1 September 2022 Corporates

JSC Nikora Trade
Georgia, Retail

SCOPE B+ STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover	2.9x	3.8x	3.4x	3.6x
Scope-adjusted debt/EBITDA	4.0x	3.0x	2.9x	2.7x
Scope-adjusted funds from operations (FFO)/debt	16%	25%	24%	27%
Scope-adjusted free operating cash flow (FOCF)/debt	1%	6%	-6%	1%

Rating rationale

The issuer rating of JSC Nikora Trade (Nikora Trade) benefits from the comparatively high profitability, ability to pass cost increase to customers and the company's ability to grow. Negative FOCF and inadequate liquidity, due to continued reliance on very high short-term credit lines, heavy dependence on foreign exchange rates and limited size are negative rating drivers.

We highlight that significant capex stretched Nikora Trade's liquidity. However, capex is related to the opening of new point of sales and the company has the necessary flexibility to adjust. This flexibility might not be used, and Nikora Trade could go ahead with new openings without bracing themselves for the refinancing event in 2024.

Outlook and rating-change drivers

The Outlook is Stable and reflects our expectation that Nikora Trade's Scope-adjusted debt/EBITDA will remain at around 3.0x and Scope-adjusted FFO/debt above 20%. The Outlook incorporates that the company can tackle inflation, keep its margins and operate business with very limited liquidity during a heavy investment phase. We do not expect any M&A activity or dividend payments in the short term.

A positive rating action could be the consequence of Scope-adjusted FFO/debt above 30% and Scope-adjusted debt/EBITDA below 3x and a sustained improvement in liquidity. This could be achieved via deleveraging while maintaining relatively high EBITDA. A positive rating action could also be warranted if the company were to grow significantly leading to higher market shares.

A negative rating action could result from a deterioration in credit metrics as indicated by Scope-adjusted FFO/debt falling below 15% or Scope-adjusted debt/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 history

Date	Rating action/monitoring review	Issuer rating & Outlook
01 Sep 2022	Affirmation	B+/Stable
02 Sep 2021	Affirmation	B+/Stable
14 Sep 2020	Affirmation	B+/Stable

Ratings & Outlook

Issuer	B+/Stable
Senior unsecured debt	BB-

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Related Methodologies and Related Research

General Corporate Rating Methodology; July 2022

Retail and Wholesale Rating Methodology; April 2022

Sovereign and Public Sector rating report on Republic of Georgia; August 2022

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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 (neutral ESG rating driver) • Profitability higher than that of international peers thanks to small shop format and integrated vertical structure while constrained by inventory shrinkage and obsolete inventory costs (negative ESG rating driver) • Active on the food retail scene, the retail industry subsector considered the least prone to cyclicality • Comfortable leverage despite high forex risk from USD-denominated leases	• Absolute size still small with low market share if we include the unorganised market • Weak diversification with operations only in Georgia, enhancing vulnerability to macro-economic changes • Inadequate liquidity

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

Corporate profile

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 Trade (95% owned subsidiary of Nikora JSC) was developed 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 opened new shops and continues to expand.

Financial overview

				Scope estimates		
Scope credit ratios	**2020**	**2021**	**LTM H1 2022**	**2022 E**	**2023 E**	**2024 E**
Scope-adjusted EBITDA/interest cover	2.9x	3.8x	4.6x	3.4x	3.6x	3.9x
Scope-adjusted debt/EBITDA	4.0x	3.0x	2.6x	2.9x	2.7x	2.5x
Scope-adjusted FFO/debt	16%	25%	30%	24%	27%	30%
Scope-adjusted FOCF/debt	1%	6%	10%	-6%	1%	3%
Scope-adjusted EBITDA in GEL '000s						
EBITDA	44,842	60,213	67,665	64,093	71,145	78,993
Other items	0	0	0	0	0	0
Scope-adjusted EBITDA	**44,842**	**60,213**	**67,665**	**64,093**	**71,145**	**78,993**
FFO in GEL '000s						
Scope-adjusted EBITDA	44,842	60,213	67,665	64,093	71,145	78,993
less: (net) cash interest paid	-15,555	-15,697	-14,741	-19,026	-19,730	-20,331
less: cash tax paid per cash flow statement	0	0	0	0	0	0
Change in provisions	0	0	0	0	0	0
FFO	**29,287**	**44,516**	**52,924**	**45,067**	**51,416**	**58,661**
FOCF in GEL '000s						
Funds from operations	29,287	44,516	52,924	45,067	51,416	58,661
Change in working capital	2,646	6,894	16,434	4,081	6,955	4,691
Non-operating cash flow	4,621	4,964	0	0	0	0
less: capital expenditure (net)	-15,140	-21,714	-29161	-35,000	-30,000	-30,000
less: operating lease payments	-18,906	-23,095	-23,503	-26,191	-26,715	-28,051
FOCF	**2,508**	**11,565**	**16,694**	**-12,042**	**1,656**	**5,302**
Net cash interest paid in GEL '000s						
Net cash interest per cash flow statement	15,555	15,697	14,741	19,026	19,730	20,331
Change in other items	0	0	0	0	0	0
Net cash interest paid	**15,555**	**15,697**	**14,741**	**19,026**	**19,730**	**20,331**
Scope-adjusted debt in GEL '000s						
Reported gross financial debt	180,629	168,392	164,711	175,686	181,701	188,016
less: cash and cash equivalents	0	0	0	0	0	0
Other items	0	10,000	10,000	10,000	10,000	10,000
Scope-adjusted debt	**180,629**	**178,392**	**174,713**	**185,686**	**191,701**	**198,016**

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Environmental, social and governance (ESG) profile[1]

Environment		Social		Governance	
Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency)		Labour management		Management and supervision (supervisory boards and key person risk)	
Efficiencies (e.g. in production)		Health and safety (e.g. staff and customers)		Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate)	
Product innovation (e.g. transition costs, substitution of products and services, green buildings, clean technology, renewables)		Clients and supply chain (geographical/product diversification)		Corporate structure (complexity)	
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	

Legend

Green leaf (ESG factor: credit positive)

Red leaf (ESG factor: credit negative)

Grey leaf (ESG factor: credit neutral)

Regulatory and reputational risk

The government of Georgia will likely put more and more pressure on unregulated retailers. While food safety standards and stricter regulations might put under pressure Nikora Trade's operating environment, we do not expect quick change in the regulatory environment for food retailers and believe that the effect of regulatory action will likely consolidate Nikora Trades' market share as it will weaken the unorganised market.

Clarity and transparency

Some issues about the group's transparency had been flagged regarding its ability to communicate and the timeliness of its financial disclosures in previous rating actions. We highlight that the flow of information between management and the rating agency has improved, and concerns related to corporate governance and transparency are fading away.

Efficiencies

The inventory shrinkage and obsolete inventory costs remain at 2% of sales, which decreases gross margins by 200 bp. While the group suffers from costly food supply chain management, it plans to integrate SAP's enterprise resource planning (ERP) management systems during this year, to track and organise stock and improve working capital management. With better access to available stocks, the group will be able to increase operating efficiency.

[1] These evaluations are not mutually exclusive or exhaustive as ESG factors may overlap and evolve over time. We only consider ESG factors that are credit-relevant, i.e. those that have a discernible, material impact on the rated entity's cash flow and, by extension, its credit quality.

Business risk profile: BB-

Credit-supportive Industry risk profile: BBB

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

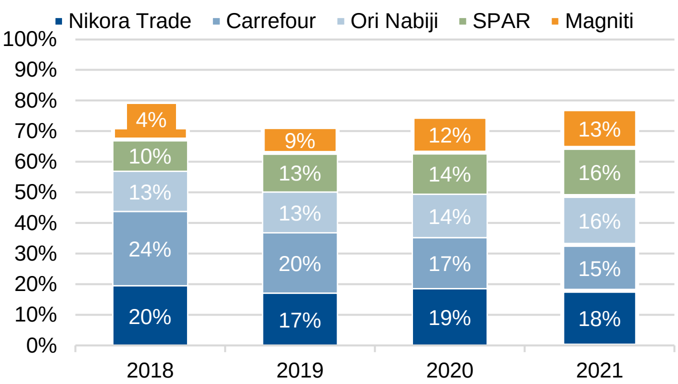
Limited size

Nikora Trade is a small player in a European context in terms of its size and scale of operations. The company's market shares is constrained by its size (GEL 651m in revenue for FY 2021). Although Nikora Trade is significant within Georgia, size remains one of the constraining rating drivers of the company's business risk profile. Even if the retailer manages to successfully maintain its top position in Georgia, it will remain a very small actor on the international food retail market.

Dominant player on Georgian retail market

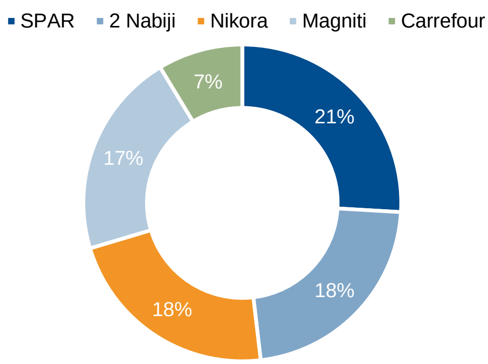
The company has achieved a leading position in the Georgian retail market in terms of sales and it was the second largest retailer by trading area as at FY 2021. Nikora Trade is the largest player with about 19% of market shares. The market share of Carrefour (largest player with 20% of market shares in 2019) has been diluted and the supermarket chain held only 15% of the market as at YE 2021 (it now ranks after Nikora, Ori Nabiji and Spar). Furthermore, while competition remains high, there is still room to capture market shares of unorganised retailers especially outside the capital, which will be a medium-term strategic pillar for Nikora Trade. Nikora Trade's market share in the Georgian fast-moving consumer goods (FMCG) retail market remains at around 5%.

Figure 1: Retail market[2] shares in Georgia by sales



Sources: TBC Capital, Nikora Trade, Scope

Figure 2: Retail market shares in Georgia by trading area (2021)



Sources: TBC Capital, Nikora Trade, Scope

Regulatory environment

While food safety standards and stricter regulations might put the operating environment under pressure, we do not expect quick changes in the regulatory environment for food retailers and we believe the effect of regulatory action will likely consolidate Nikora Trades' market share as it will weaken the unorganised market (neutral ESG rating driver).

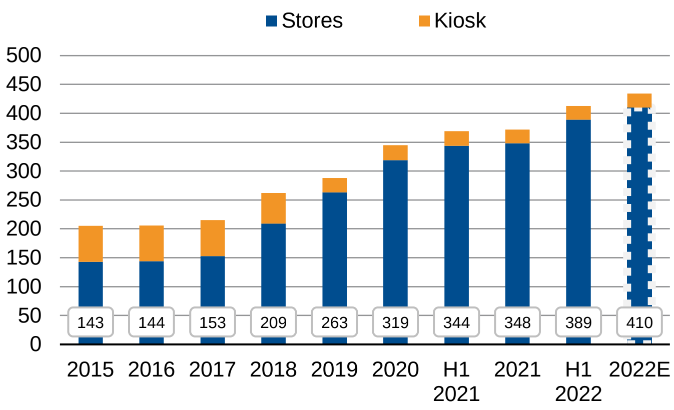
Stable top line performance

The 25% YoY revenue growth in 2021 was primarily fueled by a ramp-up of new store openings, further supported by price adjustments to tackle inflation and the gradual substitution of unorganised FMCG retailers. H1 2022 showed stronger results than H1 2021 and a positive evolution of the company's operating performance with an increase in Scope-adjusted EBITDA (in absolute volumes) and a 21% YoY revenue increase. Nikora Trade has opened 50 new stores in H1 2022 and expects to open 20-30

[2] Organized market only and excluding value added tax

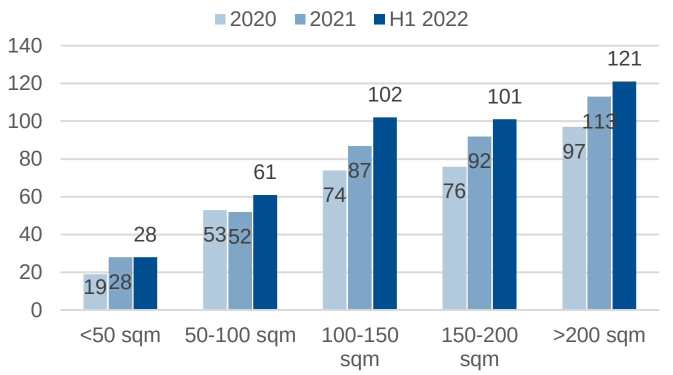
more in 2022. Growth excluding inflation stood at 5.5% for six months in 2022, mainly due to resumed substitution of unorganised FMCG retailers and the arrival of asylum seekers resulting from the Russia-Ukraine war.

Figure 3: Nikora Trade stores chain development



Sources: Nikora Trade, Scope estimates

Figure 4: Nikora stores based on trading area



Sources: Nikora Trade, Scope

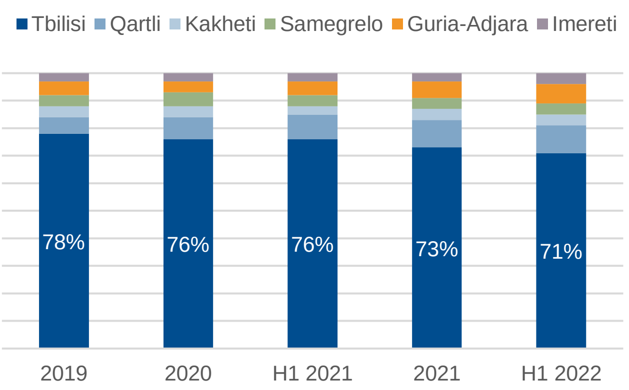
Country retail strength is low

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

Weak diversification profile

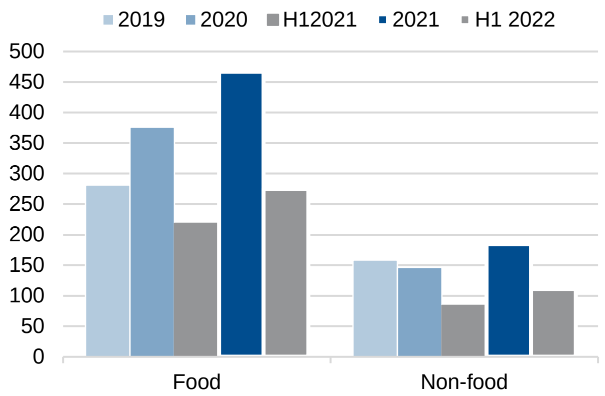
Diversification remains one of the weakest elements in Nikora Trade's business risk profile.

Figure 5: Nikora Trade's sales split by regions in Georgia



Sources: Nikora Trade, Scope

Figure 6: Nikora Trade sales split by product category (GEL m)



Sources: Nikora Trade, Scope

Country growth outlook and inflation

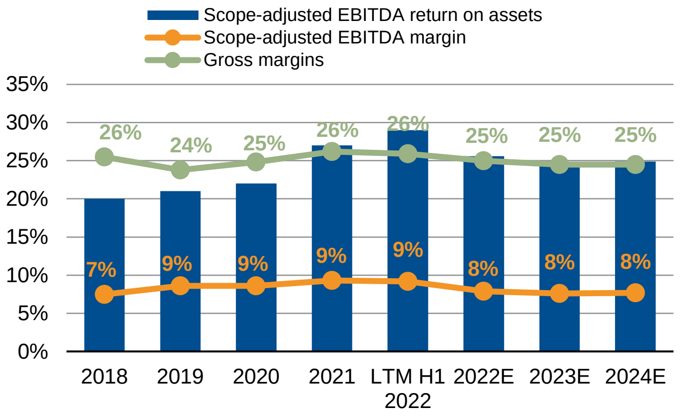
Nikora Trade's lack of geographical diversification is seen as a negative rating driver since it leads to vulnerability to macroeconomic risks. The Russian invasion of Ukraine poses economic uncertainties for the Georgian economy given its strong economic links with Russia and Ukraine: the two countries accounted for 22% of Georgian exports, 21% of remittances (mostly from Russia) and 25% of tourism inflows in 2021. We expect growth to remain strong in 2022 at 8.5% before reaching its medium-term potential of 5% by 2023.

Headline inflation peaked at 13.9% YoY in January 2022. Inflation has eased slightly since, to 12.8% YoY in June 2022, still well above the National Bank of Georgia target of 3%. The National Bank of Georgia expects inflation to average 9.6% over 2022, with this inflation rate starting to move towards its target rate as sharp rises in food and energy prices gradually dissipate.

Limited visibility on supply chain sustainability

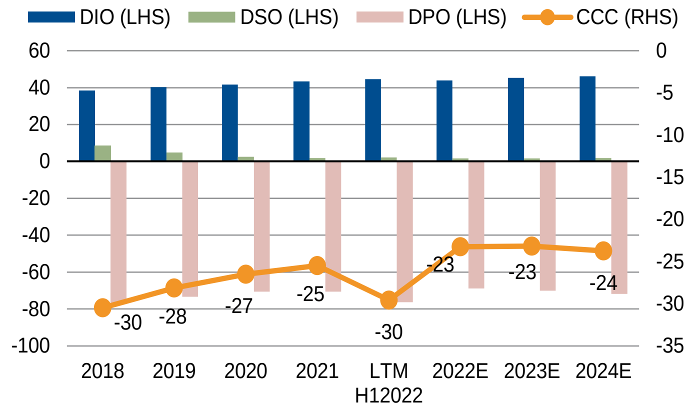
We highlight the risk of depending on the Russian, Ukrainian and Belarusian markets for primary consumption food import. Management has confirmed that there will be no significant disruption or challenges in supply chain management as main suppliers have been delivering reliably. Alternatively, Nikora could turn to markets like Poland, Türkiye and/or Brazil to substitute or diversify suppliers, but at an increased cost.

Figure 7: Operating performance



Sources: Nikora Trade, Scope estimates

Figure 8: Evolution of cash conversion cycle[3]



Sources: Nikora Trade, Scope estimates

Comfortable operating profitability margins

We expect that Nikora Trade will be able to keep comfortable profitability margins. These will be supported by i) historically stable gross margins of about 25% thanks to a vertical group structure with advantageous commercial terms; and ii) a resumed growth strategy after the Covid-19 crisis partially confirmed by new stores opened in H1 2022, which should enhance the bargaining power of the company and potentially lead to synergies and higher margins.

Ability to pass cost increase to customers

Nikora Trade's heavy dependency on imported materials threatens the sustainability of gross margin development, we see foreign exchange dependency as a common feature in the Georgian retail market, which is mitigated by the ability of companies to pass on increased costs to customers. Furthermore, while consumers may become more price conscious as inflation pressures increase, Scope does not expect any 'sticker shock' effect for Nikora Trade customers as its main product portfolio consists of non-discretionary products. The inventory shrinkage and obsolete inventory costs remain at 2% of sales which decrease gross margins by 200 bp (negative ESG rating factor).

Scope-adjusted EBITDA return on assets is gradually increasing and thanks to rapid EBITDA growth, it is expected to remain at around 25%.

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

Financial risk profile: B+

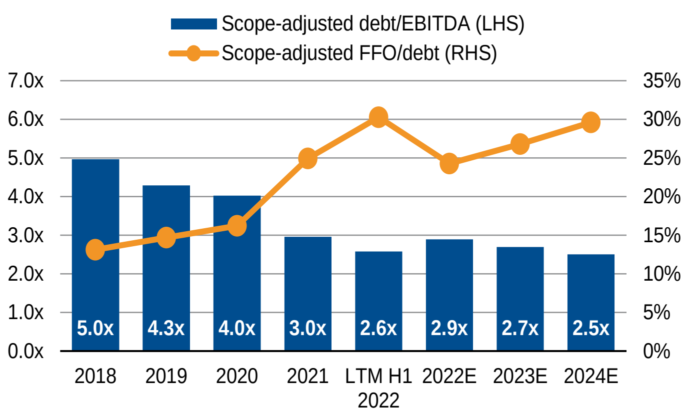
Faster-than-expected deleveraging

Nikora Trade's financial risk profile is supported by a sound cash conversion cycle, as reflected by substantial cash generation. Lower-than-expected leverage in 2021 is the result of solid EBITDA development coupled with foreign exchange gains on USD-denominated lease liabilities, which decreased overall reported debt by GEL 6m while bank loans remain at GEL 50m.

Heavy foreign exchange dependance

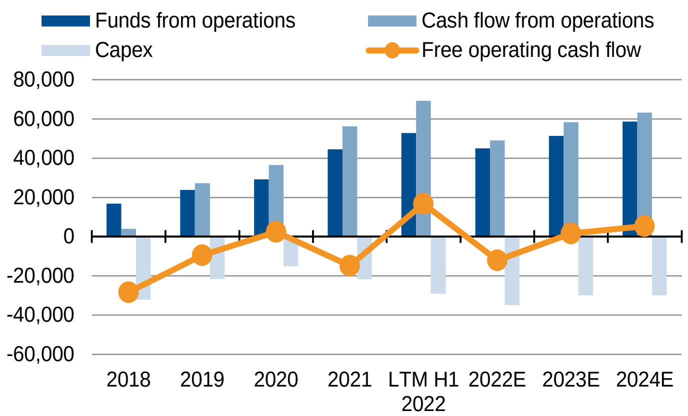
Leases remain a significant component of Nikora Trade's reported gross debt (about 70% at YE 2021). New store openings further fuel lease obligations. Scope expects these to represent over 70% of Nikora Trade's gross debt in the medium term. As JSC Nikora had a majority of leases denominated in US dollars, foreign exchange rates had a positive effect on the movement of lease liabilities (GEL 10m in 2021). Management intends to balance lease agreements with fixed and variable payment terms. The contracts in US dollars have restrictions on exchange rates to hedge the fluctuation of currency. However, heavy dependence on foreign exchange rates constrains the overall assessment of JSC Nikora Trade's financial risk profile.

Figure 9: Leverage



Sources: Nikora Trade, Scope estimates

Figure 10: Cash flow cover (GEL '000s)



Sources: Nikora Trade, Scope estimates

Further deleveraging expected going forward

While expected negative FOCF will limit room to decrease financial debt, leverage is anticipated to remain below 3.0x. The forecasted deleveraging should be driven by increasing EBITDA following Nikora Trade's expansion strategy. Indebtedness is not expected to increase significantly. For the same reasons, we expect Scope-adjusted FFO/debt to follow a similar trend, improving to above 25% from 2022

Negative FOCF while group remains in heavy capex spendings phase

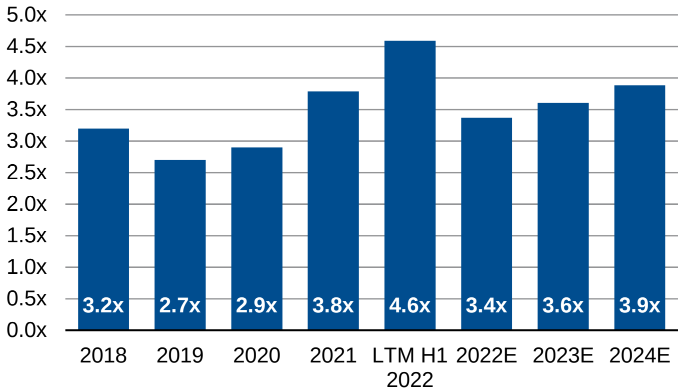
While cash flow cover remains the weakest element of Nikora Trade's financial risk profile, Scope positively regards the company's scale and financial flexibility in terms of capital spending and does not overweight this metric. Annual expected capex is expected around GEL 30m-35m), higher-than management guidance. Considering the expansion strategy of Nikora Trade, it is likely that the group will continue investments in new shops/supermarkets. We therefore expect a certain recovery of the Scope-adjusted FOCF/debt in the coming years despite the absolute values remaining around break-even in the medium term.

Relatively high cost of debt in Georgia

Interest cover had improved in FY 2021 thanks the recovery of EBITDA with the lifting of Covid-19-related restrictions over the course of the year while interest expenses remained stable. To deal with inflationary pressures, the National Bank of Georgia continues to tighten monetary policy. The refinancing rate has risen by 2.0pp over the last

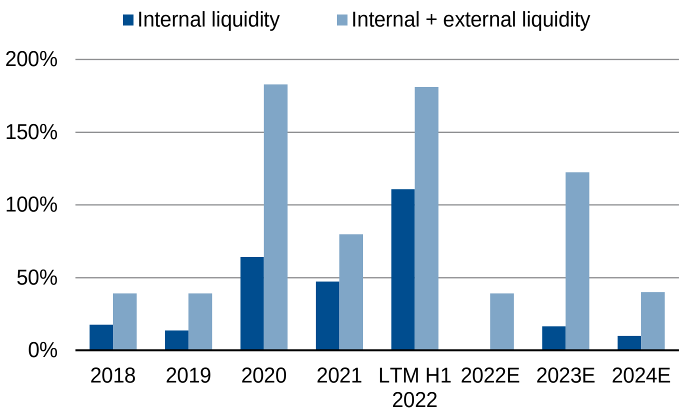
12 months to end-August 2022, to 11% from 9%, which will cause higher cost of debt, reflected in slightly deteriorating interest cover in FY 2022 compared to FY 2021. We expect the ratio to remain slightly above 3.0x in 2022-2024, supported by further growth of EBITDA driven by ability to pass on a large share of inflationary pressure to customers.

Figure 11: Scope-adjusted EBITDA/interest cover



Sources: Nikora Trade, Scope estimates

Figure 12: Liquidity



Sources: Nikora Trade, Scope estimates

Inadequate liquidity

Liquidity is inadequate. The committed credit line of GEL 10.6m remains undrawn as at end-2021 and appears to be insufficient to cover (re)-financing needs from expected negative free operating cash flow in 2022 in the range of GEL 10m with short-term debt around GEL 15m mainly compromised by amortising nature of Nikora Trade's financial debt.

We estimate lower cash levels on the balance sheet, around GEL 3.5m equivalent to the group's historical cash levels. The cash is not seen permanent in today's market environment as commercial terms of suppliers could quickly change or due to supply chain disruptions.

However, liquidity benefits from a bullet repayment structure of a newly issued GEL 35m bond, which was used to repay bridge loans.

Balance in GEL '000s	2022 E	2023 E	2024 E
Unrestricted cash (t-1)	3,500	3,500	3,500
Open committed credit lines (t-1)	10,600	10,600	10,600
FOCF	-12,042	1,656	5,302
Short-term debt (t-1)	15,065	10,000	40,000
Coverage	**52%**	**158%**	**49%**

Supplementary rating drivers: +/- 0 notches

Credit-neutral supplementary rating drivers

Previous rating actions had flagged issues about the company's transparency. We highlight that the flow of information between management and the rating agency has improved, and concerns related to corporate governance are fading away (neutral ESG rating driver).

Long-term debt rating

Senior unsecured debt rating: BB-

We have affirmed senior unsecured debt at BB-, reflecting the expectation of an above-average recovery for senior unsecured debt positions in the hypothetical event of a company default. The recovery analysis is based on a hypothetical default scenario in 2024, which assumes outstanding senior secured loans and intercompany guarantees ranked prior to senior unsecured debt.

Appendix: Peer comparison

	Nikora Trade JSC	Tegeta Motors LLC	Nikora JSC	Georgian Beer Company JSC	Evex Hospitals JSC
	B+/Stable	BB-/Stable	BB-/Stable	BB-/Negative	BB/Stable
Last reporting date	01 Sep 2022	04 Nov 2021	01 Sep 2022	05 Oct 2021	9 Jun 2022
Business risk profile	**BB-**	**BB-**	**BB-**	**BB-**	**BB**
Market share	18%	18%	19%	23%	18%
Scope-adjusted EBITDA	GEL 60.2m	GEL 75.0m	GEL 80.5m	GEL 18.6m	GEL 80.0m
Operating profitability	9%	12%	11%	26%	23%
Geographical diversification	Georgia	Georgia	Georgia	Georgia	Georgia
Financial risk profile*	**B+**	**BB-**	**BB-**	**BB-**	**BB**
Scope-adjusted EBITDA/interest cover	3.6x	2.9x	3.4x	2.8x	2.9x
Scope-adjusted debt/EBITDA	2.8x	3.6x	2.9x	3.2x	2.8x
Scope-adjusted FFO/debt	25%	14%	24%	20%	25%
Scope-adjusted FFO/debt	0%	7%	-3%	8%	7%
Liquidity	Inadequate	Adequate	Inadequate	Inadequate	Adequate

* Financial risk profile metrics are presented as average of projections

Sources: Public information, Scope

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