

# European Retailers' Margins Are Unlikely To Regain Their Pre-Pandemic Strength

November 7, 2023

## Key Takeaways

- European retailers' margins should improve moderately in 2024 and 2025, thanks to the deceleration of inflation on goods, input, and energy costs, offset by high labor costs.
- With inflation set to continue moderating and wage growth still accelerating, real disposable income will pick up, gradually easing income constraints for households and supporting consumption.
- The path to margin recovery since the COVID-19 pandemic has been uneven, and over half of rated European retailers will be unable to restore their pre-pandemic margins even by 2025.
- While rated European retail and restaurant companies' strong pricing and operating resilience have led to many positive rating actions this year, they have limited headroom in their credit metrics.
- Our stress tests show that a 100 basis-point haircut to our 2024 base-case EBITDA margins could affect the issuer credit ratings or outlooks on around 14 of the 50 retailers in our sample, without any offsetting operational or financial policy measures.

Households across Europe are battling a sharp rise in the cost of living due to higher prices of goods, services, food, and energy. Higher interest rates and the knock-on effect on mortgages and rents, especially in the U.K., have exacerbated the pressure on household budgets.

Consumer spending has seen broad support in value terms from strong wage growth and the remnants of excess savings in certain demographics. Retailers' sales have held up, and even increased in nominal value terms, mainly thanks to strong price pass-through. However, the underlying sales volumes are anemic or declining. This puts significant pressure on European retailers, which have faced a series of challenges in the past few years, including the COVID-19 pandemic, supply chain disruptions, high inflation, rising interest rates, and weak economic growth.

While S&P Global Ratings sees inflation rates moderating, slow economic growth, coupled with a tight labor market and higher interest rates, will prevent a meaningful improvement in European retailers' margins and cash flows over 2024 and 2025, curtailing their rating headroom.

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## **European Retailers' Margins Are Unlikely To Regain Their Pre-Pandemic Strength**

In this article, we focus on 50 rated retailers operating in the food, home, electrical, DIY, and apparel subsectors. Our stress tests on these retailers show that additional pressure on their EBITDA margins could erode their credit quality significantly over 2024 and 2025. A 100 basis-point haircut to our 2024 base-case EBITDA margins could affect the issuer credit ratings or outlooks on around 14 of the 50 companies in our sample, in the absence of offsetting operational or financial policy measures. However, they show greater resilience in 2025, as our forecasts show a stronger improvement in profitability that year.

## **Household Budgets Are Stretched, But Higher Wages Offer Some Respite**

The eurozone economy has barely expanded over the past few quarters. In the third quarter of 2023, seasonally adjusted GDP decreased by 0.1% in the euro area, after an increase of 0.2% in the second quarter, according to Eurostat.

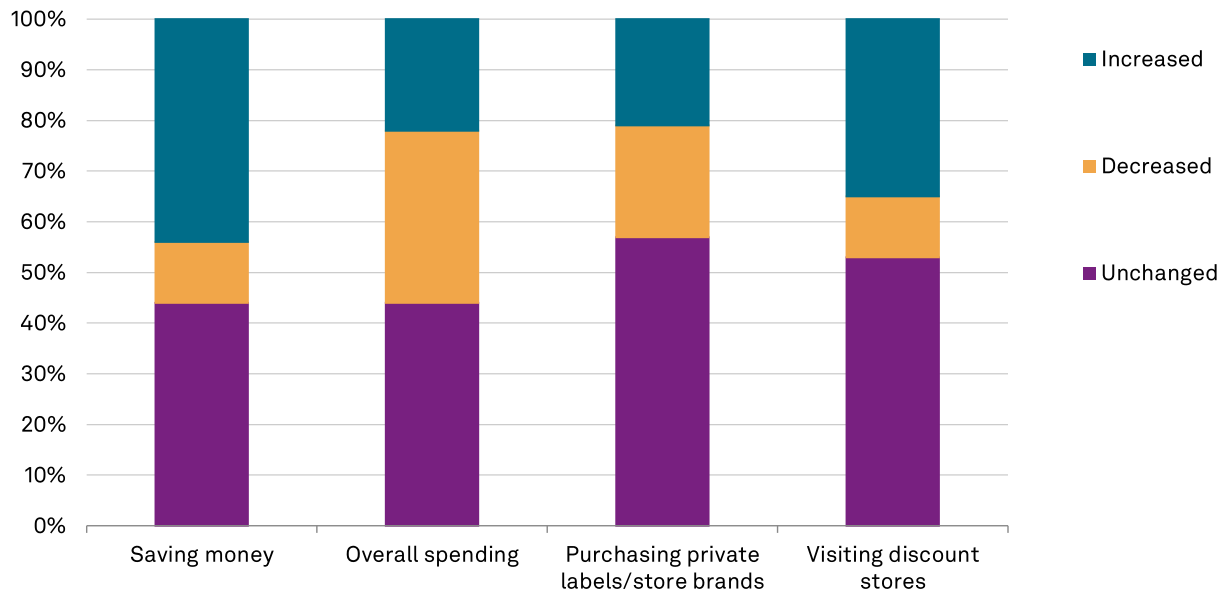
The consumer price index in the U.K. rose by 6.7% in the 12 months to September 2023, the same rate as in August as per the Office for National Statistics (ONS). Annual inflation in the euro area is expected to be 2.9% in October 2023, down from 4.3% in September, according to a flash estimate from Eurostat. While inflation has receded from the high levels we saw a few months ago, a clear and consistent downward trend on core inflation is not yet visible. We forecast slow disinflation, implying that low economic growth and high interest rates will persist for some time. We are also wary of energy price shocks and volatility as a result of geopolitical conflicts.

Consumers are weary of steeper prices, and, with higher mortgage payments and rents now eating into their disposable income, they are balancing their spending across essentials, discretionary goods, and experiences. In some countries, like Germany, rapidly rising interest rates also translate into a growing preference for saving rather than spending (see chart 1). Consumer spending has been lukewarm across all retail categories as a result.

Chart 1

**How consumers plan to change spending and saving habits**

% of respondents



Source: Euromonitor International Voice of the Consumer: Lifestyles Survey 2023.  
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**A Strong Labor Market Is A Double-Edged Sword For Retailers**

Wage rises have helped alleviate some of households' budgetary pain, especially lower-income households suffering from the rapidly escalating cost of living. While overall retail volumes are still lower than before the pandemic, the tight labor market and higher wages have helped cushion the decline. Eurostat data points to a rise in hourly labor costs by 5.0% in the EU in the second quarter of 2023, compared with the same quarter of the previous year. Annual growth in employees' average total pay (including bonuses) was 8.1% in the U.K., according to ONS data. Rising wages, combined with slowing inflation, will lift real disposable income next year, easing income constraints for households and supporting consumption. An increase in real disposable income should mitigate the dampening effects of interest rates on demand by 2024, and even offset it completely by 2025. Easing household income constraints and higher consumer spending should also drive GDP growth next year and prevent the eurozone economy from falling into recession.

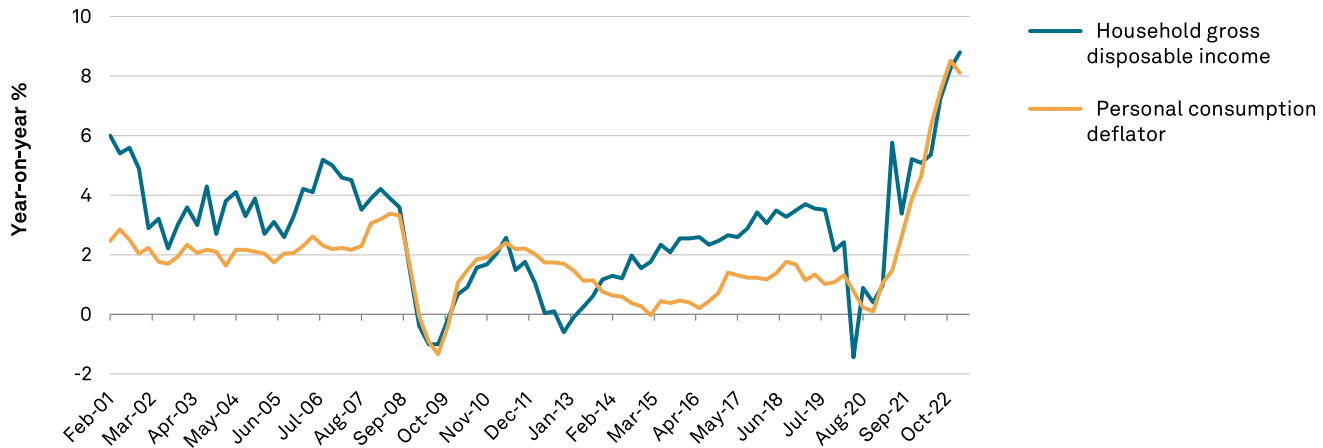
At the same time, our baseline scenario forecasts a gradual slowdown in the European labor market in 2024. Both the rise in unemployment and deceleration of wage growth will be gradual as labor market tightness will persist. However, with inflation set to continue moderating, this gradual slowdown in the labor market should not prevent real disposable income from picking up next year (see chart 2).

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Chart 2

### Household income growth has just caught up with consumer prices

Income and prices for the eurozone



Source: S&P Global Ratings.

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Being highly labor-intensive, retailers and restaurant chains face further margin pressure from higher wages, which, together with rents, often represent one of the largest overhead cost categories. Weaker sales volumes mean that higher wages feed directly into the operating cost base, thereby putting additional pressure on already tight retail margins.

Grocers and restaurants have been the hardest hit by significant increases in labor costs, with some companies increasing hourly wages multiple times over the past few quarters. While retailers have succeeded in passing on higher input costs to consumers, competitive dynamics and a focus on customer service make it challenging to mitigate or pass on spiraling labor costs. Some smaller owner-operated retailers and restaurants and pubs (especially those operating under leases and tenancies) have curtailed their opening hours or resorted to using part-time staff or family members to manage their wage bills. While retailers have increased their use of automation and workforce efficiency initiatives since the pandemic, labor costs will remain a major cost driver.

## Retailers Still Need To Balance Pricing And Volumes As The Topline Will Remain Sluggish

We have seen inflation pass-through to customers buoy retailers' revenue and offset a like-for-like contraction in volumes. That said, we anticipate that European retailers will see consumer spending increase in 2024, on the back of slowing inflation and support for household disposable income from high wages, leading to moderate topline growth and improved operating performance.

These tailwinds to profitability will improve retailers' average EBITDA margins in 2024 and 2025 compared to 2023. We expect the margin improvement to happen gradually, and predominantly over the second half of 2024, when inflation in Europe should have receded sufficiently for real

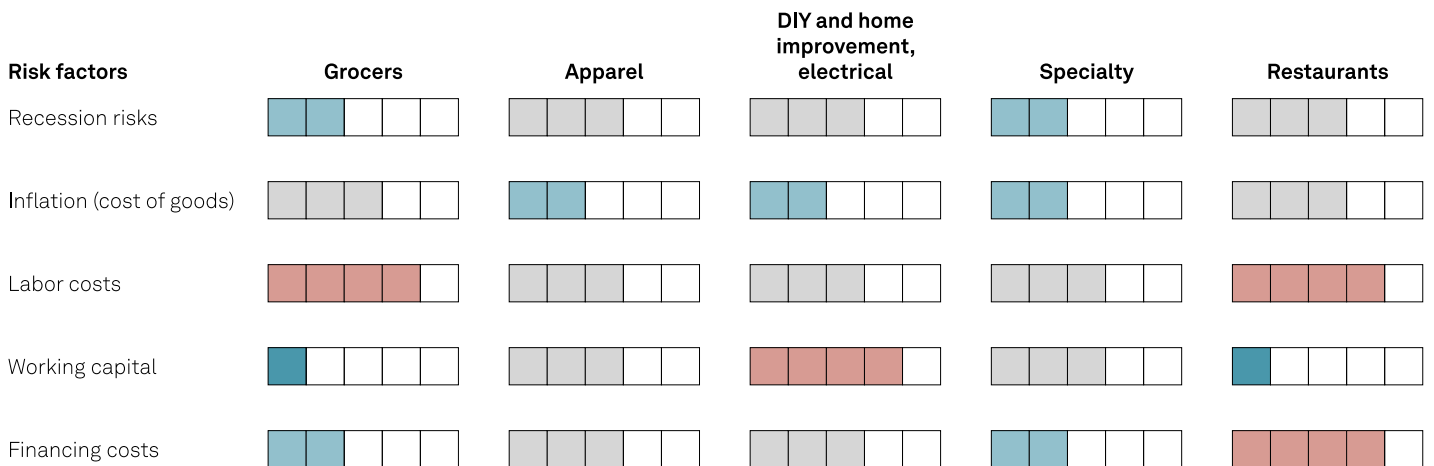
## European Retailers' Margins Are Unlikely To Regain Their Pre-Pandemic Strength

disposable income to rise again. In our view, while the positive effects of higher disposable income will benefit retailers, the extent of these effects will remain moderate due to the sector's highly competitive nature.

Our base case shows that about half of the rated portfolio will see topline growth of less than 5% over 2023 and 2024. We see less room for further price increases as customers resort to cheaper options, leading to broadly stagnant basket values for the next two years. We anticipate that retailers will need to keep negotiating with their suppliers and re-examining their product mix and price points to stay competitive. The impact of the various risk factors on retailers varies considerably by subsector (see chart 3).

Chart 3

### The key risk factors that we incorporate into our base-case forecasts by subsector



Note: The five-point scale presents our materiality assessment of forward-looking risk factors, with the risk level increasing from left to right. Copyright © 2023 by Standard & Poor's Financial Services LLC. All rights reserved.

## Pre-Pandemic Profitability Remains Elusive For Most

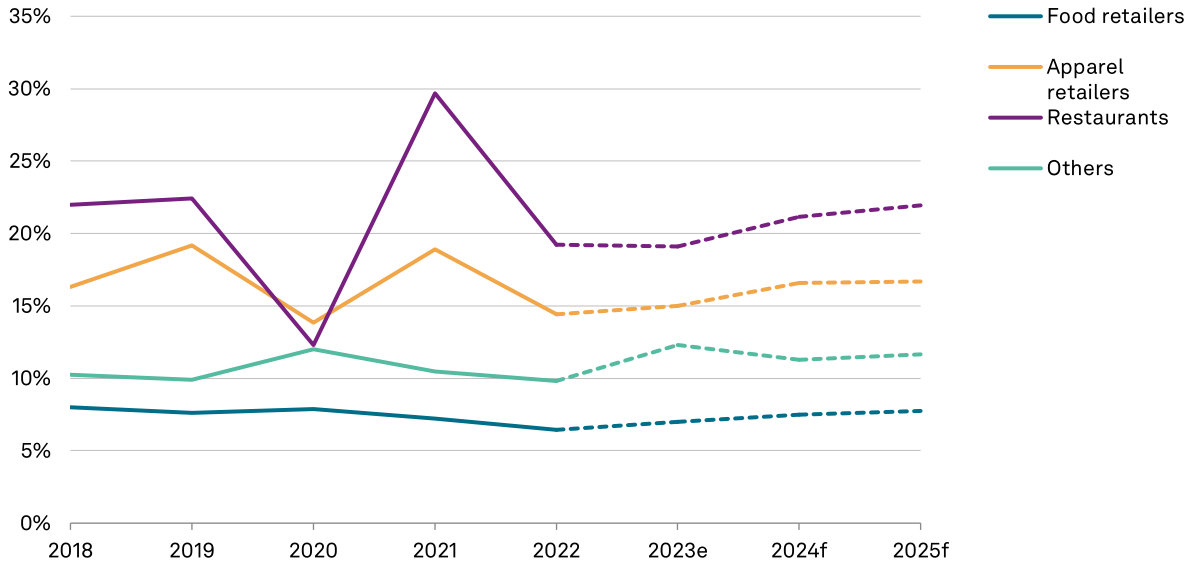
Our sample of 50 rated retailers across a variety of subsectors has seen an uneven EBITDA margin recovery since the pandemic (see chart 4). What's more, we don't expect over half of these retailers to restore their pre-pandemic margins by 2025 (see chart 5). 40% of these retailers had restored their pre-pandemic margins by 2022 on the back of pent-up demand, but high and persistent inflation in 2023 caused a slight reversal. We forecast a moderate improvement from 2024 onwards, primarily due to the gradual disinflation and rising real disposable incomes.

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Chart 4

### Median adjusted EBITDA margins

Recovery trends are uneven and vary by subsector



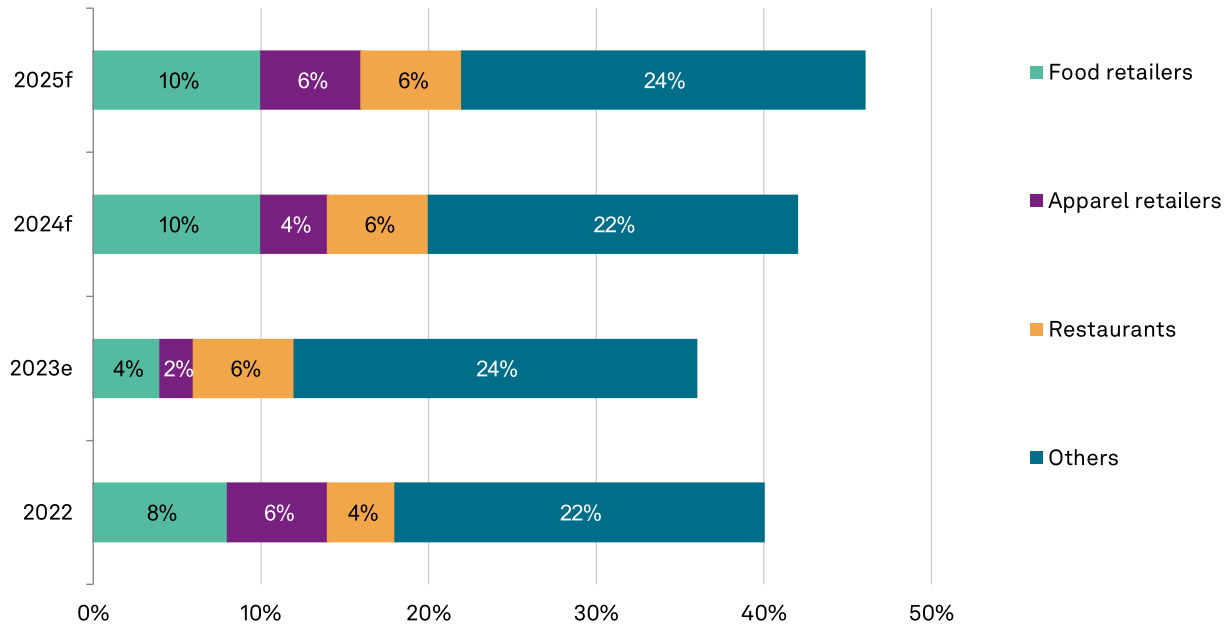
Source: S&P Global Ratings. e--Estimate. f--Forecast.

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Chart 5

### EBITDA margin recovery to pre-pandemic levels or higher



Source: S&P Global Ratings. e--Estimate. f--Forecast. The others category mainly comprises nonfood retailers from a range of subsectors, such as value, travel, specialty, DIY and home improvement, and electrical retailers.

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### Food retailers should see a slight rise in margins

This sector remains extremely price competitive. The incumbent mainstream retailers have significant competition from discounters in all the major European markets. While we expect smaller average basket sizes, the nondiscretionary nature of grocery purchases will lead customers to make more frequent grocery runs. We also expect more consumers to switch to private labels, especially for packaged food and household goods. The high penetration of private labels in Europe--now making up 38% of total fast-moving consumer goods sales, as per Circana--means that European retailers are in a good position to target trade-down shoppers, build customer loyalty, and defend their topline and gross margins.

Not only do grocers generally have the lowest margins compared to other retailers, they are also the most vulnerable to cost inflation on account of their heavier usage of energy, labor, and rapid logistics due to the perishable nature of the goods. In inflationary conditions, larger retailers, especially national grocers with strong revenue bases, have been investing in prices, increasing lower-priced offerings and opting to take a medium-term hit to their margins to expand their absolute EBITDA and cash flow.

We expect that most of the food retailers--mainstream, full-range, value, and specialty--will aim to pass on most of their cost of goods to customers without significantly hurting their topline over

## European Retailers' Margins Are Unlikely To Regain Their Pre-Pandemic Strength

2024 and 2025. This should be the case especially as the inflation rate on the cost of goods has come down considerably. However, in our view, grocers are most exposed to rises in labor costs, and we expect the pass-through of these higher labor costs to become difficult.

Nevertheless, our base-case forecasts shows that food retailers will see small improvements of up to 60 basis points (bps) in their median 2023 EBITDA margins compared to the lows of 2022. Despite the improvement, our 2024 forecasts still put the margins 10 bps below their pre-pandemic levels in 2019. This takes into account moderating inflation rates on the cost of goods, freight, and energy, offset by higher labor costs.

Grocers that have implemented more impactful operating-efficiency measures and those adopting more technology and automation will stand out from their peers. These grocers will be able to better mitigate the impact of rising labor costs and be more price competitive. In addition, just under half of our rated food retailers are investment-grade grocers with strong market positions, scale bargaining power with suppliers, and good diversification by store format and geography.

While their margins are below pre-pandemic levels, most rated grocers and food retailers have been able to comfortably accommodate higher debt-servicing costs and continue to make capital investments. Many of the large investment-grade companies and national leaders like Tesco PLC, Carrefour S.A., and Ahold Delhaize N.V. have significantly improved their ability to generate free operating cash flow (FOCF), and have seen a significant improvement in their credit metrics as a result, despite paying out higher dividends and returning surplus cash to shareholders through share buybacks.

## Apparel retailers won't see margins recover in the next two years

The majority of apparel retailers are unlikely to restore their pre-pandemic EBITDA margins by 2025. This is due to our expectation of slower sales momentum due to weak consumer confidence and discretionary spending power, coupled with structurally higher costs that are unlikely to drop as inflation eases.

The apparel retail sector saw the greatest impact from store closures and social-distancing measures during the pandemic. While there were signs of a rebound in 2021, especially for omnichannel apparel retailers, this momentum dropped off in 2022 as EBITDA margins weakened sharply (a median fall of 450 bps) due to high inflation pushing up input, freight, and logistics costs.

Many apparel retailers ended 2022 with excess inventory, due to a combination of preemptive ordering triggered by supply chain disruption, weather conditions, and weaker consumer demand. This, together with higher financing costs and capital expenditure on stores and e-commerce, dented FOCF. After lease payments, most apparel retailers will not restore their free cash flows to pre-pandemic levels. Many smaller brands and a number of department stores in the U.K. and France have closed operations or exited certain markets, benefiting the larger national retailers.

As part of a growing industry trend, many large apparel retailers have rolled out online marketplaces and started selling third-party brands, aided by platform solutions. On one hand, this enables retailers to cater to a wider set of customers and sell more merchandise using their omnichannel capabilities, but on the other, it fuels industry competition.

Due to high competition and lukewarm consumer demand, price increases should be the main source of support for apparel industry sales, even as volumes remain down. This will make the fourth-quarter festive trading period even more critical. If full-price sales volumes remain significantly below our expectations, there is a risk of a working capital buildup, leading to higher



## European Retailers' Margins Are Unlikely To Regain Their Pre-Pandemic Strength

discounting in 2024.

### Other retailers' margins will rebound strongly

The other category mainly comprises nonfood retailers from a range of subsectors, such as value, travel, specialty, DIY and home improvement, and electrical retailers. Overall, this diverse group could see a markedly stronger margin rebound than grocers or apparel retailers, for example.

We expect like-for-like volume declines to be a common prospect for retailers operating in the electrical, home goods, furniture, or DIY segments. Most retailers in these largely discretionary or big-ticket product segments still have elevated inventories that they have accumulated since the second half of 2022 due to weaker volumes. Cash flows and credit metrics will, to a large extent, depend on these retailers' ability to gradually sell down inventories without significant discounting.

At the same time, some specialty retailers, such as Pandora A/S, Goldstory SAS, and Shiba Bidco SpA, are benefiting from continued consumer demand despite strong prices, and have been able to restore and even exceed their pre-pandemic margins. These retailers have been able to raise their profitability as they have smaller operating scale and room for accelerated growth thanks to strong brand appeal, but also inherently lower fixed costs for their specialty goods.

Value retailers such as B&M European Value Retail S.A., Pepco Group N.V., and Action Holding B.V. continue to see strong consumer demand as consumers become more price conscious. They are responding by expanding their store footprints. We expect these retailers to continue increasing their revenue while benefiting from stronger EBITDA margins in the mid-teens.

### Restaurants and pubs' margins will remain under strain

Following the reopening after the pandemic restrictions, restaurants enjoyed a few months of strong recovery thanks to pent-up demand and high levels of savings. However, before the sector was able to regain its financial footing, in 2022, widespread inflation of wages, energy, and food and drink prices created a new set of challenges. Companies in the sector modified their product mix and passed on some of the elevated costs through price increases, but these costs continued to pressurize the EBITDA margins. This subsector also experiences high earnings volatility depending on the extent of franchising, as opposed to managed operations, in the business model, and other variables like weather, sporting events, tourist seasons, and consumer sentiment.

Nevertheless, from an operational standpoint, fast-paced growth in the hospitality sector wages places an enormous strain on restaurants' operating budgets. Staff costs represent one of the largest items of spending and will continue to add to the margin pressure that many operators face.

Some restaurants' business models, such as that of Burger King France SAS (BKF), rely on franchisees, which allows for a greater degree of resilience against rising labor and other operating costs. This business model is margin accretive, especially during times of high inflation, when franchisees bear the increases in the cost structure and franchisors benefit from higher selling prices as royalties are indexed to revenues. This was evident from the very sharp rise in BKF's EBITDA margins to more than 35.8% in 2023 from 31.4% in 2019.

Airport catering and restaurants operator Pax Midco (Areas) has made significant cost savings by rationalizing staff and undertaking some digitalization initiatives, such as automated cashiers. In addition, travel retailers are able to significantly increase prices without harming volumes due to the restricted choices for customers in airports or on motorways.

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On top of inflationary headwinds hampering earnings and cash generation, higher interest rates have accentuated refinancing pressures, as all the rated restaurant chains in Europe are highly leveraged. Weak cash flow generation also constrains their financial flexibility for expansion or capital expenditure.

## Retailers' Strong Operating Resilience Has Led To Positive Rating Actions

Of the 19 rating actions we have taken so far this year, 15 have been positive (five upgrades, five outlook revisions to positive, and five outlook revisions to stable from negative). This reflects retailers' stronger operating performance on the back of successful price pass-through to the end consumer, with only a moderate impact on trading volumes, as well as improved cost control and tight management of operating expenses.

Given the uncertainty around consumer confidence and behavior, management teams have adopted a prudent stance toward their financial policies and have managed liquidity proactively. All rated retail and restaurant companies except one have adequate liquidity. Barring a handful of companies rated 'B-' and below, we see limited near-term refinancing pressure for most of the rated portfolio, and a sound ability to bear the additional interest burden.

10% of the ratings have negative outlooks, and another 10% of the ratings have positive outlooks. As is natural with prolonged cost headwinds and higher interest rates, most companies have tight headroom under our downgrade thresholds, especially for the EBITDA margin, FOCF after leases, and EBITDAR coverage.

## However, Financial Headroom Is Limited

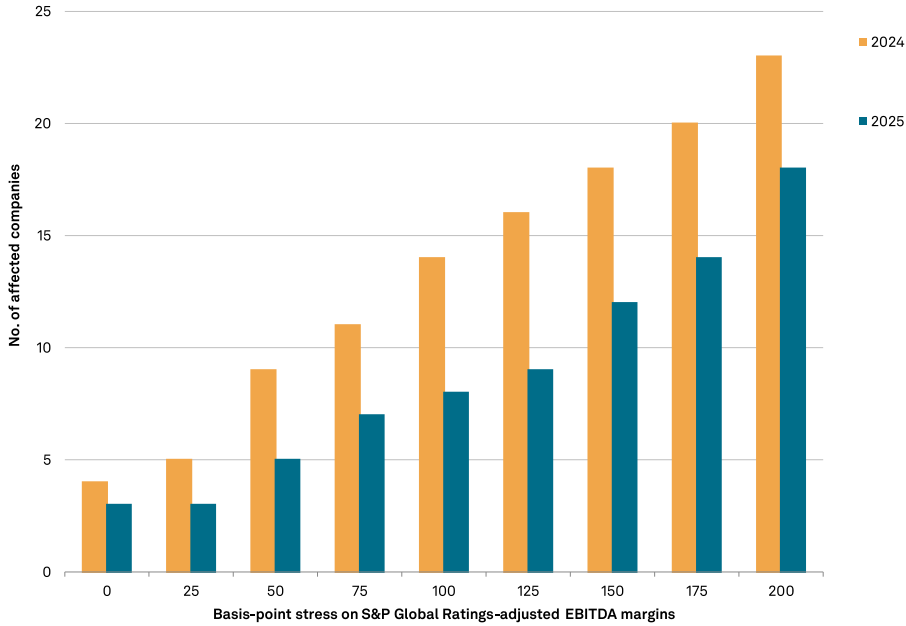
We stressed the S&P Global Ratings-adjusted EBITDA margins for the 50 rated retailers in our sample by increments of 25 bps up to 200 bps from our base-case forecasts for 2024 and 2025. We then benchmarked the stressed credit metrics against our downgrade triggers.

The financial headroom for many of the rated retailers and restaurant owners, especially those with financial sponsor owners, is quite limited. Our stress tests show that, without management actions to offset the impact, additional pressure on the EBITDA margin could erode credit quality greatly. For instance, a 100 basis-point haircut to our 2024 base-case EBITDA margins could affect the issuer credit ratings or outlooks on approximately 14 of the 50 issuers in our sample (see chart 6). That said, these retailers exhibit greater resilience in 2025 than in 2024, with the number affected by our stress test dropping to eight in 2025, as our forecasts show improving profitability that year.

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Chart 6

### Stress on base-case margins against existing downgrade triggers



We conducted our stress test on a sample of 50 rated European retailers.  
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Editor: Emily Williamson

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