Rating Methodology - Organized Retail Companies

[In supersession of "Rating Methodology - Organized Retail Companies" issued in August 2018]

Indian Retail Industry

The Indian retail industry has emerged as one of the most dynamic and fast-growing industries due to the entry of several new players in the recent times along with rising income levels, growing aspirations, favourable demographics and easy credit availability. It contributes about 10% of the country's Gross Domestic Product (GDP) and around 8% of the employment and is valued at **USD 792 billion as of 2018**. Globally, India is the fourth-largest global destination in the retail space after USA, China and Japan. The industry has witnessed CAGR of over 10% during 2013 - 2018, close to double the growth witnessed during 2008 – 2013 period.

Currently, the Indian retail market continues to be dominated by the unorganised retail (mom-and-pop stores and traditional kirana stores) accounting for about 88% of the total retail market while organised retail market is valued at about USD 95 billion, only about 12% of the sector. E-tail stands at about USD 24 billion, accounting for about 25% of the organised market or 3% of the total retail market in India. India's organised retail penetration is much lower compared with other countries, such as the USA which has organised retail sector penetration of 85%.

Rating Methodology for Organized Retail Industry

CARE Ratings (CARE) has a standard methodology for credit rating of companies belonging to 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 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 analyzing entities belonging to a particular industry.

Such additional factors considered by CARE, 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

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 with the organization are also critical to the success of retail players.

For detailed management analysis please refer to CARE's Rating Methodology-Service Sector Companies on our website www.careratings.com.

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. CARE Ratings also takes into account economy-wide factors which have a bearing on the service industry.

C. Business Risk

Business Segmentation

Retail business can be broadly classified 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. Further, higher-margin private label 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 impact on working capital requirements. Cash flow volatility is particularly important in this sector given the significant fixed nature of operating cost. Further, 'Value Retailer' is less susceptible to economic cycles on account of value proposition and less discretionary nature of product offerings as compared to 'lifestyle retailer'.

CARE Ratings analyses the market position of the player, geographical presence and ability to cater to local tastes by right product mix and pricing and the level of competition in the business segment. 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. Moreover, presence across different formats (specialty stores, department stores, supermarkets, hypermarkets) and multiple segments provides the retailer with a competitive advantage. Further, 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.

CARE Ratings also evaluates the operating synergies of the rated company with group in terms of the sourcing, logistics & distribution system etc. CARE believes that retail companies with access to real estate through group holdings enjoy an advantage over others. Further, presence of a strong group and parentage would result in enhanced financial flexibility.

The e-retailing industry, although small in size compared to overall retail market is growing at a fast pace. Though brick and mortar continues to be dominant, however, with growing preference the retail is moving towards omni channel model. CARE recognises the increase in competition from established e-commerce players.

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 as also 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 also analyses rental cost to total sales of the company vis-à-vis other players. CARE analyse '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/ IT Infrastructure

CARE Ratings evaluates the supply chain infrastructure in terms of the integrated distribution, warehouse and transportation systems, effective store level infrastructure like replenishment systems & reorder levels, as these factors have a direct bearing on the operational efficiencies and hence the profitability of a retailer.

D. Financial Risk

Capital Structure and Financial Flexibility

Retailers require significant funds for expanding stores network as well as for refurbishment of 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.

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 ability to determine and maintain optimal inventory level, right offerings and minimizes shrinkage. Lifestyle retailers need even more working capital funds due to the big-ticket items held as stock. CARE understands the management 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 also carry inventory obsolescence risk. Besides, quality of inventory in terms of its aging schedule in the context of changing needs of the consumers is analysed.

Retail being a seasonal business, the retailers needs 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 analyse 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. Further, analysis of sensitivity of these factors to adverse change in assumptions is also carried out. CARE also makes necessary adjustments to factor impact of IND AS-116.

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.

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