JSC Nikora Trade
Georgia, Retail

SCOPE B+ STABLE

Corporate profile

JSC Nikora Trade (Nikora) 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 (220), and employs more than 3,000 workers 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. The willingness to enter the retail sector led to the acquisition of a retailer, Masiv LTD, whose name was changed to JSC Nikora Trade in 2010. Nikora developed further shops over the years and acquired Nugeshi in 2015. As of today, Nikora is one of the leading domestic food retail operators in Georgia.

Key metrics

			Scope estimates	
Scope credit ratios	**2016**	**2017**	**2018F**	**2019F**
EBITDA/interest cover (x)	2.3x	3.7x	3.7x	5.4x
SaD/EBITDA	5.9x	3.8x	3.7x	3.3x
Scope-adjusted FFO/SaD	10%	19%	20%	23%
FOCF/SaD	5%	10%	-5%	6%

Rating rationale

Scope assigns an initial rating of B+, with a Stable Outlook to JSC Nikora Trade. The issuer rating mainly reflects our perception of Nikora as one of the leading national food retailers as well as its comparatively high level of profitability. The rating also reflects our view on the company operating in an evolving macro-economic and industrial environment, reflecting the risks and opportunities presented by expected industry consolidation.

The rating benefits from Nikora'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. This footprint (220 selling points in February 2018) should continue to expand due to the planned opening of more than 400 shops in the coming three years. The company should also profit from the progressive disappearance of unorganised retail which still accounts for 70% of the country's retail trade. In this matter, Scope anticipates that the Georgian government will gradually implement new laws and frameworks (based on the stricter control of hygiene standards for example) to decrease the weight of this type of retail in the overall economy. Scope is of the opinion that this progressive weakening of the unorganised market should be beneficial to Nikora, which, by developing 400 shops over the coming years, could increasingly replace unorganised retail throughout the country. The appearance of Carrefour a few years ago nevertheless illustrates the overall vulnerability of Nikora and, intrinsically, of the Georgian retail market to new external market entrants. Indeed, with only ten shops nationwide and nine in Tbilisi, Carrefour was able to seize 22% of market share in the organised food retail market, becoming the country's largest retailer. Even so, Scope believes that Carrefour will not depart from the hypermarket format and should not pose an immediate threat to Nikora's smaller shops.

Ratings & Outlook

Corporate ratings	B+
Senior unsecured rating	BB-

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Related methodology:

Corporate Rating methodology

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The rating benefits from our expectation that Nikora's bargaining power with suppliers will increase, supported by its anticipated strong growth potential as well as almost exclusive access to the meat producer, Nikora LLC, which owns 30-40% of Georgian market shares. This is advantageous for the rating as Scope expects internal suppliers to propose more favourable commercial terms than external suppliers. Nikora's significant growth ambitions should also lead to a progressive increase in the company's bargaining power, enhancing future profitability.

Scope believes that Nikora is comparatively less diversified than some of its competitors, as 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 in our view, given the level of development in Georgia, Scope does not consider Nikora to be sufficiently diversified either within the context of the small size of the domestic market or in comparison to its larger retail peers. It should be noted that while Nikora plans to remain in Georgia for the foreseeable future, the company plans to develop discount shops and some private labels. While Scope has a positive view of these initiatives, they nevertheless represent an execution risk, as it remains difficult to assess how the discount shops will be received by Georgians.

With a Scope-adjusted EBITDA margin above its peers (historically between 8-9%, jumping to 11.7% in 2017), Nikora has managed to monetise its vertically integrated structure efficiently. As mentioned above, the company sells products which are manufactured and/or processed within the holding. In our view, this integration leads to relative cost and price advantages, and, for example, to a better management of unsold products in some cases, decreasing losses. Due to our expectation that the size of the unorganised retail market will shrink and that Nikora will be able to capture some of this market in future, Scope anticipates that Nikora will manage to increase its bargaining power with suppliers over the coming years, ensuring a steady EBITDA margin above 10%.

As regards Nikora's financial risk profile, adjusted indebtedness has been established as falling within the BB category (with Scope-adjusted debt [SaD]/EBITDA at 3.8x in 2017 and funds from operations [FFO]/SaD at 19%). Scope views this leverage, including an increasing share of operating lease commitments, as relatively modest going forward considering the ambitious retail expansion plan. The operating lease commitments are underweighted in Scope's rating due to Nikora's ability to cancel rent contracts within a quarter of year without incurring penalties. In order to finance the development of these new shops, Nikora is planning to issue a mix of debt and equity, representing the equivalent of USD 10m and GEL 16.8m respectively in 2018. Scope understands that less than half of the intended equity issue has been subscribed for presently. Free operating cash flow (FOCF) and liquidity are likely to come under pressure, given the expected sharp increase in spending on expansion, until Nikora manages to monetise these new shops efficiently.

Due to relatively high profitability and a stable debt level, Scope considers the interest cover ratio to be in the BB category. The expected coupon payment for the future issue (close to 10%) should not burden Nikora's interest coverage metric as Scope anticipates that the company's profitability will increase swiftly enough to cover the interest expenses. This EBITDA increase will lead, in our view, to a stagnation of the ratio in 2018, followed by an increase to 5.3x in 2019. Scope has identified additional risk posed by the absence of a hedging policy. The company is vulnerable to potential variations in the foreign exchange rate of the dollar due to its relatively high US dollar leasing exposure.

Scope reflects 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, as 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, Scope does not expect financial policy to become an issue for the ratings as Nikora 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 topics with regard 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.

Scope's recovery assessment looks at recovery values for bond holders in a hypothetical case of default. While this possibility may appear remote from today's perspective, we have assumed a significant fall in revenues in 2019 as a consequence of unsuccessful expansion and a hypothetical adverse consolidation of the market which would hurt the retailer's profitability. Scope has calculated a recovery rate of about 100% for the USD 10m senior unsecured bond (existing bank loans are secured), all available credit lines were deemed fully drawn at default. This equates to Scope's 'excellent' ('90-100%') recovery category, resulting in a one-notch uplift for the bond compared to the issuer rating (in our hypothetical default case, based on a distressed EBITDA of about GEL 16m and an exit multiple of 4). Scope therefore proposes an upgrade of one notch from the issuer rating B+ to BB-.

Outlook

The Outlook is Stable and reflects Scope's expectation that Nikora's credit metrics will remain at the current level with regard to indebtedness (SaD/EBITDA < 4.0x and FFO/SaD > 15%). A positive rating action could be warranted by FFO/SaD and SaD/EBITDA of above 30% and below 3x respectively on a sustainable basis. A negative rating action could result from a deterioration in credit metrics as indicated by FFO/SaD ratio falling below 15% and SaD/ EBITDA increasing above 4.0x on a sustained basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• Profitability higher than peers thanks to small shop formats and integrated vertical structure	• Absolute size still small – market shares <5% (including the unorganised food retail market)
• Expected improvement in bargaining power due to Nikora's growth strategy	• Exposure to Georgia only, enhancing the vulnerability of the group to any macro-changes
• Potential for significant sales growth	
• Despite the significant expansion, financial debt levels are expected to remain relatively stable	• Below-expected equity issuance could put pressure on financing, leading to overall execution risk
• Key financial metrics are expected to increase slightly, despite huge capex programme	• Absence of hedging policy in light of significant exposure to GEL/USD
	• Huge capex programme eroding Scope-adjusted FOCF

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• FFO/SaD and SaD/EBITDA respectively above 30% and below 3x on a sustainable basis	• FFO/SaD falling below 15% and SaD/EBITDA increasing above 4.0x on a sustained basis

Financial overview

			Scope estimates	
Scope credit ratios	**2016**	**2017**	**2018F**	**2019F**
EBITDA/interest cover (x)	2.3x	3.7x	3.7x	5.4x
SaD/EBITDA	5.9x	3.8x	3.7x	3.3x
Scope-adjusted FFO/SaD	10%	19%	20%	23%
FOCF/SaD	5%	10%	-5%	6%
Scope-adjusted EBITDA in GEL m	**2016**	**2017**	**2018F**	**2019F**
EBITDA	6.726	16.210	21.484	32.135
Operating lease payment in respective year	12.386	15.022	20.267	28.229
Other	-	-	-	-
Scope-adjusted EBITDA	**19.112**	**31.232**	**41.752**	**60.364**
Scope funds from operations in GEL m	**2016**	**2017**	**2018F**	**2019F**
EBITDA	**19.112**	**31.232**	**41.752**	**60.364**
less: (net) cash interest as per cash flow statement	-4.327	-4.270	-5.940	-3.896
less: cash tax paid as per cash flow statement	-0	-429	-655	-1717
less: interest component operating leases	-3.819	-4.111	-5.293	-7.274
Scope FFO	10.966	22.422	29.863	47.476
Scope-adjusted debt in GEL m	**2016**	**2017**	**2018F**	**2019F**
Reported gross financial debt	40.543	37.983	47.500	43.762
less: cash, cash equivalents	-1.733	-10.176	-16.229	-11.049
add: operating lease obligation	74.316	90.136	121.604	169.378
Other				
SaD	**113.126**	**117.943**	**152.876**	**202.091**

Business risk profile

Dominant market share in organised retail

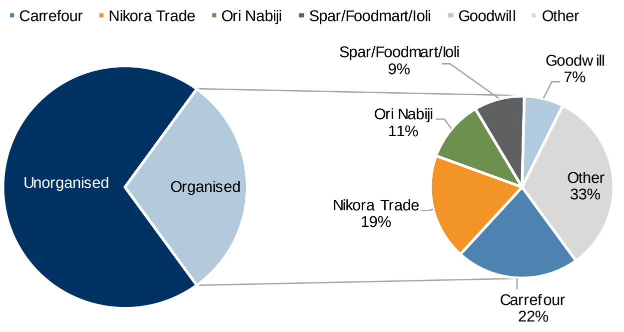
An important share of overall retail in Georgia is still ‘unorganised’, taking the form of bazaars or unaffiliated shops (representing 70% of total trade in 2016 according to Colliers International). In the remainder, Nikora seized one of the highest market shares with 19% (Figure 1) in 2017, preceded 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 governmental actions aimed at gradually incapacitating the activity of unorganised retail operators). Scope expects Nikora 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.

Scope assumes 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 Scope views Nikora’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

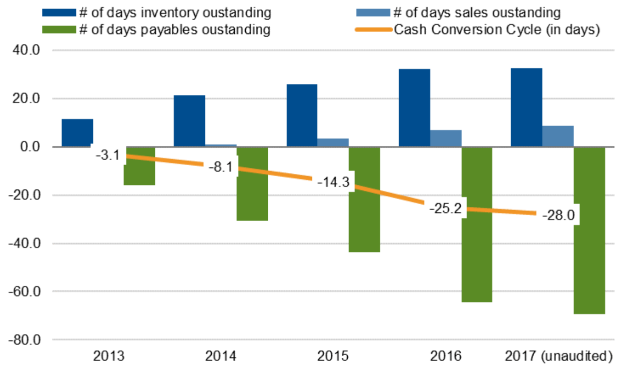
Nikora’s market share is supported by a footprint in every region of Georgia and has been created by both organic and external growth (acquisition of Nugeshi in 2015). Nikora is planning vast expansion in terms of shop coverage across the country. The retailer currently manages 220 shops, but intends to add 120, 122 and 229 shops in 2018, 2019 and 2020 respectively multiplying its total current selling area by close to 3x.

Figure 1: Food retail market shares in Georgia in 2017 versus peers



Source: Scope estimates

Figure 2: Increasing bargaining power



Source: Scope estimates

Integrated company structure helps Nikora to develop its barganing power

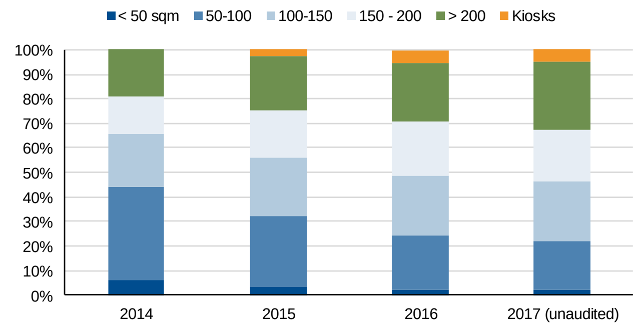
One of Nikora’s key features is its holding structure in which the parent company, Nikora JSC, not only owns Nikora but also several other food suppliers which sell their products to the food retailer. Overall, these internal suppliers offer a huge range of products, from meat to dairy and frozen products.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

Scope views this integration as positive as it should allow Nikora to benefit from more advantageous commercial terms than it would from negotiations with external entities. Scope believes 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.

A lack of geographical diversification…

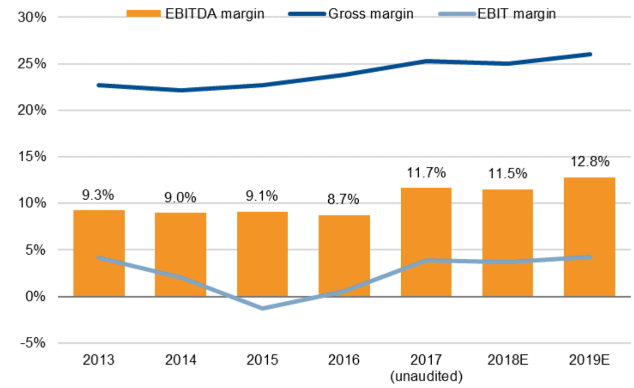
Nikora is solely active in Georgia and does not intend to develop its operations abroad in the short to medium term. This lack of geographical diversification is seen as a negative rating driver as it leads to vulnerability to macroeconomic risks. Scope considers the Georgian retail market to be relatively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

Figure 3: Diversification of Nikora by shop size



Source: Scope estimates

Figure 4: Increasing profitability



Source: Scope estimates

…burdening high product and customer diversification

Despite this focus on Georgia, Nikora is present in most of the format sizes (apart from the hypermarket format) and offers close to 10,000 types of product, ensuring high product and customer diversification. Nikora 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, Scope has not over-emphasised this factor.

Profitability above that of peers

In terms of profitability, Nikora 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 which climbed to 11.7% in 2017. This rise was due to the combination of: i) an increase of 23% in revenues generated; and ii) an increase of close to 1.5% in gross margin which reached 25.3% in 2017. Despite a comparatively low sale per sqm, representing, in Scope's view, the low average Georgian basket, Nikora benefits from a high EBITDA per sqm, demonstrating efficient space management, comparable with world leaders in food retail. This high profitability is supported by the integrated supplier structure which can also, in some cases, buy back unsold products, limiting Nikora's losses. Scope expects this margin level to continue in the mid-term due to: i) a gradual increase in bargaining power and; ii) the development of the above-mentioned new shops. Nevertheless, Scope views 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.

Business risk profile rated BB-

Based on the above, Scope assigns a rating of BB- to Nikora's business risk profile.

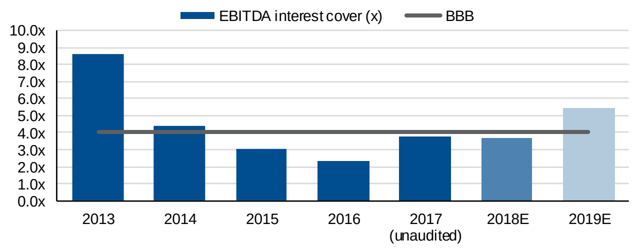
Financial risk profile

Stable leverage ratio despite the expansion plan

Scope rates Nikora's credit metrics in the BB category as shown below. For 2017, Scope calculated SaD/Scope-adjusted EBITDA of 3.8x and FFO/SaD of 19%. Scope expects leverage to remain stable over 2018 but to improve post 2019.

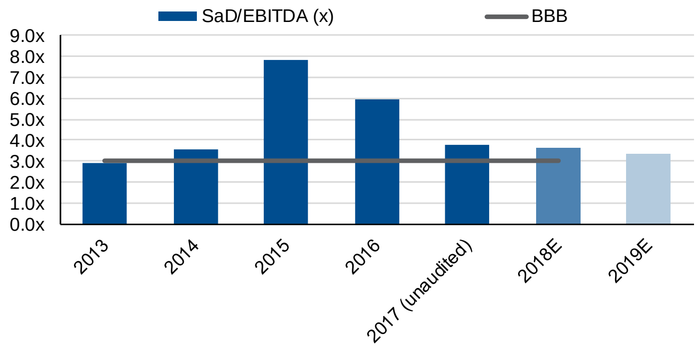
These ratios for adjusted indebtedness are seen as relatively modest for a retailer expecting to add more than 400 shops to its current shop networks. The operating leases commitment component of the SaD calculation was underweighted in the rating for Nikora. The Georgian commercial real estate market is characterised by relatively flexible rent contracts which can be cancelled subject to a three months' notice period with limited/negligible penalty fees. The future development of the shops is expected to be financed from a mix of debt and equity, representing the equivalent of USD 10m (while being denominated in local currency) and GEL 16.8m respectively in 2018. While the USD/GEL foreign exchange rate could potentially put pressure on profitability, Scope does not view the leverage metrics as particularly sensitive to such currency movements (based on data provided by the management).

Figure 5: Good positive coverage bolstered by EBITDA development



Source: Scope estimates

Figure 6: Stable debt forecasted over the coming years



Source: Scope estimates

Modest interest coverage supported by high profitability

The retailer's debt protection measure has increased from 3.0x in 2015 to 3.7x in 2017, supported by the high rise in profitability. The new bond's expected coupon payment of about 10% should not burden Nikora's interest coverage metric as Scope expects the company's profitability to increase strongly enough to cover the interest expenses. This jump in EBITDA will, in our view, lead to a stagnation of the ratio in 2018, followed by a rise to 5.3x in 2019.

Stable leverage ratio despite the expansion plan

Scope has not applied a negative notch to Nikora's liquidity, despite the drop in its coverage of short-term debt maturities with liquidity (according to Scope's calculations this was 39% in 2017 compared to 165% in 2016). The 2017 liquidity cover, calculated as reported cash (2017) added to FOCF (2018) and divided by short-term debt (2017), takes into consideration the sharp rise in investment (FOCF in 2018) representing the start of the three-year shop expansion programme. This decrease in liquidity cover, below Scope's 110% threshold, would normally lead to a negative qualifier. However, in light of the expansion plan, and considering the expected recovery of liquidity to above 110% in 2018 and 2019, Scope views Nikora's liquidity profile as neutral.

A more careful overall approach to financial risk profile assessment

As well as taking metrics into consideration in its assessment of Nikora's financial risk profile, Scope also looked at additional elements from the company's overall financial environment. This supplementary screening led Scope to decrease its rating on the company's financial risk profile by one notch.

Scope identified three risks which could potentially affect the retailer:

1) Scope reflects 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, as the food retail segment appears to be undergoing strong consolidation at present, potentially changing competitive dynamics profoundly in the near future.

2) Nikora's expansion plan is financed by an equity issuance of GEL 16.8m. According to the latest report, close to 40% of the shares have been sold. This equity financing could represent an execution risk for Nikora should the market not be willing to buy at a price sufficiently high for Nikora to fully pursue its expansion plan.

3) Scope sees an additional risk based on potential forex variation. The company has not implemented a currency hedging policy, making the profitability (as discussed in the business risk profile) vulnerable to any appreciation of the US dollar. It should be noted, however, that leverage is unlikely to be heavily impacted by a potential variation in forex.

Financial risk rated B+

Based on the above, Scope rates Nikora's financial risk profile B+.

Outlook

The Outlook is Stable and reflects Scope's expectation that Nikora's credit metrics will remain at current levels with regard to indebtedness (SaD/EBITDA < 4.0x and FFO/SaD > 15%).

A positive rating action could be warranted by FFO/SaD and SaD/EBITDA above 30% and below 3x respectively on a sustainable basis. A negative rating action could result from a deterioration in credit metrics as indicated by FFO/SaD falling below 15% and SaD/EBITDA increasing above 4.0x on a sustained basis.

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