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Rating Methodology by Sector

Retail

The retail industry encompasses department stores, supermarkets, convenience stores, and other retail outlets as well as non-store retailing, such as mail order businesses. However, this article will exclude the latter type and focus primarily on retailers operating chain stores, including supermarkets, home improvement centers, and large home appliance stores. In addition, Japanese department stores that are operated by individual stores and practically rent out space to tenant shops rather than selling their own stock are, in some cases, not applicable to this article.

1. Business base

Retailing is basically a domestic industry and, thus, largely influenced by consumer trends in the country. Nevertheless, the industry is characterized by a considerable number of individual companies that enjoy growth in sales regardless of macro consumer and industry trends. When assessing the creditworthiness of a retail company, therefore, it is necessary to consider each business model characteristics, competitive advantages, risk characteristics, and other factors relating to individual companies as well as to take macro consumer and industry trends into consideration.

(1) Characteristics of the industry

(i) Market overview

Domestic consumption expenditure comprises the largest segment of Japan's gross domestic product at approximately 60%, and the country itself boasts the second largest consumer market in the world. With the support of this massive market, many companies in Japan's retail industry confine themselves to the domestic market, in contrast to the retail industries of the United States and Europe, which have been aggressively pursuing overseas expansion. Japan's retail industry, therefore, is highly susceptible to changes in domestic business trends, employment, income trends, demographic trends, and other conditions.

Given the expected decline in the number of consumers associated with a downturn in the country's total population, the retail industry as a whole is considered a mature industry. However, given the declining birthrate and aging society, the entire consumption structure and consumer behavior is set to significantly change. Some markets targeting the elderly will grow while the conventional consumer market will diminish.

The history of Japan's retail industry reveals that Japanese department stores offering a large selection of products that were established before the Second World War have long been ranked the first in sales. In the 1970s, however, Daiei, an operator of general merchandise stores that grew in the

post-war era, climbed to the top. In the 2000s, Daiei was surpassed by Seven-Eleven Japan, an operator of convenience stores, giving evidence to the vicissitudes of each form of retailing. Also in the 2000s, specialty stores, such as clothing stores and large home appliance stores, which operate exclusively in specific categories, rapidly emerged, and department stores and general merchandise stores began losing market shares.

The retail industry includes types of business that are still growing, and the growth stages vary depending on the business in question. Consequently, not only macro consumer trends, but market trends by type of business are also considered in assessing the creditworhiness of individual businesses.

(ii) Competitive situation

The world's retail industries are increasingly oligopolistic, and such cases as the five largest companies comprising more than 50%—or the largest store chain alone comprising more than 20%—of the domestic food retail market are not uncommon. The Japanese market, in contrast, is not dominated by large companies but is, instead, composed of a large number of companies of all sizes. The combined market share of the five largest companies totals only 10% to 20%, when the convenience store industry is excluded.

In 2001, the Large-Scale Retail Stores Location Law was enforced, which, in effect, deregulated store establishment, and retailers responded by opening more stores. With the limited growth of the consumer market itself, however, the substantial increase in the number of stores and sales floor space resulted in an overstored market, in which the number of stores exceeded appropriate levels. Particularly in the suburbs, large shopping centers have been actively built, some of which are massive malls with sales floor areas of more than 50,000 square meters affecting the surrounding areas extensively. The so-called "three laws concerning urban development" enforced in 2007 nonetheless have made the development of large shopping centers in the suburbs more difficult.

Meanwhile, some supermarkets and home improvement centers have established local chains in specific regions, enjoying large market shares of more than 50%. When such a chain operating in a specific region extends its business to neighboring areas, competition with the large store chains in each region often intensifies.

Without growth in the overall consumer market, an increase in clothing stores, drugstores, large home appliance stores, and other specialty stores reduces the market shares of department stores and general merchandise stores, often intensifying competition across different forms of business.

In assigning a rating, JCR examines changes in the competitive situation of each company and focuses on their effect on the business base in the medium- and long-term.

(iii) Cost structure

Retailing is a labor-intensive industry, and, in general, personnel expenses comprise the largest

portion of selling, general and administrative expenses. Retailers operating chain stores, in particular, need a large number of employees to work the cash registers, display merchandise, and implement in-store processing among other tasks. While retailers hire low-paid part-time and temporary workers to reduce their labor expenses, the room for drastic cost cuts through improved productivity is smaller than in other industries, such as manufacturing. For this reason, JCR examines whether the ratio of personnel expenses is higher than other companies in the same industry.

Retailing has an aspect as process industry and thus involves retaining a large number of stores, in which the weight of fixed expenses related to owning facilities, such as depreciation and rent, is relatively high. In assessing ratings, JCR pays attention to whether earnings are under pressure due to higher break-even points as a result of increased fixed expenses, such as personnel expenses and rent, resulting from a larger number of stores.

(2) Key factors in market position and competitiveness

(i) Market position

Since some types of businesses or companies in the retail industry suffer a decline in their earning capacity amid the external environment changes even if their sales figures are high, their current levels of sales amount or sales ranking do not necessarily create a competitive edge. Most businesses in the Japanese retail industry purchase national brand products from wholesalers. In this case, the determinants of business conditions may depend not only on the level of buying power, but also on the market share in each region. Meanwhile, some food supermarkets and home improvement centers enjoy market shares of more than 50% in specific regions, even if their national market shares are small. For this reason, a large market share and high competitiveness within a specific region are, in some cases, assessed highly in establishing a credit rating despite a nationally low level of sales and market share.

(ii) Competitiveness of existing stores

For companies operating chain stores, the strength of their business base and basis of earnings are derived from the competitiveness and earning capacity of existing stores. JCR, therefore, determines whether a store chain has a comparative advantage or disadvantage by analyzing year-on-year changes in the sales of existing stores in comparison to the industry average and competitors' store chains. This is further decomposed into factors such as the number of customers, the spending per customer, the average price of products sold, and the number of products sold per customer to analyze and assess the reasons for any change in sales. Factors could include whether intensifying competition is reducing the ability to attract customers, whether sales are affected by price competition, and whether changes in the company's product strategy are having an effect.

(iii) Merchandising skills

Earning capacity in retailing varies, depending on the level of products' sales potential, price strategies, promotional techniques, and other issues. Based on an understanding of the characteristics of a company's merchandising policy, and taking into account the consumer trends and situations relating to that company, JCR determines the appropriateness of strategies by examining in which product areas that company has strengths or weaknesses, whether the focus is on price competition or differentiation through customer services, whether the everyday-low-price (EDLP) strategy is used, whether leaflets or point systems are used to promote sales, and other aspects.

The capacity to reduce the cost of goods purchased is an important factor in improving price competitiveness and the gross profit margin. In recent years, many store chain operators have been developing private brands using economies of scale based on their growing retail business to sell products priced lower and yielding a higher gross profit margin than national brands. JCR analyzes and assesses factors such as whether a company enjoys better business conditions in product procurement than its competitors, whether it has adequate price competitiveness, and whether the product procurement helps improve the gross profit margin.

(iv) Store strategy

For retailers operating store chains, achieving growth and expansion through opening new stores is an important strategy. The chain store theory suggests that the dominant system of concentrating stores in a specific area is advantageous in improving distribution efficiency and customer recognition. For this reason, JCR analyzes and assesses the business base and effect on the earning capacity of each region based on such factors as the store format, store network, and distribution system of each company; the business base and earning capacity in each area; planned areas for future stores; and whether to enlarge stores or concentrate on small stores.

Meanwhile, some retailers operating a store chain carry unprofitable stores, with earnings reduced by changes in the business area environment, a delay in turning a profit after opening a new store, or other reasons. For unprofitable stores that reduce immediate earnings and create a future impairment risk, JCR examines each company's criteria for closing down a store, planned measures for each individual store, and other aspects, in particular, the medium- and long-term risk of weakening the income base.

(v) Group capacity

Some relatively large retailers encompass multiple forms of businesses or affiliates, such as including a credit card company within their group. In this case, JCR observes whether group synergy among different forms of business is functioning or whether there is synergy with affiliated businesses. There have been a growing number of retailers entering foreign markets in recent years in response to the sluggish domestic retail market, and JCR monitors whether a group of companies as a whole is able to expand its business base.

2. Financial base

(1) Earnings strength

While increasing sales by opening new stores may be easy in retailing, existing stores remain the basis of earnings strength. To measure the earnings strength of the existing stores, JCR focuses on year-on-year changes in the sales of existing stores as significant indicators in addition to the sales figures themselves.

Other than speciality store retailers of private label apparel, most Japanese retailers purchase goods from wholesalers and sell them to their customers. Although their operating margins are generally not high, many of these retailers maintain relatively stable earnings in comparison to other industries.

Many growing companies experience high profitability when their sales are low and a decline in the operating margin as sales increase. Consequently, JCR investigates not only the level of the most recent operating margin, but also any declining trend in long-term profitability.

Key financial indicators:

- Year-on-year changes in sales of existing stores
- Operating margin
- Operating income
- Return on assets

(2) Cash flow

Even with the same level of operating income, different forms of retail businesses generate different levels of cash flow. Businesses that receive cash on a daily basis, such as food supermarkets, receive payments before making payments, generating funds from turnover gaps that improve the ability to generate cash flow. In contrast, businesses with a long inventory turnover period, such as home improvement centers, or a short payment period, such as direct import businesses, require working capital, resulting in a reduced ability to generate cash flow. General merchandise stores operating large shopping centers, incurs a large amount of depreciation expenses, and, in some cases, EBITDA and cash flow from operating activities are relatively larger than operating income. The level of cash flow, thus, varies significantly depending on the form of business. JCR, therefore, focuses on the actual ability to generate cash flow by adding working capital and funds from turnover gaps to EBITDA in its rating assessments, taking the characteristics of each form of businesses into consideration.

Retailers operating chain stores should basically reinvest the earnings from existing stores in new stores. In reality, however, investment in new stores is often made through external financing. In this case, the invested capital must properly generate cash flow and be returned within a certain period of time. Especially when many new stores are opened during a certain period, resulting in a temporary increase in interest-bearing debt, whether the investment subsequently generates adequate profit to restore the original financial structure becomes an important issue.

Retailers often use financial leasing to open new stores, and JCR considers that unpaid lease charges in off-balance sheet financial lease transactions are included in interest-bearing debt. Interest-bearing debt held by any financial business, such as a credit card company or bank, included in a retailer's company group are accordingly adjusted before assessment.

Key financial indicators:

- Cash flow from operating activities
- EBITDA
- Ratio of interest-bearing debt to EBITDA
- Ratio of interest-bearing debt to cash flow from operating activities

(3) Safety

The swift closure of unprofitable stores is an important alternative in any attempt to quickly restore earnings when a retailer suffers a significant decline in its financial performance. This, however, requires adequate equity capital to endure the subsequent loss.

A store that has continued to incur a net loss for a certain period must report an impairment loss upon the decision to apply impairment accounting. Because the decision to apply impairment accounting is basically made for each store in the retail business, a store to which impairment accounting is newly applied emerges almost every fiscal year. Particularly when the earnings of the company are declining, the number of stores subject to impairment accounting consecutively increases. The asset retirement obligation introduced due to changes in the accounting standards now requires advanced reporting of the future cost of store closure. Any assessment for assigning a rating, therefore, must consider whether a company's equity capital would be enough to endure the risk of such an accounting loss.

In Japanese business practice, a large amount of guarantee money is deposited when a store is established based on a long-term lease contract. In addition to tangible fixed assets, guarantee money or "caution money" deposited and construction assistance funds comprise a relatively large portion of retailers' balance sheets. In this case, the credit risk of the party holding the guarantee or caution money and construction assistance funds arises. The credit status of such a party may change during the term of store lease contracts, which sometimes cover a period of more than 20 years. In fact, there have been cases in which the deposits were not returned or were reduced as a result of the party's bankruptcy or insolvency. Naturally, the credit risk of the counterpart and whether its financial base is capable of enduring the risk of collecting the deposits if collection becomes impossible are important.

Key financial indicators:

- Impairment loss
- Shareholders' equity
- Equity ratio
- Debt equity ratio

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