20 July 2018 Corporates

CECONOMY AG
Germany, Retail

SCOPE BBB- STABLE

Corporate profile

CECONOMY is the European market leader in consumer electronics retail, with about EUR 22bn of revenue generated in FY 2017 (fiscal year ending September). The group has two established brands, Media Markt and Saturn, resulting from the demerger of METRO Wholesale & Food Specialist GmbH from Metro Group. CECONOMY has a broad presence in Europe with more than 1,000 stores and leads the market in nine of its 15 countries of operation. The group's network of physical stores, combined with its online platform, allows it to record 5.8 million customer contacts per day.

Key metrics

			Scope estimates	
Scope credit ratios	**2015/16**	**2016/17**	**2017/18F**	**2018/19F**
EBITDA/interest cover (x)	10x	10x	11x	11x
SaD/EBITDA	2.0x	2.2x	2.0x	1.9x
Scope-adjusted FFO/SaD	38%	36%	38%	41%
FOCF/SaD	-4%	9%	7%	10%

Rating rationale

Scope Ratings affirms its BBB- issuer rating to German consumer electronics retailer CECONOMY Group. The short-term rating is S-2. The rating Outlook is Stable.

The ratings continue to reflect Scope Ratings' view of CECONOMY's underlying consumer electronics retail market as inherently more stable than macroeconomic trends, its position as Europe's clear market leader in that industry, as well as its diversified product range, which comprises 'white' and 'brown' goods as well as telecommunications and entertainment equipment. Comparatively low operating margins constrain the ratings, in our view. The assessment also reflects Scope's view of management's conservative financial policy – underlined by its recent decision to increase equity following its investment in Russia's leading electronics retailer PJSC M.video, as well as the strong balance sheet after the demerger, organic growth focus, and future operating-margin enhancement. CECONOMY's ownership structure is credit-neutral, despite the strong voting representation (21.6%) of Convergenta, the minority owner of MediaMarkt Saturn Holding.

In terms of the business risk profile, the group's clear dominance in European consumer electronics is the main support for the ratings. This is despite a lack of activity in large key European markets, such as France – meanwhile addressed via its 24% stake in Fnac Darty SA (Fnac) - and the UK, and a presence in several 'problem countries', in which the group has low market shares and unsatisfactory profits. The latter was also partially addressed with respect to Russia, where CECONOMY sold its loss-making store portfolio to M.video and took a 15% stake in the company.

Scope's financial risk assessment reflects the expectation that CECONOMY will maintain the strong balance sheet that followed the Metro demerger (wholesale and food retailing activities). While this had initially resulted in an almost financial-debt-free balance sheet, the two transactions mentioned above have changed this. At the end of March 2018, CECONOMY reported EUR 670m of financial debt on its balance sheet, reflecting the Fnac investment of EUR 458m.

Ratings & Outlook

Corporate Ratings	BBB-/Stable
Short Term Rating	S-2

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Related methodology

Corporate Ratings Methodology, January 2018

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Counting in the additional net debt for the Russian transaction (about EUR 258.5m purchase price for the stake in M.video) which is likely to be fully offset by the recently announced equity injection of more than EUR 270m from new shareholder freenet AG, we believe the effect on credit metrics in fiscal 2018 to be negligible.

This is also supported by our formerly conservative estimate of group EBITDA in the current year which we were upgrading by 6%. We continue to believe management's financial policy is conservative – as evidenced by its prudent exercise of an equity increase, signalling a strong commitment to maintain its investment grade rating.

Outlook

The Stable Outlook reflects Scope's expectations that CECONOMY's financial risk profile will not significantly deteriorate in the coming years. Specifically, present ratings are commensurate with credit metrics reflective of a BBB category, as indicated by Scope-adjusted funds from operations/net debt of 35-40% and a SaD/EBITDA ratio of below 2.5x.

A higher rating could be triggered by an improved business risk assessment, for example, through better operating margins and free cash flow, or financial metrics sustainably exceeding aforementioned levels. A trigger for a positive rating action could also be provided by the successful integration in the business models of the two recent M&A transactions and further success in improving weak positions in individual countries. A negative rating action could result from a more aggressive financial policy or a sustained, negative deviation from ratios commensurate with the present ratings.

Rating drivers

Positive rating drivers	Negative rating drivers
• Europe's leading consumer electronics retailer • Diversified product range encompassing white and brown goods as well as communication equipment • Credit-supportive industry risk • Strong balance sheet following Metro AG demerger • Conservative financial policy and a commitment to an investment grade rating	• Company in transition for higher growth • Low operating margins in a peer group context

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Increasing margins and free cash flow • Credit metrics sustainably ahead of levels specified in the outlook statement with regard to a positive rating action	• Potential M&A to erode level of credit metrics • Inability to maintain at least 30% funds from operations/Scope-adjusted debt and a leverage of below 2.5x

Financial overview

			Scope estimates	
Scope credit ratios	**2015/16**	**2016/17**	**2017/18F**	**2018/19F**
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Scope-adjusted FFO/SaD	38%	36%	38%	41%
FOCF/SaD	-4%	9%	7%	10%
Scope-adjusted EBITDA in EUR m	**2015/16**	**2016/17**	**2017/18F**	**2018/19F**
EBITDA	619	599	730	785
Operating lease payment in respective year	664	675	690	691
Other	0	0	0	0
Scope-adjusted EBITDA	1,283	1,274	1,420	1,477
Scope funds from operations in EUR m	**2015/16**	**2016/17**	**2017/18F**	**201819F**
EBITDA	619	599	730	785
less: (net) cash interest as per cash flow statement	-8	-3	-10	-20
less: cash tax paid as per cash flow statement	-178	-160	-190	-200
less: pension interest	0	0	0	0
add: depreciation component operating leases	542	555	569	567
add: dividends received from equity	0	0	0	0
Scope funds from operations	975	991	1,099	1,132
Scope-adjusted debt in EUR m	**2015/16**	**2016/17**	**2017/18F**	**2018/19F**
Reported gross financial debt	18	544	500	450
deduct: cash, cash equivalents	-759	-861	-834	-885
Cash not accessible	100	100	100	100
add: pension adjustment	769	622	622	624
add: operating lease obligation	2,440	2,369	2,484	2,484
Other	0	0	0	0
Scope-adjusted debt	2,567	2,774	2,872	2,774

Business risk profile

Industry risk

Cyclicality – medium risk

In Scope's view, the overall retail industry exhibits relatively stable characteristics, with turnover growing constantly even in times of macroeconomic stress. The amplitude of annual growth generally ranges between -2% to 4% and has limited volatility. This growth includes more stable and 'low ticket' retail sub-segments like food, as well as slightly more cyclical sectors like electronics or DIY. Importantly, the overall retail segment has proven resilience to macroeconomic shocks. For example, in 2009, when European GDP declined by more than 4%, the retail industry's growth rate was slightly positive.

Medium to high entry barriers

A country's retail markets are usually highly concentrated and centre on a dominant player. For most European countries this applies to food, DIY and electronics. Scope judges entry barriers to be medium to high, reflecting the comparatively concentrated markets, and the necessity for operators to have a national network, established relationships with manufacturers, and high-quality products. The need for scale and diversified operations is supported by the comparatively low EBITDA margins in most large retail segments, and such levels are only financially viable upon reaching a critical scale.

In Europe the electronic goods retail market is rather fragmented: often, top-five retailers barely hold half of a country's market share. Even so, Scope does not consider this to threaten CECONOMY, because market leaders have continued to expand their shares over the years. Yet price competition is intensifying in each of the CECONOMY's markets, against both traditional 'pure players' (based in physical shops; Euronics, CE Partners, Fnac) and e-commerce retailers (Amazon).

Low substitution risk

Scope judges substitution risk to be low because the retail business model has very few conceivable alternatives. The only possibility is direct distribution by manufacturers. An example is Apple Store, but Scope believes this is and will remain the exception, as such a strategy is costly and necessitates entry into a business segment in which manufacturers have limited experience.

In our view, e-commerce does not constitute a different industry to retail, but is merely a different form of distribution, one which is increasingly adopted by classic 'brick and mortar' retailers.

The combination of the three industry risk drivers, according to our Corporate Ratings Methodology, results an industry risk for CECONOMY of BBB-.

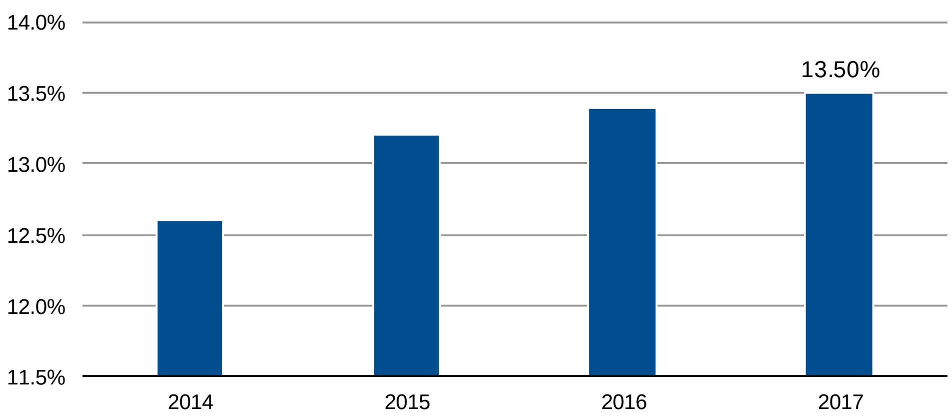
Competitive position

Market shares

Clear European market leader

CECONOMY is Europe's leading consumer electronics retailer, with about EUR 22bn of revenue and EBITDA of above EUR 700m before special items. The group has over 1,000 stores in 15 European countries, in nine of which the group is market leader.

Figure 1: Evolution of European market share



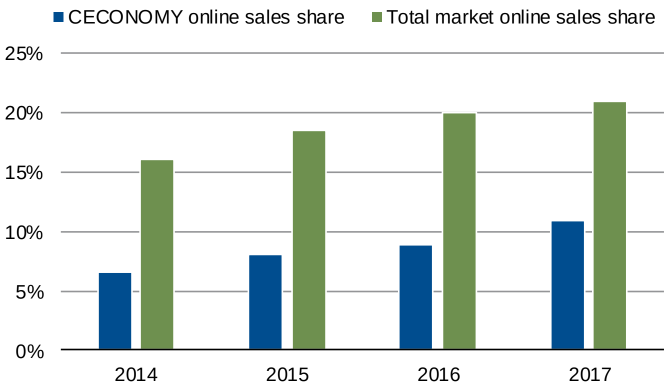
Source: CECONOMY

Recovering growth rates

Figure 3 shows that like-for-like growth during 2014-2017 of the group's two established brands, Saturn and Media Markt, is on a positive trend. Scope expects this to continue, likely at even a faster pace in future, as CECONOMY on a standalone basis has improved operating flexibility and the ability to develop growth channels. The brands' new focus should immediately impact footfall in each shop, while new shops will noticeably influence online traffic.

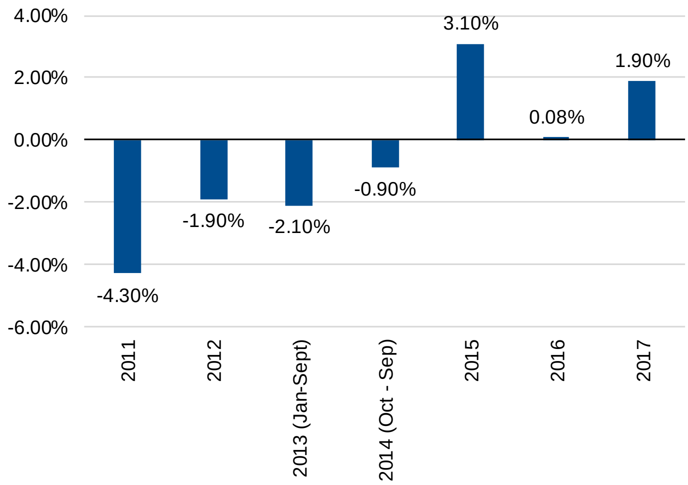
E-commerce is crucial for CECONOMY's market position, driving sales growth and boosting differentiation in its multi-channel strategy (its main online competitor is Amazon).

Figure 2: Online growth catching up (fiscal year-ends)



Source: Ceconomy, Scope

Figure 3: Like-for-like group sales growth (fiscal year-ends)



Source: Ceconomy, Scope

Figure 2 shows that, for CECONOMY, online sales, including the 'pick-up option' (online customers can collect orders at a physical location), are a major driver of total sales.

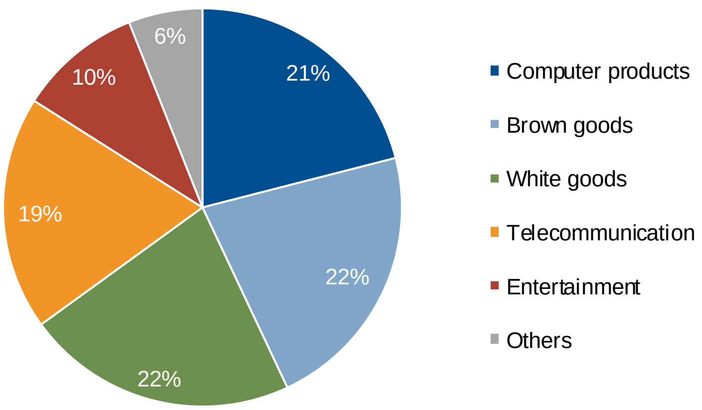
Nevertheless, the group's online traffic is still substantially below that of the total market (21% versus 10.9% for CEconomy).

The group's increased online presence is boosted by a major advantage over American digital peers – its ability to interact with buyers in brick-and-mortar shops, who can purchase online and collect the product at a desired time. This 'hybrid' positioning resulted in 42% of its online customers using the pick-up option in FY 2017, versus 42% in the year before, and 40% in FY 2015. Scope views this positively: not only does it capture customers' preference for online shopping, but also their desire to handle and collect products in person.

Diversification

CECONOMY focuses on consumer electronics in Europe and covers all segments in that industry. In our view, this leads to high product diversification. The product range is not limited to communications (telecoms, computers and brown goods), but also encompasses white goods (figure 4). Thus, shifts in demand between product categories can be counterbalanced readily, for example, the recently declining share of photographic products and brown goods was offset by stronger demand for IT and telecommunication products.

Figure 4: Product category breakdown fiscal 2017

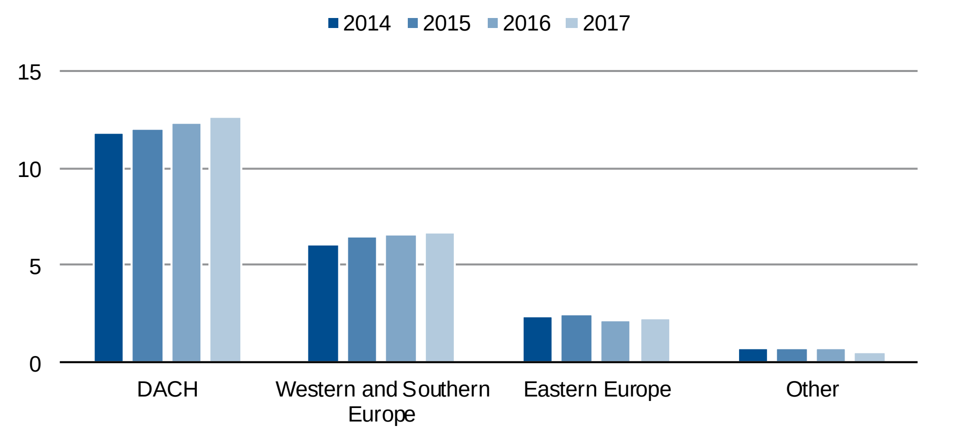


Source: CECONOMY, Scope

Scope considers CECONOMY to have a broad spread across its product range, which itself is also very extensive (160 different coffee machines, for example). Within the sub-category of brown and white goods, CECONOMY has developed its own brand (named, 'ok', 'ISY', 'Koenic' and 'PEAQ'), which offers entry-level goods at competitive prices. The combination of these low-cost electronic goods with high-end products (Apple or Samsung) ensures the company appeals to different customer segments.

Geographically, CECONOMY focuses on Europe, with a clear strength among the so-called DACH countries (Germany, Austria, Hungary and Switzerland; figure 5). The group is the only one among European peers to operate across the region (except for online players); most peers focus on home markets instead. The group is well diversified in Europe through its mix of mature and developing countries. However, the developing-economy exposure is a double-edged sword, potentially creating high cultural and political risks and operating losses at the early stage of exposure, while not being able to capture the markets' growth potential immediately.

Figure 5: Geographical diversification



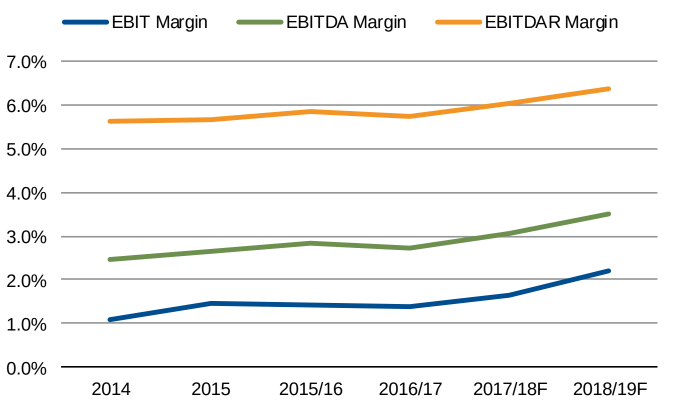
Source: CECONOMY, Scope

Operating margins

Comparatively low operating margins

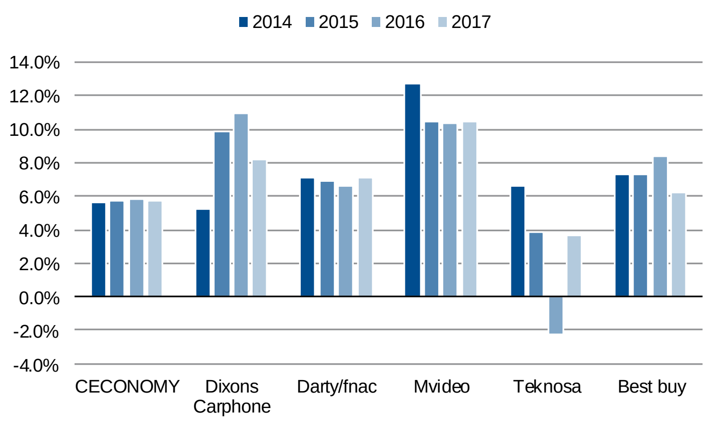
Compared with peers' (figure 7) CECONOMY has low operating margins, which is surprising at first glance given the company's size and market dominance.

Figure 6: Operating profit trends



Source: CECONOMY

Figure 7: EBITDAR margins peers



Source: Annual reports

The explanation for the low margins are twofold, in our view:

- The group has the largest international network of stores and the broadest product range, leading to significant costs per square meter (CECONOMY leases all of its stores)
- Operating losses that persist(ed) in Russia (divested to M.video), Sweden and Turkey (was already turned around in fiscal 2017).

Management has addressed these problems by setting strategic financial targets for the mid-term, including an unadjusted EBITDA margin of 5% (2.8% in 2016/17, still depressed by restructuring charges, however). In our view this strongly correlates with its achievement of a 3% revenue growth target following the demerger.

Thus, CECONOMY's EBITDA margin still needs to improve; however, the group's large size relative to competitors generates the largest absolute operating profit by far. Fnac, one of the group's main competitors and mainly active in France generated an EBIT of about EUR 270m in FY 2017 on a pro-forma basis, significantly smaller than CEconomy's.

In Scope's view, the acquisition in 2017 of a 24% stake in Fnac Darty SA strategically enhances CECONOMY's business risk profile in the longer term, given Fnac's leading position in the French consumer electronics and editorial products retail market. Firstly, the deal opens access to the French market, in which CECONOMY has not been active yet. Secondly, the deal proactively addresses the consolidation needed among European retailers to remain competitive. Thirdly, the exposure indirectly broadens CECONOMY's product range to editorial products as well as widens its multi-channel sales approach thanks to Fnac's significantly stronger e-commerce outreach (16% of online sales versus 10,9% for CECONOMY).

Business risk profile rated BBB-

We continue to assess CECONOMY's business risk profile at BBB-. This includes the BBB- industry risk and our competitive positioning analysis (BBB). The latter considers CECONOMY's strong market shares and good diversification, though offset by the below-par operating margins.

Financial risk profile

Credit metrics

CECONOMY's key credit metrics, which have trended slightly weaker in fiscal 2017 in a year-on-year comparison, due to the investment in Fnac (EUR 458m for a 24% stake) are projected to improve again in the current financial year to about the level of fiscal 2016.

This is despite the 15% investment in M.video for a total of about EUR 258.5m. CECONOMY announced in June a 10% capital increase by way of a private placement to telecommunications company freenet AG. CECONOMY's main debt constituents are the EUR 250m Schuldschein issued in March 2017 as well as about EUR 250m drawn from the group's EUR 500m commercial paper programme, EUR 622m pension obligations (not Scope-adjusted, as assets cover payments by less than 6x, and operating leases for the shops (about EUR 2.4bn).

The forecasts applied in our base case scenario involve the following assumptions:

- Comparable revenue growth of between 0.5% and 1.5% for FY 2018 and FY2019, while group revenues on an absolute scale will be held back by deconsolidation of the Russian business in fiscal 2018 which had contributed about EUR 500m revenues. Sales growth could be a bit stronger in fiscal 2019, helped by CECONOMY's increased online penetration and first likely effects of its retail alliance.
- A strong increase in EBITDA in fiscal 2018 (+22% to EUR 730m projected), based on the non-recurrence of EUR 104m restructuring charges in the previous year
- 50% of net profits are distributed as dividends
- Positive free operating cash flow in fiscal 2018, supported by operating profitability and lower capital expenditure.

Figure 8: Positive free operating cash flow

Free operating cash flow	2015/16	2016/17	H1/18	2017/18F
FFO	433	436	325	530
Change in working capital	-226	52	-132	-100
Net capex	-313	-231	-91	-220
FOCF	-106	257	102	210

Source: Annual reports, Scope projections

Liquidity

Scope views the group's liquidity as sound: limited financial debt on the balance sheet, more than EUR 600m of available cash, and small free cash flow generation. The short-term rating is S-2, in line with the mapping in our rating methodology.

Key supplementary rating drivers

Conservative financial policy

Management's financial policy is conservative from our standpoint. The clear commitment for its investment grade rating was supported by its decision for new equity following the transaction with M.video, which basically neutralises the effect of the acquisition from a credit perspective.

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