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Research

France-Based Auchan And Subsidiary Downgraded To 'BBB+' On Tough Western European Operating Environment; Outlook Stable

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- French retailer Auchan Holding faced a difficult operating environment in its core markets in Western Europe in 2015. Although we expect improved prospects in China and some of the Eastern European markets for the group, we do not think this will be strong enough to offset the operating weakness in France and Western Europe.
- We believe that the group will be challenged to restore its profitability at the historical levels of a Standard & Poor's-adjusted EBITDA margin of about 6.5%-7%. Furthermore, we believe that it would be difficult to restore its competitive edge in the hypermarkets sector. We have therefore changed our assessment of Auchan's business risk profile to the lower end of our strong category, in line with its main peers. As a result, we choose the lower of the two possible anchors, at 'bbb+'.
- We are therefore lowering our long-term corporate credit rating on Auchan and its subsidiary Banque Accord to 'BBB+' from 'A-'.
- The stable outlook reflects our expectation that the group will partly recover its profitability in France, stabilize its Western European operations, and will be actively engaged in cost management, enabling the group to start generating positive discretionary cash flows and maintain adjusted ratios commensurate with the intermediate financial risk profile.

LONDON (Standard & Poor's) April 28, 2016--Standard & Poor's Ratings Services said today that it lowered its long-term corporate credit rating on

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France-based international retailer Auchan Holding (Auchan or the group) and its core banking subsidiary, Banque Accord, to 'BBB+' from 'A-'. The outlook is stable.

Our short-term rating on Auchan and Auchan Coordination Services S.A. is unchanged at 'A-2'.

The senior unsecured debt is also rated 'BBB+', in line with the corporate credit rating.

The downgrade follows the difficult operating environment that Auchan faced in its core markets in Western Europe in 2015 and reflects our view that the group will be unable to maintain or restore its profitability at the historical levels. We therefore view Auchan as being at the mid-to-low end of the strong category in our business risk profile assessment, in line with its main peers, compared with our previous view of it being at the high end. Accordingly, we choose a 'bbb+' anchor score versus our previous choice of 'a-', resulting in overall corporate credit rating being lowered to 'BBB+'.

We revised our ratings on Banque Accord because we equalize them with those on Auchan.

Our choice is based on the competitive pressures in the French food retail sector and Auchan's high dependence on the very competitive hypermarkets store format. Auchan's reported 2015 revenues fell by 2.7% in France and 4.1% in Western Europe excluding France. We believe that the highly competitive pricing environment along with consumer preference for convenience stores did not help the hypermarket players who thrived on lower price points in the past. Therefore, we see structural shifts in the retail space in favor of convenience stores, which is hindering the big hypermarket player.

We believe that a hypermarket in France is a challenged format for a store type with aggressive price points. We also see convenience stores gaining more popularity and preference in urban and sub-urban markets. We therefore believe that Auchan's profitability will remain under pressure during at least 2016, primarily due to the very weak macroeconomic conditions in Western Europe coupled with expected continued competitive pressures in the French food retail sector due to store formats. The repositioning of the hypermarkets in France is likely to continue to be a challenge and constraint for the group's financials. Although we expect some recovery and improved profitability in France on the back of modest price repositioning, in our view, this is unlikely to be strong enough to offset the negative pressures, which we expect will continue to experience trading pressures throughout 2016 and 2017.

However, we still believe that Auchan has a relatively strong position and compares well with other large retailers that operate internationally--namely Carrefour and Tesco in the U.K.--which we also assess as having a strong business risk profile. Auchan's recent purchasing renegotiations and efforts in 2014 and 2015 with various suppliers in France, Spain, and Italy, have resulted in significant purchasing benefits. Its Standard & Poor's-adjusted

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EBITDA margin improved marginally by 20 basis points year-on-year, to 6.2% in 2015. We attribute this to gains from purchasing partnerships and tight cost control across retail operations offset by continuing effects of the weak Italian economy on private consumption, and strong price-focused competition in France and Spain.

Our strong assessment of Auchan's business risk profile also reflects its resilient and well-positioned property management portfolio. Auchan owns 97% of its property portfolio with full control, worth €7.9 billion in terms of market value.

We continue to view Auchan's financial risk profile in the intermediate category, characterized by adjusted metrics of debt to EBITDA of 2x-3x and funds from operations (FFO) to debt of 30%- 45%.

Our base case assumes that Auchan's EBITDA margin will stabilize in 2016 at 2015 levels and gradually improve in the next 24 months because of margin benefits achieved through the purchasing agreements that the group has signed in France, Italy, and Spain. It also signed a purchasing agreement with German diversified retailer Metro AG, which covers the international operations of both groups.

However, we anticipate that it could prove difficult for Auchan to restore its previous margin levels in Western Europe, during this period. We expect consumers to remain price-focused and unlikely to substantially increase their food purchases, while economic and employment prospects in France and Italy, remain relatively weak over the next 12-24 months. We have also revised down our macroeconomic forecast on various Western European countries, to real GDP growth of 1.7% in 2016 and 1.8% in 2017.

Weaker profitability had a limited impact on the group's credit metrics in 2015 if we consider China's operations proportionally consolidated at 36.4%. Auchan's real estate subsidiary, Immochan, sold 22 assets in 2015 in France and divested a 50% stake in one of its Portuguese properties. As a result, Standard & Poor's adjusted debt-to-EBITDA and FFO-to-debt ratios remained broadly in the intermediate category at 2.0x in 2015 (2.3x in 2014) and 40% (33.7%), respectively.

We continue to analyze Auchan's financial risk profile on a proportional basis to better reflect our view of its limited access to cash originating from China, even though it changed its International Financial Reporting Standards reporting in 2014 to include 100% of its Chinese operations.

In our analysis, we do not consider 100% of revenues, EBITDA, and debt from Auchan's Chinese subsidiary Sun Art. We only include 36.4%, versus our previous analysis where we included 51%, as we believe that the group currently owns 36.4% of the Chinese subsidiary, even though it has full control and majority voting rights. In our analysis, we do not include, at this stage, the put liability that can be exercised from January 2016 by the Chinese partner, as we believe it is unlikely to be exercised in this

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environment.

Our view stems from the belief that Auchan's joint venture in China holds a No. 2 market position in the country. Its performance is well above the market average and the joint venture has recently launched its e-commerce operations. Auchan's partner, Ruentex, would not have a strong economic incentive to exercise the put option. We therefore believe that is the option is unlikely to be exercised and accordingly, we have not included this in our analysis.

However, in the future, if we were to see it as likely that the put could be exercised, we would consolidate the put and the 51% of the Chinese business in Auchan's figures. In the case of the option being exercised, we understand it would be repaid in three equal tranches in three years and Auchan would have some flexibility to offset the cash impact through lower capex. In this case, we believe that Auchan's financial ratios would still be well within our assessment of an intermediate financial risk profile. As an illustration, Auchan's current debt-to-EBITDA ratio with 51% consolidation and the put, would be 2.3x, only 0.2x higher than currently. In addition, Auchan owns 97% of its property management portfolio, which is worth about €7.9 billion.

In our view, Auchan's Western and Eastern European operations are critical to our assessment of the group's financial risk profile and credit quality because it has much greater access to cash and cash flows generated in these regions than to those in Russia and China. Although its operations in China and Russia are very important to our analysis, we give them less weight in assessing the financial risk profile. In the case of Russia, although Auchan has more access to cash in the subsidiary there because it fully owns it, we think Auchan's ability to upstream cash from Russia would depend on the amount of dividends its subsidiary could pay in any given year along with capital expenditure done in Russia and China.

Under our base case, we forecast that Auchan will continue to report credit ratios in line with the current rating and our assessment of its business risk at the lower end of the strong category--that is, adjusted FFO to debt greater than 30% and adjusted debt to EBITDA lower than 3x. Auchan's relatively weak free cash flow and discretionary cash flow-to-debt ratios continue to constrain its financial risk profile as the group pursues the remodeling of its stores in Western Europe and expands its network in China and Russia.

In our approach to rating Auchan, we combine our views of its strong business risk profile and intermediate financial risk profile to derive an anchor of either 'a-' or 'bbb+'. We apply the lower anchor of 'bbb+' to Auchan to account for the relative positioning at the low end of the category of its business risk profile within the strong category.

In our base case, we assume:

- A subdued economic recovery in the eurozone (European Economic and Monetary Union), with real GDP growth of about 1.3% in France, 2.6% in Spain, and 1.1% in Italy in 2016, and limited improvement thereafter.
- Reported revenue growth of 0%-1% in 2016 and 2017, based on growth in

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China and a return to growth in France.
- An increase in capital expenditures (capex) over the next two years.

Based on these assumptions, we arrive at the following credit ratios, based on proportional consolidation of Auchan's Chinese operations:
- An adjusted EBITDA margin gradually improving to about 6.1% in 2016.
- Adjusted FFO-to-debt ratio close to 35%.
- An adjusted debt-to-EBITDA ratio of about 2.0x-2.3x.

The stable outlook on Auchan factors in our assumption that moderately positive operating trends, combined with a prudent financial policy, will enable Auchan to maintain credit ratios in line with its expectations for a 'BBB+' rating, namely an adjusted FFO-to-debt ratio of more than 30% and an adjusted debt-to-EBITDA ratio well below 3x. In our base-case scenario, we assume that the French operations will grow moderately and that the Western European operations will continue to recover.

We might consider upgrading Auchan if the company built a good track record of like-for-like growth and rising profitability in all its markets, notably in its home market of France, and also in Italy, and China, while maintaining robust credit ratios. This would prompt us to revise up our anchor, or baseline assessment, for Auchan to 'a-' from 'bbb+'.

Rating upside appears limited for now, in our opinion, considering the highly competitive market conditions in France and other Western European markets. Furthermore, we do not see meaningful upside from the financial risk profile without substantial improvement in the group's discretionary cash flow generation, which is heavily constrained by high capex.

Although unlikely at this stage, we could downgrade Auchan if deteriorating operating performance weakened credit ratios below the levels we regard as commensurate with the current rating. We would also consider a negative rating action if the group's financial policy became more aggressive, possibly with large debt-financed acquisitions or materially increased cash shareholder remuneration.

Downward rating pressure might also arise if Auchan's leadership position weakens in Asia and Eastern Europe, notably in China and Russia, together with sharp slippage in its key Western European markets, with profitability becoming subpar compared with its peers, for a prolonged period. Such a scenario, which we do not at present envisage, could prompt us to lower our assessment of the group's business risk.

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