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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

Many companies in Japan's retail industry primarily operate in the domestic market. Some have penetrated into overseas markets; but there are only a small number of companies whose overseas businesses significantly contribute to their overall performances. Although some companies enjoy demand from foreigners visiting Japan, the domestic retail industry is highly susceptible to changes in domestic business trends, employment, income trends, demographic trends, etc.

Given the decline in the number of consumers over medium- to long-term associated with a downturn in the country's total population, the retail industry as a whole is positioned as 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. Drugstores have increased the presence by strengthening product line-up of food items other than drugs and cosmetics. E-Commerce is also getting popular and some are putting efforts on such transactions.

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 creditworthiness of individual businesses.

(ii) Competitive situation

The Japanese market is not overly dominated by large companies except for the convenience store industry. It is composed of a large number of companies including small- and medium-sized ones. With the limited growth of the consumer market itself, it is in an overstored market situation where a large number of stores operate and compete. In the suburbs, large shopping centers have been built, and they have been giving impacts on the surrounding areas extensively. Price and service competition among stores are increasingly intensified.

Under such circumstances, some local chains in specific regions enjoy large market shares. When such a chain operating in a specific region extends its business to neighboring areas, intense competitions with the large store chains in each region are also seen. While specialty store businesses such as clothing stores, drugstores, large home appliance stores, etc. are gaining power, department stores and general merchandise stores are taken away the market shares of the applicable product category by them, and competition beyond the boundary of business types are intensifying.

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. In amid of decreasing population, a shortage of manpower is becoming a serious issue and a burden of personnel expenses is increasing. Under such circumstances, retailers are reducing in-store workload by introducing self-checkout or semi-self-checkout registers, and establishing process centers. JCR examines a trend of the personnel expense ratio as implementing measures to reduce amount of work that requires manpower, etc. is important.

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 opening 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 earnings 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. Some retailers enjoy high market shares in specific regions while their market shares are small countrywide. Product lineup that reflects characteristics of the area where the store is located is an important factor for food supermarkets to gain support from consumers. In some cases, JCR highly values retailers with small sales size and market share countrywide but have a high competitive power in a specific region in assigning credit ratings.

(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 brand products using economies of scale based on their growing retail business to sell products priced lower and yielding a higher gross profit margin than national brand products. 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, opening new stores and renovating existing stores are important strategies. 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. In addition, renovating aged stores, etc. are necessary in order to increase competitive power of existing stores. 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; whether to enlarge stores or concentrate on small stores; and how renovations of existing stores carried out.

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 checks business plans for overseas businesses and an impact given to earnings and financial conditions. A key point is whether a group of companies as a whole is able to strengthen its business base on a medium- to long-term basis.

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 specialty store retailers of private label 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 (ROA)

(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. JCR, therefore, pays attention to difference in patterns of cash flow generated by business type.

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, it is important that the invested capital must properly generate cash flow and be recovered 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 leasing in opening new stores. For operating leases, we also consider adjusted financial statements if they are highly essential assets in operating business and have impact on the total assets. 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. Any assessment for assigning a rating, therefore, JCR also considers whether a company's equity capital would be enough to bear 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, whether its financial base is capable of enduring the risk of collecting the deposits in case of an emergency is also important together with the credit risk of the counterpart.

Key financial indicators:

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

Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza, Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026