SCOPE

Scope Ratings

ESG considerations for the credit ratings of retail corporates

Consumers' growing interest in sustainability is evident in shopping habits. Retailers are under pressure to adapt to consumers' changing tastes and expectations linked to environment, social and governance factors, some of which will be long lasting. This trend is intertwined with the rapid growth in e-commerce and the shock of the Covid-19 crisis on consumption. This document explains the ESG factors we consider relevant for retailers' credit ratings.

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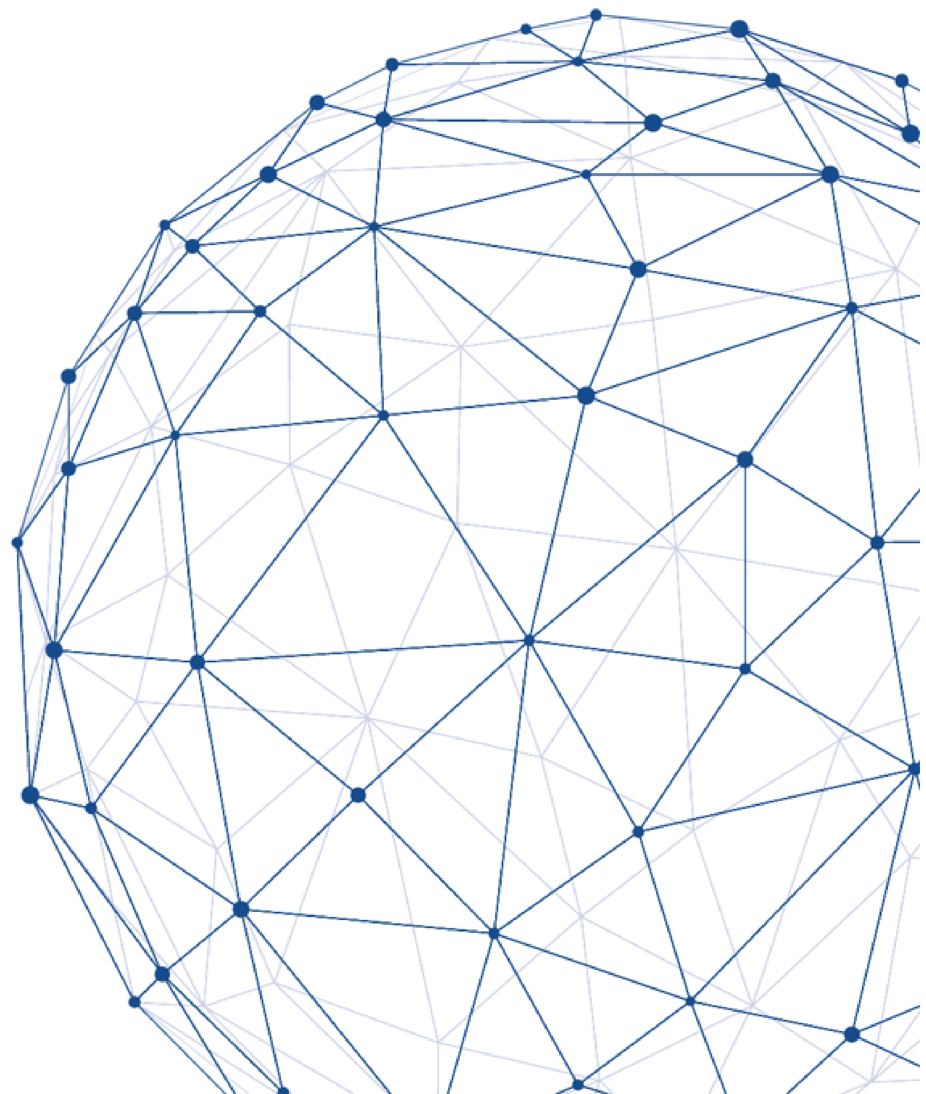

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1. General ESG framework at Scope

Our ESG framework evaluates the extent to which ESG factors are credit-relevant for different industries. We also provide an overview of how ESG factors are integrated into our credit analysis. Our evaluations are not mutually exclusive or collectively exhaustive as these factors overlap and evolve. Reporting standards for these non-financial key performance indicators are undergoing major changes, increasing stakeholders' understanding and expectations of ESG. We therefore aim to update the framework on a regular basis.

Our corporate credit rating analysis remains focused on credit quality and credit assessment drivers. We only consider an ESG factor relevant to our credit rating process if it has a ubiquitously discernible and material impact on the rated entity's cash flow profile and, by extension, its overall credit quality. Contrary to ESG ratings, which are largely based on quantitative scores for different rating dimensions, credit-relevant ESG drivers are mostly of a qualitative nature. Hence, identified ESG rating factors are based on an opinion in a relative context.

The importance/relevance of certain ESG factors is specific to each rated entity, industry and region, except for the dimension of governance, which is universally applicable across all industries. For example, the risk of pollution and environmental damage is important in the utilities, chemicals and natural resources industries but less relevant to the retail sector, where governance and social factors are more relevant. The same applies to an assessment of ESG-related factors that might have a significant impact on a company located in western Europe but no effect on an eastern European corporate with a similar business model. A good example is the impact of regulatory risks, which may be significantly greater in some jurisdictions.

Governance is an indication of how well a corporation is controlled and directed and the extent to which the interests of different stakeholders are safeguarded, including the payment of all due amounts on time and in full. Governance is thus relevant to all rated entities. In contrast, environmental and social variables capture risks and opportunities that are often specific to the activities of a company and the industry in which it operates. All such factors may have a direct or indirect impact on a rated entity's market position and its financial performance.

ESG-related factors can directly or indirectly affect all the rating elements which make up our assessment of an issuer's business risk profile, financial risk profile and supplementary rating drivers. We provide a list of ESG factors that we normally consider for a given industry, although only some of the factors listed are likely to apply and be relevant to any given company.

ESG rating drivers are part of the rating framework that is outlined in our general rating approach in addition to our specific approach to the sector: see our rating methodology for retail and wholesale corporates.

Scope Corporate Sector Ratings

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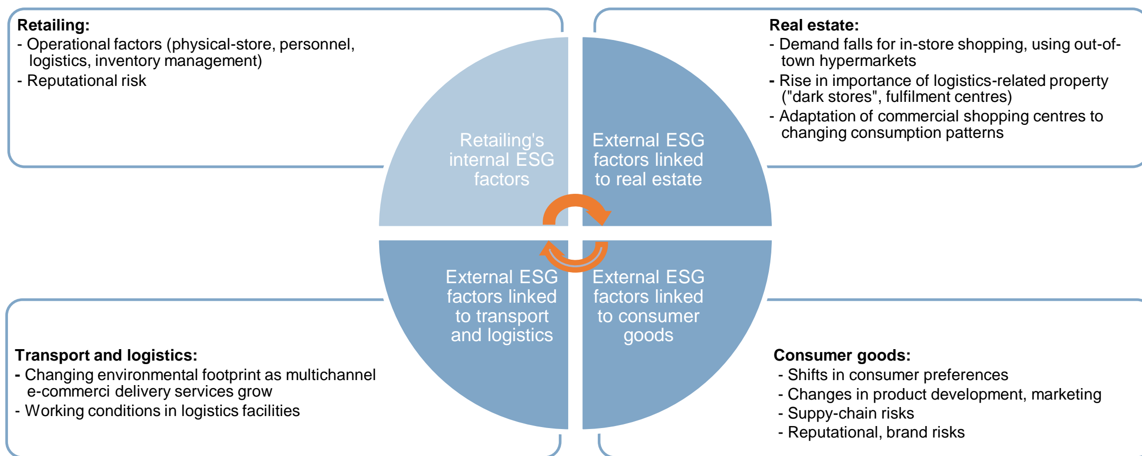
2. Important ESG themes in the European retail industry

Questions of sustainability have become increasingly important for the retailing sector. Consumers' interest in the environmental, societal and governance factors related to how and where they shop and what they buy has put pressure on retailers to adapt accordingly. So too has the increasingly tight focus of policy makers, notably in Europe, and investors in ensuring that companies are paying more attention to ESG factors. Retailers are also contending with the rapid growth in e-commerce and the impact of the Covid-19 shock on consumption patterns and supply chains. These two trends are in themselves altering the environmental footprint of the sector and social factors at play.

At the same time, the particularity of the retailing sector is how closely its ESG risks and impacts are correlated with those in three other sectors: **consumer goods, transport and logistics,** and **real estate.** Retailers have no direct control over the ESG footprint of their suppliers and partners, but they can influence these ESG impacts and risks in their supply chains - the so-called "scope 3" category as defined by the Greenhouse Gas Protocol – by how they choose their partners.

Figure 1: Selected ESG risks, impacts: retail links to real estate, transport and logistics, consumer goods



Consumer goods

Retailers increasingly have to differentiate themselves through the sustainability of their products and meet consumer expectations for a broader availability and choice of products as e-commerce has grown. Questions around the origins, manufacturing and durability of products have put pressure on retailers to increase their share of ESG-compliant products and improve the transparency of their supply chains.

Transport and logistics

The Covid-19 crisis has accelerated the global shift to online shopping. Retailers have had to forsake bricks-and-mortar shops and integrate alternative distribution channels – at short notice for those late to e-commerce – such as click-and-collect, home delivery and drive-in services. To do so, retailers need to carry plenty of inventory and have the ability to deliver products quickly and in a variety of ways. In turn, this puts pressure on transport and logistics, where providers are also looking to minimise their environmental footprint under scrutiny from retailers and other stakeholders.

Real estate

The symbiotic relationship between retailing and real estate will endure despite the shift to more virtual than physical shopping accelerated by the pandemic. For example, we expect growth in urban fulfilment centres to facilitate the fast distribution of goods in metropolitan areas. We also expect a rethinking of shopping centres and what constitutes a prime retail location. These portfolio adjustments will reflect what new formats and locations are best suited to reduced footfall and the risk that some assets will end up stranded, with consequences for the local environment and stakeholders.

We have identified four main interlinked ESG challenges and risks for retail companies:

- Consumer expectations
- Product sourcing
- Downsizing into convenience
- Omnichannel integration

2.1 Consumer expectations drive retailing business model

One specificity of sustainability in retail is the direct exposure to consumer sentiment rather than just ESG legislation and regulation as in some other sectors. A retailer with a good understanding of customers' ESG expectations is more likely to gain market share and pricing power, whereas a retailer with a poor understanding might antagonise consumers and, in extreme cases, lead to boycotts, which would feed through to financial performance and market share.

Covid-19 restrictions have been devastating for most retailers. Most shopping was quickly directed online during lockdowns, with in-store shopping unlikely to return to pre-pandemic levels as lockdowns and other restrictions are eased or removed. Though too early to quantify, on possibility is that people might start buying less of some products in a focus on consuming only essential items. Alternatively, pent-up demand might be so great that consumption quickly returns to pre-crisis levels as consumers regain confidence in doing their shopping in physical stores. The uncertainty around consumer expectations has nonetheless put pressure on retailers to adapt.

One of the few certainties we have is that "sustainability sells." Not only have retailers adjusted their product-sourcing but they are also adopting new initiatives. One example is the reinforcement of after-sale, repair and second-hand marketplaces. While not new, this C2C market continues to grow, carried by the concept of circular and more responsible consumption. B2C retailers may also benefit indirectly from such gross merchandise value growth by charging a fee to host such services. Shorter supply chains, for example, are also contributing to sustainability through increased demand for local raw produce and meal kits, putting some pressure on established supermarkets, at least at the margin.

One way retailers are starting to adapt is to offer customers more subscription-based services rather than point-in-time transactions with options to rent or lease a wider range of goods than buy them outright – encouraging re-use, recycling, trade-ins - not dissimilar to the car-leasing schemes which are long established in the auto sector.

ESG factors will also have a potential impact on personnel costs. As customers become better informed and more demanding for sustainability-related products and product information, retailers will have to ensure staff keep pace with training and education.

Relevance to our rating approach:

Consumer behaviour evolves continuously and inevitably feeds through to retailing, with implications for the credit quality of retailing companies to the degree that they adapt to shifting shopping habits. Society's increasing focus on sustainability is having a growing impact on consumer behaviour, hence its importance for corporate credit. Take the example of the trend toward consuming fewer but higher quality products, judged by sustainability criteria among others, which might shrink aggregate demand and increase marketing costs for some products, with an impact on recurring operating cash flow. ESG-related regulatory and reputational risk are also growing.

Retailers best placed to profit from ESG-linked trends are set to be those which have and are expanding services to improve competitiveness and expand profit margins without sacrificing sales. Retail services also help retain customer loyalty and brand value. Managing and adapting to ESG trends helps retailers protect market share by increasing customer loyalty. It can also increase operating profitability, strengthening a retail company's credit rating in terms of its business and financial risk profile. The rise of e-commerce is also blurring the distinctions between the retail and consumer goods sectors, as some goods suppliers develop their own stores and distribution channels to better manage their brands and replace intermediary bricks-and-mortar retailers – and vice-versa with own-label goods. We expect to see fewer pure-player retailers in future, with our business analysis of the sector gradually more intertwined with other industries.

2.2 Product sourcing: toward an increase of scrutiny and comparability

Retailers have improved transparency of how they source their products as part of efforts to enhance sales, customer loyalty and competitiveness. This is partly in response to the greater sustainability focus not only among consumers but also among regulators and lawmakers. Customers expect a greater variety of products and have more information on hand to help with their decision. For example, they expect detailed nutritional information, a choice of vegan and organic products, easier ways to repair and replace products, and more information on a product's geographic origin and condition of manufacturing.

In this context, retailers are increasingly screening products and suppliers to manage reputational risks. Reputation allows retailers to charge premium prices and even label their products as discount, premium, organic, responsible or locally sourced. Equally, a retailer's reputation can suffer from holding the inventory of suppliers with poor regulatory, social, environmental profiles. Reputational risk can quickly turn into financial risk through lower gross profit margins and higher costs on unsold inventory The onus falls on retailers to scrutinise supply chains before choosing which products to stock.

Consumers' focus on sustainability also creates opportunities for smaller, more nimble companies. One example is small food retailers offering 'no-packaging' stores, an approach that established players are increasingly adopting.

Relevance to our rating approach:

Different types of consumer goods determine a retail issuer's industry risk profile and can have repercussions on each component of our competitive positioning assessment.

We acknowledge that reputational damage can affect large and small companies differently. Theoretically, large retailers with deep pockets can better control supply chains and are less dependent on individual products, ensuring their revenues are operating profitability are more resilient. In practice, large retailers facing reputational challenges tend to experience longer embargos and the reputational stain on their products tends to last longer. Small retailers are more vulnerable in terms of revenues, profitability and cash flow, heightening the immediate credit risk for the investor. We assess such risks by looking at supplier diversification and operational locations as different markets have different sensitivities and values.

An important issue remains the lack of adequate ESG disclosure across many corporate sectors, including retailing. The problem is more acute in emerging markets and for smaller companies that do not use commonly accepted disclosure for non-financial data. Another issue is the effectiveness of a retailer's screening of sourcing risk. The sector is increasingly likely to separate between companies that can document and pressure suppliers to make products that adhere to their ESG-linked criteria and the smaller retailers whose more limited financial means prevent them from exerting a similar level of control.

We assess the balance of commercial power between retailers and their suppliers using financial indicators including EBITDA margins, returns on assets deployed, the cash conversion cycle and gross margins. We might also consider qualitative factors, for example, if the retailer has conducted ESG-related supply-chain analysis and made changes where necessary. This would be a strong positive rating driver as it shows that management is willing to modify supply contracts based on ESG factors.

2.3 Downsizing into convenience: the search for optimal retail space

Long gone are the days when hypermarkets thrived and households organised their week around a shop's opening hours. Convenience is now the name of the game, seven days a week, with shoppers looking for a quality shopping experience near home rather than in an out-of-the-way commercial zone. Online platforms have bolstered this trend by enabling the purchase of goods anytime, anywhere.

Retailers are increasingly focusing on smaller stores in prime locations where there is a bigger market for related services such as home deliver and, where local regulations allow, opportunities for longer opening hours. Smaller shops require fewer staff, potentially generating greater profitability per square metre. These formats tend to be renovated or refurbished to improve the shopping experience. Their city locations can help their environmental profile as customers travel less far to use them: by some estimates, each retail customer accounts for almost 30% of total emissions in the sale of a product. On the other hand, keeping inner-city shops and convenience stores fully stocked requires that retailers have a network of out-of-town fulfilment and logistics centres supplying them, which comes with its own set of environmental and social costs.

The question is what happens to obsolete stores, particularly in commercial zones outside of cities. Maintaining them may result in a loss on invested capital. They often also have a larger environmental footprint because some form of transport is needed to access these locations. We see increasing attempts to revamp these centres into a mixed retailing-entertainment use (arts, culture, sport, personal services) or to reduce sellable areas by increasing delivery/click and channel possibilities. Yet the danger remains that they become stranded assets with adverse financial, environmental and social consequences.

One way retailers are coping with these risks is to rely more on franchises to expand their shop network, sacrificing returns for greater risk-sharing. However, franchise agreements are not necessarily transparent regarding ESG, again raising the issue of reputational risk.

From the perspective of buildings' energy consumption, retailers' reduced reliance on physical stores is a positive trend. However, the shift to e-commerce is uneven across Europe where consumer habits can vary sharply from market to market – for example, high online-shopping penetration in the UK but much less in southern Europe – so any net favourable benefit in the region will take time to emerge. Growing reliance on digital infrastructure – over and above logistics – might only shift energy consumption away from physical stores, not reduce it.

Relevance to our rating approach:

Our approach takes into consideration the formats of a retailer's stores and their locations, both important in assessing brand strength and operating profitability.

Downsizing might also imply a retailer has decided to take more asset-light strategy through selling buildings outright or signing sale-and-leaseback deals, with long-term if not short-term implications from an ESG-linked credit perspective.

Changing consumer habits also present the danger that some retailers' assets might end up stranded – think of hypermarkets or stores within commercial centres with poor energy efficiency and much reduced footfall – leading to avoid steadily diminishing returns on assets.

2.4 Multichannel sales: no easy route to making environmental gains

E-commerce generates at least 2.3x fewer CO_2-equivalent emissions on average than brick-and-mortar shops, according to estimates by consultancy Oliver Wyman. Even more remarkable, the emissions related to the sale of a single item in a physical store are typically equivalent to 60% of the CO2 footprint of the entire shop and exceeds the emissions related to the same product if it is sold online.

However, growth in e-commerce still leaves the retail industry facing a significant environmental challenge, not least because online shopping complements rather than replaces in-store shopping.The most successful retailers have embraced multichannel sales, marketing and distribution strategy. Even pure online players, including Amazon.com, have flagship physical stores or temporary “pop-up” shops offering a physical retail experience.

A viable multichannel approach requires a brick-and-mortar and an e-commerce presence. However large the proportion of products are sold online rather than in physical shops, they still have to be delivered quickly requiring investment in physical logistics infrastructure, from fulfilment centres to pick-up points, all contributing to a retailer’s environmental footprint – depending on the buildings and type of transport involved.

Away from the environment, social factors are increasingly under scrutiny in the retailing sector – from data privacy to the treatment of employees throughout the retailers’ upstream supply chains and at their own facilities. Retailers which are slow to tackle social problems risk reputational damage, excess taxes and fines.

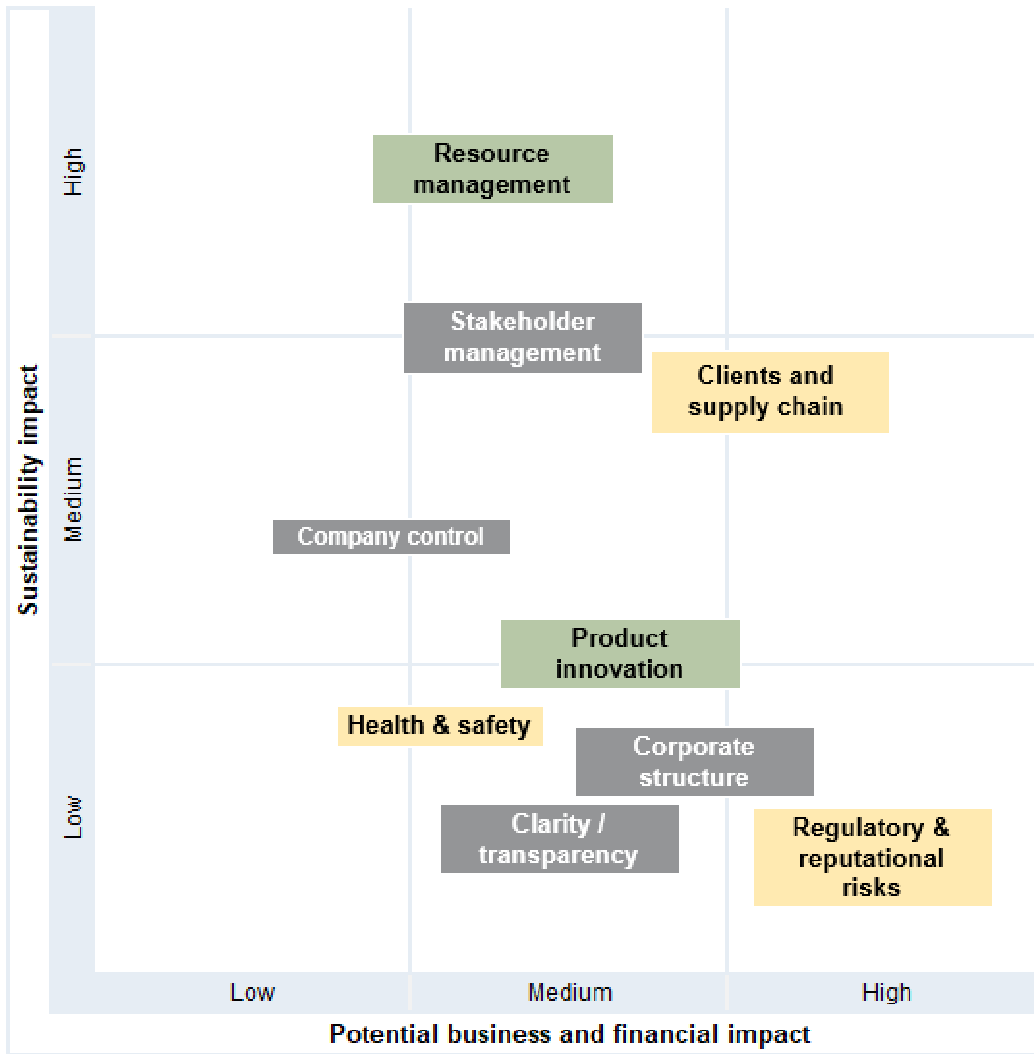
Relevance to our rating approach:

Consumer embrace of e-commerce is a potential source of growth for retailers worldwide but requires significant adaptation on the part of traditional shop-based companies. The diversification of sales channels allows retailers to target broader markets, diminishes the reliance on physical location, and can create cost savings and revenue gains through growth in market share, improved customer loyalty in addition to wider profit margins, which, in turn, enhance corporate business- and financial-risk profiles.

Paying greater attention to ESG factors in e-commerce has the potential for the retail sector to increase direct and indirect employment and improve land and building management to delivery products to customers more efficiently. However, the rush to take advantage of the continuing shift to online shopping accelerated by the Covid-19 pandemic might see more retailers seek to cut corners in terms of staff welfare and environmental impact in the quest for market share. We won’t be surprised to see more scandals and cases of reputational damage in the coming years.

3. Materiality of ESG factors in the retail industry

Within our ESG framework we look at various broader categories related to E, S and G. We seek to differentiate the sustainability impact of the companies' internalities and externalities, between what is considered sustainable (sustainability impact) and the potential business and financial (credit) impact of ESG factors. Not all ESG factors influence an issuer's creditworthiness to the same extent.



4. Typical ESG factors in retail

Governance factors apply to all industries. How it is measured is therefore important. The environmental and social factors listed here provide a realistic reflection of the risks and opportunities that a retailer might face. The list below is non-exhaustive and expected to evolve over time.

Environment			
	Sub-indicator	**Measurement/Indicator**	**Credit impact**
Resource management	Land use	• Sales and EBITDA per square metre • Scope-adjusted EBITDA return on assets • Shop format compositions	• Higher cash flow generation affecting ability to repay debt
	Emission reduction	• Indication on methods used to counter increase of CO_2 linked to delivery and e-commerce development	• Increased brand recognition which might impact market share and ability to charge a premium
	Waste management	• Indication on use of waste; when applicable, presence of aftersales services	• Higher revenue and potential premium effect due to a distinctive feature leading to higher market positioning • If aftersales services, potentially higher EBITDA
	Packaging	• Indication on initiatives to decrease environmental footprint	• Higher revenue and potential premium effect due to a distinctive feature leading to higher market positioning
Product innovation	Use of new technologies	• Use of click and collect • Use of drive-in stores • Use of alternative distribution channels to brick and mortar • Indications on measures to reduce environmental footprint of shops	• Higher revenue and potential premium effect due to a distinctive feature leading to higher market positioning • Higher capex leading to a lower net cash flow

Social			
	Sub-indicator	**Measurement/Indicator**	**Credit impact**
Health & safety	Health & safety	• Number of incidents and/or illnesses related to quality of building facilities and/or operations such as equipment malfunction, accidents and personnel issues • Accessibility of property • Absentee rate and number of work-related fatalities	• Well-maintained assets minimise the risk of incidents, lowering insurance premiums • Easy physical access to properties provides the widest possible tenant base, supporting stability of cash flow • Attention to health and safety measures should result in fewer occupational injuries and lost days, lowering absenteeism
	Privacy and data security	• Compliance with local client data protection laws	• Potential fines impacting cash flow
Clients and supply chain	Local economic development	• Favouring locally produced goods over imports	• Increased brand recognition which might impact market share and ability to charge a premium • Higher flexibility in negotiation of goods • Lower transport costs impacting profitability positively
	Branding assessment	• Cash conversion cycle and gross margin	• Increased brand recognition which might impact market share and ability to charge a premium.
Regulatory and reputational risk	Regulatory risk	• Might lead to discontinued products	• Decreased sales • Impact long-term strategy
	Reputational risk	• ‘Embargo’ customers on brand	• Decreased sales • Worsening supplier relationships (expressed in cash conversion cycle)

Governance	Sub-indicator	Measurement/Indicator	Credit impact
Company control	Board structure and effectiveness	• Board independence • Competency and diversity of board members • Effectiveness of oversight, risk management and internal control mechanisms • Sustainability targets at board and executive management levels	• Ineffective board or lack of controls can result in poor decision making and failure to achieve strategic goals. • Fraud, theft or misapplication of company resources.
	Risk management	• Risk management framework and culture • Risk-adjusted return/performance measures	• Risk awareness and focus at all levels of an organisation is key to effective strategic, operational and financial risk mitigation.
	Bribery and corruption	• Frequency and magnitude of bribery and corruption incidents	• Adverse reputational consequences, leading to regulatory reprimands or fines, and ultimately a loss of assets or license to operate.
Clarity/ transparency	Financial disclosure	• Timeliness and quality (GAAP) of disclosures • Comprehensiveness of disclosure (e.g., terms of loan agreements, contingent liabilities, related-party transactions, ownership structure) • Consistency in reporting formats	• Rapid and comprehensive financial reporting instils confidence and signals strong and effective internal controls. • Conversely, slow and incomplete reporting may signal weak controls, incompetence or attempts to conceal (creative accounting).
	Transparency of communication	• Earnings call and investor presentations that provide clarity over performance drivers and company strategy • Risk factors (including ESG-related) and sensitivity analysis	• Transparency often associated with strong governance. • Understanding of and openness about risk factors allows a company to hedge against risks and prepare mitigation strategies.
Corporate structure	Complexity	• Complex and opaque ownership structure (nominee holdings concealing true owners) • Complex group structure • Complex debt structure • Significant related-party transactions • Aggressive tax optimisation • Frequent legal or regulatory infractions	• Opaque company ownership, cross holdings and significant minority interests may hide conflicts of interest. • Complex debt structures can result in unexpected events of default and cross acceleration. • Related-party transactions can disguise inappropriate diversion of company assets. • Aggressive tax strategies can backfire and result in unexpected tax penalties, negative publicity and reputational damage.
Stakeholder management	Stakeholder relations	• Respect and balancing of interests of all stakeholders	• Stakeholder disputes may have negative reputational and financial consequences.
	Shareholder distributions	• Financial policy clarity, consistency, credibility and track record • Board-level endorsement of financial policy	• A clear and credible financial policy to help steer a company towards strategic targets and manage stakeholder expectations

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