CRISIL
An S&P Global Company

Criteria for Retailing Industry

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Executive summary

Retailing is a distribution channel through which goods are sold in small quantities to the final consumer. A retailer is typically a reseller, who buys products from a manufacturer/supplier/distributor and sells them to customers, without altering the characteristics of the product significantly. Generally, retailers are at the end of the distribution channel. However, a manufacturer may also be a retailer if he sells products directly to customers.

This criteria focuses on risks related to **'Organised Brick and Mortar (B&M) Retailing'** which can be defined as a form of retailing wherein the consumer can buy goods in a similar purchase environment, across more than one physical location. There are different 'verticals' in organised B&M retailing including food & grocery, apparel, household appliances, footwear etc. Retailers operate through various formats such as specialty stores, department stores, supermarkets and hypermarkets.

The industry is characterised by intense competition from other organised retailers, local stores and the recently booming e-retailing segment. Increase in disposable incomes, growing urbanization, higher GDP growth over the medium to long term, and implementation of GST are key macro-economic factors aiding this growth.

CRISIL's analysis of business risk comprises of factors like demand-supply dynamics, segments of presence and competition, pricing and brand equity, geographical coverage and scope of expansion, store profitability and overall profitability, leased vis-a-vis owned stores, and share of private labels.

The analysis of financial risk takes into account financial position as reflected in the debt coverage ratios. Further, the financial flexibility is evaluated by studying the working capital management, and the availability of internal and external fund sources (such as payables, unencumbered cash, unutilised bank lines, and funds from promoter) to tide over unanticipated stretch in working capital.

For the analysis of the management risk of retailing industry, CRISIL follows the standard criteria used for all manufacturing companies.

Scope

The criteria[1] focuses on the risks that 'organised retail industry' faces. It covers organised retailers across store formats and category of goods sold. Services like beauty salons, multiplexes, restaurants, etc. have been excluded from this definition, though they may be available in the same location (such as a mall).

The analysis covers different store formats, including single product stores, departmental stores, cash and carry and malls. The analysis of goods retailed includes different product categories such as food and grocery, apparel, consumer durables, FMCG, footwear etc.

[1] *For accessing previous published document on "Criteria for Retailing Industry", kindly follow the below mentioned link: https://www.crisil.com/content/dam/crisil/criteria_methodology/consumer-discretionary/archive/CRISIL-Ratings-crieria-retailing-industry_2008.pdf*

Business Risk

This section outlines the risks inherent to the organised retailing business and the components of business risk evaluated by CRISIL.

Demand-supply dynamics

These form an important constituent of CRISIL's analysis of business risk of players in the retailing industry. Key demand side factors include favourable demographics, rising disposable incomes, increasing penetration of internet, changing consumer preferences, improving standard of living, better credit availability, increasing use of plastic money and rising urban population. These factors increase the spending power of consumers and encourage them to move from unorganised segment towards organised segment. Key supply side factors include rapid real estate infrastructure development, easier access to corporate credit and increased efficiency of supply chain.

CRISIL also believes that moves by government have strong demand-supply implications for players For example policies like implementation of GST and demonetisation will benefit organised retail segment over long term as it will create a level playing field with unorganised segment in terms of cost of doing business and reduce operational and supply cost. In addition, policies like financial inclusion and implementation of pay hikes as per 7th Pay Commission will also aid the sector growth over the near to medium term

While evaluating the industry risk, CRISIL considers demand supply dynamics of the product category in which the company has a presence, as these affect growth prospects, barriers to entry and exit, and extent of competition.

Segments of presence and competition

Players in organised retail segment are present across multiple segments. Setting up shop in one vertical would expose the retailer to the risk of cyclicality. Selecting the right format for a particular location and with the right sized store is also a key success factor for players. Analysis of competition is an important input in the analysis of market position. CRISIL analyses the extent of competition, and the market position of players in different retailing segments. CRISIL also estimates the present and future competition

Brand equity and private labels

CRISIL believes that since organised retailing is a business to consumer (B2C) business, brand equity and positioning are crucial factors in attracting the right customers. For example, apparel retailers may position themselves as lifestyle or value players and food & grocery retailers may position themselves as offering value for money.

CRISIL also considers share of private labels to overall sales as private labels tend to generate better profitability, than branded products of other manufacturers. Players with higher share of private labels have consistently seen their profitability expand, as their brands also get established in more geographies through expansion.

In non-food retail segment, retailers with strong brand portfolio or portfolio of private labels offering value for money tend to see strong demand and therefore maintain steady same store performance and store productivity. However, demand and store productivity for food & grocery retailers are determined by ability to provide value (discount), ability to realign with local consumer preferences, reputation and strong control over cost and procurement.

Entry barriers

Value retailing, which is built on price-based value propositions, may face higher competition as against lifestyle retailing, which requires strong brand and customer franchise; this takes a longer time to build and thus acts as a strong entry barrier. The current plans of large corporates in the retailing segment involve substantial capital outlay in the near future. Thus, any new player entering the retailing industry will require very large capital outlay to compete with the existing players. This can constrain the number of new players likely to enter the segment. Also, the amount of capital and effort required for the development and implementation of a good supply chain management system successfully, in case of value retailing, will also add to the challenges for a new entity.

Presence in e-retailing segment

The e-retailing industry, although nascent in India, is likely to witness robust growth on the back of increase in internet (broadband and 4G) penetration and changing consumer perception towards e-commerce. Consumers are developing confidence in online transactions, with many e-retailers providing the cash-on-delivery option.

The segment is expected to gain traction going forward due to availability of a wider product portfolio, convenience to consumers, ability to compare products and also look for deals and discounts offered by sellers.

CRISIL recognises the risk of increase in competition from this segment. To mitigate the risk, brick and mortarentities have entered the e-commerce space and are going omni-channel. However, the current entry of brick and mortar players into e-commerce segment is only a reaction to online retailers and these entities are yet to unleash the full potential of this channel which includes augmenting physical location experience, use of analytics and using the internet to lure customers.

Geographical coverage and expansions

Location and geographical coverage are critical aspects of market position; this is because sales patterns are likely to vary from region to region. The player's geographical coverage is likely to determine its volume of sales, products sold, and growth potential. Under geographical coverage, CRISIL also factors in the entity's business model and business location — urban, semi-urban, or rural. Strategic expansion can yield long-term benefits in the form of economies of scale and lower cost of sourcing from suppliers, in addition to customer loyalty. CRISIL also considers the pace of store additions and method of funding. CRISIL recognises that sustainable growth is the key to a healthy credit profile.

Store level dynamics

CRISIL considers the stores as a microcosm of the entity. Thus we consider factors like like-to-like sales growth, revenue per square foot, inventory turnover, proportion of stores which have achieved break even, time to break even for new stores, growth in footfalls, profitability of stores and aging of stores, amongst other factors. These parameters highlight the structural parameters of the retailer. For example an entity may have a strong overall revenue growth on account of addition of new stores but same store revenue growth may be low highlighting the risk of slowdown in revenue growth if new store additions reduce. Similarly, faster break-even of new stores will be lesser of a drag on overall profitability.

Good catchment area, strong brand equity along with value proposition will not only determine store productivity i.e. sales per square foot, inventory turnover but also help replicate it in various geographies generating the benefits of economies of scale.

Ability to adapt to regional customers' preferences

India has very high regional diversity and the ability of a retailer to adapt to this diversity and provide customers with the right products at the right price can be a key success factor. A retailer can decide on size of the store and merchandise, based on the tastes and preferences of customers in a particular location. A study of the consumption pattern can help retailers adopt a suitable product mix and also offer services to generate brand loyalty, thereby countering competition.

Marketing initiatives

CRISIL considers marketing as both a method to increase sales and improve brand positioning, and a cost centre impacting profitability. Success of a marketing campaign is judged based on past performance of marketing campaigns, impact of marketing campaign on revenues in subsequent financials and increase in repeat sales seen via loyalty programs.

Supply chain management:

CRISIL's analysis of supply chain management considers factors such as supplier network, inventory and working capital management and the ability to negotiate with suppliers.

Supplier network and infrastructure

One of the most important factors affecting retailers is the strength of the supplier network. The ability of suppliers to cater to the requirements of the retailing entity, including their ability to adapt quickly to changing needs, is critical. To gauge the effectiveness of a retailer's supplier network, CRISIL analyses factors such as the number of suppliers and the extent of the retailer's dependence on a few critical suppliers. CRISIL also factors in the existence of strong infrastructure facilities in the form of a well-connected, enterprise resource planning (ERP)-based network of suppliers that would be within easy reach of the retailer's stores. Another key factor considered is shortening of supply chain which enables efficiency in procurement, reduction in wastages, improved margins for participants in the chain and low prices for the final consumer.

Inventory and working capital management

CRISIL analyses the supply chain management systems of companies and the infrastructure available for the same; this includes the ability to ensure the ready availability of stocks at all times. Large inventories, however, tend to increase working capital requirements. Players, therefore, need to optimise their inventories so as to minimise working capital levels, while ensuring the ready availability of stocks at all times; this is a critical factor as it can significantly impact the profitability of the retailing entities. Inventory management also includes tackling obsolescence in stock; which impacts an entity's operations, especially in times of changing customer preferences. Information technology solutions help in timely dissemination of information across all levels, besides aiding sound inventory management. This enables a retailer to deal with stock-outs, seasonality of demand, and transfer of stocks from one store to another and ensure lower levels of slow-moving or dead stock.

CRISIL, therefore, analyses the entity's ability to determine and maintain its optimal inventory level.

Ability to negotiate with suppliers

The ability of a retailer to negotiate and obtain better prices will affect its profitability. Also, the retailer's ability to approach the producers directly for procurement will help in reduction of procurement costs through the elimination of middlemen margin and other associated costs.

Availability of skilled personnel: The ability to attract and retain skilled personnel is important for ensuring smooth operations. Given the increasing competition and expansion in the retailing industry, employee costs are expected to increase rapidly; retaining employees and containing costs are, therefore, likely to be twin challenges for players in the retailing industry over the medium to long term.

Pricing power and profitability: Sustainability of retailing businesses, especially in models such as supermarkets, depends on the player's ability to price products at a discount and still maintain profitability. For a specialty store, the ability to attract a premium for products will be determined by the degree of brand equity the player acquires over time, and its ability to maintain quality of service. The long gestation period required to build a customer franchise leads to a longer break-even time. The ability of the entity to establish strong private labels will impact its profitability; private labels have a higher margin as compared to branded products. CRISIL considers improvement in both overall profitability and store level profitability into account. It also considers cost reduction measures undertaken by company such as reduction in cost through supply chain management and use of better technology, reduction in advertisement cost while maintaining revenue growth and controlling rental expenses

Financial Risk

CRISIL considers the current and future financial position in its analysis of financial risks of a retailer. The analysis considers the following::

Capacity expansions and capital structure: CRISIL's analysis takes into account the capital structure adopted by a retail entity for expansions. Accordingly, CRISIL factors the management's policy and track record with regard to capital structure into its analysis.

Debt protection measures and financial flexibility: Debt protection measures indicate the company's ability to service its debt, while financial flexibility refers to its ability to raise additional capital. The financial flexibility of retailing entities is enhanced by factors such as deferrable capital expenditure, and the cash-based business model (characterised by the absence of credit sales) that is inherent to the retailing business. A strong parentage would also result in enhanced financial flexibility in terms of cost of funds, easy access to funding, as well as distress support.

Also refer to CRISIL's detailed criteria on financial risk analysis in our publications, 'Rating Criteria for Manufacturing and Services Sector Companies' and 'CRISIL's Approach to Financial Ratios'.

Management Risk

For the analysis of the management risk of retailing industry, CRISIL follows the standard criteria used for all manufacturing companies. This criteria is presented in detail in our publication, 'Rating Criteria for Manufacturing and Services Sector Companies[2]'.

Conclusion

In CRISIL's opinion, the key determinants of success for retailing entities include favourable government policies, sound pricing and branding strategy amidst stiff competition from other organised and unorganized retailers, besides e-commerce players, well-managed supply chain management systems, diversified geographical presence, strong understanding of customer preferences, and ability to respond to changes in consumer behaviour. Availability of quality real estate at reasonable costs for expansions and skilled manpower pose serious challenges that organised retailers have to overcome to remain profitable on a sustained basis.

[2] *The detailed criteria is on the CRISIL website under the "Criteria and Methodology" section – Rating Criteria for Manufacturing and Services Sector Companies and "CRISIL's approach to Financial Ratios"*

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