Spotlight: Sri Lankan Modern Grocery Retail

Strong Growth Prospects Helped by Stable Balance Sheets

Strong Growth Momentum: Fitch Ratings expects the modern grocery retail sector in Sri Lanka to expand in the mid-teens in the medium term, supported by aggressive expansion and growth in same-store sales. Increasing per capita income and rising urbanisation should make modern grocery retail more affordable and accessible to a larger portion of the population. Sri Lanka's supermarket penetration is still around 15% compared to 30% for regional peers with similar social and economic characteristics, which indicates the potential for the industry to grow.

Positive Customer Perception: We believe more people are now willing to shop at supermarkets and hypermarkets compared with five years ago, helped by the competitive prices offered by modern retailers, which are equal to or even below the prices of traditional retailers. Modern retailers are able to source products at low prices due to their larger scale while most of the fast-moving consumer goods (FMCG) they sell are subject to maximum retail prices which reduce the price difference with traditional retailers. We believe customers will gradually prioritise convenience and quality over price amid rising income levels, which also bodes well for modern grocery retail.

Stable Credit Profiles: Fitch expects the credit profiles of the three largest operators of modern grocery retail chains in Sri Lanka − Cargills Food City, Keells Super and Arpico (the retail arm of Richard Pieris & Company PLC (A(lka)/Stable) − to remain stable in the medium term despite high capex. We expect strong top line growth and stable profit margins to help generate sufficient operating cash to meet the companies' expansion needs. Consequently we expect gross leverage (defined as lease adjusted gross debt/EBITDAR) of the companies to remain in the 2.0x-3.0x range in the medium term until cash inflows from new stores allow meaningful deleveraging.

In addition, all three companies, which run supermarkets and hypermarkets, are supported by strong parents that have diversified sector exposures and strong access to funding.

Large Formats and Regional Expansions: We believe the companies that focus on hypermarket formats with extensive product portfolios are likely to make the most gains in urban areas, where customers prioritise convenience, variety and quality. We do not expect the established players to aggressively expand outside of the Western province in the near term, but provinces such as North Central, North Western and Uva provide strong growth potential as they are supported by high per capita income growth and low supermarket penetration.

We expect growth in the Western province to stagnate in the medium term, especially for companies that focus on FMCG products, as demand for such products tends to be inelastic.

High Entry Barriers: We do not expect competition in the modern retail sector to be much changed by new entrants in the medium term. The incumbents have secured a mix of owned and leased properties in prime locations in main cities that would be difficult for a new player to replicate at a time when property prices and rents are rising. A potential entrant will also have to build strong relationships with suppliers to secure lower costs, which could take years. The significant investment required to set up sophisticated warehousing and transportation facilities could also deter new entrants in the absence of third parties that provide such services.

Online Sales Still Small: We believe modern grocery retailers will benefit from online sales only in the long-term because delivery costs are likely to remain high compared to the average basket-size in the next three to four years. Positively, the established operators have the necessary infrastructure, such as extensive warehousing and transportation facilities, to cater to this market. At the same time, rising internet penetration, increased use of credit cards, and a preference for convenience amid rising income levels have created a conducive environment for online retail.

Regulatory Risks Remain High: We believe regulatory changes in the form of taxes and price controls are the key risk for the industry. The industry was affected by previous ad-hoc changes to value added tax (VAT) that significantly reduced sector margins. The large modern retailers were affected the most as the VAT is imposed on high revenue generators. We believe the tax environment has improved for modern retailers with the removal of deemed VAT – a sales tax that retailers were not allowed to pass on to consumers. However even a slight change in taxes could have a material impact on profitability, which is already thin.

From time to time the government has imposed price ceilings on essential items which have forced supermarkets to sell existing stocks at lower margins or losses. Price controls have also led to supply shortages and low quality products hitting the market, but the impact of such actions have been short term and negligible on the credit profiles of the large grocery retail operators.

Credit Profiles to Remain Stable

Fitch expects the credit profiles of the three main supermarket chains to remain stable in the next couple of years, helped by strong demand and stable margins, which will offset their aggressive store opening plans. Cargills Food City (Cargills), Keells Super (Keells) and Arpico together account for more than 80% of the modern grocery retail sector in Sri Lanka. The aggregate adjusted gross leverage (lease adjusted gross debt/EBITDAR) of the three entities improved to 2.4x by the end of the financial year to end-March 2017 (FY17) from 4.4x at FYE13, supported by double-digit revenue growth and margin expansion.

Aggregate Financial Ratios for Cargills, Keells and Arpico*

	FY13	FY14	FY15	FY16	FY17
Revenue (LKRm)	74,209	76,676	86,286	99,951	120,913
Revenue growth (%)	13.5	3.3	12.5	15.8	21.0
EBITDAR (LKRm)	4,178	5,100	4,743	6,921	8,801
EBITDAR margin (%)	5.6	6.7	5.5	6.9	7.3
Lease adjusted gross debt/EBITDAR (x)	4.4	3.8	2.8	2.0	2.4
Lease adjusted net debt/EBITDAR (x)	4.1	3.6	2.6	1.8	2.1
EBITDAR fixed charge cover (x)	2.3	2.7	3.1	4.8	4.2
Rent/revenue (%)	0.7	0.8	0.8	1.0	1.0
Capex/revenue (%)	5.1	4.4	2.7	3.1	3.3

*Please see appendix for individual ratios
Source: Company, Fitch

Fitch expects top-line growth to average in the mid-teens in the medium term, driven by new store openings. We expect modest contributions from existing stores, supported by an increase in both customer footfall and number of items sold in a single purchase, which will be driven by rising disposable incomes, rapid urbanisation and a shift in customer preference towards convenience and quality. We believe companies that have strategies to expand outside the overcrowded Western Province, particularly in the North Western, North Central and Uva provinces, where per capita income is relatively higher and growth is fast, should see higher growth in operating cash flows.

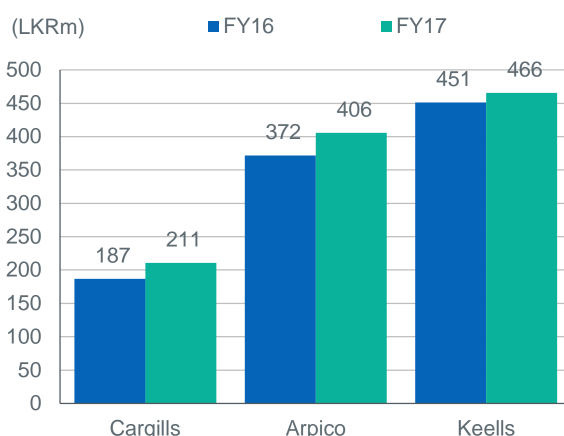
Fitch expects limited upside to current EBITDAR margins, which are already at levels typical for the industry. Also, the majority of the products sold are either essential items subject to government price controls or are subject to manufacturers' maximum retail price, which leaves little flexibility for margin expansion. However the scale advantage shared by the three large players should continue to help them to source products at low prices. We believe Cargills is ahead of other two players in this regard because it has strong backward integration with farmers and suppliers. Any steps taken to reduce other indirect costs such as energy, warehousing and transportation should also have a favourable impact on margins as such costs made up 4%-5% of revenue. However, the continued rise in rents could keep fixed costs high as the majority of the stores are on operating leases. We estimate the cumulative rent cost to revenue ratio of the three established players to have increased around 30bp from FY13 to FY17 due to higher rent and a shift towards more rented stores.

A material increase in the portfolio of premium product ranges or consumer discretionary products, which tend to do well as disposable incomes rise, should help improve margins. Arpico already follows such a strategy and enjoys margins around 150bp-200bp above those of its peers. Keells which is increasingly moving towards the hypermarket format that offers extensive products should see margins improve.

Peer Comparison			
	Cargills	**Keells**	**Arpico**
No. of stores at end-March 17	315	64	61
Coverage of store network	All 25 districts	8 districts with high concentration in the Colombo district	13 districts with high concentration in the Colombo district
Type of stores	Small and medium-sized supermarkets with a few operating 24 hours	Mainly small and medium-size supermarkets with a few in the hypermarket format	17 hypermarkets with the rest made up of small supermarkets and stores
Type of grocery sold	Over 10,000 products focusing mainly on FMCG and homeware	Primarily FMCG and homeware	Over 45,000 products including FMCG, homeware, furniture and electronics
Online retail	No	Yes	Yes
Other services provided	Bank kiosks, ATMs, bill payments, pharmacy and bakery but not in all stores		
Backward integration	Yes, manufacturing of dairy, frozen food and confectionaries under own brand/different brands	Yes, manufacturing of frozen food and confectionaries and beverages under own brand/different brands	Less backward integration than the other two, with mainly its own branded rubber products and furniture sold in the supermarkets
Value proposition	Wide store network, value for money to customers facilitated through its strong supply network	Extensive parking facilities at its hypermarkets. Wide product offering including imported products	Extensive parking facilities and one-stop shop for all household requirements. Extensive product offering including imported products

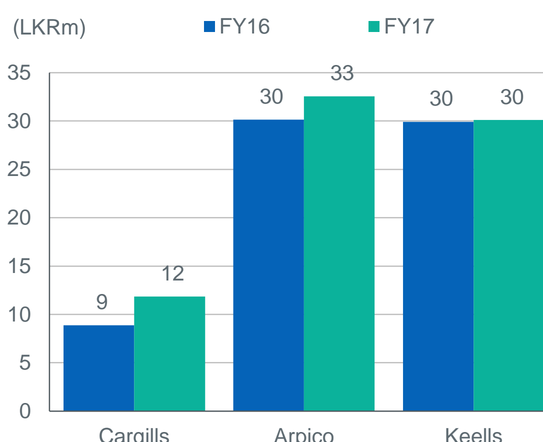
Source: Company, Fitch

Revenue per Store



Source: Company, Fitch

EBITDA per Store



Source: Company, Fitch

We expect capex relative to revenue for the sector to climb to the mid-single digits in the next couple of years from around 3% seen in the past two years. The majority of the investments will be from Keells and Arpico to support their expansion into suburban areas and larger store formats. Cargills, which expanded aggressively in FY13 and FY14 should continue to reap the benefits of its island-wide coverage. Cargills' future investments will be mostly limited to store upgrades, which would be at a lower cost. We expect the expansion plans to be funded primarily through internally generated funds as the companies' use borrowings for working capital needs.

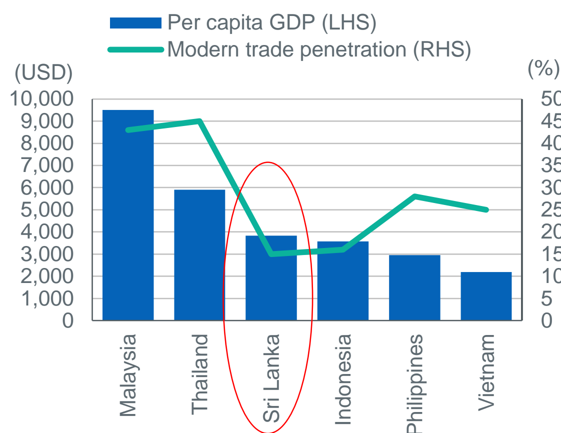
We expect gross leverage of the three companies' to remain around 2.0x-3.0x in the next couple of years, but leverage should reduce substantially once the capex cycle moderates and new stores become cash accretive. The companies estimate a new store typically takes around two years to become cash positive. In addition to the standalone strength of their individual credit profiles, all three players are supported by strong parents, which are diversified and have strong access to funding.

Rising Incomes and Urbanisation to Drive Strong Demand Growth

We expect the modern grocery retail sector to continue its double-digit growth over the medium term, helped by the currently low penetration of supermarkets in the country, improvement in per capita income, rising urbanisation and changes in customer buying patterns. We believe the overall grocery retail sector will track GDP growth, which Fitch estimates will be 4.6% and 4.7% in 2017 and 2018 respectively, but modern grocery retail is likely to expand at a much faster pace by attracting more customers from traditional grocery retail channels.

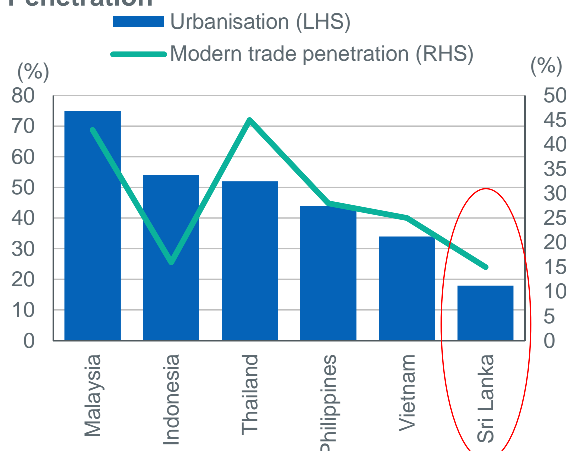
Data from consumer research company Nielsen show that 12%-15% of FMCG sales in Sri Lanka in 2016 were generated by modern grocery retail, which is much lower compared with regional peers with similar characteristics. We believe the modern trade penetration is low due to a lack of access and not affordability as Sri Lanka's per capita income is much higher than that of regional peers, such as Vietnam and the Philippines. Sri Lanka is less urbanised, however, with around 75% of supermarkets concentrated in cities while only 15% of the population lives in urban areas. This is also apparent from the supermarket density, which was low at 39 stores per million population compared with closer to 100 stores for regional peers. As such we believe there is a large untapped market for modern trade in rural areas. Increasing urbanisation will also drive growth of modern retail; a 1pp increase in the urbanisation rate could increase access to modern retail for more than 200,000 people.

Regional per Capita GDP vs. Modern Trade Penetration



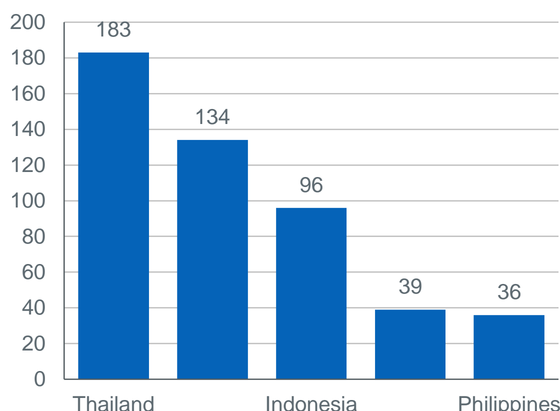
Source: World Bank, Euromonitor, Fitch

Regional Urbanisation vs. Modern Trade Penetration



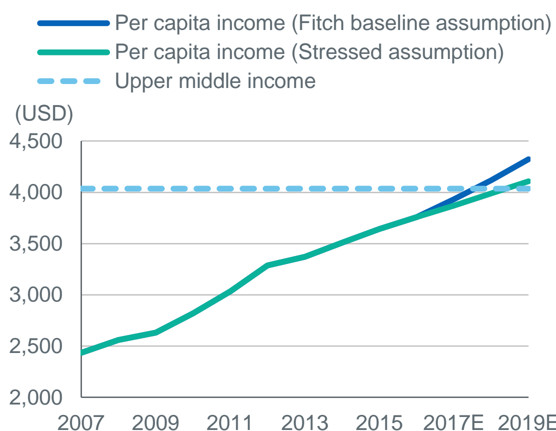
Source: World Bank, Euromonitor, Fitch

Modern Retail Outlet Penetration per Million Population



Source: Euromonitor Fitch

Sri Lanka per Capita Income Trend



* Fitch baseline assumption of 4.8% growth; and stressed assumption of 3% growth.
Source: CBSL, Fitch

Customer buying patterns and product preferences tend to change as income levels rise, which should bode well for modern trade in Sri Lanka. The country is on the cusp of reaching the upper middle-income group. According to Nielsen, convenience is one of the key considerations in the purchasing decisions of customers of that group. Consequently supermarkets and hypermarkets that provide a one-stop solution for most daily needs should attract more customers than traditional grocery stores, which stock only a limited number of products. Extensive parking

facilities, air-conditioning and additional facilities, such as bank branches and pharmacies, within the supermarket premises also enhance convenience to the customer. The variety of brands and branded products that are typically stocked by supermarkets are also more appealing to these consumers, who are increasingly brand conscious.

We also believe consumers' association of higher prices with modern trade has been largely dispelled in recent years by the ability of modern trade to sell products at the same or even at lower prices compared with traditional grocery stores. The scale advantage enjoyed by established players has helped them to source products at low prices, which the companies have passed on to the end customer. The maximum retail price imposed by most FMCG manufactures has also aided modern retailers. We also believe modern grocery retailers are better placed to offer regular discounts to customers, because their scale allows them to negotiate such deals with suppliers.

Regulatory Changes Remain a Key Risk

The recent changes in the regulatory environment, including adjustments to applicable tax laws, have adversely impacted the modern grocery retail sector’s profitability. We do not expect regulatory uncertainty to ease off in the near term because of the government’s weak finances. Any impact from regulatory changes are likely to be short term as the retailers will eventually adjust prices to recover additional costs, but the margin volatility could be significant as the sector's margins are thin.

The sector was greatly impacted when VAT was first introduced in 2013 for the wholesale and retail trade. In the absence of any mechanism to claim input tax on existing inventory, supermarkets had to absorb a one-time charge to account for higher tax on inventory while a maximum retail price on most products prevented supermarkets from immediately passing on the higher tax to customers. The retailers also had to pay a deemed VAT on supplies, which were exempt from VAT, resulting in them bearing the entire tax on such products. In addition retail VAT was applicable for only the larger operators, resulting in consumers shifting back to traditional grocery stores, which offered products at lower prices. As a result, the EBITDA margins of the top three retailers shrank almost 200bp from FY12-FY15 before recovering from FY16 with the removal of the deemed VAT.

The regulatory uncertainty continued during the latter part of 2016 when the government increased the VAT to 15% from 12%, but went back and forth on the effective date. As a result the retailers had to adjust their prices multiple times, which resulted in in margin volatility

Sector Protected by High Entry Barriers

We believe there are unlikely to be new entrants to the sector because the existing operators are well-established, high capex is required to start even a medium-scale supermarket chain, and potential new entrants would need to cultivate strong supply-chain relationships.

The three large players already have a strong presence in the Western province and other major cities in the country. They have secured prime locations with ample parking facilities, which would be tough for a new entrant to replicate. The National House Price Index of property website LankaPropertyWeb showed that real-estate prices in Colombo increased by more than 30% in 2016 while we estimate rental yields to have averaged 6%-7%, which can result in high overheads for new players that would weaken their competitiveness. Based on our calculations, the cost of opening a medium-sized modern grocery store in a main city is LKR70 million-LKR80 million (USD456,000-USD521,000).

We also see strong competition among established players for market share. The top-three companies have been regularly upgrading their store formats to suit the modern customer needs, including wider aisles, extensive parking facilities and introducing value-added services such as delivery, loyalty schemes, bakery and food court facilities.

Cargills has a significantly stronger presence in the rural areas compared to other two players due to its small store format that focuses on FMCG products and its ability to compete effectively with government-run low-priced grocery chain Sathosa and other traditional grocery retailers. Cargills has been able to source products at very low costs, which attracts rural customers from traditional grocery stores, because of its strong linkages with farmers and suppliers. A new entrant seeking market share in the rural areas would have to compete on price while providing modern retail facilities.

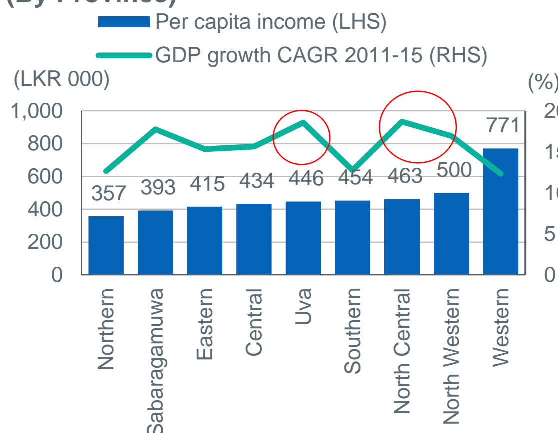
Modern grocery retail also requires sophisticated warehousing facilities and an efficient transportation network to supply fresh products to the end customer. The incumbents use a mix of owned and third-party service providers to meet their logistical needs, which could be quite costly. For example, Keells is setting up a new warehouse at a cost of LKR3.2 billion. We believe such large investments could deter new entrants to the sector.

Greater Growth Potential Outside of the Western Province

Modern grocery retailers have focused on the prosperous Western Province in the past, but demand in the province is likely to stagnate in the medium term, especially for essential FMCG products that have inelastic demand. We estimate that around half of the retail outlets operated by the three established players are in the Western Province. However, we believe demand for modern trade is likely to be higher in areas outside the province that have higher economic growth and low penetration of modern trade.

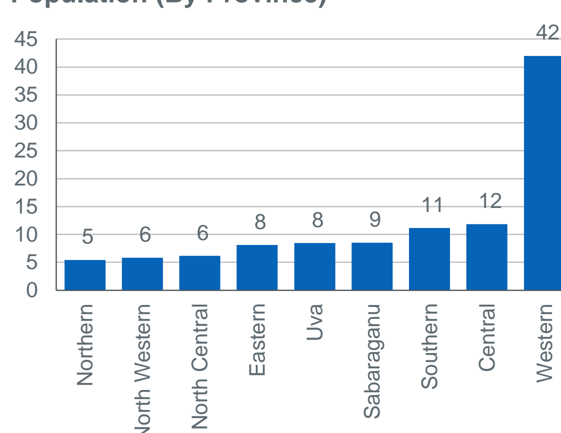
Nominal GDP growth in the Western Province averaged 12% a year in 2011-2015, below the national average of 14%. The growth was higher in other provinces, especially North Western, North Central and Uva provinces, which also had higher per capita income than most other provinces outside the Western Province. The number of supermarkets operated by the three established players was significantly lower in these areas than in the Western Province, indicating the potential for market growth.

Per Capita Income and GDP Growth (By Province)



Source: CBSL, Fitch

Supermarket Penetration per Million Population (By Province)



Source: CBSL, Company, Fitch

Growth Potential from Online Sales, but Will Take Time to Materialise

We believe modern grocery retailers will benefit in the long term from the slow but gradual take up of online retail in the country. Online grocery retail is still at the nascent stage with Keells, Arpico and a couple of other standalone online retailers providing such a service. Both Keells and Arpico has set up their own online platforms with product offerings identical to what is available at their supermarkets while Cargills has teamed up with a third-party online retail platform offering a limited product range.

Rising internet penetration, which stood at 26% at end-June 2017 after a 30% yoy increase in subscribers; the availability of 3G and 4G connectivity across the country; and growth in credit card use (50% increase in credit cards in the country in the last five years) provide strong support for online sales. Increasing traffic on the roads and lack of parking facilities will also drive consumers to opt for online shopping.

However, the perishable nature of most products sold by grocery retailers is likely to limit the take-up of online sales in the near term, as seen in developed countries where grocery sales account for only 2%-3% of total online sales. In addition, costs associated with online retail, such as packing and delivery costs, could make online retail less attractive for consumers, especially as most shoppers buy less than LKR1,000 each time. Consequently the current minimum delivery charges of online retailers account for around 30%-35% of the value of the average purchase.

Once online retail starts growing, we do not expect it to cannibalise sales from the brick-and-mortar stores, which have low penetration rates. Fitch believes there is sufficient room for both formats to grow by winning market share primarily from traditional grocery retailers. We also do not expect a rise in standalone online retailers in the medium term as they will be less price-competitive compared with the online channels of already established modern retailers. This is because a standalone online retailer will have to set up its own secure supply network and warehousing and transportation facilities from scratch, which could be quite costly.

Appendix

Individual financial ratios for Cargills, Keells and Arpico					
Number of stores	**FY13**	**FY14**	**FY15**	**FY16**	**FY17**
Cargills	188	218	256	297	315
Keells	44	44	45	50	64
Arpico	47	49	59	59	61
Revenue (LKRm)					
Cargills	44,220	45,288	49,351	55,450	66,345
Keells	13,800	15,049	18,248	22,574	29,814
Arpico	16,189	16,339	18,687	21,927	24,754
Revenue growth (%)					
Cargills	12.8	2.4	9.0	12.4	19.6
Keells	15.8	9.1	21.3	23.7	32.1
Arpico	13.6	0.9	14.4	17.3	12.9
EBITDA (LKRm)					
Cargills	2,477	2,866	1,810	2,637	3,728
Keells	53	472	816	1,495	1,926
Arpico	1,125	1,176	1,390	1,778	1,986
EBITDA margin (%)					
Cargills	5.6	6.3	3.7	4.8	5.6
Keells	0.4	3.1	4.5	6.6	6.5
Arpico	6.9	7.2	7.4	8.1	8.0
EBITDA per store (LKRm)					
Cargills	13	13	7	9	12
Keells	1	11	18	30	30
Arpico	24	24	24	30	33
Gross debt/EBITDA (x)					
Cargills	5.1	4.7	4.0	2.7	2.9
Keells	18.5	2.2	0.5	0.3	0.4
Arpico	1.2	1.1	0.8	0.3	1.1
Net debt/EBITDA (x)					
Cargills	4.8	4.6	3.6	2.2	2.7
Keells	15.0	1.9	0.4	0.2	0.3
Arpico	0.9	0.9	0.7	0.2	0.4
EBITDA/interest charge (x)					
Cargills	2.3	2.6	2.6	6.6	4.6
Keells	1.0	7.4	22.1	2,123.9	1,020.8
Arpico	7.7	9.9	17.3	78.5	17.5

Rent/revenue (%)					
Cargills	1.0	1.1	1.3	1.3	1.2
Keells	0.1	0.1	0.1	0.8	0.8
Arpico	0.5	0.5	0.4	0.4	0.4
Capex as a % of revenue					
Cargills	6.4	5.4	2.7	3.1	2.5
Keells	3.2	3.3	2.6	3.7	5.9
Arpico	3.2	2.9	2.7	2.3	2.5

Source: Companies, Fitch

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