FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Ceconomy AG at 'BB'; Outlook Stable

Fri 24 Nov, 2023 - 13:11 ET

Fitch Ratings - Milan - 24 Nov 2023: Fitch Ratings has affirmed Ceconomy AG's (Ceconomy) Long-Term Issuer Default Rating (IDR) at 'BB'. The Outlook is Stable.

The affirmation recognises recovery in trading performance in FY23 (year-end September) from a very weak FY22 and successful improvement of working capital position, despite a challenging trading environment, particularly in its core markets of Germany and Italy. It also reflects our expectation of a return to positive cash flow generation and to a deleveraging trajectory from FY23, after leverage peaked in FY22 at a level that was inconsistent with the rating.

The rating also continues to reflect Ceconomy's large-scale, well-diversified product offering, omnichannel capabilities and a pan-European footprint with operations in a competitive market, low operating margins, a history of volatile free cash flows (FCF) and tight interest cover metrics. The Stable Outlook reflects our view that it should restore its EBITDA margin towards 2.5% in FY24-FY25 and reduce its EBITDAR net leverage to below 4.0x.

KEY RATING DRIVERS

Recovery from Low Profitability: Ceconomy operates in the largely commoditised mass market of appliances and consumer-electronics retailing, which is exposed to intense competition, limited customer loyalty and increasing online market penetration.

After falling to below 2% in FY22, we expect EBITDA margin - which we assess at 'B' - to continue its recovery towards 2.5% from FY24. We forecast EBITDA to rise towards EUR600 million by FY25 from EUR368 million in FY22. This will be aided by cost-efficiency measures, product mix initiatives that include increasing the contribution of services and solutions business, as well as, post-FY24, improvement of demand in its core market as consumer confidence recovers.

Leading European Consumer-Electronics Retailer: Ceconomy is the largest consumer-electronics retailer in Europe, but we place its business profile at between the 'BBB' and 'BB' categories due to the challenges of operating in a fiercely competitive and volatile market. Ceconomy benefits from its strong brand name, sizeable operations with a pan-European footprint, and well-diversified product offering with adequate omnichannel capabilities underlined by its online sales at 25% of total sales in FY22. However, trading performance is predominantly driven by its core market of Germany.

Resilience to Macroeconomic Challenges: Ceconomy's geographic diversification defended its revenues in FY23 against weak sales in Germany, where consumers were tightening spending on major non-discretionary items, with the strength of the Turkish market. For FY24, we expect spending on electronics and appliances to remain subdued in Europe, but to be supported by remaining availability of accumulated savings stemming from heavy spending restraint and lower volumes in Germany in FY23.

FCF Recovery; Working Capital Improvements: Based on 9M23 results, we estimate working capital (WC) to have declined in FY23, although only partly reversing the heavy outflows of close to EUR800 million suffered in FY21-FY22 in conjunction with supply chain shortages related to the pandemic. While store-related investments remain subdued and store portfolio growth ambitions are limited, Ceconomy is investing in redesigning its logistics model.

Overall, we project that, barring a resumption of dividend payments, which management has ruled out until it has delivered on its strategic plan in FY26, Ceconomy should be able to lift FCF to EUR150 million-EUR250 million per annum from FY25.

Execution Risks: Ceconomy is shifting from largely relying on third-party distributors and stocking products in the warehouses of each of its stores, to a model with one large nation-wide hub, complemented by smaller regional ones. We see this transformation as carrying some execution risks due to the magnitude of its scope but believe that, once complete, it will lead to more agile management of inventories, enabling it to operate with lower stocks and, once the automation project is also completely implemented, to a reduction of operating costs.

Leverage Recovery in FY23: The weak FY22 performance, combined with two years of inflated WC, led to a spike in EBITDAR net leverage to 5.2x, but we estimate this to have now come down closer to the maximum 4.0x that is commensurate with the rating. We see scope for further improvements in FY24 and thereafter.

Lease Adjustments to Leverage: Ceconomy's pure financial debt leverage is low, when capitalised leases contributing most to its lease-adjusted credit metrics are excluded.

However, in our rating analysis of non-food retailers, whose business models rely on a store network, we assess and compare financial risk profiles using lease-adjusted leverage metrics, which place Ceconomy's financial structure score in the mid-to-low end of the 'BB' rating category.

Tight Fixed Charge Cover: We see weak EBITDAR fixed charge cover remaining below 2.0x, which corresponds to a low 'B' level. This is balanced by its actively-managed leased store network, mitigating the impact of inflation indexation, and leading to broadly flat lease payments in combination with modest cash debt service. However, tightening fixed charge cover ratios would signal less effective property management and could put ratings under pressure.

Adequately Managed Property Portfolio: Fitch recognises Ceconomy's active management of its operating leases, which provides financial flexibility, given the short-term nature of leases (average remaining lease is less than three years versus sector peers of around eight-10 years) as well as the inclusion of early termination clauses, usually linked to store-based profitability metrics. Fitch uses a lower estimated 7x lease multiple (standard lease multiple is 8x) when computing Ceconomy's lease- adjusted debt metrics to reflect the roughly one third proportion of its turnover-based leases.

DERIVATION SUMMARY

Ceconomy's 'BB'/Stable combines the 'BBB' traits of its sizeable operations, market position and product offering, with 'B' levels of operating profitability and credit metrics. We also regard as a rating constraint the highly commoditised consumer electronics markets in which Ceconomy operates, with exposure to demand volatility and growing competing online penetration. We consequently view Ceconomy's credit profile as being in line with that of the consumer electronics retail sub-sector.

Ceconomy's closest Fitch-rated peer is FNAC Darty (BB+/Stable). Compared with Ceconomy FNAC has smaller scale but it enjoys superior profitability driven by its stronger focus on premium segments, editorial products and subscription services, and a demonstrated ability to pass on price increases and protect margins. This is underlined in their one-notch rating differential.

Compared with wider non-food retail peers including Marks and Spencer Group plc (M&S) and Kingfisher plc (BBB/Stable), Ceconomy enjoys similarly strong market positions in its respective markets, combined with scale and good diversification. We take a positive view of Ceconomy's conservative financial policy and well-managed leased property portfolio, although this is offset by considerably lower profitability versus M&S's and Kingfisher's.

Relative to Spanish department store El Corte Ingles S.A. (ECI), Ceconomy is larger in scale, more geographically diversified (ECI generates 95% of sales in Spain) and better positioned in its online service offering. ECI however has a more premium service offering, with prime-city store locations and customer loyalty, as well as higher own-brand sales, which translate into higher profitability than Ceconomy (5.7% for ECI vs. around 2.0% for Ceconomy).

Compared with another direct peer in the consumer-electronics space, UK retailer Currys plc, Ceconomy is around 2x-3x the scale in absolute sales, reflecting operations across multiple European countries. Gross profit and EBITDA margins are similar to Currys' at around 17%-18% and 2%-3%, respectively.

KEY ASSUMPTIONS

- Around 1% average annual sales growth over FY24-FY26, from reported EUR22.2 billion in FY23

- Fitch-defined EBITDA margin to improve to 2.2% in FY24 (FY22: 1.7%) and gradually expanding to around 3.0% in FY26

- Leases at 2.3%-2.4% of sales p.a. to FY26

- Trade WC of EUR300 million inflow in FY23 followed by normalisation in FY24 with a marginally positive cash impact over FY25-FY27

- Capex at around EUR300 million p.a., corresponding to around 1.3% of sales to FY27

- No dividend payments over FY23-FY25; EUR100 million a year in FY26 and FY27

RATING SENSITIVITIES

Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

-Improved profitability and like-for-like sales, for example due to a strengthened competitive position or an improved business mix, with Fitch-defined EBITDA margin sustained above 2.5%

-EBITDAR net leverage sustained below 3.5x

-EBITDAR fixed-charge cover above 1.8x

-Neutral to marginally positive FCF generation and improved cash flow conversion leading to lower year-on-year trade WC volatility

Factors That Could, Individually or Collectively, lead to Negative Rating Action/Downgrade

-Decline in profitability and like-for-like sales, for example, due to increased competition or a poor business mix, with EBITDA margin remaining below 2%

-EBITDAR fixed charge cover below 1.6x

-EBITDAR net leverage sustained above 4.0x

-Mostly negative FCF

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: We estimate Ceconomy's readily available cash balance at a higher level than the EUR769 million of FYE22, which is adequate for its limited debt service requirements in the absence of material contractual debt maturities until FY26. We project low single-digit FCF margins leading to a FY25 cash balance at above EUR1 billion, closer to the group's historical average.

Manageable Short-Term Financing Needs: Ceconomy has access to an undrawn committed revolving credit facility (RCF) of EUR1.06 billion with EUR353 million maturing in 2025 and EUR706 million in 2026, as well as a EUR500 million commercial paper programme to support short-term financing needs (EUR5 million utilised as of June 2023) even though we do not include the latter in our liquidity calculation.

We do not restrict the cash balance for WC purposes, as we view its cash position in the fourth quarter of its financial year as a fair representation of the average annual level, despite large WC swings during the year, particularly around the first and third quarters. Our assessment considers that the favourable WC swing between the fourth and first quarters tends to be larger than the cash-absorbing WC swing between the third and fourth quarters.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			RECOVERY	PRIOR
Ceconomy AG	LT IDR	BB Rating Outlook Stable	Affirmed		BB Rating Outlook Stable
senior unsecured	LT	BB	Affirmed	RR4	BB

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 13 Oct 2023) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 03 Nov 2023) (including rating assumption sensitivity)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 03 Nov 2023)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

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