RATING ACTION COMMENTARY

Fitch Publishes Ceconomy's 'BB' IDR; Outlook Stable

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Fitch Ratings - Frankfurt am Main - 13 Dec 2022: Fitch Ratings has published Germany-based electronics retailer Ceconomy AG's (Ceconomy) Long-Term Issuer Default Rating (IDR) at 'BB' with a Stable Outlook. Fitch has also published its rating for its five-year EUR500 million senior unsecured bond at 'BB' with a Recovery Rating of 'RR4'.

The 'BB' rating balances Ceconomy's large-scale, well-diversified product offering, omnichannel capabilities and pan-European footprint with operations in a competitive market, low operating margins, volatile free cash flows (FCF) and tight interest cover metrics.

The Stable Outlook reflects our view that the company should be able to restore its EBITDA margin to or above 2.5% in FY24-FY25 (financial year end September) and to reduce its EBITDAR net leverage towards 4.0x from a level currently not consistent with the rating. This will mainly be driven by stronger volumes in a recovering macro-economic environment, after temporary trading softness in FY23 amid recessionary pressures, particularly in its main German market.

KEY RATING DRIVERS

Leading European Consumer-Electronics Retailer: Ceconomy is the largest consumer-electronics retailer in Europe, but we place its business profile between the 'BBB' and 'BB' categories due to its scale, market position and diversification, but also given the challenges of operating in a fiercely competitive market. Ceconomy benefits from its strong brand name, sizeable operations with a pan-European footprint, and well-diversified product offering with adequate omni-channel capabilities as evident in its

online sales having reached 25% of total sales in FY22. However, its trading performance is predominantly driven by Germany and is exposed to a challenging and volatile consumer-electronics market.

Profitability Lower than Sector Peers': Ceconomy operates in the largely commoditised mass-market end of consumer-electronics retailing, which is exposed to substantial competitive pressures amid high price comparability. This is exacerbated by increasing online market penetration, and retailer-agnostic consumer behaviour. We assess Ceconomy's EBITDA and fund from operations (FFO) margins at 'B', which could come under further pressure in FY23 as consumers delay their purchases or trade down while the company can only partly pass on inflation-cost increases. We anticipate a restoration of EBITDA and FFO margins towards 2.5% and 2%, respectively, (FY22E: 1.9% and 1.1%) from FY24, mainly on potentially stronger volumes in a recovering macro-economic environment.

Volatile FCF: We estimate that FCF will remain prone to high volatility, which we attribute mostly to sizeable inventory-led changes in trade working capital (TWC) and pronounced sales seasonality, combined with an uncertain trading environment. Based on the company's tighter stock control to manage goods availability and actual consumer demand, we project at least a partial funds release leading to slightly positive TWC cash flow in FY23-FY24. This follows two consecutive years of a large cumulative cash outflow estimated by Fitch at around EUR900 million, which includes company-reported changes in TWC adjusted by Fitch for use of factoring for part of its receivables.

Low Working-Capital Visibility: The visibility of the TWC changes remains extremely low, which may be aggravated by recessionary pressures over the coming months, and will also strongly depend on the success of cash conversion cycle-reduction measures. At the same time, irrespective of the timing of the TWC reversal over the rating horizon, we estimate that Ceconomy's liquidity at financial year-end will likely remain under EUR1 billion in the medium term versus around EUR1.3 billion during FY18-FY21.

Leverage Weak in FY23: Based on our view of lower trading volumes and cost pressures, we project a temporarily heightened EBITDAR net leverage of around 5.0x in FY23, which is weak for the 'BB' IDR. From FY24, we estimate that leverage will strengthen to 4.0x on gradually improving macro-economic conditions leading to an EBITDA recovery towards EUR600 million, from a below EUR350 million projected for FY23. This 4.0x leverage is commensurate with the mid-to-low end of the 'BB' rating category for non-food retailers, and is a critical consideration behind the rating.

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 in the mid-to-low end of the 'BB' rating category. The 'BB'/Stable IDR is therefore strongly predicated on Ceconomy's ability to rebuild its EBITDA towards EUR600 million by FY25, as consumer confidence improves from the currently low point affected by an increased cost of living.

Tight Fixed Charge Cover: We see weak fixed charge cover ratios for Ceconomy with FFO and EBITDAR based metrics estimated to remain below 2.0x, which correspond 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 over 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 the company'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, growing online penetration and shortening product lifecycle due to technological advancements. We consequently view Ceconomy's credit profile as in line with that of the consumer electronics retail subsector.

Compared with wider non-food retail peers including Marks and Spencer Group plc (M&S) and Kingfisher (BBB/Stable), Ceconomy enjoys similarly strong market positions in its respective markets, combined with scale and good diversification. Likewise, 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% EBITDA margin for ECI vs. 2.1% for Ceconomy in FY21).

Compared with direct peers in the consumer-electronics space UK retailer Currys plc and French retailer Fnac Darty, 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 plc's at around 17%-18% and 2%-3%, respectively, with some pressure emerging as both companies increase lower-margin online sales. However, Ceconomy's EBITDA margins are lower than Franc Darty's 4%-5%, which highlights a less lean cost base as well as structural margin pressure in the commoditised end of the consumer-electronics market.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Revenue at EUR21.8 billion in FY22, as reported in the FY22 trading statement. Around 1% average annual sales growth over FY23-FY25

- Fitch-defined EBITDA margin to decline to 1.9% in FY22 and 1.5% in FY23 before gradually recovering to 2.7% in FY25

- Leases at 2.5% of sales p.a. to FY25

- TWC of EUR450 million outflow in FY22 followed by a normalisation in FY23 with a largely neutral cash impact over FY23 and FY24. TWC outflow at around 1% of sales in FY25

- Capex at 0.7% of sales p.a. in FY22 and FY23 before returning to 1.5% (public guidance) from FY24

- Dividend payments of EUR63 million to shareholders and EUR26 million to Convergenta in FY22. No dividends over FY23 and FY24; 40% of prior year's net income assumed by Fitch for FY25

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 strengthened competitive position or improved business mix, with EBITDA margin (Fitch-defined) sustained above 2.5% and FFO margin above 2%

- EBITDAR net leverage sustainably below 3.5x and FFO-adjusted net leverage below 4.0x

- FFO fixed charge cover sustainably above 1.6x and EBITDAR fixed charge cover above 1.8x

- Neutral to marginally positive FCF generation and evidence of improved cash flow-conversion cycle leading to reducing TWC 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 poor business mix, with EBITDA and FFO margins remaining below 2% and 1%, respectively

- FFO fixed charge cover sustainably below 1.4x and EBITDAR fixed charge cover below 1.6x

- EBITDAR net leverage sustainably above 4.0x and FFO-adjusted net leverage above 4.5x

- Mostly negative FCF

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: Ceconomy's readily available cash balances estimated at EUR700 million at FYE22 was adequate relative to its volatile FCF generation and low ongoing debt service requirements in the absence of material contractual debt maturities until FYE25. Based on the TWC outflow in FY21 and FY22, we project a lower year-end cash balance of EUR600 million-EUR700 million over the rating horizon, versus an average of EUR1.3 billion of Fitch-calculated freely-available cash during FY18-FY21.

Manageable Short-Term Financing Needs: Ceconomy also has access to an undrawn committed revolving credit facility (RCF) of EUR1.06 billion and a EUR500 million commercial paper programme to support short-term financing needs (EUR45 million utilised as of November 2022) even though we do not include the latter in our liquidity calculation.

We believe that cash is not inflated at fiscal year-end in September, as this is typically close to its average level of TWC for the year, therefore, we only restrict EUR100 million of cash at year-end.

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

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This 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. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

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

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 28 Oct 2022) (including rating assumption sensitivity)

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

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Ceconomy AG	-

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Corporate Finance Retail and Consumer Europe Germany