S&P Global
Ratings

Industry Top Trends 2019

Retail and Restaurants

November 13, 2018

Authors

Robert Schulz, CFA
New York
+1 212 438 7808
robert.schulz@spglobal.com

Hina Shoeb
London
+44 (0)207 176 3747
hina.shoeb@spglobal.com

Raam Ratnam
London
+44 (0)207 176 7462
raam.ratnam@spglobal.com

Makiko Yoshimura
Tokyo
+81 3 4550 8368
makiko.yoshimura@spglobal.com

Luis Martinez
Mexico
+ 52 55 5081 4462
luis.martinez@spglobal.com

Luisa Vilhena
Sao Paulo
+55 11 3039 9727
luisa.vilhena@spglobal.com

Abigail Klimovich
London
+44 (0)207 176 3554
abigail.klimovich@spglobal.com

Mickael Vidal
Paris
+ 33 14 420 6658
mickael.vidal@spglobal.com

Aniki Saha-Yannopoulos
+1 (416) 507 2579
aniki.saha-yannopoulos@spglobal.com

Key Takeaways

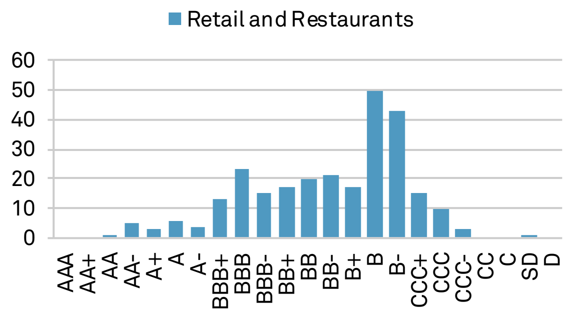
- **Ratings Outlook:** Rating trends among retail and restaurants will be negative in 2019, as they were in 2018, even if more than half the outlooks are stable. The retail landscape continues to shift for most subsectors (particularly department stores), driven by consumer preferences, nimble new entrants, and global e-commerce trends. These are contributing factors to the solidly negative outlook bias even though global economic conditions remain satisfactory.
- **Forecasts:** Overall, we expect mixed revenue growth. Some companies or subsectors will experience revenue declines (negative same-store sales or store closings) such as departmental stores, while others will continue to increase their top-line supported by favorable sector dynamics such as value retail or via e-commerce and geographical expansion. Growth in mature western markets will come from companies experimenting with store formats, product and pricing mix, cross-border acquisitions, and strengthening omnichannel propositions.
- **Assumptions:** We assume slow but continued global GDP growth, some wage growth in developed markets (stimulating consumer spending, but pressuring retailers' margins), and continued significant investment in e-commerce by most retailers. As economics of in-store retail erode for most, chasing ways to increase e-commerce, save costs in the supply chain, and lower operating expenses remain imperative for most retailers.
- **Risks:** Companies fail to adapt to shifting consumer preferences, consumers become even more cautious and hardwired to seek value. Trade, tariff, or tax regimes in key markets disrupt retail supply chain economics or raise costs and pressure margins. Higher-rated issuers shift capital allocation more aggressively toward shareholders, even as the economic expansion ages.
- **Industry Trends:** Urgency of adaption and execution remains critical, including investments in online commerce and associated supply chain and delivery logistics. Other trends include the need to proactively address the balance of physical versus online infrastructure, rise of private-label offerings by traditional retailers, and emergence of smaller and niche brands coupled with powerful demographic trends rooted in the millennial generation.

Ratings trends and outlook

Global Retail and Restaurants

Chart 1

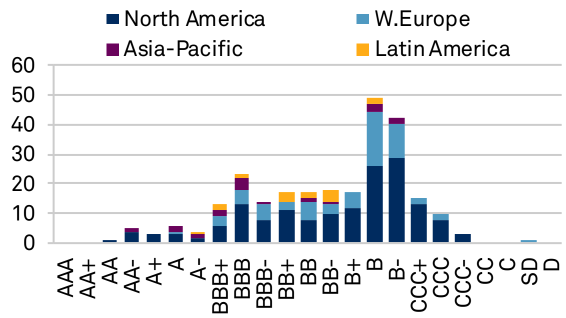
Ratings distribution



The broad distribution of ratings is comparable to 2017, with most ratings speculative-grade. The 'B' category has the highest number of ratings.

Chart 2

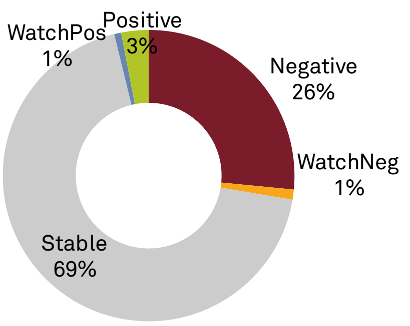
Ratings distribution by region



EMEA and the U.S. continue to have the highest number of ratings in the 'B' category.

Chart 3

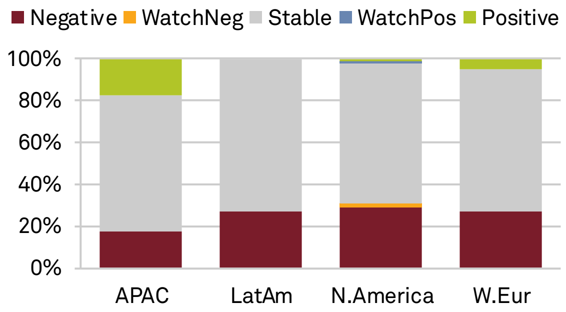
Ratings outlooks



Most rating outlooks are stable, but the vast majority of non-stable outlooks are negative, and we expect the trend to continue. The shift toward negative outlooks continues with major negative changes coming from apparel and departmental stores.

Chart 4

Ratings outlooks by region



Negative rating actions continue across regions. The U.S. has not yet bottomed out, and EMEA continues with the accelerating negative decline. There have been about 15 downgrades since January 2017 in western Europe, while headroom for the vast majority of ratings with stable outlooks has diminished. For Latin America, pressures are lower than one year ago, when negative outlooks were above 40% of the total. In APAC, our net outlook bias is neutral for now, after we took negative rating actions in 2017-2018.

Chart 5

Ratings outlook net bias

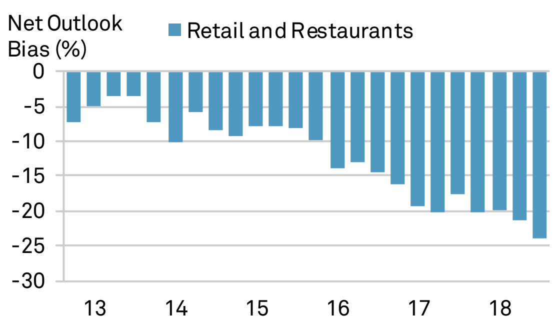
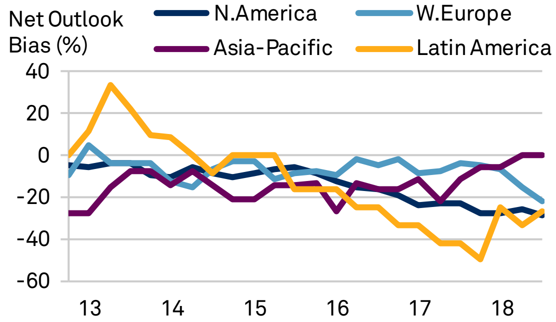


Chart 6

Ratings net outlook bias by region



The net negative rating bias is highest in retail globally, with apparel and departmental stores leading the way.

Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending September 30, 2018

The dominance of speculative-grade ratings is consistent across regions. The 'B' category dominates the rating scale. Net negative bias remains elevated and has accelerated over the last few years.

Except APAC, all regions have more negative outlooks than positive, reflecting secular shifts. While the majority of our ratings are speculative-grade, **in the U.S. the share of ratings in the 'CCC' category remains over 15%, reflecting distress in the retail sector**. We do not expect much upward rating migration across categories given industry dynamics, slow growth, investment needs, potential mergers and acquisitions (M&A), and financial policy shifts in light of real and potential activists.

In Europe, the Middle East, and Africa (**EMEA**), 78% of ratings in retail and restaurants are speculative-grade, with 42% in the 'B' category as of September 2018. **Outlooks are increasingly moving toward negative, with 25% of the portfolio negative** versus 10% in December 2017. Further, headroom under the credit metrics continues to shrink even for names with fairly stable ratings.

A majority of downgrades are due to persistent weakness in apparel and general merchandising retail. However, in 2018 ratings on food retailers also followed the negative trend due to increasing pressure from pure online and value retailers. Since January 2017, there were 15 downgrades in EMEA retail and two defaults each in 2018 and 2017. This compares to seven for the U.S. in 2018 and 11 in 2017.

For Latin America, the majority of our ratings are in the 'BB' category, and outlooks are mostly stable. About 25% of the companies carry a negative outlook, reflecting risks of a downgrade due to weakening leverage and liquidity. We expect higher GDP growth in 2019 for Brazil (2.2%, versus expected 1.8% in 2018) and Mexico (2.4%, versus expected 2.2% in 2018) to drive increasing retail sales but with no major impact on the credit quality of our rated portfolio. We believe the U.S.-Mexico-Canada Agreement (USMCA) will be formally approved by the U.S., Mexico, and Canada, and it seems that Mexico's new presidential administration elected in July could be positive for consumption. Mexico's consumer confidence index reached a 10-year high, leading to a 6.1% increase in same-store sales during September. Moreover, a low unemployment rate, sustained growth in consumer credit, and a strong inflow of remittances support this improvement. We expect solid capital expenditures (capex) from Mexican convenience and department store retailers, which confidently expect robust consumption for next year. In Brazil, we also expect a recovery in consumer confidence after presidential elections in October 2018. The maintenance of lower inflation and interest rates than in recent years support higher credit availability to consumers and stronger growth for retailers. However, consumption trends might face some downside risks next year related to exchange-rate volatility that could result in higher inflation and interest rates than our current base-case scenario suggests for the region.

Unlike other regions, in APAC our net outlook bias is neutral for now (we have even numbers of positive outlooks and negative outlooks). Our rating universe is split into two groups, one for strong investment-grade ratings in developed countries such as in Japan and Australia, with an exception for Chinese e-commerce retailers, and another for speculative-grade ratings in developing countries including China. Despite the large rating gap, in 2017-2018 we took actions equally on both investment- and speculative-grade ratings, mostly driven by company-specific issues such as overwhelmingly strong operating performance, M&A, larger investment, or liquidity. We expect this trend to continue. We view companies with positive outlooks in APAC as mostly industry leaders or disruptors. Through 2019, we have a somewhat cautious stance on overall operating performance for APAC retailers because slowing economies and U.S.-China trade tensions would erode consumer sentiment in the region. Still, we believe the consumption remains robust.

Industry forecasts

Global Retail and Restaurants

Chart 7

Revenue growth (local currency)

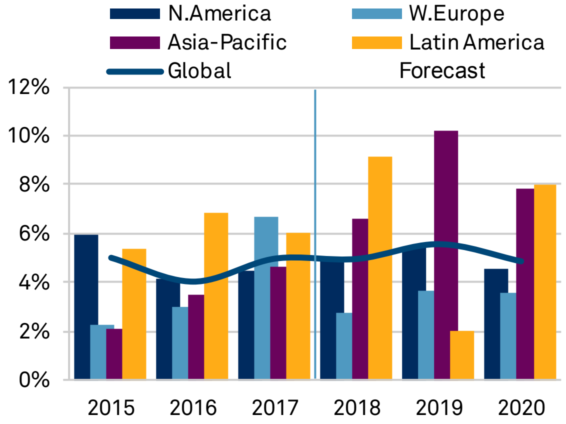


Chart 8

EBITDA margin (adjusted)

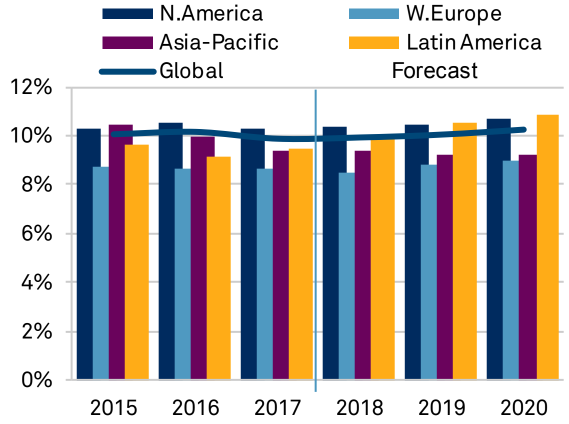


Chart 9

Debt / EBITDA (median, adjusted)

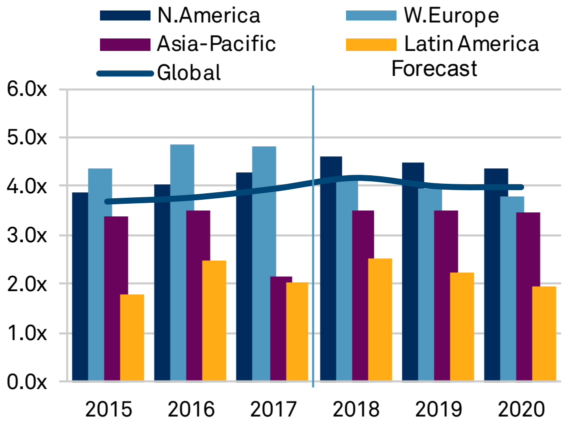
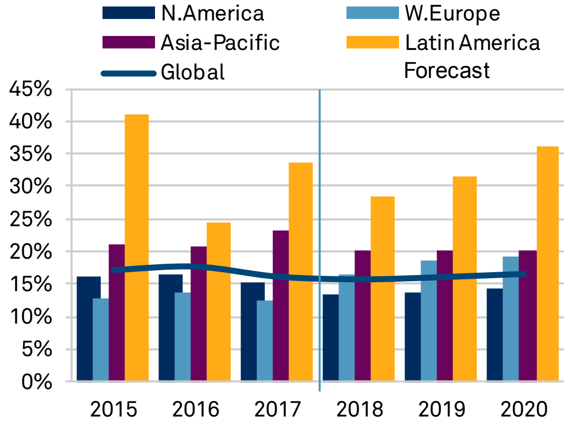


Chart 10

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. Revenue growth shows local currency growth weighted by prior-year common-currency revenue-share. All other figures are converted into U.S. Dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO--Funds from operations.

U.S. and Canada industry forecast

In the U.S., we expect many companies to report flat or declining same-store sales and further store closure announcements, but perhaps not to the extent of the last two years. This will lead to decreased revenue for sectors such as department stores and specialty apparel, unless a consistent trend of same-store sales growth emerges, which would be better than our base-case assumption. The October 2018 bankruptcy of Sears Holdings Corp. could place up to $14 billion of revenues up for grabs over time, and an extensive store closure program will also be a risk and opportunity for retailers (and REITs).

Revenue and net store openings for other retail segments (grocery, discounters and restaurants) will vary. We think wage growth will be more of a headwind in 2019 and finally accelerate, and not just because of rising state or local minimum wage requirements. Amazon Inc. raising its minimum wage to $15 per hour is an example. Wage pressure, freight costs, and for some, tariffs, will pressure margins in some segments. So far, low unemployment is not a big catalyst for small-ticket retail spending. We are watching the ongoing escalation of tariffs between the U.S. and China for signs that companies are facing higher costs that they cannot pass through.

In Canada, we forecast flat to modest growth in same-store sales over the next 12 months. This incorporates our view that modest GDP with falling unemployment and modest wage growth should translate into higher same-store sales. Profit margins may be pressured for some retailers, as some provincial governments (for example, Ontario and Alberta) increased minimum wage requirements. However, the second phase of a minimum wage increase in Ontario scheduled for Jan. 1, 2019, was halted in September. In our view, this provided some relief to retailers since Ontario accounts for about 40% of Canada's population. In our opinion, the profits from increased same-store sales could be offset by increased competition (both e-commerce and brick-and-mortar stores), higher labor costs and freight charges, and negative foreign currency movements. Nonetheless, we expect retailers to defend margins through selling high-margin products and increasing prices, adding self-checkout counters, automating distribution centers, and other initiatives to improve productivity.

EMEA industry forecast

Although the eurozone growth cycle appears to have peaked, it continues at a relatively brisk pace with the European Central Bank (ECB) slowing its tapering by ending its bond purchase program in December 2018 and heading for a first rate hike in the third quarter of 2019 as scheduled. Inflationary pressure in the eurozone for 2018 is expected to be 1.7%. This, combined with real wage growth slower than originally expected and unemployment remaining 8.3%, creates a static real income environment and a squeeze on disposable income.

European retail as of October year-to-date included two defaults, House of Fraser and Hold IKKS, reflecting continued pressure on apparel and departmental stores. The net negative bias in EMEA continues at a faster rate than in all sub sectors, escalated by apparel and department store closures. That, with many company voluntary arrangements (CVAs) in the leisure and restaurant industries expected in the U.K., indicates retailers are struggling with high occupancy costs exacerbated by low customer footfall.

We continue to see thematic challenges with consumer preference shifts, price transparency, and continued pursuit of convenience (speed of delivery, store proximity to home, or niche focus of the retailer). E-commerce disintermediation across Europe with pure online players thriving alongside physical and digital partnerships result in a so-called "phygital" space--physical and digital partnerships in which retailers scramble to find the sweet spot between the platforms. Acquisitions and buying alliances have gained momentum across Europe alongside rising share of private-label products in the mix for the pursuit of gross margin.

Retailers are focused on optimization of store networks and logistics that would result in capital investments staying elevated in 2019. Omnichannel capabilities continue to be the primary focus with strategies to moderate the decline in brick-and-mortar store sales and the increase in store running costs.

European food retailers traditionally perceived as more protected from disruption face severe challenges, with customers progressively switching their purchases to online or reducing a basket size when shopping to top up their purchases from specialized grocery retailers, resulting in decreasing store traffic and till rolls. That, the longstanding intensifying competition from larger domestic competitors, and German discounters entering premium private-label categories will likely shrink food retailers' margins. A case in point is that the three large food retailers in France--Carrefour, Casino, and Auchan--all have negative outlooks, two of the three following a downgrade.

The more discretionary general merchandising segment, in particular apparel, remains volatile with competition from value, off-price, and online retailers, exacerbated by inherent weather and fashion risks. Across Europe, gross margins remain under pressure from persistent markdowns.

Lastly, the rise of pure online players such as Ocado, ASOS, or Zalando will exert pressure on well-established retailers to improve their e-commerce services.

APAC industry forecast

Surprisingly, despite the U.S.-China trade dispute, consumer sentiment remains robust in most Asia-Pacific (APAC) countries. However, we expect retail sales growth for developing countries, China, and Association of Southeast Asian Nations (ASEAN) countries to be slower than the previous year at high-single-digit percentages. This is because of the softening macro economy and subdued consumer sentiment by the trade dispute and spillover to ASEAN countries. Still, we believe growth is supported by continuing urbanization and increasing middle-class consumers in these countries. In China, while we expect around 9% growth for total retail sales, online retailers will continue to significantly outpace offline retailers. In developed and mature markets such as Japan and Australia, we expect total retail sales to increase by low-single-digit percentages. We also expect the trade dispute to slow consumer sentiment to some extent, but not significantly. We believe retailers' operating performance is more likely affected by intense competition and oversupply of stores. In Japan, some retail formats, such as general merchandise stores (GMS), suffer from shifting consumer preference, and we expect more industrywide consolidation.

LATAM industry forecast

In Latin America, we expect somewhat stronger organic revenue growth in 2019 compared with 2018 as political uncertainties diminish and consumer confidence improves. Growth will come from a combination of same-store sales and organic expansion from large, well-capitalized retailers mainly in food, convenience, and department stores. We expect the companies to continue to focus on efficiency and cost control measures that should drive increasing profitability and cash flow generation. As a result, we forecast reduced leverage for rated retailers in the region, even despite increasing capex.

Key assumptions

Retail and Restaurants

1. Slow global GDP growth

Slow GDP growth will be the norm in most western countries. For others (China and LATAM, for example), growth will be moderate but remain above that of other regions. We expect a moderate slowdown in the eurozone following a slipping investment climate due to less favorable fundamentals and as vulnerabilities in emerging economies surface. Due to geopolitical uncertainties, the increasing risk of recession in the U.K. and further decline in business and consumer confidence across Europe could contribute to higher earnings volatility.

We expect GDP growth of 2.2% for Latin America (not including Venezuela) in 2019 compared to our expectation of 1.7% in 2018. After the uncertainties related to presidential elections in both Mexico and Brazil this year, higher GDP growth and declining unemployment should improve consumer confidence. In Peru, we expect GDP growth of 3.8% driven by the services sector and higher infrastructure investments. As a result, we expect same-store sales growth in the mid-single-digit percentages during 2019 for most rated retailers in the region, and additional revenues growth deriving from new stores. The retail industry in Latin America is still highly fragmented, which should allow large players to maintain relevant growth even amid low GDP.

2. Interest rates will rise in certain markets

Increased interest rates in the U.S. in 2019 will likely be the most notable scheduled increase as quantitative easing (QE) unwinds. A recent interest rate increase in the U.K. along with uncertainties surrounding its pending exit from the European Union (EU) continue to affect investment and funding decisions. Rising rates in other regions remain subject to a more sustained economic recovery as QE ends by December 2018. How rising rates affect economic growth, including consumer spending, remains a question. In addition, rising funding costs will likely affect the ability of highly indebted 'B' category rated companies to orderly refinance maturities coming due in 2019 and 2020. For LATAM and APAC (developing countries), we expect consumer lending to remain solid, as both credit supply and demand should be relatively strong on high consumer confidence.

3. A more inflationary environment

We expect an increased likelihood of rising wages and continued mixed news on energy prices as challenges for retail, even if higher wages could help consumer spending. We expect other sources of inflation such as freight costs, tariffs, store running costs (including rising business rates in the U.K.), and often outsourced fulfillment costs as pressure margins for some retailers.

Overall, we believe inflation might be more of a drag than an opportunity for retailers, as in such a competitive environment, and might be hard to pass increases to consumer prices.

Key risks and opportunities

Retail and Restaurants

1. Adapting to shifts in consumer preferences is critical as e-commerce shapes most retail segments

While consumers increasingly focus on value retail, millennials' buying habits (including brand choices) are more varied. Technology drives high price transparency and lower barriers to entry to which many traditional retailers are struggling to adapt.

E-commerce is disrupting almost all segments of retail to greater or lesser degrees, leading many legacy retailers to reconsider their go-to market strategies and physical footprints. Among more heavily challenged retailers, some department stores and consumer electronics (Best Buy Co. Inc. in the U.S. has been an exception) stand out as the worst performers, in particular in **EMEA**, where almost major market players posted profit warnings, if not bankruptcy filings. That trend expands to the food segment, once perceived as more immune from e-commerce disruption. We assume that online competitors and traditional retailers will continue to take pages from each other's playbooks to attract and retain consumers. Not all strategies will be successful, but success will attract new offerings; execution will be the risk factor. We think signs of winners and losers are emerging now, although the upheaval of the retail landscape will continue.

In **Japan**, for instance, we expect consumption to remain slightly weak in the next 1-2 years given recent price rises, including for fresh food and energy; price-consciousness of consumers; and expectations of reduced purchases after a consumption tax increase scheduled for October 2019. In Australia, consumers are more focused on prices, and retailers were forced to cope with increasing penetration of discounters. In China, consumers are shifting preferences to services and leisure in physical stores. Average online transactions per person per year is much higher in Asia at about 22.1 compared with 19 for the U.S. and 18.4 in western Europe, which could translate to faster transition in China. To cope with this, retailers have scraped and rebuilt old retail formats into shopping centers with entertainment offerings. We think profitability of predominantly offline retailers in Japan and China is unlikely to recover materially, because of severe competition on price with online retailers as well as investment burdens to digitalize their businesses. In addition, continuous investment in physical stores and rising investment in e-commerce business and infrastructure, such as for information technology (IT) and logistics, will inflate their financial burdens.

Online and offline retailers are beefing up both their physical and virtual operations. Major online retailers crossed into the offline retail business by acquiring brick-and-mortar retailers or by partnering with them. After acquiring Whole Foods Market in 2017, Amazon struck a deal with Casino in France, and Alibaba and Auchan formed a joint venture in October 2017. Walmart acquired Flipkart in India in 2018. Further cross-segment development and penetration by online retailers poses a material threat to traditional retailers but encourages change in retail business structures. In particular, major retailers' efforts to attract customers with a combination of online and offline experiences will be a key to growth. As online retail giants grab market share and escalate competition both online and offline, rated offline retailers will need ample financial buffers plus financial management capable of balancing financial discipline with investment for growth.

2. Geopolitical shifts and regulatory pressure

Election results over the last two years reflect de-globalization in many cases but have not yet significantly disrupted the status quo to the extent some predicted. But retail growth prospects around the world compete with evolving geopolitical trade effects on companies, consumers, supply chain, trade relationships, and evolving economic tensions and policies including the U.S.-China trade dispute and related tariffs. Rising tensions around tariffs could lead to pressures for U.S. retailers. In the U.S., we revised an outlook to negative based upon expected tariff headwinds.

In Europe, looming deadlines such as **EU parliamentary elections** and **Brexit** in absence of an agreement raise the risk of a greater slowdown (or even decline in the U.K.), GDP growth, and weaker business and consumer confidence. Weaker local currencies would fuel inflation and revenue growth for retailers, but tariffs and regulation could disrupt supply chains and increase costs and working capital outflows more than what we include in our base case, eroding further financial flexibility.

Until the formal U.K. departure from the EU in March 2019, we expect retailers to work toward cost optimization and supply chain effectiveness to maintain market shares and resist price increases that could hurt top lines. We believe discounters have more headroom because of lean structures and their focus on efficiencies. Therefore, we expect to see blurring lines between discounters and supermarkets. Grocers are increasingly pushing private-label brands to compete with discounters on every front possible. The new trade, quota, and tariff landscape might evolve post Brexit but has yet to be revealed. However, retailers are already rearranging supply chain agreements.

European elections in May 2019 could translate into a more sovereigntist-colored parliament, likely to affect consumer confidence in continental Europe.

We also expect **regulatory pressures** to become increasingly important in 2019. For instance, the EU is in the process of adopting a directive that will set a new framework reinforcing suppliers' bargaining power vis-à-vis food retailers. The framework addresses measures such as shorter payment terms and restricted order cancellation on perishable products, more stringent than supply agreement terms. Regulatory changes of trading hours or of promotional sales periods are already affecting retailers operating in Poland and France.

This inflection in regulation, however, is not an EMEA-only nor brick-and-mortar phenomenon. While 2018 is marked by mounting debate on regulating unfair market practices from the online platforms in the U.S. and EMEA, 2019 could mark the start of concrete legislation or legal actions on both sides of the Atlantic Ocean. For instance, in the EU, legal actions are under way by the Competition Commissioner to challenge the preferential tax regime granted to Amazon by Luxembourg authorities. Another is being discussed to tax more efficiently digital companies operating in the EU. Large technology companies have come under greater public scrutiny as they hold vast amounts of personal data or market importance. Time will shape the regulatory environment, and this could translate into changes in the legal landscape. As of now, we don't see such potential changes materially affecting business models of either brick-and-mortar or online retailers.

We do not expect the **USMCA** to meaningfully affect Canadian grocers, although smaller retailers could be affected by the introduction of a higher de minimus threshold for cross-border purchases.

If the USMCA is approved, Mexican retailers could benefit from a better trade environment and restored investor confidence. The new agreement largely preserves the trade framework and contains only marginal changes maintaining the overall status quo. The USMCA will require approval by the legislatures of the U.S., Mexico, and Canada to take effect, which will not happen until 2019. We expect that the trade deal could boost investment for Mexico, improve business confidence, and reinforce the positive consumer sentiment generated after the presidential election in July.

On the other hand, Mexico's President-elect Andres Manuel Lopez Obrador recently announced that he plans to cancel construction of the New Mexico City Airport, following a public consultation. In our view, this announcement will trigger a period of volatility and uncertainty that could undermine investment confidence and affect consumer decisions, which may very well hinder the sector's short- and medium-term growth prospects.

In **APAC**, U.S.-China trade affects the supply chain, with several trade-oriented and open Asian economies integrated into the global chain. In particular, South Korea, Japan, and Taiwan are key trading partners for China and significant members of the regional goods supply chain, while China is the biggest trading partner for most of the region. We also believe that reduced demand from the U.S. and China, because of lower growth in these two large economies, would weigh on Asia-Pacific economies and subdue consumer sentiment.

U.S.-North Korea negotiations over denuclearization of the peninsula are continuing, but the situation is somewhat eased. Market reaction (or overreaction) to an event that could undermine credit conditions.

3. A sharp downturn in the global economy in 2019

Many retailers across the globe struggle to stabilize their top lines and margins amid secular shifts--as noted above, negative outlooks outweigh positives. While we do not predict a sharp downturn in the global economy in 2019, in such an event we would expect a jump in the rate of downgrades of those issuers that are barely treading water. We would likely expect downgrades or negative outlooks even on companies performing relatively well since, regardless of the form of the downturn, we assume consumer spending would be hard hit. Value-focused retailers performing strongly now may not face negative rating actions since they demonstrated solid performance in the financial-crisis-triggered great recession.

For instance, in the scenario of a sharp downturn in the global economy in 2019, we could expect significant currency devaluation in Latin America, leading to higher interest rates to counterbalance rising inflation. We would likely expect lower consumption mainly for discretionary retailers and profitability pressures related to both higher costs and wage expenses. As Brazilian entities recently experienced similar conditions due to a severe local downturn, we believe they are well positioned to adjust operations and costs if needed to mitigate the expected pressures. Also, in Brazil and Mexico, we believe that retailers' lower leverage than the global average, low refinancing needs, and flexibility to delay expansion capex mitigate likely weaker cash flow generation in a global downturn, limiting the downside risk for the ratings.

Industry developments

The ramifications of permanent change in consumers' retail shopping habits will continue to benefit some retailers and confound others in 2019. E-commerce's share continues to expand for almost all retail sectors, but share gains are not confined to pure play online retailers. Winners and losers are emerging, but it's not a winner-take-all game.

We don't expect any change to key trends:

- **Consumers are sensitive to prices** and tend to seek the best bargains.
- **Millennials are a large and influential demographic** in many countries. In the U.S. for example, the millennial generation is the most populous.
- **Rampant growth in online sales** has created more price transparency and made comparisons and access easier for many products.
- **Increasing private-label penetration**, with most retailers doing so to protect margins in certain categories.

The e-commerce evolution has already shown that previously successful retailers may not remain so. At a minimum, their growth rates will slow if they do not execute e-commerce strategies well. Simply closing stores in oversaturated sectors will not be a sufficient ingredient for future success.

Internet sales, although increasing faster than the sector in general, still only account for around 10% of total U.S. retail sales, yet e-commerce has a disproportionately large impact on the traditional retail sector. The suggestion that Amazon may enter a segment of retail is usually sufficient to trigger a drop in market value for even well-established players in that sector.

It is not easy to reformat parts of the business model, including supply chain and distribution networks, while enhancing customers' store experiences. At the same time, pure online operators are building a physical presence--often via acquisitions or partnerships--while some traditional retailers are also on acquisition sprees for digital capabilities. We think the consumer is comfortable with multiple channels and that many retailers are working to catch up. Because of this, we do not see e-commerce penetration diminishing, nor do we imagine the vast majority of sales in most segments occurring online.

Grocery is a good example of how the mixture of brick-and-mortar and online channels is evolving. In the U.S., grocery online penetration is low, and Amazon is not dominant. About a year after the Whole Foods acquisition by Amazon, large traditional grocers continue to invest in and test online formats (such as click-and-collect) and prepared foods. Food away from home is about 50% of food consumption in the U.S., so grocers are increasingly competing with restaurants. We see similar early-stage dynamics in other retail segments, such as pharmacy and perhaps auto parts. Other segments--apparel, electronics, and office supplies, for example--are further along in share capture by e-commerce. This does not mean that long-term winners and losers are determined; each retailer competes constantly and must evolve to stay relevant.

An increasingly popular European phenomenon is "phygital". Retailers have experimented with store models, customer flows in-store, and investing in employees for better customer service for a while. But new age e-commerce retailers have perfected the last-mile reach and are strong in using analytics to target customers better. To bridge this physical and digital gap, traditional brick-and-mortar retailers are entering into partnerships with tech giants. Through these win-win partnerships, retailers are looking to redefine traditional retail through digital transformation. For example, Carrefour announced an exclusive partnership with the buying alliance Systeme U for the purchase of the national and international brands and an increased commitment in favor of French agricultural producers. It also signed a three-year partnership with Tesco, the U.K.'s largest grocer, to jointly purchase own-brand products and provide greater choice at lower prices. Auchan announced a partnership with Alibaba, which we expect will further solidify its position in China. Casino also signed a partnership with Amazon to offer Monoprix grocery items in express delivery (1-2 hours) via the Amazon Prime platform. In the U.S., Kroger is partnering with British online retailer Ocado for its automated fulfillment expertise. Ocado also shook hands with Casino to develop the platform for automated delivery in France.

For **EMEA** retailers, long-term competitiveness, apart from appealing product variety, will depend on an ability to meet increasingly demanding customer expectations on fulfillment. Technology and systems that improve stock availability while maintaining nimble inventories and overall minimize transaction time for consumers--such as fast checkout, seamless access to a shopping basket across mobile or desktop platforms, smart search engines, speed of delivery--will remain among top priorities for transformational investments in 2019.

In **Latin America**, the retail market remains more fragmented than in the U.S. and Europe, with a significant share of the market controlled by the informal market and mom-and-pop shops. The large retailers we rate are investing in big data and new technologies to understand consumer needs, stay relevant, and gain market share. Still, e-commerce remains small compared to total retail revenues as the still-low internet penetration in households limits consumer demand. For most retailers that we rate in LATAM, online sales represent less than 5% of total sales, and we don’t expect a major change in the next two years. Nevertheless, important investments in this channel recently are both organic and through acquisitions. Companies are positioning to take advantage of the long-term high growth potential of this segment and to face competition from international players, such as Amazon, which is gradually expanding in Brazil.

Related Research

- Countdown to Brexit: No Deal Moving Into Sight - Oct. 30, 2018
- Credit FAQ: Credit Implications Of Sears Holdings Corp.'s Bankruptcy Filing For Retailers, REITs, CMBS, And Our Recovery Analysis - Oct. 17, 2018
- Where Spain's El Corte Ingles Stands Amid The Retail Market Disruption- Oct. 10, 2018
- Asian Retailers: Taking On The Titans Of E-Commerce Requires Greater Financial Punch July 23, 2018
- Disruption: The French Food Market Gets No Respite From Tough Trading Conditions- July 4, 2018
- Retail Disruption: Can Canadian Retailers Protect Their Sales Amid The E-Commerce Shift? - June 11, 2018
- Real Estate Disruption: How Retail REITs are Wading Through the E-commerce Waters Around The Globe - May 23, 2018
- Disruption: The Sands are Shifting Under Europe's Traditional Bricks-And-Mortar Grocers - May 1, 2018
- Food Retail Disruption: How Can "Modern" Grocers And Consumer Goods Makers In The U.S. And EMEA Remain Seasoned? - May 1, 2018
- Disruption: U.S. Grocers Must Stay Fresh To Meet Customer Demand - May 1, 2018
- Stressed And Distressed Retailers: Looking Forward (Or Down) Past The Tipping Point - Feb. 27, 2018
- Tech Disruption: Amazon Drives (And Flies) Into The Delivery Business--Not So Fast - Feb. 22, 2018
- Tech Disruption: U.S. Health Care Is "Prime" For Change By Amazon And Others - Feb. 15, 2018

This report does not constitute a rating action.

Cash, debt, and returns

Global Retail and Restaurants

Chart 11

Cash flow and primary uses

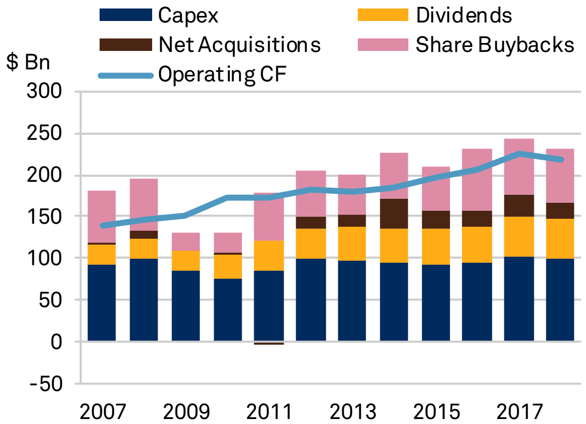


Chart 12

Return on capital employed

Chart 13

Fixed versus variable rate exposure

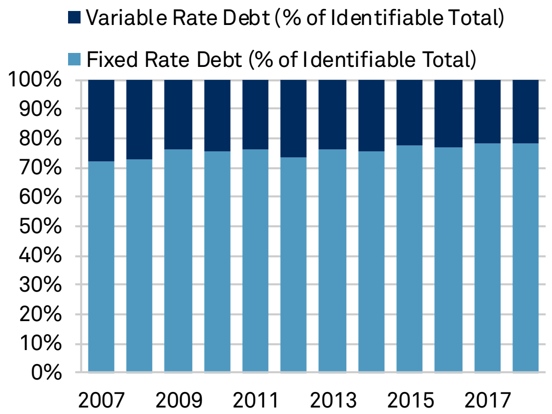


Chart 14

Long term debt term structure

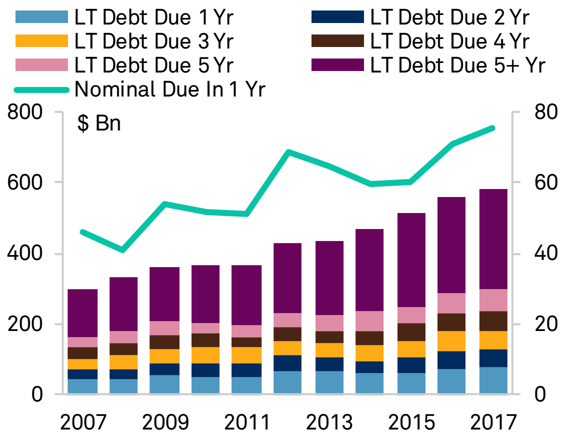


Chart 15

Cash and equivalents / Total assets

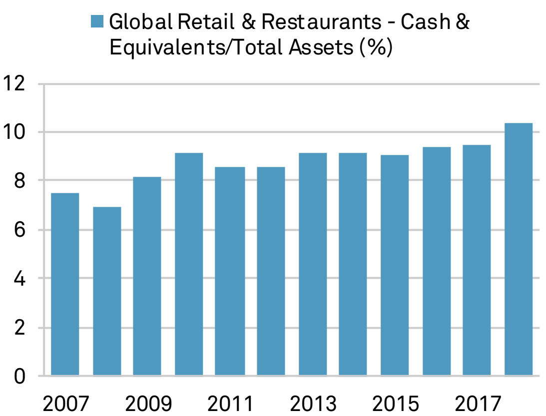


Chart 16

Total debt / Total assets

Source: S&P Global Market Intelligence, S&P Global Ratings calculations

spglobal.com/ratings