S&P Global Ratings

Industry Top Trends 2022

Retail and Restaurants

Inflation And Volatile Consumer Demand Could Make For A Bumpy 2022

This report does not constitute a ratings action

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What's changed?

The new normal is elusive. The emergence of new coronavirus variants dashed hopes that the pandemic would subside in 2021. We believe the acceptance of COVID-19 as endemic and the permanent implementation of some social distancing will be central to achieving a new normal.

Inflation is a growing concern. Inflation has reached its highest levels in decades and retailers are balancing capitalizing on the elevated demand with avoiding sticker shock for consumers.

What are the key assumptions for 2022?

Supply chain constraints ease gradually. Challenging supply chain dynamics limited the upside for many retailers in 2021. As demand softens in 2022, the use of creative workarounds, and their associated costs, will likely decline.

Consumer spending softens. We believe discretionary spending will slow in the second half of 2022 as consumers spend down their savings and face rising prices.

Interest rates rise moderately. We expect the gradual tightening of central banks' monetary policies will be manageable for issuers that need to refinance.

What are the key risks around the baseline?

Demand declines as cost pressures persist. If the exhaustion of their savings and reduced confidence make consumers less accepting of price increases before inflation subsides, retailers' margins and cash flow could be pressured.

Additional variants that reduce mobility. The emergence of a new, more dangerous coronavirus variant could curb out-of-home activities and cause demand to become increasingly volatile.

Fueled by strong trading, companies could aggressively raise shareholder rewards. Expectations for a relatively stable operating environment in 2022 will likely give issuers the confidence to continue returning cash to their shareholders.

Ratings trends and outlook

Global Retail and Restaurants

Chart 1

Ratings distribution

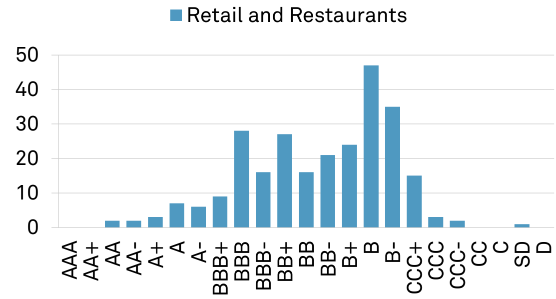


Chart 2

Ratings distribution by region

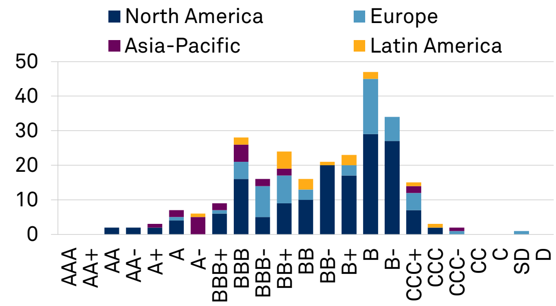


Chart 3

Ratings outlooks

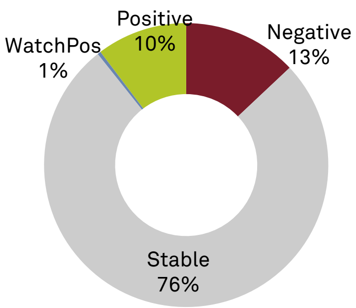


Chart 4

Ratings outlooks by region

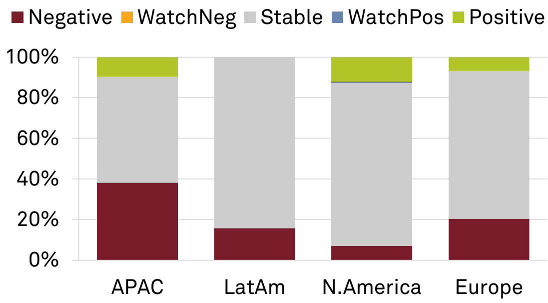


Chart 5

Ratings outlook net bias

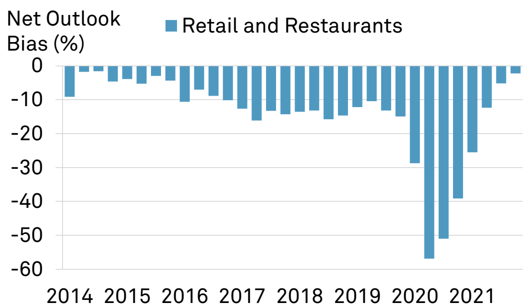
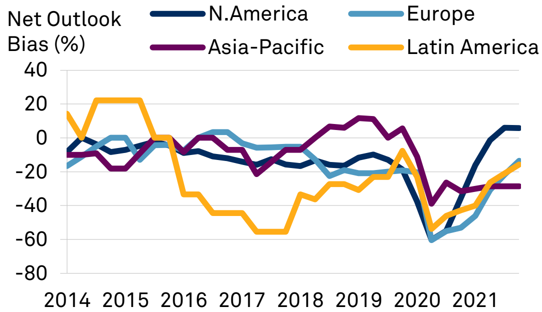


Chart 6

Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter end.

Retail and Restaurants

Ratings trends and outlook

The positive credit quality trends in the retail and restaurants sector that began in the second half of 2020 continued through 2021. During the year, upgrades vastly outnumbered downgrades in this sector because issuers benefited from supportive macroeconomic trends, which enabled them to restore their credit quality (on average across the portfolio). Consumers started the year flush with cash accumulated from government stimulus payments and savings from their reduced spending on vacations and dining out during 2020. The warmer weather in the spring, the subsiding level of COVID-19 cases, and the rollout of vaccines spurred consumers to release their pent-up demand in malls and online, leading U.S. retail sales to rise by 10% in March 2021 relative to February and remain elevated through the year. In Europe too, the overall retail sales value index remained higher than before the pandemic for most of the year

Consumers proved their resilience to the delta and omicron variants as the volume of in-person activities, such as dining out, declined only modestly and spending remained strong overall throughout the year. The favorable operating environment was complemented by amenable conditions in the credit and equity markets, which enabled issuers to refinance at appealing rates and undertake IPOs and other transformative transactions, such as Bath & Body Works Inc.'s separation from Victoria's Secret.

In the U.S., the volume of upgrades peaked in the second quarter as issuers capitalized on the positive trends to restore their balance sheets, which had been negatively affected by the pandemic. For the full year, we undertook about 10x as many upgrades as downgrades. In Europe, our rating activity was mainly positive through the year.

In addition, the proportion of issuers in our U.S. and European portfolio that we rate 'CCC+' or lower improved to less than 10% from a peak of more than 25% in 2020. Furthermore, there were only two defaults during the year in the U.S., which is the lowest number since 2014. The recovery in the credit quality of retail and restaurant issuers suggests that 2022 will also see few defaults. While we have negative outlooks on 20% or more of the companies in our other regional portfolios (Europe, Asia, and LatAm), the positive bias among our outlooks in the U.S. suggests that their credit quality will likely improve further in 2022. For example, we have a positive outlook or CreditWatch on about 15% of the U.S. issuers, which compares with a negative outlook or CreditWatch on about 7%.

The regional timing of COVID-19 case surges and vaccination rollouts has led to diverging rating trends around the global. In Asia-Pacific (APAC), downgrades outnumbered upgrades in 2021 with a continued negative rating bias of about 30% through the year. This is due, in part, to aggressive growth investments among our rated issuers and the comparatively slower initial vaccination rollouts in the region, which led to a delayed transition toward a new normal. During 2022, the credit quality of the companies in our APAC portfolio may gradually improve, similar to other regions, as each country adapts to living with the virus, which will likely provide a more stable operating environment for retailers.

Main assumptions for 2022 and beyond

1. Consumer spending will start the year strong but gradually wane

Because consumers are in good financial shape, we anticipate demand will likely remain strong. However, we believe current consumer spending levels are unsustainable over the longer term. Specifically, dwindling savings combined with sticker shock will likely cause consumers to trade down or postpone some purchases in 2022. Price increases at the grocery store will also leave limited room for discretionary spending on products such as apparel and home décor in consumer budgets. The timing of this shift is very uncertain, though we believe spending will slow in the second half of the year.

2. Supply chain constraints will remain manageable

Retailers have implemented creative workarounds to ensure their products reach customers, either on the store shelf or delivered to their homes. We believe the cost of circumventing bottlenecks will remain manageable because of consumers' acceptance of most price increases and retailers' relatively healthy balance sheets. We believe supply bottlenecks will ease in tandem with slowing consumer demand, which will bring the supply chain back into equilibrium. This will give retailers the option to restock inventory. We believe most will resist the temptation to return to pre-pandemic inventory levels because they found that the limited stock imposed by supply chain challenges led to increased pricing power and higher margins. Nevertheless, we expect some reinvestment in inventories to reduce cash flows in 2022.

3. Investment in omnichannel operations will continue

In 2021, consumers demonstrated that the shopping habits they picked up during 2020 are here stay. This means retailers will need to continue to invest on multiple fronts to remain competitive and relevant. For example, physical stores need refurbishment to stay fresh and continue to attract consumers. Digital sales also require continuous investments in technology, marketing, and distribution to compete with the operational prowess of the largest players, such as Amazon, and the smallest players that effectively reach customers on social media.

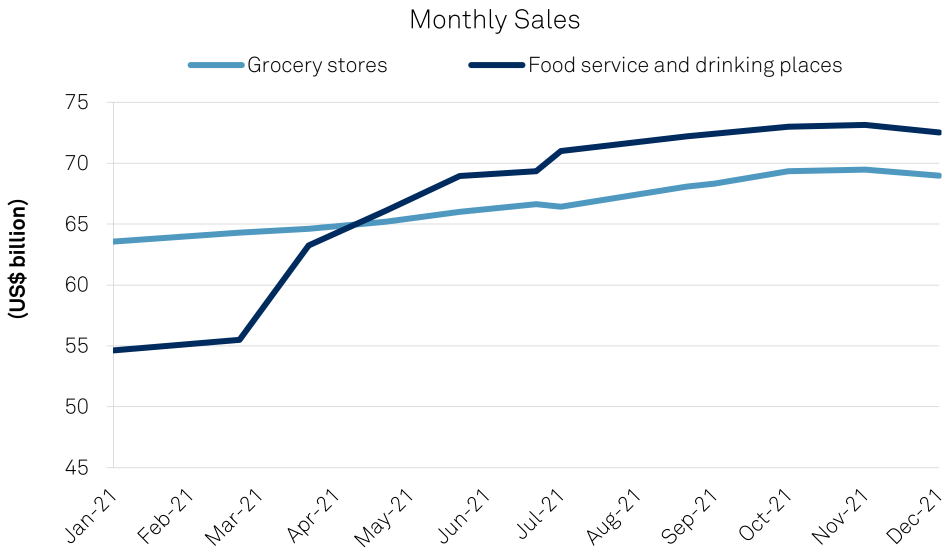
In some major APAC economies, we expect to see a continued divergence in macroeconomic conditions relative to the US. Inflation in Japan and China remains modest at between 0% and 2% year over year, despite rising wholesale prices, enabling central bank authorities to maintain, or even lower, interest rates. In China, real estate market weakness and the country's ongoing adherence to its zero-COVID policy will likely constrain the improvement in consumer sentiment and weigh on retailers in 2022. In Japan, retailers' performance continues to hinge on COVID-19 and the government's reactions to additional waves of the virus, which will affect consumer spending patterns.

Grocers and Big Box

Grocers and big box retailers continued to enjoy high demand through 2021. Even when consumers became more comfortable with returning to food-away-from-home purchases, sales at grocers remained high (see chart 7). We expect this stickiness to continue in 2022 as hybrid work and school arrangements persist, allowing grocers to maintain the food-at-home market share they gained during the pandemic. As their excess savings dwindle in the face of double-digit inflation, consumers will cut their spending on more discretionary items before groceries and basics. Trading down to private-label products will boost grocers' margins and help to offset the inflationary pressures for labor, packaged food, and household products. Big box retailers, such as Walmart, Target, and Costco, in the U.S. and large national retailers in Europe, such as Tesco in the U.K., REWE in Germany, and Carrefour in France, are poised to benefit from similar dynamics. Digital sales will continue to be an area of intense focus and investment because U.S. online sales grew to $100 billion in 2021 and some estimate about 70% of U.S households received one or more online orders during the year. Globally, we expect the market share of online grocery delivery services will continue to increase rapidly. Grocers have embraced data analytics with a focus on targeted marketing and promotional optimization to increase their share of customer spending and their position in the overall market. These attributes will also allow grocers to manage their margins against the backdrop of rising inflation in an increasingly competitive landscape.

Chart 7

U.S. Grocery Sales Remain High Despite A Return To Restaurants



Source: U.S. Census Bureau.

Department Stores, Specialty Apparel, Luxury, and Travel Retail

Department stores experienced a material recovery in 2021 and outperformed many other retail segments, which reflected the continued vaccination progress, greater mobility, and pent-up demand. E-commerce remains a key growth platform, supported by their enhanced omni-channel capabilities, loyalty programs, and other operating initiatives. We estimate the department stores' digital penetrations leapt forward and rose by about 6-10 percentage points relative to 2019 levels for the leading issuers. Our September rating action on Macy's Inc. (see "Macy's Inc. Upgraded To 'BB-' From 'B+' On Strong Performance Recovery And Debt Reduction; Outlook Positive") illustrates how favorable economic tailwinds and the growth in digital sales are affecting these companies' credit quality. Similarly, despite the COVID-19 pandemic disrupting U.K. based retailer Marks & Spenser' trading at its clothing and home stores, the group managed to leverage its revamped food offering and online presence to surpass its pre-pandemic revenue by 5% in the first half of the current financial year. Resilient sales in the food segment and a strong rebound in the clothing and home segment, combined with reduced store costs, have boosted the group's earnings.

On the other hand, we note that the presence of activist investors persisted at Macy's and Kohl's during 2021, where they have most recently been arguing for digital spin-offs or other asset sales, or a buyout. We believe that further developing their omnichannel experience will not only provide consumers with the seamless digital and in-store shopping experience they seek but also build stronger customer loyalty through more effective brand-bonding and store-bonding experiences. The future success of any department store will continue to hinge on its ability to adapt to the increasingly digital consumer shopping environment.

Specialty apparel retailers will likely continue to grapple with supply chain challenges. However, we believe this will only limit their potential upside rather than lead to significant credit quality deterioration. As supply chain issues ease, it will be important for these retailers to remain disciplined with their inventory so they can maintain the pricing power they gained during the pandemic. If they overstock inventory, it may be difficult to avoid the competitive discounting cycle that afflicted the industry before the pandemic. We expect the casualization of attire and elevated demand for athleisure to continue for the foreseeable future due, in part, to our belief that most employers will adopt a hybrid return-to-office model that includes spending a significant portion of the week working from home. Because of this shift, the demand in certain niches, such as formal wear and menswear, may never return to pre-pandemic levels.

Specialty Retail

Many specialty retailers continued to outperform our expectations in 2021. This mainly includes retailers offering products that enhance life at home, both in the form of physical goods and activities. For instance, we upgraded Best Buy Co. Inc. to 'BBB+' from ‘BBB’ and sporting goods retailer Great Outdoors to 'BB-' from 'B+', partly due to their strong performances. In Europe, we undertook one-notch rating upgrades on Kingfisher PLC (to ‘BBB’), Hornbach Baumarkt (to ‘BB+’), and B&M European Value Retail S.A. (to ‘BB’) because their operating performances surpassed our expectations amid the elevated demand for home improvement, gardening, and do-it-yourself (DIY) products as people spent more time at home during the pandemic.

We expect these tailwinds to continue into 2022 before leveling off over the course of the year. The extraordinary level of consumer savings that bolstered the elevated spending will likely to decline, especially as consumers face the highest level of inflation in decades. With less purchasing power, they will likely dedicate a larger portion of their budgets to necessities, leaving less cash to spend on discretionary items like home entertainment and décor. Softer demand could make it difficult for issuers to absorb the higher costs from supply chain workarounds and wages, which will likely dent their margins.

Restaurants and Pubs

In 2021, the full-service restaurants we rate proved resilient to the on-and-off imposition of social distancing measures with effective pivots to off-premise operations, slimming down their menus, and beefing up their digital platforms. After a slower than expected start in the first quarter due to the omicron variant, health and safety measures will likely be less onerous in 2022 and enable restaurants to turn their attention to the growing challenges posed by commodity and labor-cost inflation. Therefore, we expect issuers to take a targeted approach to wage increases because competition tends to stem from the regional presence, or absence, of alternative opportunities, such as warehouse fulfillment centers. If commodity cost inflation rises faster than restaurants can raise their menu prices, it could lead their credit quality to decline. Broad-based inflation will likely also pressure consumer budgets and potentially lead to softer demand at casual diners as consumers shift to food-at-home. On the other hand, quick-service restaurants (QSRs) tend to perform well in times of economic stress because of the relative value of their offerings.

Credit metrics and financial policy

Amid the supportive macroeconomic environment in 2021, retailers engaged in shareholder-friendly activity, which they funded with their good operating cash flow and the debt they raised to provide emergency liquidity during the pandemic that they no longer viewed as necessary. Expectations for a relatively stable operating environment in

2022 will likely give issuers the confidence to continue returning cash to their shareholders. Therefore, we expect investment-grade issuers to continue to return cash while remaining within the range of their current financial policies. We will be watching for evolving financial policies of issuers who face increasing pressure from activist investors. As such, we could downgrade issuers that are more aggressive than we expect for the rating or those that do not leave enough room for an underperformance amid a more volatile environment, especially those with relatively weak business risk profiles.

Key risks or opportunities around the baseline

1. Wage inflation is higher than expected

Payroll is the largest cost component for most retail and restaurant companies, ranging from 20%-40% of their total costs. In 2021, wage increases were manageable due--in part--to the price elasticity of consumers stemming from their pent-up demand and healthy savings. As these tailwinds fade, the margins of retail and restaurant companies could become pressured if wage inflation rises at a faster pace than we expect. Larger investment-grade issuers will likely be better positioned to absorb these higher costs, though weaker credits could be challenged to maintain their credit quality.

2. Evolving business models present opportunities to gain market share

The pandemic turbocharged the shift to e-commerce and introduced new ways of shopping and dining to many consumers. Consumer expectations are set by the performance of large, proficient operators like Amazon and Walmart. At the same time, data mining and social media platforms have facilitated creative ways to reach new markets.

3. Consumer spending growth slows more dramatically than we expect

In 2022, consumers will need to dip into their excess savings to cover the higher prices they'll encounter at the grocery store and elsewhere. While our base-case scenario assumes a gradual slowdown in spending, an unexpected macroeconomic shock could lead to a more dramatic pullback. This would likely lead specialty apparel companies and retailers of other discretionary categories to revert to broad discounting. Lower volumes amid an unfavorable pricing environment could also pressure the credit metrics of many issuers.

Liquidity and covenant concerns were relatively rare in 2021 due to the supportive macroeconomic and credit market conditions. The positive operating environment gave companies the confidence to return cash to their shareholders, including using much of the excess cash they held at the beginning of the pandemic. If volatile conditions return in 2022, issuers that have whittled away their liquidity cushions with excessive shareholder returns could struggle to maintain sufficient liquidity at a time when they need it most. Higher interest rates could also make it more difficult for them to amend their covenants or refinance.

Similarly, a significant rise in capital expenditure or acquisition spending could lead to higher leverage if their earnings start to moderate. The companies that are forced to invest in e-commerce, particularly those in the discretionary segments, face payback risk if their sales do not improve as anticipated because of intense competition or weaker demand.

Related Research

- ESG Credit Indicator Report Card: Retail and Restaurants, Dec. 17, 2021
- Global Credit Outlook 2022: Aftershocks, Future Shocks, And Transitions, Dec. 1, 2021
- Holiday 2021 Sales Outlook: Santa's Bag Is Filled This Holiday Season, Thanks To Deep Consumer Pockets, Nov. 23, 2021
- European Retailers And Consumer Product Companies Will Show Resilience Against Rising Costs, Nov. 22, 2021
- On Activists' Wish List: New Spin On Macy's And Kohl's This Holiday Season, Nov. 15, 2021
- Labor And Supply Chain Woes Chill Retail Spirits For Holidays And Beyond, Sept. 28, 2021
- European Retailers Seek To Reopen Their Doors To Usher In The Post-Pandemic Recovery, June 29, 2021
- The Rebound U.S. Retail Has Been Waiting For Arrived In March, April 15, 2021
- U.K. Pubs, Shaken And Stirred, Look To Recover After A Cocktail Of Headwinds, April 8, 2021
- U.S. Restaurants And Foodservice Distributors Face A Jagged Recovery While Food And Beverage Fare Better, March 1, 2021

Industry forecasts

Global Retail and Restaurants

Chart 8

Revenue growth (local currency)

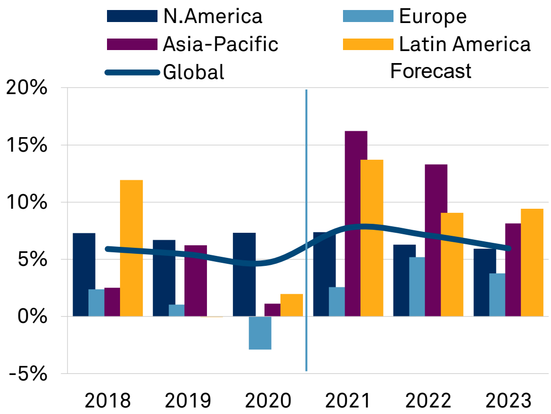


Chart 9

EBITDA margin (adjusted)

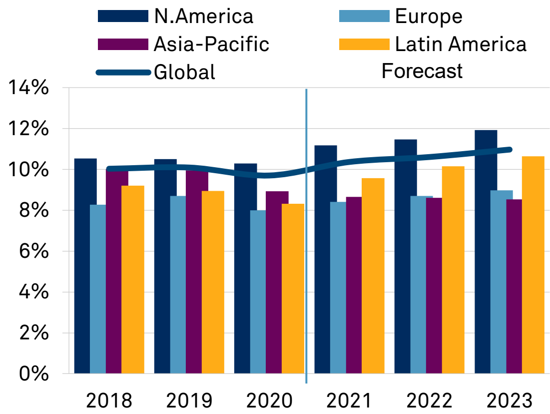


Chart 10

Debt / EBITDA (median, adjusted)

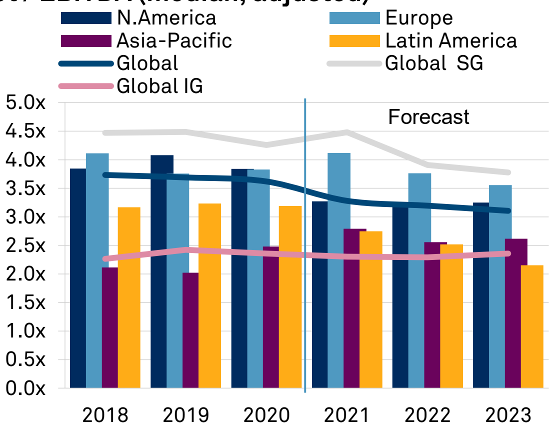
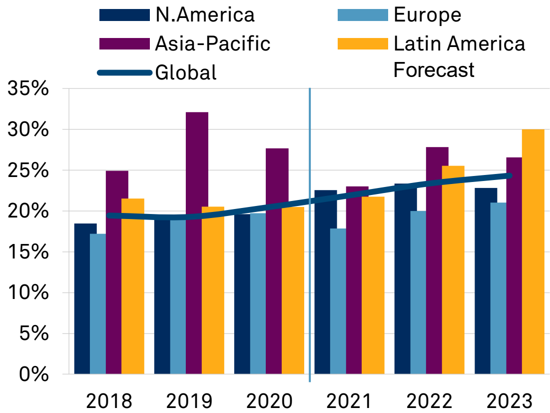


Chart 11

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.

Cash, debt, and returns

Global Retail and Restaurants

Chart 12

Cash flow and primary uses

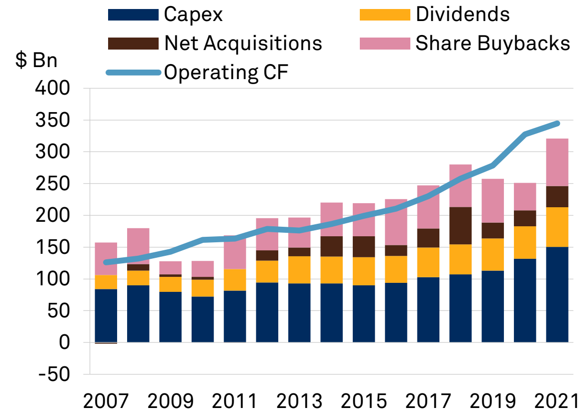


Chart 13

Return on capital employed

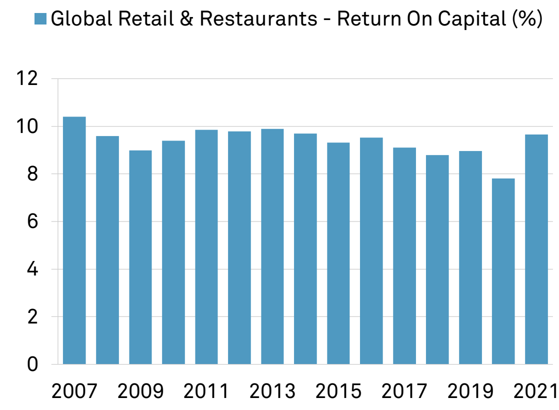


Chart 14

Fixed versus variable rate exposure

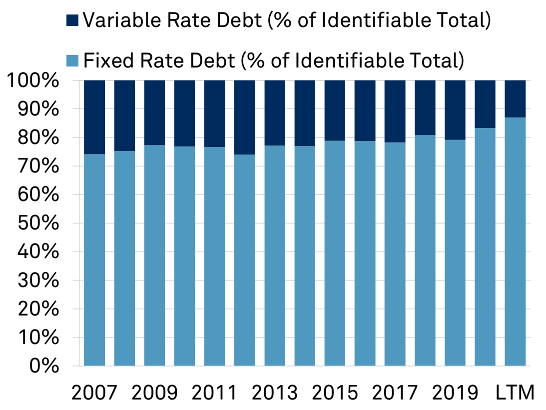


Chart 15

Long term debt term structure

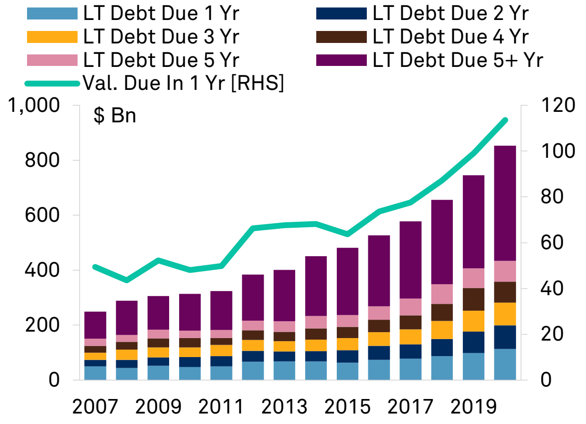


Chart 16

Cash and equivalents / Total assets

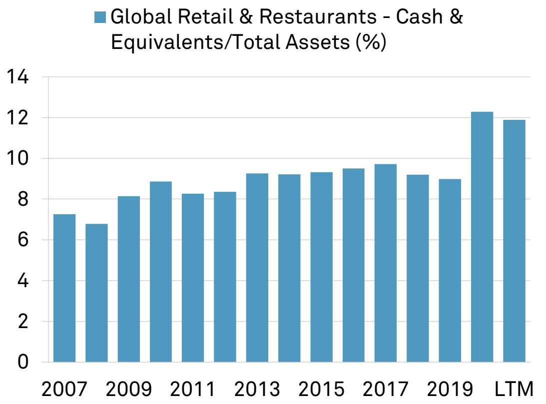


Chart 17

Total debt / Total assets

Source: S&P Global Market Intelligence, S&P Global Ratings calculations. Most recent (2021) figures are using last twelve months (LTM) data.

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