# Metro AG (to be renamed CECONOMY) Germany, Retail

SCOPE BBB- STABLE

## Corporate profile

**Metro AG (to be renamed CECONOMY AG; hereafter 'CECONOMY') is the European market leader in consumer electronics retail, with about EUR 22bn of revenue generated in FY 2016 (fiscal year ending September). The group has two established brands, Media Markt and Saturn, and is in the demerger process of Metro AG. CECONOMY has a broad presence in Europe with more than 1,000 stores, and leads the market in nine of its 15 countries of operation. The group's network of physical stores, combined with its online platform, allows it to record 5.8 million customer contacts per day.**

## Ratings

| | |
|---|---|
| Corporate Rating | BBB- |
| Outlook | Stable |
| Short-Term Rating | S-2 |

## Rating rationale

**Scope Ratings assigns BBB- issuer rating to German consumer electronics retailer Metro AG (to be renamed CECONOMY AG). The short-term rating is S-2. The rating Outlook is Stable.**

The ratings reflect Scope's view of CECONOMY's underlying market of consumer electronics retail, which is inherently more stable than macroeconomic trends; position as Europe's clear market leader; and diversified product range, which comprises 'white' and 'brown' goods, telecommunications and entertainment equipment. However, comparatively low operating margins constrain the ratings. The assessment also reflects Scope's view of management's conservative financial policy, the strong balance sheet after the demerger of Metro Group, organic growth focus, and future operating-margin enhancement as a stand-alone company. CECONOMY's ownership structure is credit-neutral, despite the voting representation (21.6%) of Convergenta, the minority owner of Media Markt Saturn Holding.

In terms of the business risk profile, the group's clear dominance in European consumer electronics is the main support for the ratings. This is despite a lack of activity in large key European markets, such as France and the UK, and a presence in several 'problem countries', in which the group has low market shares and unsatisfactory profits. In addition, CECONOMY's online growth has increased substantially since 2012 through the implementation of an online platform. The group's diversification is also credit-positive, a result of its scale, reach, product breadth, and 'hybrid' character (physical and online presence). CECONOMY's has more than 1,000 physical stores across Europe as well as an online platform that has generated double-digit sales growth in the last three years. Although CECONOMY's online business share is only about half the market's, Scope believes this remains essential to the multi-channel approach as customers value the ability to both order online and assess the product in person. CECONOMY's low operating margins among peers also limit the rating.

Scope's financial risk assessment reflects the expectation that CECONOMY will maintain the strong balance sheet that followed the demerger. This has resulted in an almost financial-debt-free balance sheet; the only sizeable element of Scope-adjusted debt (SaD) comprises leasing-debt equivalents of about EUR 2.4bn. Scope believes management's financial policy, including a strong commitment to achieve and maintain an investment grade level, provides sound protection for the ratings.


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### Related Research // Methodology

Corporate Ratings Methodology, January 2017


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## Outlook

The Stable Outlook reflects Scope's expectations that CECONOMY's financial risk profile will not significantly deteriorate in the coming years. Specifically, present ratings are commensurate with credit metrics reflective of a BBB category, as indicated by Scope-adjusted funds from operations/SaD of 35-40% and a SaD/EBITDA ratio of below 2.5x.

A higher rating could be triggered by an improved business risk assessment, for example, through better operating margins and free cash flow, or financial metrics sustainably exceeding aforementioned levels.

A negative rating action could result from a more aggressive financial policy or a sustained, negative deviation from ratios commensurate with the present ratings.

## Rating drivers

| Positive | Negative |
|---|---|
| Europe's leading consumer electronics retailer | Company in transition for higher growth |
| Diversified product range encompassing white and brown goods as well as communication equipment | Low operating margins in a peer group context |
| Credit-supportive industry risk | |
| Strong balance sheet following the demerger | |
| Conservative financial policy and a commitment to an investment grade rating | |

## Rating-change drivers

| Positive | Negative |
|---|---|
| Increasing margins and free cash flow | Potential M&A to erode level of credit metrics |
| Credit metrics sustainably ahead of levels specified in the outlook statement with regard to a positive rating action | Inability to maintain at least 30% funds from operations/Scope-adjusted debt and a leverage of below 2.5x |

## Financial overview

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2014/15** | **2015/16** | **2016/7F** | **2017/18F** |
| EBITDA/interest cover (x) | 9x | 10x | 10x | 11x |
| SaD/EBITDA | 2.2x | 2.0x | 2.1x | 2.0x |
| Scope-adjusted FFO/SaD | 35% | 38% | 38% | 39% |
| FOCF/SaD | 0% | -4% | 9% | 4% |

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope-adjusted EBITDA in EUR m** | **2014/15** | **2015/16** | **2016/17F** | **2017/18F** |
| EBITDA | 573 | 619 | 600 | 688 |
| Operating lease payment in respective year | 664 | 664 | 680 | 690 |
| Scope-adjusted EBITDA | 1,237 | 1,283 | 1,275 | 1,378 |

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope funds from operations in EUR m** | **2014/15** | **2015/16** | **2016/17F** | **2017/18F** |
| EBITDA | **573** | **619** | **600** | **688** |
| deduct: (net) cash interest as per cash flow statement | -20 | -8 | -10 | -10 |
| deduct: cash tax paid as per cash flow statement | -144 | -178 | -170 | -190 |
| deduct: pension interest | 0 | 0 | 0 | 0 |
| add: depreciation component operating leases | 542 | 542 | 552 | 564 |
| add: dividends received from equity | 0 | 0 | 20 | 20 |
| Scope-adjusted funds from operations | 951 | 975 | 992 | 1,072 |

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope-adjusted debt in EUR m** | **2014/15** | **2015/16** | **2016/17F** | **2017/18F** |
| Reported gross financial debt | 423 | 18 | 252 | 252 |
| deduct: cash, cash equivalents | -979 | -769 | -920 | -837 |
| Cash not accessible | 100 | 100 | 100 | 100 |
| add: pension adjustment | 718 | 769 | 729 | 689 |
| add: operating lease obligation | 2,440 | 2,440 | 2,484 | 2,540 |
| Scope-adjusted debt (SaD) | 2,702 | 2,557 | 2,645 | 2,744 |

## Business risk profile

### Industry risk

**Cyclicality – medium risk**

In Scope's view, the overall retail industry to exhibit relatively stable characteristics, with turnover growing constantly even in times of macroeconomic stress. The amplitude of annual growth generally ranges between -2% to 4% and has limited volatility. This growth includes more stable and 'low ticket' retail sub-segments like food, as well as slightly more cyclical sectors like electronics or DIY. Importantly, the overall retail segment has proven resilience to macroeconomic shocks. For example, in 2009, when European GDP declined by more than 4%, the retail industry's growth rate was slightly positive.

**Figure 1: Retail and TCG market in western Europe vs euro area GDP**


Source: OECD, GfK, Eurostat, Scope

**Medium to high entry barriers**

A country's retail markets are usually highly concentrated and centre on a dominant player. For most European countries this applies to food, DIY and electronics. Scope judges entry barriers to be medium to high, reflecting the reasonably concentrated markets, and the necessity for operators to have a national network, established relationships with manufacturers, and high-quality products. The need for scale and diversified operations is supported by the comparatively low EBITDA margins in most large retail segments, and such levels are only financially viable upon reaching a critical scale.

In Europe the electronic goods retail market is rather fragmented: often, top-five retailers barely hold half of a country's market share. Even so, Scope does not consider this to threaten CECONOMY, because market leaders have continued to expand their shares over the years. Yet price competition is intensifying in each of the CECONOMY's markets, against both traditional 'pure players' (based in physical shops; Euronics, CE Partners, Darty/Fnac) and e-commerce retailers (Amazon).

**Low substitution risk**

Scope judges substitution risk to be low because the retail business model has very few conceivable alternatives. The only possibility is direct distribution by manufacturers. An example is Apple Store, but Scope believes this is and will remain the exception, as such a strategy is costly and necessitates entry into a business segment in which manufacturers have limited experience.

In our view, e-commerce does not constitute a different industry to retail, but is merely a different form of distribution, one which is increasingly adopted by classic 'brick and mortar' retailers.

The combination of the three industry risk drivers, according to our Corporate Ratings Methodology, results in an industry risk for CECONOMY of BBB-.

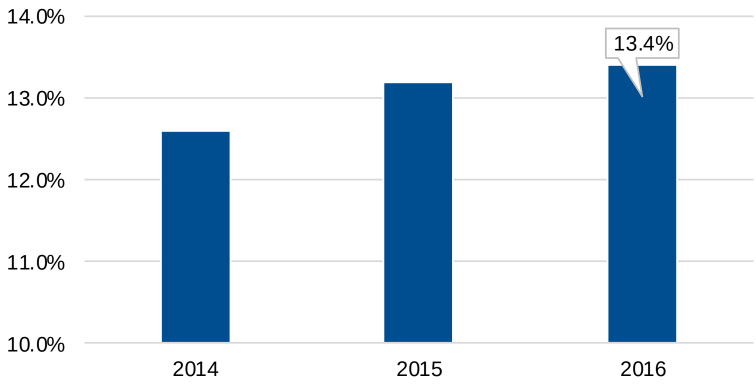
## Competitive position

### Market shares

**Clear European market leader**

CECONOMY is Europe's leading consumer electronics retailer, with about EUR 22bn of revenue and an EBITDA of above EUR 600m. The group has over 1,000 stores in 15 European countries, in nine of which the group is market leader.

**Figure 2: Evolution of European market share**



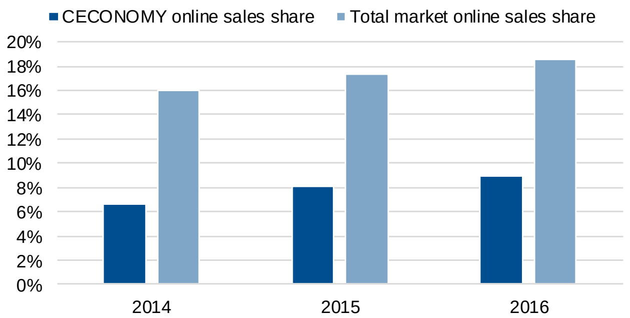

Source: Metro, Scope

**Recovering growth rates**

Figure 4 shows that like-for-like growth during 2014-2016 of the group's two established brands, Saturn and Media Markt, is on a positive trend. Scope expects this to continue, likely at even a faster pace in future, as CECONOMY on a standalone basis has improved operating flexibility and the ability to develop growth channels. The brands' new focus should immediately impact footfall in each shop, while new shops will noticeably influence online traffic.

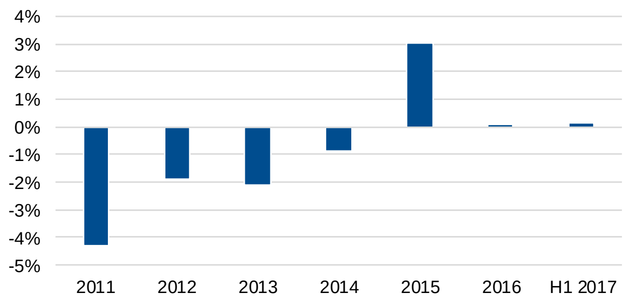
E-commerce is crucial for CECONOMY's market position, driving sales growth and boosting differentiation in its multi-channel strategy (its main online competitor is Amazon).

**Figure 3: Online growth catching up (fiscal year-ends)**




Source: Metro, Scope

**Figure 4: Like-for-like group sales growth (fiscal year-ends)**




Source: Metro, Scope

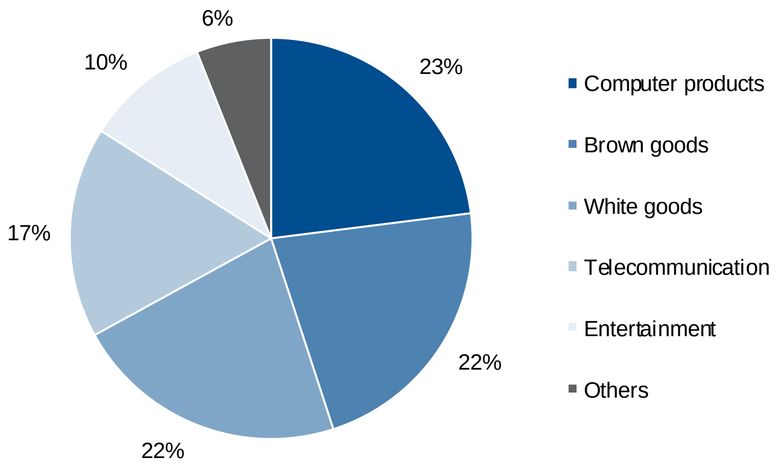
Figure 3 shows that, for CECONOMY, online sales, including the 'pick-up option' (online customers can collect orders at a physical location), are a major driver of total sales. Nevertheless, the group's online traffic is still substantially below that of the total market (18%; twice the group's relative exposure).

The group's increased online presence is boosted by a major advantage over American digital peers – its ability to interact with buyers in brick-and-mortar shops, who can purchase online and collect the product at a desired time. This 'hybrid' positioning resulted in 42% of its online customers using the pick-up option in FY 2016, versus 40% in the year before, and 33% in FY 2014. Scope views this positively: not only does it capture customers' preference for online shopping, but also their desire to handle and collect products in person.

## Diversification

CECONOMY focuses on consumer electronics in Europe and covers all segments in that industry. In our view, this leads to high product diversification. The product range is not limited to communications (telecoms, computers and brown goods), but also encompasses white goods (figure 5). Thus shifts in demand between product categories can be counterbalanced readily, for example, the recently declining share of photographic products and brown goods was offset by stronger demand for IT and telecommunication products.

**Figure 5: Product category breakdown fiscal 2016**

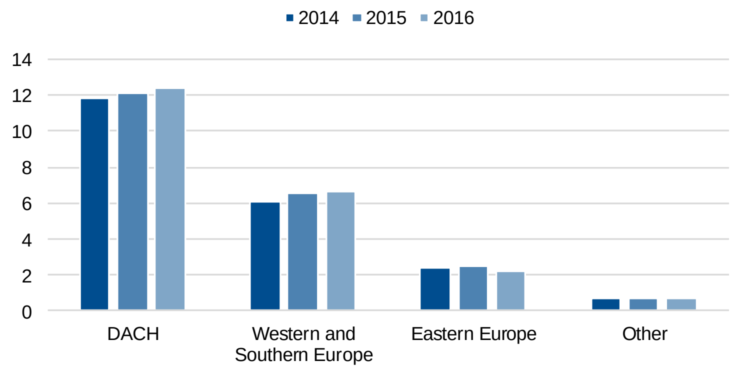



Source: Metro, Scope

Scope considers CECONOMY to have a broad spread across its product range, which itself is also very extensive (160 different coffee machines, for example). Within the sub-category of brown and white goods, CECONOMY has developed its own brand (named, 'ok'), which offers entry-level goods at competitive prices. The combination of these low-cost electronic goods with high-end products (Apple or Samsung) ensures the company appeals to different customer segments.

Geographically, CECONOMY focuses on Europe, with a clear strength among the so-called DACH countries (Germany, Austria, Switzerland and Hungary; figure 6). The group is the only one among European peers to operate across the region (except for online players); most peers focus on home markets instead. The group is well diversified in Europe through its mix of mature and developing countries. However, the developing-economy exposure is a double-edged sword, potentially creating high cultural and political risks and operating losses at the early stage of exposure, while not being able to capture the markets' growth potential immediately.

**Figure 6: Geographical diversification (sales in EUR bn)**



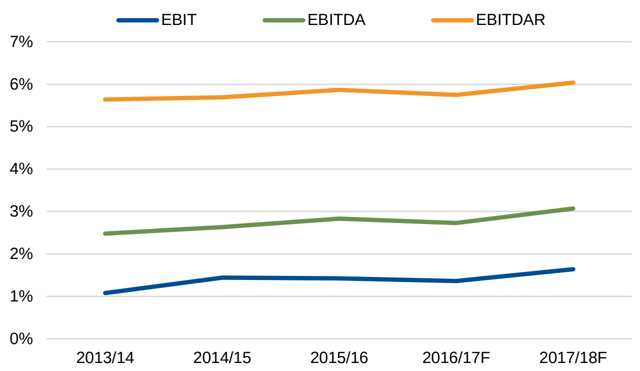

Source: Metro, Scope

## Operating margins

**Comparatively low operating margins**

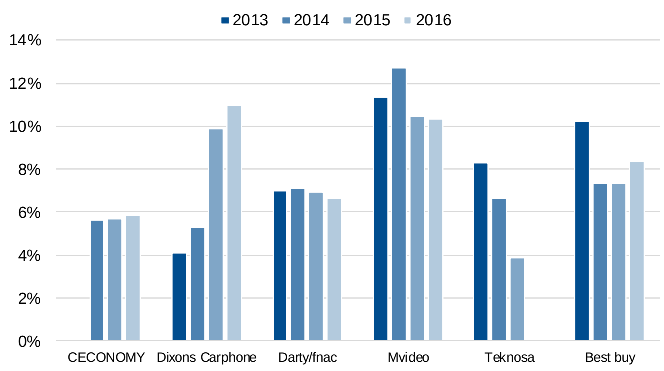
Compared with peers' (figure 8) CECONOMY has low operating margins, which is surprising at first glance given the company's size and market dominance.

**Figure 7: Operating margin trends (on a reported basis)**




Source: Metro, Scope

**Figure 8: EBITDAR margins peers**




Source: companies, Scope

The explanation for the low margins are twofold, in our view:

- The group has the largest international network of stores and the broadest product range, leading to significant costs per square metre (CECONOMY leases all of its stores)
- Operating losses that persist in Russia, Sweden and Turkey

Management has addressed these problems by setting strategic financial targets for the mid-term, including an unadjusted EBITDA margin trending to 5% against 3.3% before special items in 2015/16 (figure 7). In our view this strongly correlates with its achievement of a 3% revenue growth target following the demerger.

Thus CECONOMY's EBITDA margin still needs to improve; however, the group's large size relative to competitors' generates the largest absolute operating profit by far. Darty/Fnac, one of the group's main peers (mostly based in its home country) generated an EBIT of about EUR 200m in FY 2016 on a pro-forma basis, less than half of CECONOMY's.

**Business risk profile rated BBB-**

Scope assesses CECONOMY's business risk profile at BBB-. This includes the BBB- industry risk and our competitive positioning analysis (BBB). The latter considers CECONOMY's strong market shares and good diversification, though offset by the below-par operating margins.

## Financial risk profile

### Credit metrics

CECONOMY's balance sheet has strengthened following the demerger decision.

**Figure 9: Overview credit metrics**

| | | | Scope estimates | |
|---|---|---|---|---|
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| EBITDA/interest cover (x) | 9x | 10x | 10x | 11x |
| SaD/EBITDA | 2.2x | 2.0x | 2.1x | 2.0x |
| Scope-adjusted FFO/SaD | 35% | 38% | 38% | 39% |
| FOCF/SaD | 0% | -4% | 9% | 4% |

Source: Scope

Main debt constituents are therefore pensions (not Scope-adjusted, as assets only cover payments 2x, and operating leases for the shops amount to EUR 2.4bn.

The forecasts applied in our base case scenario involve the following assumptions:

- Revenue growth of 0.6% for FY 2017 and 1.8% for FY 2018 in line with H1 interim FY 2017 growth of 0.1% (0.3%, adjusted for restructuring costs within the subsidiary 'redcoon' and 0.5% in Q2), followed by a faster development in FY 2018, assuming online business continues to progress and problem countries on the company's now-more-flexible standalone position are addressed
- A slight decline in EBIT for FY 2017, based on the H1 trend (-13% to EUR 280m)
- 50% of net profits are distributed as dividends
- Tax rate remains high (60-70% of pre-tax profit), reflecting slow progress in tackling the underlying issues: high level of non-deductible one-off charges and slow use of tax-loss carryforwards
- Cash release from working capital in FY 2017: recent unusual build-up in last two fiscal years has led to cash absorption of EUR 202m and EUR 226m, respectively, and were due to the necessity to provide for increased product availability connected with its improved online offering
- Strong recovery for free cash flow in FY 2017, due to some normalisation of working capital. This aspect has already provided a positive swing factor of over EUR 220m in H1 2017

### Liquidity

Scope views the group's liquidity as sound: almost no financial debt on its balance sheet, more than EUR 600m of available cash, full availability of multi-year committed back-up facilities of €1,015 million and expectations on slightly positive free cash flow generation. The short-term rating is S-2, in line with the mapping in Scope's corporate rating methodology.

**Financial risk profile rated BBB**

Scope assesses CECONOMY's financial risk profile at BBB. This summarises the level of its financial key metrics after the demerger, which is actually slightly above-par, as well as the company's sound liquidity profile. Given the new company's nascent state and the fact that revenue growth and profitability targets are ambitious, our assessment of CECONOMY's financial risk starts on a conservative basis.

### Key supplementary rating drivers

**Conservative financial policy**

Management's financial policy is conservative from our standpoint. Scope understands that the group prioritises attaining (and then maintaining) an investment grade rating over any potential M&A, of which we do not foresee any in the immediate future.

# Regulatory disclosures

## Important information

Information pursuant to Regulation (EC) No 1060/2009 on credit rating agencies, as amended by Regulations (EU) No. 513/2011 and (EU) No. 462/2013

Responsibility

The party responsible for the dissemination of the financial analysis is Scope Ratings AG, Berlin, District Court for Berlin (Charlottenburg) HRB 161306 B, Executive Board: Torsten Hinrichs, Dr Stefan Bund

| **Rating prepared by** | **Rating committee responsible for approval of the rating** |
|---|---|
| Olaf Tölke, Lead Analyst | Werner Stäblein, Committee Chair |

The rating concerns an entity, which was evaluated for the first time by Scope Ratings AG.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

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## Methodology

The methodology applicable for this rating (Corporate Rating Methodology) is available on www.scoperatings.com. The historical default rates of Scope Ratings can be viewed on the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's default rating, definitions of rating notations and further information on the analysis components of a rating can be found in the documents on methodologies on the rating agency's website.

## Examination of the rating by the rated entity prior to publication

Prior to publication, the rated entity was given the opportunity to examine the rating and the rating drivers, including the principal grounds on which the credit rating or rating outlook is based. The rated entity was subsequently provided with at least one full working day, to point out any factual errors, or to appeal the rating decision and deliver additional material information. Following that examination, the rating was not modified.

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