JSC Nikora Trade
Georgia, Retail

B+ STABLE

Corporate Profile

JSC Nikora Trade is one of the leading food retailers in Georgia. The company has developed a significant market share in organised retail, with a large range of shops (345) and more than 4,500 employees selling over 10,000 different products.

Nikora is affiliated to Nikora JSC, which developed Nikora Trade to sell the meat products generated by one of its entities. Entry into the retail sector has led to the acquisition of smaller retailers in recent years. Nikora Trade has developed further shops and continues to expand successfully.

Key metrics

			Scope estimates		
Scope credit ratios	2019	2020	2021E	2022E	2023E
EBITDA/interest cover	2.7x	2.9x	2.5x	2.7x	3.1x
Scope-adjusted debt (SaD)/EBITDA	4.3x	4.0x	3.6x	3.4x	3.2x
Scope-adjusted funds from operations/SaD	15%	16%	17%	18%	20%
Free operating cash flow/SaD	-6%	1%	-8%	-4%	1%

Rating rationale

Scope Ratings GmbH has today affirmed its B+/Stable issuer rating on JSC Nikora Trade. Scope has also affirmed its BB- rating on the senior unsecured debt category.

The affirmation is driven by the company's solid development despite constrained operations during lockdowns. During the second wave of the pandemic in H2 2020, this trend started to reverse as the overall panic subsided and safety measures in retail stores were applied efficiently. At the same time, revenue growth of 19% YoY was supported by the high resilience of the sector. This remained primarily fueled by new store openings, further benefitting from the gradual substitution of unorganised fast-moving consumer goods retailers. The company repaid its bond obligations in August 2021 via a bridge loan from TBC bank and is currently in the process of issuing a new bond (GEL 30-35m) with similar terms.

Nikora Trade has gained a leading position in the Georgian retail market in terms of sales and trading area. In 2019-2020, the big players' market share decreased due to the more rapid expansion of several fast-moving consumer goods retailers. In that period, Nikora Trade became the largest player with around 19% in market shares, overpassing Carrefour (the second largest) by 200 basis points.

Higher-than-expected leverage in 2020 with Scope-adjusted debt/EBITDA of 4.0x is the result of the restatement of lease liabilities at YE 2019 of around GEL 10.0m and a foreign exchange loss on USD denominated lease liabilities. Borrowings from banks remained at GEL 47.3m at YE 2020 (GEL 47.5m at YE 2019). Our rating case incorporates leverage gradually returning towards 3.0x.

We see liquidity as inadequate. Committed credit lines of GEL 10.2m remained undrawn in 2020 and cash of over GEL 1.0m available on the balance sheet appears insufficient to fully cover (re)-financing needs of GEL 10-20m from expected negative free operating cash flow in 2021-2022 and short-term debt of around GEL 6.0-8.0m. The repayment of bond obligations in August 2021 via bridge loans increased short-term debt on the balance sheet

Ratings & Outlook

Corporate rating B+/Stable

Senior unsecured rating BB-

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Related Methodology

Corporate Rating Methodology: July 2021

Rating Methodology: Retail and Wholesale Corporates March 2021

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for 2021. The company is currently in the process of issuing a new bond. However, bridge loans from TBC could be rolled over if the issuance of the new bond is delayed.

Outlook and rating-change drivers

Stable Outlook

The Outlook is Stable and reflects our expectation that Nikora Trade's Scope-adjusted debt (SaD)/Scope-adjusted EBITDA will gradually improve to below 4.0x and that funds from operations (FFO)/SaD will stay above 15%. It also incorporates our expectation that the company will continue operating with very limited liquidity due to a heavy investment phase weighing on free operating cash flow generation. We do not expect any M&A activity or dividend payments in the short term.

Rating upside

A positive rating action could be the consequence of FFO/SaD and SaD/EBITDA above 30% and below 3x respectively or an improvement in liquidity, all on a sustained basis. This could be achieved if, for instance, the top line grows more strongly, outpacing the forecasted surge in raw materials prices, or the level of inventory shrinkages is decreased. A positive rating action could also be warranted if the company grows in size gaining significant market shares outside of Tbilisi area.

Rating downside

A negative rating action could result from a deterioration in credit metrics as indicated by FFO/SaD falling below 15% or SaD/EBITDA increasing above 4.0x on a sustained basis. Such weak financial performance could be triggered by greater competition on the market, putting operating profitability under pressure.

Rating drivers

Positive rating drivers	Negative rating drivers
• Strong national market positioning, with the gradual crowding out of the unorganised retail market leading to potential for significant sales growth • Profitability higher than peers thanks to small shop formats and integrated vertical structure • Active on the food retail scene, considered the retail industry subsector least prone to cyclicality • Comfortable leverage despite high forex risk from USD denominated leases	• Absolute size still small with low market shares if we include the unorganised market • Weak diversification with operations only in Georgia, enhancing vulnerability to macro-changes • Inadequate liquidity • Weak transparency (negative ESG rating driver)

Rating-change drivers

Positive rating drivers	Negative rating drivers
• SaD/Scope-adjusted EBITDA below 3x and Scope-adjusted FFO/SaD above 30% on a sustained basis • Improved liquidity • Increase in the company's critical size	• SaD/Scope-adjusted EBITDA above 4x on sustained basis • Scope-adjusted FFO/SaD below 15% on sustained basis

Financial overview

			Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest cover	2.7x	2.9x	2.5x	2.7x	3.1x
SaD/EBITDA	4.3x	4.0x	3.6x	3.4x	3.2x
Scope-adjusted FFO/SaD	15%	16%	17%	18%	20%
FOCF/SaD	-6%	1%	-8%	-4%	1%
Scope-adjusted EBITDA in GEL ‘000	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Scope-adjusted EBITDA	37,682	44,842	52,958	59,548	63,329
Operating lease payments in respective year	0	0	0	0	0
Other	0	0	0	0	0
Scope-adjusted EBITDA	**37,682**	**44,842**	**52,958**	**59,548**	**63,329**
Scope-adjusted funds from operations in GEL ‘000	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Scope-adjusted EBITDA	37,682	44,842	52,958	59,548	63,329
(Net) cash interest as per cash flow statement	-13,908	-15,555	-21,040	-22,044	-20,559
Cash tax paid as per cash flow statement	0	0	-160	-691	-1,460
Other	0	0	0	0	0
Scope-adjusted FFO	**29,287**	**29,287**	**31,758**	**36,813**	**41,311**
Scope-adjusted debt in GEL ‘000	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Reported gross financial debt	161,720	180,629	181,345	189,502	191,609
Cash, cash equivalents	0	0	0	0	0
Guarantees	0	0	10,000	10,000	10,000
Provisions	0	0	0	0	0
SaD	**161,720**	**180,629**	**191,345**	**199,502**	**201,609**

Business risk profile: BB-

Credit-supportive industry risk

Nikora Trade's business risk profile benefits from the underlying non-cyclical retail industry's low cyclicality, low entry barriers and low substitution risk.

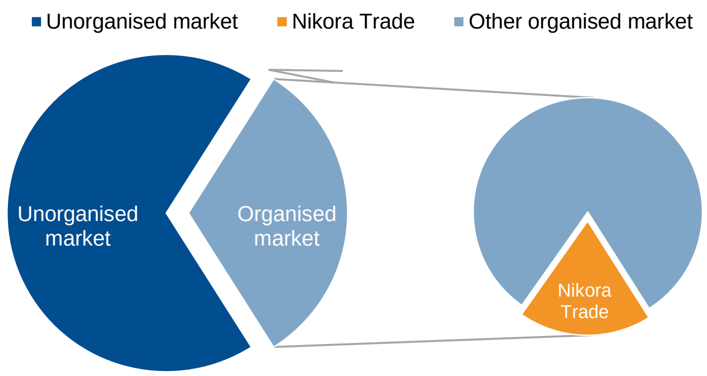
Limited size

Nikora Trade is a small player in a European context in terms of its size and scale of operations. Following the introduction of our dedicated sectorial methodology, we assess the group's market shares as constrained by its size (GEL 522m in revenues for FY 2020). Although Nikora Trade's size is significant in Georgia, this is one of the constraining rating driver of the company's business risk profile. Even if the retailer manages to successfully maintain its number one position in Georgia, it will remain a very small actor on the international food retail market.

Dominant player on Georgian retail market

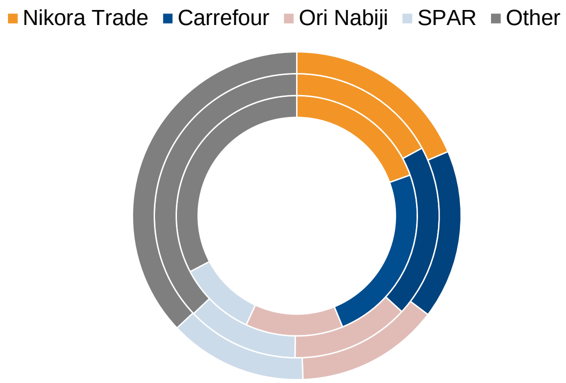
The company has achieved a leading position in the Georgian retail market in terms of sales and trading area. In 2019-2020, the big players' market share decreased due to the more rapid expansion of several fast-moving consumer goods retailers. In that period, Nikora Trade became the largest player with around 19% of shares, overpassing Carrefour (the second largest) by 200 basis points. Management has maintained its expansion strategy by opening new stores and ramping up newly opened locations.

Figure 1: Retail market structure in Georgia (2020)



Source: Nikora Trade, Scope

Figure 2: Retail market shares in Georgia (inner circle Dec 2018, middle circle Dec 2019, outer circle Dec 2020)



Source: Nikora Trade, Scope

Additional potential for consolidation on underpenetrated market

Besides competition among market players, there is still a great potential to capture the market share of unorganised retailers, especially outside the capital. This will be one of the medium-term strategic objectives of Nikora Trade's management.

Resilient market has protected operations

As we anticipated, Nikora Trade's top line took a hit from the Covid-19 pandemic, with like for like sales adversely affected by the lockdown and the reduction of working hours. During the second wave of the pandemic in H2 2020, this trend started to reverse as the overall panic subsided and safety measures in retail stores were applied efficiently. At the same time, revenue growth of 19% YoY (in line with our and management's forecast) was supported by the high resilience of the sector. This remained primarily fueled by new store openings, further supported by the gradual substitution of unorganised fast-moving consumer goods retailers.

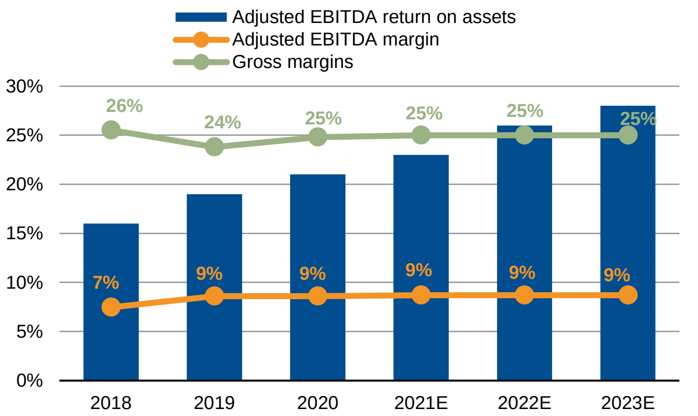
Country retail strength is low

We see the country retail strength of the company's operations as 'low'. Although the market is fairly mature, it still has development possibilities, underlined by the largely underpenetrated market outside of the capital of Georgia.

Diversification remains weakest component of business risk profile

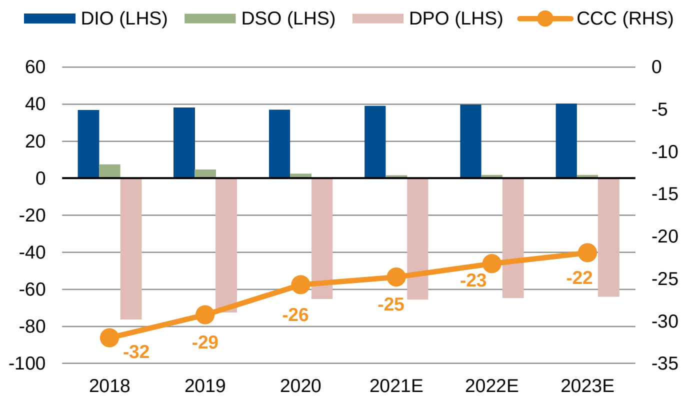
Diversification remains one of the weaker elements in Nikora Trade's business risk profile. There are no sales outside of Georgia and distribution channels are not diversified. We do not place too much emphasis on weak distribution channels as e-commerce is still in a nascent stage in Georgia. At the same time, Nikora Trade remains mostly exposed to sales in Tbilisi (75% of total sales in 2020). Management aims to diversify sales 50%/50% outside of the capital but it is still too early to give credit for this plan.

Figure 3: Operating performance



Source: Nikora Trade, Scope estimates

Figure 4: Evolution of cash conversion cycle[1]



Source: Nikora Trade, Scope estimates

Profitability margins are relatively high compared to local sector median

Nikora Trade's flat profitability is the main supporting element of its business risk profile. The company's margins proved robust during the Covid-19 pandemic. Despite the increased operational costs and additional safety or regulatory standards, Nikora Trade managed to keep a comfortable Scope-adjusted EBITDA margin at around 9%. The restated costs allocation due to inventory shrinkage and obsolete inventory costs for the years 2019-2020 decreased gross margins to 25% from 27% but had insignificant impact on EBITDA.

We believe that Nikora Trade will be able to keep profitability margins at the current level going forward. These will be supported by: i) historically stable gross margins of around 25%, benefitting from the vertically integrated group structure with advantageous commercial terms; and ii) the company's growth strategy, which should continue to enhance its bargaining power, potentially creating higher margins. A heavy dependence on imported materials - a common characteristic of the Georgian retail market - may put Nikora Trade's gross margins profile under further pressure if the Georgian currency continues to devalue against the euro/US dollar in 2021-2023.

Scope-adjusted EBITDA return on assets is high

We now measure operating efficiency with a newly introduced metric, the Scope-adjusted EBITDA return on assets. This allows us to evaluate how well assets are used to generate a certain EBITDA level. The adjusted EBITDA return on assets is gradually increasing and we expect it to remain above 20% going forward, thanks to rapid EBITDA growth.

[1] CCC: cash conversion cycle; DIO: days inventory outstanding; DSO: days sales outstanding; DPO: days payable outstanding

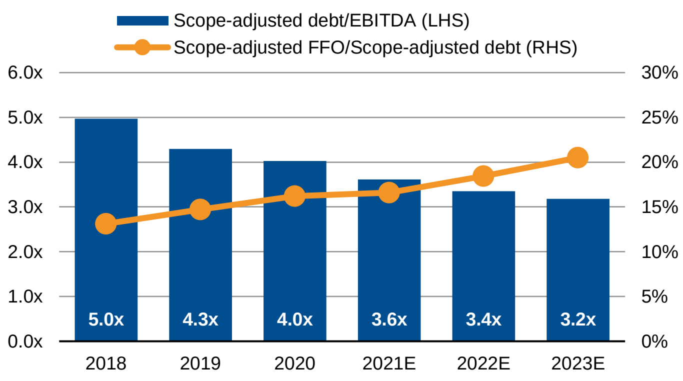
Financial risk profile: B+

Nikora Trade's financial risk profile is supported by a comfortable cash conversion cycle, reflected in substantial cash flow generation. Slightly deteriorated operating performance due to the Covid-19 pandemic was boosted by a governmental subsidy in 2020 and is expected to benefit from a further subsidy in 2021.

Higher-than-expected leverage in 2020 with Scope-adjusted debt/EBITDA of 4.0x is the result of the restatement of lease liabilities at YE 2019 of around GEL 10.0m and a foreign exchange loss on USD denominated lease liabilities in 2020. Borrowings from banks remained at GEL 47.3m at YE 2020 (GEL 47.5m at YE 2019).

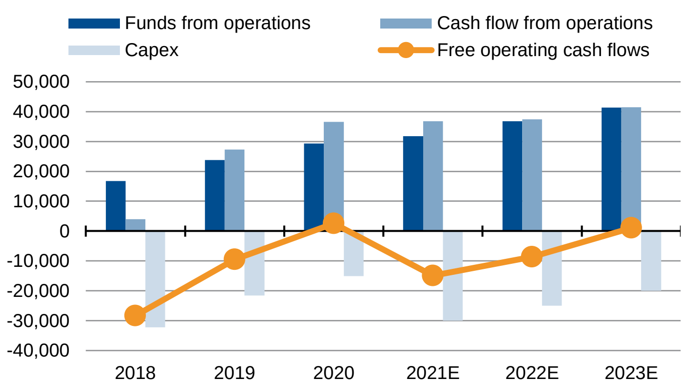
Leases remain a significant component of Nikora Trade's reported gross debt (around 70% at YE 2020). As new store openings will require further leases, we expect this figure to stay above 60% in medium term. The majority of the company's leases are denominated in USD, with the result that foreign exchange rates had a significant effect on the movement of lease liabilities in the amount of GEL 13.1m in 2020. Management intends to balance lease agreements with fixed and variable payment terms. Nikora Trade has confirmed that, going forward, performance-based variable lease payments will only be denominated in local currency.

Figure 5: Leverage



Source: Nikora Trade, Scope estimates

Figure 6: Cash flow cover (GEL '000)



Source: Nikora Trade, Scope estimates

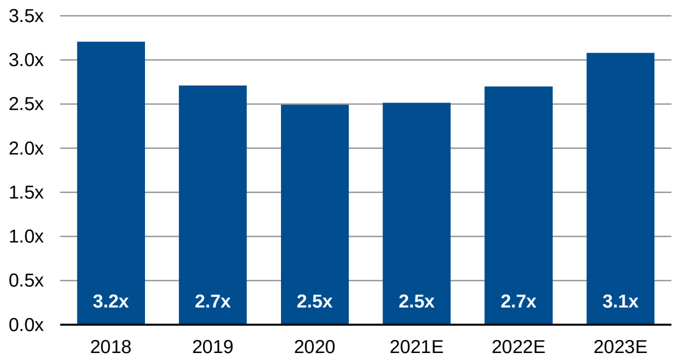
While expected negative free operating cash flow will limit room to decrease financial debt, our rating case incorporates leverage gradually returning towards 3.0x (2021E: 3.6x, 2022E: 3.4x, 2023E: 3.2x). Deleveraging should be driven by increasing EBITDA following the company's sales expansion strategy and the ramp-up of newly opened stores, while indebtedness remains at current levels. For the same reasons, we expect FFO/SaD to follow a similar trend, improving to levels above 15% from 2020.

The cost of debt in Georgia is relatively high, which puts pressure on EBITDA interest coverage. Interest cover deteriorated further in 2020 due to higher-than-expected interest on leases. We expect the ratio to remain at a modest level, above 2.0x, in 2021-2023 in line with anticipated deleveraging.

In light of Nikora Trade's expansion strategy, it is likely that the company will continue investments, but at a slower pace. We therefore expect free operating cash flow/SaD to recover somewhat in the coming years despite absolute values remaining strictly negative.

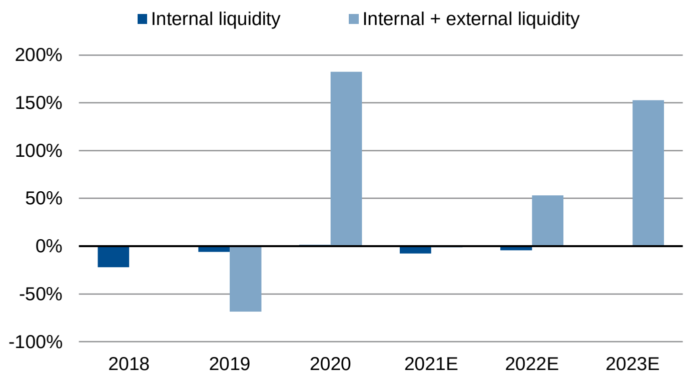
While cash flow cover is the weakest element of Nikora Trade's financial risk profile, we do not overweight this metric. We view positively the company's financial flexibility in terms of capital spending. Annual capex is anticipated to remain in the low double-digit million range (GEL 20-30m).

Figure 7: EBITDA interest cover



Source: Nikora Trade, Scope estimates

Figure 8: Liquidity



Source: Nikora Trade, Scope estimates

Inadequate liquidity profile

We see liquidity as inadequate. Committed credit lines of GEL 10.6m remained undrawn in 2020 and cash of over GEL 1.0m available on the balance sheet going forward appears insufficient to fully cover (re)-financing needs from expected negative free operating cash flow in 2021-2022 of GEL 10-20m and short-term debt of around GEL 6.0-8.0m. Short-term debt mainly compromised from amortizing nature of Nikora Trade's financial debt.

The repayment of bond obligations in August 2021 via bridge loans increased short-term debt on the balance sheet for 2021. The company is currently in the process of issuing a new bond. However, bridge loans from TBC could be rolled over if the issuance of the new bond is delayed.

Position	2021E		2022E	
Unrestricted cash (t-1)	GEL	3.9m	GEL	1.3m
Open committed credit lines (t-1)	GEL	10.6m	GEL	10.6m
Free operating cash flow	GEL	-14.9m	GEL	-8.6m
Short-term debt (t-1)	GEL	35.9m	GEL	6.2m
Coverage		**0.0x**		**0.5x**

Supplementary rating drivers

Credit-neutral supplementary rating drivers

We have not made any explicit rating adjustment for supplementary rating drivers. We note that the flow of information between management and Scope was often very slow. While this has not led to any rating impact so far, it may warrant a downgrade going forward (ESG rating driver).

Long-term debt rating

Senior unsecured debt affirmed at BB-

We have affirmed senior unsecured debt at BB-, reflecting our expectation of an above-average recovery for senior unsecured debt positions. Our recovery expectations are based on an estimated enterprise value, assuming operation as a going concern, in a hypothetical default scenario in 2023. In this scenario we assume that market conditions are tough and that the outstanding bank facility at the time is fully drawn.

While Nikora Trade's 2020 annual report states that assets (accounts receivables and inventories) are pledged to senior secured debt, the company has confirmed specific limits on the pledged accounts receivables and inventories.

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