# JSC Nikora Trade
# Georgia, Retail

B+ STABLE

## Corporate profile

JSC Nikora Trade (Nikora Trade) is one of the leading food retailers in Georgia. The company has developed an important market share in organised retail, established with a large range of shops (265), and has 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 led to the acquisition of retailer Masiv LTD, whose name was changed to JSC Nikora Trade in 2010. Nikora Trade developed further shops over the years and acquired Nugeshi in 2015. Today, Nikora Trade is one of the leading domestic food retail operators in Georgia.

## Key metrics

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2017** | **2018** | **2019F** | **2020F** |
| EBITDA/interest cover (x) | 4.17x | 4.36x | 4.37x | 5.17x |
| SaD/EBITDA | 2.93x | 3.59x | 3.26x | 2.67x |
| Scope-adjusted FFO/SaD | 25% | 21% | 24% | 30% |
| FOCF/SaD | 2% | -19% | -3% | 12% |

## Rating rationale

**Scope Ratings has today affirmed issuer ratings of B+ for JSC Nikora Trade (Nikora Trade). The agency also affirms the rating of BB- on senior unsecured debt issued by Nikora Trade. All ratings have a Stable Outlook.**

The rating benefits from Nikora Trade's dominant market share in Georgia's organised food retail market. The retailer is one of the pioneers in the creation of a nationwide food shop network, leading to a high market share of 19% in the organised market (defined as non-bazaar or brand affiliated shops) in 2017. 2018 saw a delay in Nikora Trade's expansion plans due to difficulties in grid connections for new shops and with the recruitment of competent sales clerks. As a result, 61 shops opened in October 2018, compared to management expectations of 120 at year-end 2018. This setback has not changed our view on the group's growth because we took the precaution of factoring in some postponements in the opening of new shops. Nonetheless, management has now announced a change in its expansion ambitions by focusing on more organic growth from 2019 onwards. Scope views this strategy positively because the group benefits from strong business competition tailwinds (e.g. the gradual disappearance of unorganised retail's market share and limited development potential for Carrefour across the country). The new strategy will also reduce capex pressure on cash flows.

The rating benefits from our expectation that Nikora Trade's bargaining power with suppliers will increase, supported by: i) its anticipated strong growth potential; and ii) access to the various fast-moving consumer goods-producing entities of the holding company (Nikora JSC), spearheaded by meat producer Nikora LLC which commands over 30% of Georgian market shares. This is advantageous for the rating because we expect internal suppliers to propose more flexible commercial terms than external suppliers.

### Ratings & Outlook

| | |
|---|---|
| Corporate ratings | B+/Stable |
| Senior unsecured rating | BB- |


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### Related methodology

Corporate Methodology 2019


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We believe that Nikora Trade is less diversified than some of its competitors because the company is solely active in Georgia and does not offer any online services. While the latter point is not overly relevant for the rating, given the level of development in Georgia, we do not consider Nikora Trade to be sufficiently diversified either within the context of the small size of the domestic market or in comparison to its larger retail peers.

With a Scope-adjusted EBITDA margin above its peers (historically between 8%-9%, jumping to 11% in 2017 but decreasing to 10% in 2018), Nikora Trade has managed to monetise its vertically integrated structure relatively efficiently. As mentioned above, the company sells a significant share of goods which are manufactured and/or processed within the group. In our view, this integration leads to relative cost and price advantages, and to a better management of unsold products in some cases, decreasing losses. We expect the size of the unorganised retail market to shrink and that Nikora Trade will be able to capture some of this market in future. Nikora Trade should therefore manage to increase its bargaining power with suppliers over the coming years. Nonetheless, due to the delays in the opening of new stores and the increase in rents, we affirm our EBITDA margin forecast at the current level (approx. 10%) representing the new strategy towards more organic development.

As regards Nikora Trade's financial risk profile, we see adjusted indebtedness within the low BB category (with Scope-adjusted debt [SaD]/EBITDA at 3.6x in 2018 and funds from operations [FFO]/SaD at 21%). Free operating cash flow (FOCF)/SaD was most impacted in 2018, due to the sharp increase in capex while EBITDA remained stable, leading to negative FOCF (around GEL 25m). We expect a recovery in the coming years due to decreasing capex spending and a better monetisation of existing shops.

In order to address this situation, management has issued a substantial amount of equity (GEL 11.475m), alleviating the weight of debt on liquidity. We have applied a negative notch for liquidity due to limited availability of unrestricted liquidity relative to short-term financial maturities. The drop in EBITDA led to a covenant breach (the interest cover ratio) in 2018, waived afterwards by all the bondholders. A modification of the calculation method for this ratio should provide some leeway to the retailer and decrease the probability of a future breach if it is performed this year. We expect an additional covenant breach in 2019 if the method for calculating the interest cover ratio is not modified. We have, however, received a prospective waivers from the bondholders of a future covenant breach for YE 2019, limiting the risks on the instrument.

Going forward, we expect metrics to improve due to Nikora Trade's new, more organic strategy. This change will impact the retailer on different levels. We expect a lower growth rate for annual sales but opex/depreciation and amortisation should be under better control, ensuring more stable profitability. Cash levels should also be higher due to better cash flow generation, unburdened by capex, leading de facto to less pressure from capex on FOCF generation. Our forecasts remain cautious but show an improvement in every ratio over the coming years.

We reflect the evolving dynamics of both the Georgian country and the retail industry with a more conservative interpretation of financial credit metrics. This is to account for potential downside in fast-moving economies and industries such as the retail industry in Georgia because the food retail segment appears to be undergoing strong consolidation at present, potentially changing competitive dynamics profoundly in the near future.

Among the supplementary ratings drivers, we do not expect financial policy to become an issue for the ratings as Nikora Trade does not have a track record of implementing an aggressive shareholder remuneration policy or entering into expensive M&A transactions. We also understand – and the rating assumes – that corporate governance matters with regards to debt-holder protection vis-à-vis shareholders are addressed adequately within the company as stipulated and monitored by the Georgian capital markets regulation via the National Bank of Georgia.

We also look at recovery values for bondholders in a hypothetical case of default. We calculated a recovery rate of about 100% for the GEL 25m senior unsecured bond considering existing secured bank loans ranking ahead, and that some of the foreign-currency denominated debt could appreciate in local currency, as well as emerging market risk for bankruptcy resolution. This results in a rating of BB-, one notch higher than the issuer rating.

## Outlook

The Outlook is Stable and reflects our expectation that Nikora Trade will maintain its credit metrics at the current level for indebtedness (SaD/EBITDA below 4.0x and FFO/SaD above 15%).

A positive rating action could result from FFO/SaD above 30%, SaD/EBITDA below 3x and a significant improvement in liquidity on a sustainable basis.

A negative rating action could result from a deterioration in credit metrics, e.g. if FFO/SaD falls below 15%, SaD/EBITDA increases above 4.0x and liquidity declines significantly on a sustained basis.

## Rating drivers

| Positive rating drivers | Negative rating drivers |
|---|---|
| • Strong national market positioning, leading to potential for significant sales growth<br>• Profitability higher than peers thanks to small shop formats and integrated vertical structure<br>• Change to a more organic and cautious growth strategy | • Absolute size still small – market shares under 5% (due to the high share of bazaars)<br>• Exposure to Georgia only, enhancing the vulnerability of the group to any macro changes<br>• Low liquidity |

## Rating-change drivers

| Positive rating-change drivers | Negative rating-change drivers |
|---|---|
| • FFO/SaD above 30% on a sustainable basis<br>• SaD/EBITDA below 3x on a sustainable basis<br>• Significant improvement in liquidity on a sustainable basis | • FFO/SaD ratio falling below 15% on a sustained basis<br>• SaD/EBITDA ratio increasing above 4x on a sustained basis<br>• Significant drop in liquidity on a sustained basis |

## Financial overview

| Scope credit ratios | 2017 | 2018 | Scope estimates 2019F | Scope estimates 2020F |
|---|---|---|---|---|
| EBITDA/interest cover (x) | 4.17x | 4.36x | 4.37x | 5.17x |
| SaD/EBITDA | 2.93x | 3.59x | 3.26x | 2.67x |
| Scope-adjusted FFO/SaD | 25% | 21% | 24% | 30% |
| FOCF/SaD | 2% | -19% | -3% | 12% |
| **Scope-adjusted EBITDA in GEL m** | **2017** | **2018** | **2019F** | **2020F** |
| EBITDA | 15,034 | 15,155 | 17,842 | 24,039 |
| Operating lease payment in respective year | 14,917 | 19,861 | 25,032 | 30,059 |
| Scope-adjusted EBITDA | 29,951 | 35,016 | 42,873 | 54,098 |
| **Scope funds from operations in GEL m** | **2017** | **2018** | **2019F** | **2020F** |
| EBITDA | 15,034 | 15,155 | 17,842 | 24,039 |
| less: (net) cash interest as per cash flow statement | -4,196 | -4,064 | -4,804 | -4,443 |
| less: cash tax paid as per cash flow statement | -453 | -964 | 25 | 26 |
| add: depreciation component operating leases | 11,933 | 15,888 | 20,025 | 24,047 |
| Scope funds from operations | 22,318 | 26,015 | 33,088 | 43,669 |
| **Scope-adjusted debt in GEL m** | **2017** | **2018** | **2019F** | **2020F** |
| Reported gross financial debt | 38,281 | 48,801 | 46,665 | 42,653 |
| add: operating leases commitments | 59,667 | 79,442 | 100,126 | 120,235 |
| less: cash, cash equivalents | -10,176 | -2,692 | -6,968 | -18,529 |
| Scope-adjusted debt | 87,772 | 125,551 | 139,823 | 144,359 |

## Business risk profile

**Dominant market share in organised retail**

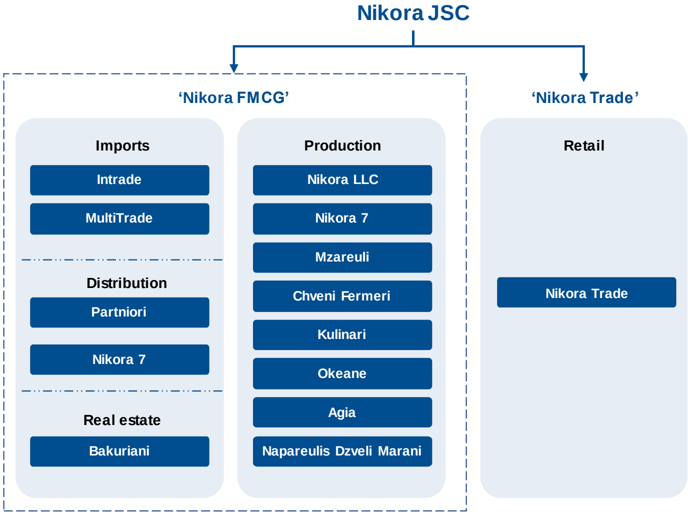
An important share of overall retail in Georgia is still ‘unorganised’, taking the form of bazaars or unaffiliated shops (representing 80% of total trade in 2017 according to TBC Capital). In the remainder, Nikora Trade has seized one of the highest market shares with 19% (Figure 2) in 2017, preceded only by Carrefour (22% in 2017). The retailer is expecting to reinforce its market shares following the erosion of unorganised retail in the country (due to government actions aimed at gradually incapacitating the activity of unorganised retail operators). We expect Nikora Trade to capture some of this potential growth, as the company has one of the highest numbers of food shops across the country and should increase its market shares substantially.

We assume that Carrefour will have some difficulties in unlocking this growth potential. Carrefour has 90% of its presence in Tbilisi (via seven supermarkets and two hypermarkets) and a move to smaller, more flexible, shop formats would automatically lead to a loss of its competitive advantage which is based on a westernised shopping experience and vast choice of products. While we view Nikora Trade’s potential strategy as consistent, we must bear in mind that the retailer remains a small player with a market share of less than 5% based on the whole Georgian food retail market.

**Vast expansion plan aimed at reinforcing market shares**

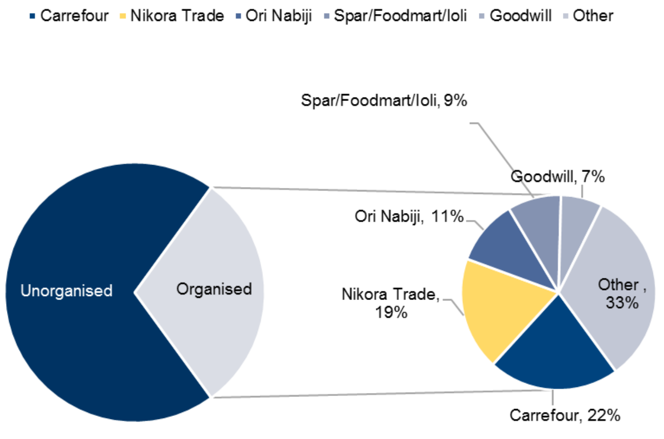
Nikora Trade’s market share is supported by a footprint in every region of Georgia and has been created by both organic and external growth (the acquisition of Nugeshi in 2015). In 2017, Nikora Trade announced the launch of a major expansion plan to increase its amount of shops dramatically over the 2017-2020 period. Nonetheless, due to difficulties in recruiting competent clerks, connecting the new shops to the electrical grid and/or rent increases, Nikora Trade only opened 61 shops in 2018 (versus the 120 initially planned). In 2019, management decided to put its ambition on hold and focus more on organic growth. This change in strategy has impacted revenue and EBITDA growth rates. Nevertheless, we have not modified our assessment of the subrating because: i) our forecasts were already very conservative; and ii) we continue to believe that it will be difficult for any local entrant to capture Nikora Trade’s market share.

**Figure 1: Organigram of the group**




Source: Scope

**Figure 2: Market share of JSC Nikora Trade**




Source: Scope, TBC Bank

**Integrated company structure helps Nikora Trade to develop its barganing power**

One of Nikora Trade’s key features is its holding structure in which the parent company, Nikora JSC, not only owns Nikora Trade but also several other food suppliers which sell their products to the food retailer. These internal suppliers offer a huge range of products, from meat to dairy and frozen products. In 2018, this vertical integration led to 23% of Nikora Trade’s revenues coming from these internal suppliers (26% in 2017).

We view this integration positively because it should allow Nikora Trade to benefit from more advantageous commercial terms than it would from negotiations with external entities. We believe that this approach has helped to improve both the cash conversion cycle and gross margins over the years. The company’s organic growth strategy should also continue to enhance the two aforementioned ratios as the bargaining power of the company increases, potentially creating higher margins in future.

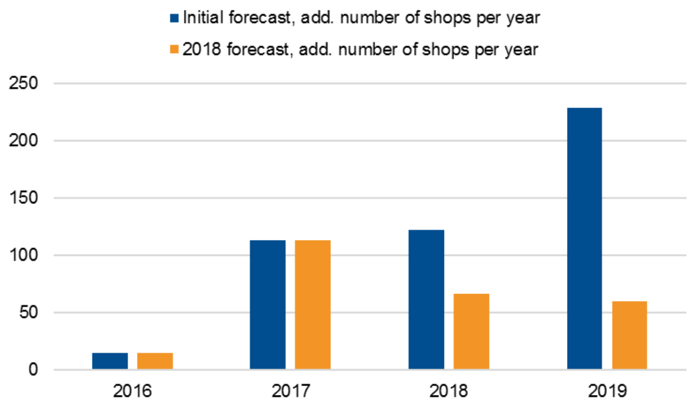
**Lack of geographical diversification…**

Nikora Trade is solely active in Georgia and does not intend to develop its operations abroad in the short to medium term. This lack of geographical diversification is seen as a negative rating driver as it leads to vulnerability to macroeconomic risks. We consider the Georgian retail market to be relatively small (3.5m inhabitants) and dependent on imports for some of its key products.

**…burdening high product and customer diversification**

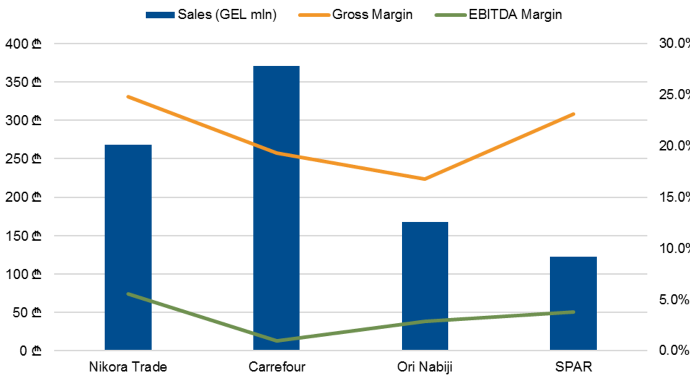
Despite this focus on Georgia, Nikora Trade is present in most format sizes (apart from the hypermarket format) and offers close to 10,000 types of product, ensuring high product and customer diversification. Nikora Trade has announced its intention to bolster its offering by developing discount shops and increasing its share of private labels (from 1% to 5% in 2018), both innovations for the Georgian market. The absence of any e-commerce services would normally be seen as a shortcoming for a company involved in retail activity, but in light of the developmental level of Georgian retail, we have not over-emphasised this factor.

**Figure 4: Development of new shops (initial versus actual)**




Source: Scope, Nikora Trade

**Figure 4: Profitability margins against local peers (2017)**




Source: Scope, TBC Bank

**Profitability above that of peers**

In terms of profitability, Nikora Trade benefits from a high Scope-adjusted EBITDA margin, ranking the Georgian retailer above its international peers. The company has benefited from a margin continuously between 8%-9% over the years, climbing to 11.7% in 2017 and falling slightly to 10% in 2018. The main reason for this slight fall was the unsuccessful expansion in terms of new shops because some costs had already been paid but the shops were not operational, and de facto not monetisable by the end of the year. Due to the switch of strategy to a more organic one, we expect smaller but more stable growth in profitability per year. Forecasts indicate a margin at the same level in 2019 and a slight increase in the following years. Despite this more cautious approach, Nikora Trade continues to benefit from a relatively strong competitive advantage compared to its national peers due to the semi-integrated suppliers within the group. This should continue to lead to an overall higher gross margin and Scope-adjusted EBITDA. Nevertheless, we view the absence of a hedging policy against the US dollar as a negative rating driver. Furthermore, the retailer pays a high share of its rents in US dollars, increasing its dependence on this currency.

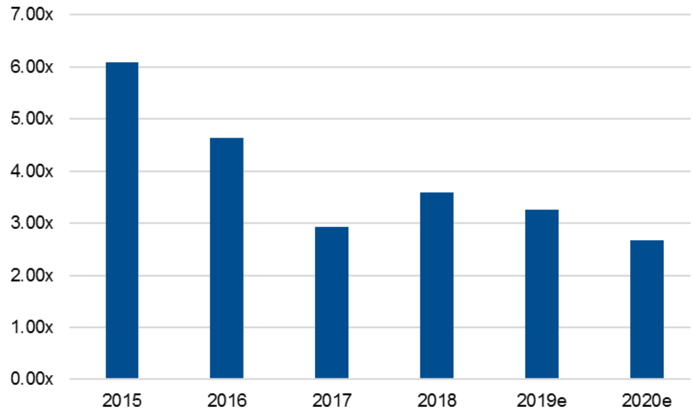
## Financial risk profile

**Stable leverage ratio despite the expansion plan**

We rate Nikora Trade's leverage metrics in the low BB category as shown below. For 2018, we calculated SaD/Scope-adjusted EBITDA of 3.6x and FFO/SaD of 21%. As management has indicated that it is going to implement a deleveraging strategy for Nikora Trade, we expect quick debt reduction, especially by YE 2020. This strategy was reflected in the issuance of GEL 11.475 worth of equity at the end of 2018, intended to mitigate the small drop in equity and alleviate the weight of debt in the financing mix.

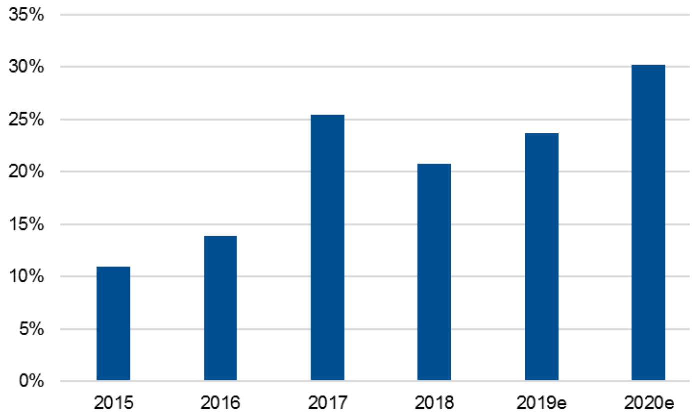
We see these ratios for adjusted indebtedness as relatively modest for a retailer expecting to add more than 400 shops to its current shop networks. The operating leases commitment component of the SaD calculation was underweighted in our rating for Nikora Trade, as the Georgian commercial real estate market is characterised by relatively flexible rent contracts which can be cancelled subject to a three months' notice period with limited/negligible penalty fees.

**Figure 5: Nikora Trade's evolution of SaD/EBITDA**




Source: Scope, Nikora Trade

**Figure 6: Nikora Trade's evolution of FFO/SaD**




Source: Scope, Nikora Trade

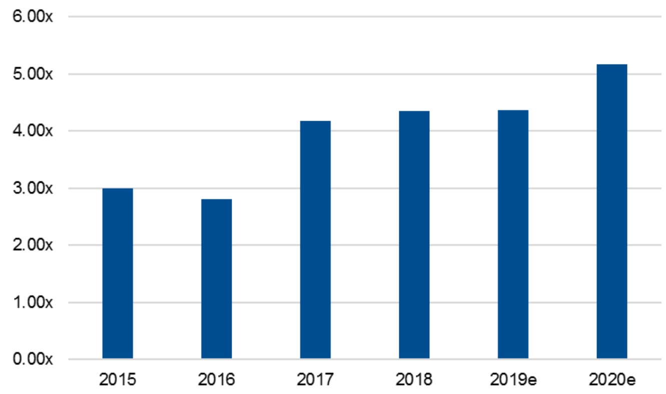
**Modest interest coverage supported by profitability**

The retailer's debt protection measure has increased from 3.0x in 2015 to 4.4x in 2018, supported by the high rise in profitability over these years, which counterbalanced the bond emission of 2018. We expect this metric to increase to above 5x in 2020 while interest cover should remain stable in 2019.

**Stable leverage ratio despite the expansion plan**

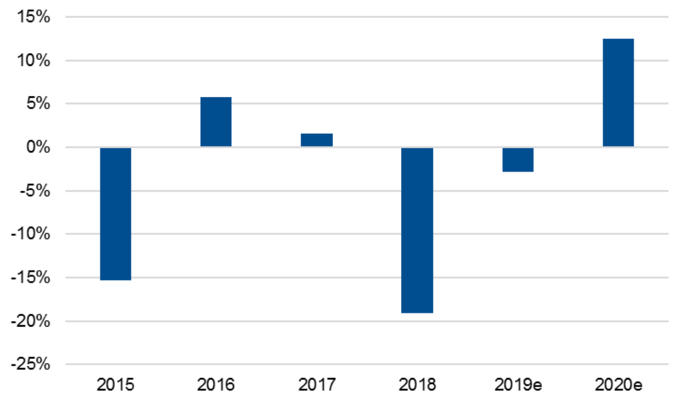
Due to the expansion plan, liquidity remains under pressure and still represents the main negative rating driver for the financial risk profile. Despite the planned alleviation of the investment phase, softening the weight of capex on FOCF, liquidity remains under our rating threshold, leading to a negative notch.

**Figure 5: Nikora Trade's evolution of interest cover**




Source: Scope, Nikora Trade

**Figure 6: Nikora Trade's evolution of FOCF/SaD**




Source: Scope, Nikora Trade

**Expected covenant breach at YE 2019, already waived by the main bondholders**

In 2018, Nikora Trade breached its interest cover ratio, due to lower EBITDA growth than initially forecasted. This covenant breach was waived in 2019 by all the bondholders. Despite our forecast of a gradual margin recovery, we anticipate another breach of the interest cover ratio covenant at the end of 2019. In order to mitigate this event, the European Bank for Reconstruction and Development and TBC Bank (the main bondholders) have already announced their willingness to waive this covenant breach at YE 2019.

**A more careful overall approach to financial risk profile assessment**

As well as taking metrics into consideration in our assessment of Nikora Trade's financial risk profile, we also looked at additional elements from the company's overall financial environment. This supplementary screening led us to be more conservative in our assessment.

**BB- bond rating**

We also look at recovery values for bondholders in a hypothetical case of default. We calculated a recovery rate of about 100% for the USD 10m senior unsecured bond considering existing secured bank loans ranking ahead, and that some of the foreign-currency denominated debt could appreciate in local currency, as well as emerging market risk on resolution of bankruptcy. This results in a rating of BB-, one notch higher than the issuer rating.

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