotiating of lease contracts. However, own stores require higher initial capital cost per square feet and entail larger exit cost (compared to lease option). In case of lease or revenue-sharing contracts or franchise model, multi-year leasing contracts entails sharing of risk and reward are evaluated to assess its impact on future cash flows and its associated impact on the entity's risk profile. CARE Ratings also analyses rental cost to total sales of the company vis-à-vis other players. CARE Ratings analyses 'anchor tenant' status of the retailer as it enables access to quality real estate at relatively cheaper rates as well as mitigate to an extent lease renewability risk.

Supply chain infrastructure

CARE Ratings evaluates the supply chain infrastructure in terms of the integrated distribution, warehouse and transportation systems, as these factors have a direct bearing on the operational efficiencies and hence the profitability of a retailer. CARE Ratings also evaluates the operating synergies of the rated company with the group in terms of the sourcing, logistics & distribution system, etc.

Presence in e-retailing segment

The e-retailing industry, although small in size compared to overall retail market is growing at a fast pace supported by increase in internet penetration and gradual shift in consumer behaviour towards online sales. Though brick and mortar continue to be dominant, the retail is moving towards omni-channel model with growing preference. In order to combat the impact from online players, majority of brick and mortar players have also entered into online channels. CARE Ratings recognises the increase in competition from established e-commerce players and the company's strategy in this regard.

D. Financial risk

Capital structure and financial flexibility

Retailers require significant funds for expanding stores' network as well as for refurbishment of the existing stores. CARE Ratings evaluates the capital mix used to fund these assets. Low leverage and comfortable debt coverage indicators are viewed positively, and aggressive debt-funded expansion is considered adverse from a rating perspective. The company's ability to generate sufficient internal accruals and/or raise timely equity, if required, to meet its capital expenditure is one of the key rating factors. Also, strong parentage would result in enhanced financial flexibility. CARE Ratings also analyses off-balance sheet exposures of the company and adjustments are made to the accounts, wherever necessary.

Inventory and working capital management

As retail business is highly working capital intensive in nature mainly on account of high level of inventory required to be maintained to ensure ready availability of stock, inventory management assumes importance. Inventory management encompasses the ability to determine and maintain optimal inventory level, right offerings and minimise shrinkage. Lifestyle retailers need even more working capital funds due to the big-ticket items held as stock. CARE Ratings understands the management's policy on stocking inventory on 'outright purchase' or 'sales or return basis'. Although the 'Private label portfolio' and 'outright model' have higher margins vis-à-vis other business models, they entail higher working capital requirements and carry inventory obsolescence risk. Besides, quality of inventory in terms of its aging schedule (wherever critical) in the context of changing needs of the consumers is analysed. CARE Ratings also analyses the adequacy of provisioning against the slow-moving or obsolete inventory. Moreover, use of technology and onmi-channel capability of retailer provides efficieny in inventory management.

Retail being a seasonal business, the retailers need to maintain higher stocks during certain part of the year. The liquidity with the retailer helps the company to maintain higher inventories as well as meet any temporary cash flow mismatch. CARE Ratings analyses the liquidity available to a retailer in the form of liquid assets/unutilised bank limits.

Operating cash flows and debt protection measures

Cash flow analysis forms an important part of credit rating exercise. The ability of the company to generate healthy positive operating cash flows is very critical. Cash accruals vis-à-vis debt levels and other debt protection measures like interest coverage ratio, Debt/ PBILDT, Debt service coverage and total debt/cash flow from operations are examined. Furthermore, analysis of sensitivity of these factors to adverse change in assumptions is also carried out. CARE Ratings also makes necessary adjustments to factor impact of IND AS-116.

E. Environmental, social and governance (ESG) risk factors

CARE Ratings in its overall credit rating framework directly or indirectly analyses the critical ESG risks and their impact on the credit profile of the entities. CARE Ratings analyses the materiality of ESG risk factors and mitigating factors, if any, being implemented by the entity.

The retail industry has very low environmental impact, mainly because of low emissions and water utilisation due to the trading nature of operations and increasing focus on the usage of sustainable packaging. CARE Ratings analyses the social impact of the retail industry based on its workforce and customer base.

CARE Ratings looks at the composition of the board of directors and track record of legal and statutory compliance by its management/ directors to understand the corporate governance structure. Furthermore, the quality of disclosure related to financial statements, related-party transactions and transparency in sharing information with various stakeholders are also helpful to gauge the corporate governance practices.

Conclusion

The rating outcome is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CARE Ratings analyses each of the above factors to arrive at the overall assessment of credit quality of the Issuer.

[For previous version please refer 'Rating Methodology – Organised Retail Companies' issued in December 2020**]**

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About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and detailed research. CARE Ratings Ltd, the parent company in the group, is one of the leading credit rating agencies in India. Established in 1993, it has a credible track record of rating companies across multiple sectors and has played a pivotal role in developing the corporate debt market in India. The wholly-owned subsidiaries of CARE Ratings are (I) CARE Advisory, Research & Training Ltd, which offers customised advisory services, credible business research and analytical services (II) CARE Risk Solutions Private Ltd, which provides risk management solutions.