

This methodology note stands superseded. Refer to ICRA's website www.icra.in to view the updated methodology note on the sector.

RATING METHODOLOGY FOR ENTITIES IN THE RETAIL INDUSTRY

This rating methodology updates and supersedes ICRA's earlier methodology note on the sector, published in January 2015. While this revised version incorporates a few modifications, ICRA's overall approach to rating entities in the sector remains materially similar.

This rating methodology provides a reference tool for investors and issuers to understand ICRA's approach to assessing the business and financial risk profiles of entities in the retail industry. Retailers are defined as those companies whose final business activity involves trading (including e-commerce) / selling of goods and services to the final / end consumer. ICRA also rates a large number of entities in gold jewellery retail and automobile dealerships – for these two categories, ICRA has separate rating methodologies which are available on our website www.icra.in. This document does not include an exhaustive discussion of all the rating factors that our analysis considers, but provides an overall perspective of the considerations that are usually the most important. For analytical convenience, the key rating factors are grouped under the following broad heads:

- **Business risk assessment**
 - Business model
 - Scale of operations, market position and competitive intensity
 - Risks inherent to the industry
 - Location of real estate assets
 - Supply chain and operational efficiency
- **Financial risk assessment**
 - Profitability
 - Leverage and liquidity
 - Cash flows and debt coverage indicators
 - Capital expenditure plans
 - Tenure mismatches, and risks relating to interest rates and refinancing
 - Debt servicing track record
 - Accounting quality
 - Contingent liabilities and off-balance sheet exposures
 - Consolidated financial analysis and group support
 - Adequacy of future cash flows
- **Event risk**
- **Management quality and corporate governance**

Business risk assessment

Business model

In assessing the credit quality of a retailer, ICRA studies its business model across various parameters which determine the retailer's ability to generate sustained and consistent cash flows over a long time period. In terms of business model, retailers can be classified on the basis of products being sold - into value retailers (primarily food and grocery products) and lifestyle retailers (apparels, consumer durable goods, accessories, etc.), on the basis of store formats - into brick-and-mortar retailers and e-commerce, and on the basis of depth of products being sold - into exclusive brand outlets and multi-brand outlets.

Such vastness and variety of areas of operations in the retail industry require us to analyse a particular retailer in conjunction with the relevant factors that determine / influence the stability of operations and cash accruals for that particular industry sub-segment. For example: a value retailer focused on selling essentials is more likely to demonstrate stability in operations vis-à-vis a lifestyle retail outlet, that though entails relatively higher margins, is more prone to cyclicalities in demand and economic sentiments, thereby exposing such retailer to volatility in cash flows. Similarly, a retailer's product breadth and depth, industry cyclicalities and regulatory risks are among the factors that influence the business dynamics of a retailer. While brick-and-mortar stores account for a large share of the retail pie, India is witnessing increased retailing (albeit on a low base) through e-commerce. Overall, the business model followed by a retailer influences the credit risk assessment framework.

Following are some of the key business / industry parameters that could have a strong bearing on the performance and business strength of a retailer.

Product breadth, product depth and inventory management: The revenue potential of a retailer is closely linked to the range of products it offers and the pricing, which in turn drive footfalls / enquiries. A retailer with a wide range of products across categories is better placed to cater to a customer's requirements more effectively. The various categories of products being sold, brand-wise concentration of revenues, and the ability of a retailer to maintain various stock keeping units (SKUs) in each product category is analysed as it enables better customer service, thereby ensuring repeat customers. ICRA notes that maintaining optimal levels and the right kind of product inventory is critical in determining the performance of a retailer as inventory has an associated carrying cost and thus too much inventory can strain the working capital position and also increase the risk of obsolescence, while too little of it increases the risk of stock-outs, thereby risking loss of customers. ICRA analyses a retailer's efficiency in inventory management on the basis of its arrangement with brand owners for inventory liquidation, return policies, among others. In addition, the brand strength of the products offered by the retailer and the retailer's own brand position is also analysed as it drives demand and footfalls into the stores. Another factor taken into consideration is the mix of private label and external brand sales. While private label sales do offer retailers higher gross margins, sales volumes are generally limited on account of the low marketing / promotion. In contrast, for a retailer with multi-brand sales, while the gross margins may tend to be low, the wide scale promotions and marketing by the brands generally support higher sales volumes.

Price competitiveness / flexibility: An important aspect influencing the sales volumes of a retailer is its price competitiveness vis-a-vis other players in the market. This is especially so in case of commoditised products where a meaningful price difference between players can result in switching of customer loyalties. However, while this is true in general, we note that retailers of certain categories of products are relatively less vulnerable to pricing pressures compared to others. That said, ICRA notes that, despite relatively higher price competition in certain segments, retailers with strong brand and / or having niche or value added products (as against commoditised products) command pricing premium, reflecting product strength which is factored in suitably.

Risks arising from nature of products dealt in: ICRA analyses retailers in the light of certain risks that are inherent to the nature of business operations / products dealt in. A retailer's ability to mitigate the same is critical in sustaining its credit profile. Following are some of the factors that impact the performance of certain segments:

- **Obsolescence / seasonality of products and demand:** Product segments such as apparels, footwear and certain technology products witness high pace of change in trends and upgradation, thereby rendering the previous designs / models obsolete. On the other hand, the beer industry in India witnesses seasonal demand, thereby resulting in uneven cash flow generation. Similarly, in industries that are dependent on products where the availability of raw materials is seasonal, the cash flow generation from such products is uneven. When assessing such retailers, ICRA studies the risks arising from the obsolescence and seasonality of products and demand in conjunction with the retailer's ability and measures to manage the same. In such industries, large inventory holding accentuates the risk of inventory write-downs and hence is a key rating sensitivity.
- **Perishable nature / expiry of stock:** Certain products such as agri-commodities, dairy products and sea-food are exposed to perishability risk. Consequently, the retailers of such food products / grocery face the risk of inventory loss in the event of their inability to a) liquidate inventory in a timely manner

or b) maintain requisite storage conditions (which could have cost implications thereby hurting margins). While analysing retailers involved in trading of such products, in addition to other parameters, we assess the ability of such retailers to plan / manage inventory in a manner which can minimise inventory loss because of expiry.

Scale of operations, market position and competitive intensity

Scale of operations of a retailer is an important determinant of the operating leverage it enjoys with respect to its industry peers. Scale is not only dependent on the number of outlets the retailer operates but also on the product mix – per unit realisation for an automobile dealer is significantly different than that of a fast moving consumer goods (FMCG) or an apparel retailer. While analysing retailers on this parameter, ICRA takes into account factors like number of retail outlets in operation, mix of formats, expansion plans of the retailer, sales per square feet, same store sales growth, debt per retail outlet, among others.

Generally, a large revenue base leads to economies of scale in terms of cost efficiencies in procurement and administrative functions, thereby supporting the margins of the retailer. Further, other factors remaining similar, a large scale retailer is more likely to exhibit higher operational stability and financial flexibility.

The degree of competition faced and the retailer's market position play an important role in determining its growth prospects and in turn its future cash flows. A retailer's market position and track record of successfully operating its business reflect its ability to respond to competitive pressures, and its ability to negotiate with suppliers and maintain profitability across business cycles. This factor can be measured through a retailer's scale (total revenues), segmental market share and competitive position, investments in technology and inventory management systems, and cost efficiency and profitability. A retailer in a highly competitive segment is likely to face pressures in terms of pricing and volume growth, thereby impacting the same store sales growth. However, a retailer's strong market position and healthy demand for products / brands being sold could drive its operating performance, despite the competition. Further, an entity with strong market position is also better placed to negotiate favourable procurement terms with its vendors, and attract the right talent / skilled workforce which in turn drive operational efficiency. Given the high attrition levels in the retail industry, ICRA notes that a retailer with scale is likely to be in a better position to manage the attrition more effectively, thereby providing it an edge over competition. A sustained healthy market position also acts as an entry barrier for new players, thereby requiring new players to make significant investments in marketing, warehousing and technology. The ability to defend market share on a consistent basis is the key to sustain margins.

Risks inherent to the industry

Industry cyclicity / macroeconomic risks impacting consumer spending: Businesses are sensitive to economic cycles in varying degrees depending on the extent of their correlation to the economic activity and consumer sentiment in the country. Thus, in cases of retailers in cyclical sectors, an important factor to be studied is the extent of diversification of revenue mix across products / services, customer segments and geographies which are critical factors influencing operational stability.

Regulatory risks: In India, prices of products such as alcoholic beverages and pharmaceutical drugs are regulated to a large extent, thereby restricting the scope for margin expansion by a retailer. Further, regulatory restrictions on mode of mass marketing / promotions, like in case of alcoholic beverages – limits to some extent – the volume growth potential of the industry, in turn impacting the revenue growth of a retailer involved in the sales of those products. Also, these industries are exposed to risks of adverse regulatory changes in terms of pricing and product sales. A case in point here is the implementation of the Drug (Price Control) Orders and the National List of Essential Medicines (NLEM) announced by the National Pharmaceutical Pricing Authority (NPPA) which have been consistently increasing the coverage of number of drugs under pricing control, thereby impacting the cash generation of pharmaceutical drug retailers.

The retail industry has also been facing political roadblocks in attracting foreign investments, which has restricted the benefits arising from transfer of technology and increased supply chain efficiencies. Though the industry has been opened up with 100% foreign direct investment (FDI) in single brand retail, 51% FDI in multi-brand retail and 100% FDI in business-to-business e-commerce, it includes a set of riders,

complicating its implementation. Furthermore, most of the compliance requirements for organised retail are a state subject and consequently there is less uniformity in regulations.

While regulations generally pose an entry barrier for competition, the quantum of favourable or unfavourable impact of the same on the business and financial profile of the players remains a key rating sensitivity.

Location of real estate assets

In case of brick-and-mortar stores, the location of retail outlets is a critical aspect driving footfalls and sales volumes. For example, an apparel retail outlet located in a fairly densely populated area is likely to experience higher footfalls as against one located significantly away from the populated areas or in the outskirts of a city. While in some cases, the brand strength of a retail outlet and of the products it sells generate strong footfalls despite the location of the outlet; in ICRA's experience, it is observed that the outlets situated in a demographically favourable location [including in malls / central business districts (CBDs)] enjoy the distinct advantage of high visibility and better recall with existing and prospective customers, in turn driving business volumes.

In India, a growing demand for retail space coupled with lack of alternatives with supporting infrastructure has pushed commercial rentals in many locations to uneconomical levels. Given this, several retailers are working on different strategies to acquire retail space - retailers are now tying up with land-owners with agreement to share revenues, sub-letting space to specialty retailers at higher rentals (to bring down overall rental cost), and acting as anchor tenant in malls at lower rentals. However, delays by developers in handing over the properties is a significant risk, which not only results in delays by the retailer in opening its stores but can also lead to cost overruns. ICRA thus analyses the lease rental economics of the retailers in terms of rental per square feet vis-a-vis sales per square feet and the capital expenditure per square feet.

Supply chain and operational efficiency

A retailer's business involves providing consistent access to the right products, in the right locations at the right time, and with the appropriate value proposition. One of the enabler to this is the use of technology which aids in optimising order cycles and order quantities for various products, better inventory management and shorter delivery times. Any slippage in execution can have an adverse impact on customer loyalty, and subsequently its financial performance. Particularly, in an emerging retail market such as India, supply chain plays a key role in enhancing execution capability of a retailer. While significant upfront investments on technology and the subsequent costs associated with upgradation may impact profitability of a retailer, its ability to manage fixed costs and benefit from the cost savings arising from the efficiencies generated by usage of technology are crucial. In this context, a large retailer is generally better positioned to leverage the use of technology on account of its bigger scale of operations. That said, irrespective of the scale, a retail entity that manages its supply chain in a manner that supports optimum inventory levels at its warehouses and in a cost-effective manner is better placed to face competition and is also likely to generate better margins.

Financial risk assessment

While assessing the financial position of a retailer, ICRA reviews the Accounting Policies followed by the entity and factors in any deviations from standard accounting practises so as to make its comparison against other players in the industry more meaningful. In addition to balance sheet strength, ICRA also evaluates the profitability and cash-generating ability of the business as well as other sources of financial flexibility available to an entity to evaluate its overall financial risk profile. For a more detailed description, readers may refer to the note titled, "Approach for Financial Ratio Analysis" published on ICRA's website.

Profitability

Retail format is typically the most important determinant of gross margins, while scale does bring operational efficiencies. For instance, supermarkets have a much lower gross margin as compared to lifestyle retailers. Gross margins are also a function of the product mix (FMCG / apparel / consumer durables etc.), vendor negotiations, contribution of private label sales (which have high margins) to overall

sales, and the discounts being offered which in turn is dependent on the competitive intensity and demand scenario.

Overall, retail is a high fixed cost business – the two major costs being employee costs and rentals. Rental cost is one of the key determinants of breakeven level for a store. For instance, despite higher sales per square feet, stores with high rental levels would take relatively longer time to achieve break-even levels. Further, since the retail industry faces high attrition and there is a dearth of key talent, the employee cost is also high in order to retain key talent. ICRA analyses the store level contribution of a retailer to determine its profitability.

Leverage and liquidity

ICRA assesses the financial policies followed by the entity – past as well as future – to determine the risk appetite of the management and the impact of the same on the financial performance of the entity. The financial risk profile of the retailer is evaluated based on its cash flow generating capacity, which the retailer would further use in meeting its debt service obligations and for investing in the business.

The financial policy followed by the entity determines to a large extent its leverage and financial flexibility, especially in times of an economic downturn. An entity that follows an aggressive financial policy and relies heavily on debt financing would be more vulnerable to an economic slowdown, as compared to an entity with lower leverage, which would have better ability to raise funds. The extent of leveraging by a retailer, and hence, its financial flexibility, is reflected in leverage ratios like Total Debt/ Tangible Net Worth, Total Outside Liabilities/ Tangible Net Worth, Total Debt/ OPBDIT¹ and NCA²/ Total Debt. Low leverage ratios reflect low reliance on debt funding, and better ability to raise funds from alternative sources in times of need.

ICRA also evaluates the liquidity profile of the entity to assess its ability to meet short-term obligations. The liquidity profile of entities is assessed based on their ability to generate cash from internal resources and their access to committed sources of external financing, in relation to cash obligations such as debt repayments and investments over the near term. Higher the cushion available between the resources available and the obligations, better the liquidity profile of an entity.

Cash flows and debt coverage indicators

Retail is highly capital intensive and requires significant investments in fixed assets, including retail outlets, warehouses and distribution networks. In addition, it is also a high working capital intensive business with significant investments in maintaining sufficient inventory. Thus, as discussed before, a critical determinant of a retailer's performance is the entity's ability to maintain optimal levels and right kind of product inventory - as too much inventory can strain the working capital position as also can result in substantial inventory losses in the event of any sudden change in preferences or demand slowdown, while too little increases the risk of stock-outs, thereby risking the loss of business. More importantly, the long-gestation nature of business, results in negative cash flows for the initial few years of operations, and thus requires regular infusion of funds. Thus, building a long-term sustainable business model is of paramount importance, and only those retailers with more robust format offerings are generally in a position to recoup the initial few years of losses.

The debt coverage indicators like Interest Coverage and DSCR³ are a reflection of the ability of the entity to service its external borrowings after meeting its expenses. ICRA evaluates the coverage indicators of the entity to determine how comfortably it can service its debt obligations through profits or cash flows generated from its operations.

Capital expenditure plans

The capital expenditure plans of a retailer comprise its agenda of opening new stores/ outlets and investments in supply chain and IT systems. While opening of new stores/ outlets is a positive, as it boosts revenue growth, it needs to be done in a rationalised manner. There have been several instances in the

¹ Operating Profit Before Depreciation, Interest and Tax

² Net Cash Accruals

³ Debt Service Coverage Ratio

past where a few retailers have been very aggressive in store expansion, yet fail to achieve long-term viability, and they have to subsequently shut shop. Hence, while capital expenditure plans for a retailer are generally considered a positive, these are not evaluated in isolation. The quantum of capital expenditure and funding plans for the same are also evaluated to understand their impact on the financial risk profile of the entity going forward.

Retailers having a balanced focus on store network expansion and achieving profitability for its existing stores are likely to have better long-term cash flows.

Tenure mismatches, and risks relating to interest rates and refinancing

Tenure mismatches, like funding of long-term investments through short-term borrowings, expose the entity to refinancing risks. Such risks are especially significant in periods of tight liquidity. The existence of adequate buffers of liquid assets/ bank lines to meet short-term obligations is viewed positively. ICRA also takes into account the impact of movement in interest rates on the cash flows of the entity, and the extent to which the debt servicing ability of the retailer would be impacted by the same.

Debt servicing track record

The debt servicing track record of an entity is an important input for any credit rating exercise. Any delays or defaults in the past in the repayment of principal or interest payments reduce the comfort level with respect to the retailer's future debt servicing capability. A track record of wilful default, either by the issuer or related entities, also raises concerns with respect to the issuer's debt-servicing willingness. ICRA also takes into consideration the entity's demonstrated ability to service debt during periods of stress.

Accounting quality

Given the reliance on the audited financial statements for analysing a retailer's financial performance during the rating process, ICRA places due importance on the quality of accounting practises followed by the entity. ICRA reviews the Accounting Policies, Note to Accounts and Auditor's Comments that are part of the Annual Report of the issuer. Any deviation from the Generally Accepted Accounting Practises is noted, and the financial statements of the issuer are adjusted to reflect the impact of such deviations, and make it comparable with industry peers. ICRA also interacts with the statutory auditors to assess the quality of accounting practices followed by the entity.

Contingent liabilities and off-balance sheet exposures

ICRA reviews the contingent liabilities and off-balance sheet exposures as disclosed by the issuer in its Annual Report, and the likelihood of their devolvement and the financial implications of the same.

Consolidated financial analysis and group support

In case of groups consisting of companies with strong financial and operational linkages, various parameters such as capital structure, debt coverage indicators, and future funding requirements are assessed at the consolidated/ group level, which provides a better picture of the entity's financial risk profile.

While assessing an entity that is part of a larger group, ICRA also takes into consideration the strengths and weaknesses arising from the group association. The probability of cash outflows from the issuer to support group entities is evaluated in case of the issuer being among the stronger entities of the Group. On the other hand, if the entity is among the weaker entities in the Group, the ability and willingness of the Group/ promoters to lend support to the issuer in the event of required capital infusion are also assessed.

Adequacy of future cash flows

Since the primary objective of the rating exercise is to assess the adequacy of the entity's debt servicing capability, ICRA draws up projections on the likely financial position of the entity factoring in its expansion plans, expected sales per square feet, store contribution, capital expenditure requirements, working capital requirements as well as upcoming debt obligations. ICRA carries out sensitivities on key variables to test the cash flow position of the entity under various scenarios and also evaluates the funding requirements of the entity, and the funding options available to it.

Event risk

ICRA recognises the possibility of events that can have a material impact on the credit profile of a retailer. Examples of such events include unrelated diversification, mergers and acquisitions, business restructuring, asset sales and spin-offs, capital restructuring and litigations. ICRA evaluates the entities' risk appetite for acquisitions and for related or unrelated diversification. This can become a rating concern if the acquisition or diversification has a long gestation period or is funded mainly through debt, which can adversely impact the capital structure and profitability.

Management quality and corporate governance

Management quality, though an intangible parameter and thus difficult to quantify, is one of the most important factors in determining the credit quality of the entity being rated. The participation of professional management and the constitution of the Board (number of promoter members vs. independent directors, background of each director) and their participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements are factored in. Usually, a detailed discussion is held with the management to understand its views on past performance as well as its future plans and strategies and the outlook on the industry. Some of the points assessed are:

- Experience of the promoter/ management in the industry
- Commitment of the promoter/ management to the entity for growth plans as well as during stress
- Risk appetite of the promoter/ management and risk mitigation plans
- Management's past success in managing changes in external environment
- Management's plans on new projects, acquisitions, expansion, etc.

Periodic interactions with the management provide insights into the operations of the entity and ongoing developments, and also help ICRA estimate the probability of the management's tendency to deviate from its business philosophy in times of stress.

Summing up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the issuer's business and financial risks, its competitive strengths, its likely cash flows over the life of the instrument being rated and the adequacy of such cash flows vis-à-vis its debt servicing obligations and other funding requirements. While the product breadth and depth, inventory management and scale of operations would ultimately determine the business risk profile of a retailer, the retail format, key costs like rentals per square feet and employee cost per square feet vis-a-vis sales per square feet are the determinants of its financial risk profile.



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