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SECTOR COMMENT
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Retail – Europe

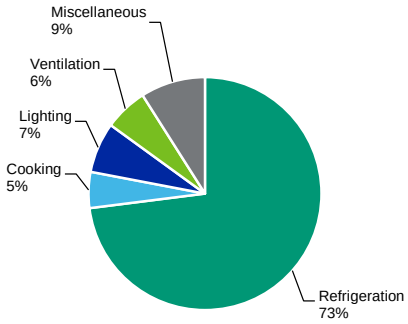
Rising energy costs will hit frozen food specialists hardest

Excerpted from Top of Mind, October 2022

Rising energy costs are particularly challenging for European food retailers because they have much higher energy needs and generally have lower EBITDA margins than nonfood retailers. The price of some fresh foods is also closely linked to energy prices.

We estimate that fuel costs linked to logistics and transport make up about 30% of food retailers' energy cost on average and utility bills the other 70%. Refrigeration is by far the biggest component of food retailers' utility bills (Exhibit 1).

Exhibit 1
Refrigeration is by far the largest portion of grocery retailers' electricity consumption
% energy consumption by end use



Store heating and cooling (included in miscellaneous) can vary significantly based on the climate where the store is located
Source: E Source

Food retailers' exposure to refrigeration costs differ depending on what proportion of their products are fresh or frozen. Frozen food specialists Picard Bondco SA (B3 stable) in France and the UK's Iceland VLNCo Limited (B3 negative) are the most exposed to rising energy prices. These companies spent around 1.5% of their total revenue on energy costs in 2021, which was before the energy price spike this year. We recently downgraded Iceland VLNCo to B3 negative from B2 stable because we think its credit ratios will materially weaken, in part because of these rising input and energy costs.

By contrast, general merchandise retailers and retailers that specialize in unrefrigerated, or ambient food, like France's Euro Ethnic Foods Bidco S.A.S. (B2 stable) have the lowest

energy consumption. We estimate energy costs accounted for at or below 0.5% of total 2021 revenue. As a result these companies' credit quality is unlikely to weaken, even if energy tariffs rise sharply.

Fuel and energy prices have already increased food costs because the price of inputs like fertilizer and transportation has increased. We expect fresh food prices to rise further this winter because the cost of heating energy-intensive greenhouses will continue to increase. Energy costs represent 20%-30% of Dutch greenhouse growers' costs, according to ABN Amro. This will weigh on grocers' margins and credit quality because steep increases in prices are difficult to pass on to end customers, especially as consumer purchasing power is also deteriorating.

Exposure to energy price increases also varies depending on retailers' ability to absorb the cost. Everything else being equal, companies with narrower EBITDA margins like UK grocers Wm Morrison Supermarkets Limited (B1 stable) and Bellis Finco PLC (Asda, B1 stable) will find this more difficult (Exhibit 2).

Exhibit 2

Grocers with the lowest profitability are most exposed to energy price increases

2021 Moody's adjusted EBITDA margin

↓ denotes faster than average deterioration in EBITDA margin as energy prices rise

Source: Moody's Investors Service

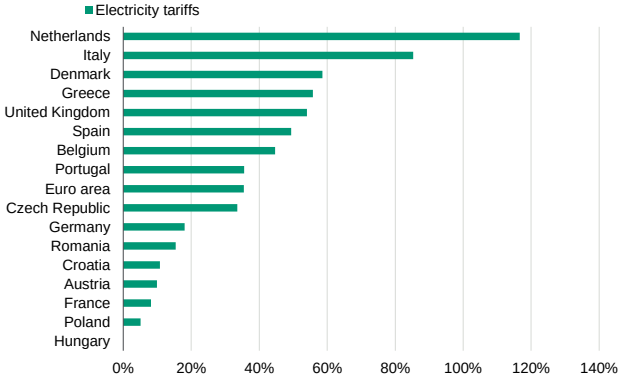
EBITDA margins will also be at risk of narrowing in the next 12 to 18 months. Retailers' gross margins continue to contract as they struggle to fully pass on price increases from suppliers and other fixed costs like wages also continue to rise.

Energy cost exposure will also depend on differences in electricity tariffs across Europe and differing government interventions (Exhibits 3 and 4).

Exhibit 3

Exposure to electricity cost increases varies across Europe

Electricity tariff increase July 2022 year-on-year %

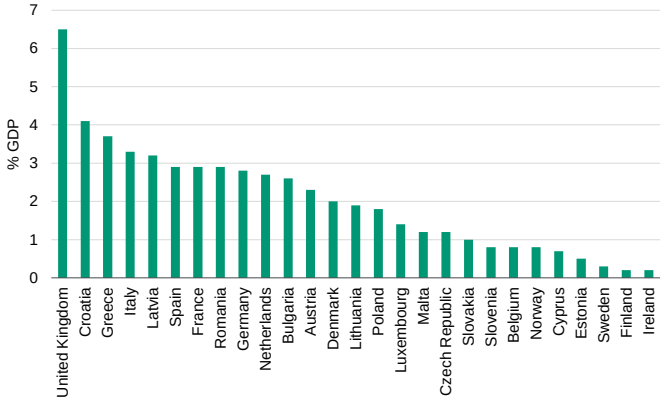


Sources: Haver Analytics and Moody's Investors Service

Exhibit 4

Government intervention will help offset rising energy prices, but extent varies

Governments have allocated funding to support households and businesses between Sep 2021 and Sep 2022



Last updated by Bruegel on 21 Sep 2022

Source: Bruegel

For example, UK food retailers face higher energy tariffs than those in France. Future government interventions, like price caps on tariffs, could help offset the impact of rising energy prices. Retailers in countries where governments have intervened to keep electricity tariffs down will be better insulated from further increases.

Energy hedging contracts will also help determine if companies can weather higher prices. However companies typically hedge for a year, so even companies that have hedged their energy costs will feel price increases, although with a lag. Most European grocers tend to focus on local markets. However, those that have operations outside Europe where the cost of energy is not increasing as quickly will be better insulated against European energy price increases. These include French retailers Carrefour SA (Baa1 stable) and Casino Guichard-Perrachon SA (B3 negative). These companies both have large operations in Latin America where the government typically regulates electricity tariffs. Latin American operations contributed 19% of Carrefour's total revenue in 2021 and 50% for Casino. The Netherlands' Koninklijke Ahold Delhaize N.V. (Baa1 stable) has a strong presence in the US where energy costs are not increasing as rapidly, because the US is not dependent on Russian gas. Ahold's US operations accounted for 62% of total 2021 revenue.

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