

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. It 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 entities belonging to the service sector. It encompasses an assessment of risk factors that 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 industries within the sector. These methodologies attempt to point out factors, 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, and 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 management's ability to analyse consumer behaviour, changing preferences and quickly respond through innovation and formulation of appropriate strategies remains 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. CARE Ratings evaluates the management's risk appetite by examining their retail network expansion plans and funding strategies, and risk management systems they have in place to facilitate quick liquidation of inventories.

B. Industry analysis

CARE Ratings' analysis of the industry risk focuses on current and evolving industry scenario, demand-supply factors, industry size, key industry players and competitive factors, cyclicity and seasonality, if any, associated with the industry, and regulatory policies, among others. 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 'lifestyle retailing'. Value retailing caters to essential needs of the consumer and is relatively immune to economic downturns against lifestyle retailing. Value retailing is a high-volume-low-margin business. In contrast, lifestyle retailing is a high-margin-low-volume business and also fosters higher customer loyalty with relatively low substitutes

and high entry barriers. Higher-margin private brands portfolio across segments contributes significantly to profitability of players in this segment. A lifestyle retailer needs to have a judicious mix of private labels to not dilute offerings compared to other brands. For retailers having licence brands, CARE Ratings evaluate the tenure and renewal terms of such licence agreement with brand owners to understand longitivity of business. CARE Ratings also analyses terms of royalty payments for such lience 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 lifestyle retailer are relatively seasonal, leading to an impact on working capital requirements. Cash flow volatility is particularly important in this sector given the significant fixed operating costs. A value retailer is less susceptible to economic cycles considering value proposition and less discretionary nature of product offerings compared to lifestyle retailer.

Diversification and competitive position

The success of a retailer largely depends on its ability to win consumer confidence and ensure consumer loyalty. CARE Ratings analyses the player's market position, product diversification, geographical presence and ability to cater to local tastes by right product mix, pricing and level of competition. Diversification through geographies, offerings, demographic groups and sales channels mitigate the impact in a particular geography, brand or sales channel and provides edge to the retailer over competitor. CARE Ratings also analyses revenue share from online sales apart from specialty stores, department stores and supermarkets/hyper markets. CARE Ratings further analyses the share of revenue from food and grocery products and non-food products to see stability of cash flows.

Moreover, supplier diversification and reputation of suppliers 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 failures at the supplier's-end.

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

Store-level analysis

The operating parameters including 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 due to shoplifting, (inclduing human erorr, faurd, and theft amog others), are some key indicators for assessing 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, in terms of saving major cost components and the ability to expand faster. Ownership of stores ensures business continuity especially in case of strategic locations and reduces uncertainties of renewal or re-negotiation 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 against other players. CARE Ratings analyses 'anchor tenant' status of the retailer, as it enables access to quality real estate at relatively cheaper rates and mitigate lease renewability risk, to an extent.

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, profitability of a retailer. CARE Ratings also evaluates operating synergies of the rated company with the group in terms of the sourcing, logistics and distribution system, among others.

Foreign currency (forex) risk

CARE Ratings analyses foreign currency risk for a retailer importing goods or having retail outlets in overseas markets. There is a possibility of impact on profitability due to adverse movement in foreign exchange rates on unhedged foreign currency liabilities. CARE Ratings evaluates the hedging policy adopted by entities to mitigate foreign exchange risk.

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 purchases. Though brick and mortar continue to be dominant, the retail is moving towards omni-channel model with growing preference. To combat impact from online players, majority brick and mortar players have also entered online channels. CARE Ratings recognises increase in competition from established e-commerce players and evaluates the company's strategy in this regard.

D. Financial risk

Capital structure and financial flexibility

Retailers require significant funds for expanding stores' network and 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 adversely from a rating perspective. The company's ability to generate sufficient internal accruals and/or timely raise equity, if required, to meet its capital expenditure is one of the key rating factors. 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, 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 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 against other business models, they entail higher working capital requirements and carry inventory obsolescence risk. This apart, quality of inventory in terms of its aging schedule (wherever critical) in the context of changing needs of consumers is analysed. CARE Ratings also analyses the adequacy of provisioning against slow-moving or obsolete inventory. Moreover, use of technology and omni-channel capability of retailer provides efficiency in inventory management.

Retail being a seasonal business, retailers need to maintain higher stocks in certain part of the year. Liquidity cushion available with the retailer helps the company maintain higher inventories and meet temporary cash flow mismatch. CARE Ratings analyses 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 company's ability to generate healthy positive operating cash flows is very critical. Cash accruals against debt levels and other debt protection measures including interest coverage ratio, Debt/ PBILDT, Debt service coverage and total debt/cash flow from operations are examined. 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 on 'leases'.

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

In the last few years, ESG risks have been gaining importance across the globe and are increasingly influencing investment decisions. CARE Ratings in its overall credit rating framework directly or indirectly analyses critical ESG risks and their impact on credit profile of entities. CARE Ratings analyses materiality of ESG risk factors and mitigating factors being implemented by the entity.

Environmental risk

The retail industry has low environmental impact, mainly because of low emissions and water utilisation due to trading nature of operations and increasing focus on usage of sustainable packaging.

Social risk

Social impact of the retail industry is influenced by large workforce, suppliers, supply-chain and customer base. Hence, compliance with Government norms and adequate safety measures for manpower provide long-term sustainability. Increasing collection of customer data and growing penetration of e-commerce increases risk of data breaches and expose entities to potential legal liabilities.

Governance risk

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. Quality of disclosure related to financial statements, related-party transactions and transparency in sharing information with various stakeholders are also helpful to gauge corporate governance practices.

Conclusion

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

[For previous version please refer 'Rating Methodology – Organised Retail Companies' issued in [December 2022](#)]

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