European retail: defaults still on the rise after jump in 2023

Suppliers of discretionary consumer products remain at high risk

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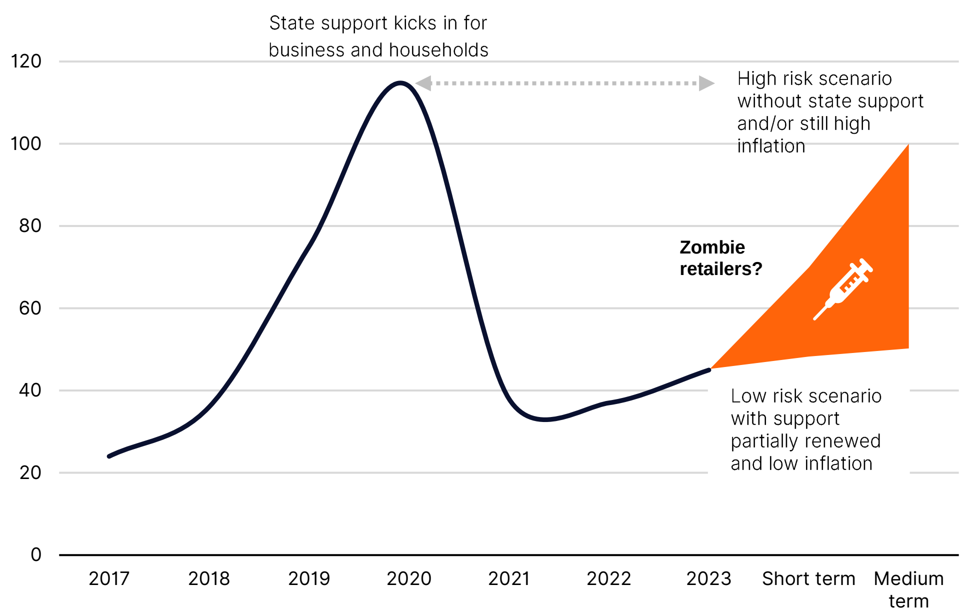
Credit risk remains high in Europe's retailing sector this year, particularly in the discretionary goods segment, with no sign that the rising trend of business failures from last year will reverse in 2024 after defaults rose in the first quarter.

The prospect of more business failures in the sector continues to partly reflect the impact of direct and indirect government support, now largely withdrawn, for companies during the pandemic and last year's energy crisis which, as in other sectors, propped up many enterprises that might otherwise have failed. The impact is visible in the sharp decline in bankruptcies in the sector in 2021 compared with the previous year and then the subsequent increase. (**Figure 1**).

Figure 1: Zombie effect: retail bankruptcies to rise as government support fades, but less inflation to partially offset risk

Number of retail bankruptcies in Europe 2017-2023, short-, medium-term scenarios



Source: Scope Ratings

Default risk varies widely across Europe's fragmented retail sector

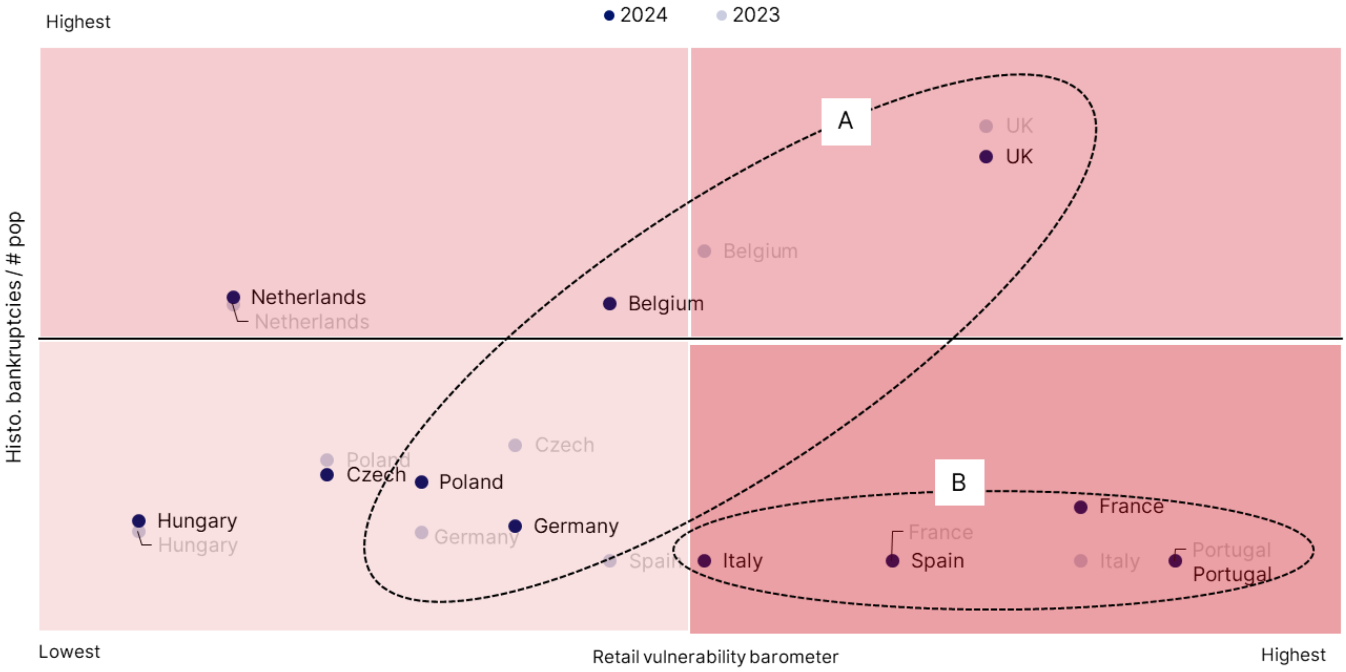
However, e-commerce's continued disruption of traditional retailing and the rising cost-of-living, with inflation only slowly retreating from last year's highs, is straining many retailers' financial performance in the context diminished state support – hence the continuation of the adverse conditions which weighed down on the sector in 2023.

The risks facing retailers today are spread unevenly across Europe, a phenomenon captured by our analysis of bankruptcy rates over the past six years and Scope's retail vulnerability barometer (RVB) (**Figure 2**).

Scope's retail vulnerability barometer maps default risk

We compile the RVB from several sources: data for per capita GDP to approximate purchasing power; the proportion of retailers paying on time and with a delay of at least 90 days to approximate their liquidity; and the World Bank's logistics performance index as a measure of vulnerability to competition from e-commerce.

Figure 2: Default risk: historical bankruptcies cross-referenced with Scope's retail vulnerability barometer



Countries with highly concentrated markets dominated by (inter)national incumbents, crowding out weaker national retailers.
Countries with smaller national markets more inclined to consumer behavior changes notably due to higher e-commerce penetration
Highly competitive market, high level of past bankruptcies, elevate risk of more to come
Fragmented markets likely to see consolidation led by national incumbents resulting in an increasing number of bankruptcies among SME retailers.
A Countries showing "normal" maturing of and concentration within retailing sector
B Fragmented markets with most bankruptcies happening among non-rated SMEs

Sources: public information, Scope. Note : Light shade denotes position of country in 2023.

Several factors will determine how fast the European retail insolvency rate rises in the coming years. We see a relatively higher risk if most governments continue to reduce or remove their support in 2024, only partly offset by falling inflation and improving consumer confidence. (See table on **page 6** for details).

Other factors such as changes to suppliers' payment terms, penetration rates for e-commerce and overall purchasing power will play important roles, as captured in the RVB.

The degree of country divergence is visible in **Figure 2**. Countries with high scores in the RVB find themselves in the right-hand quadrants. In the bottom-right quadrant, we find those countries where we expect to see consolidation in fragmented retail sectors as larger incumbents take advantage of failing small and medium-sized enterprises amid relatively difficult trading conditions.

Competitive UK market remains vulnerable to business failure

The intense competitiveness of the UK market ensures that retailers in the sector there remain vulnerable in line with high levels of defaults in the recent past.

In contrast, the left-hand quadrants represent areas where bankruptcy risk is lower, such as in Germany (size of the market) and Hungary (regulation protecting the national players up to a certain extent) where conditions favour local incumbents. The same applies to smaller economies such as Belgium and Czech Republic where retailing has become more highly concentrated, reflecting the perhaps "natural" progression toward greater corporate resilience in the sector.

About our retailing vulnerability barometer:

We have set up a database made up of 383 cases of bankruptcies of retailers in 19 European countries from 2017 to 2024 Q1.

We used the following criteria for inclusion:

- The company needs to be of a significant size or have a local strong brand recognition.
- A bankruptcy-like event must be documented in the media and tracked in the judicial systems of the country.
- The company's business needs to meet our definition of retailers, which can be found in our rating methodology.

The Scope's Retail Vulnerability Barometer (RVB) serves as a proxy to measure the vulnerability of retailers present in each country. The RVB is the product of the following factors: i) GDP/Capita (approximation of purchasing power); ii) share of retailers paying on time and with a delay of at least 90 days (approximation of retailers' liquidity); iii) the logistics performance index (approximation of entry barriers).

Limits of the approach:

In this research, we studied retailers fitting our inclusion criteria. However, the reporting of bankruptcies varies significantly from country to country in Europe, so our study is by no means comprehensive. However, we believe it provides insight into the main trends in the industry and its subsectors, for Europe as a whole and some of the region's biggest economies.

Retailing has idiosyncratic credit risks

Low profit margins are typical for many retailers

Retailing is a singular sector, one that adds no value to manufactured goods, hence a reliance on high-volume sales rather than profitability to generate cashflow. Retailers are therefore particularly vulnerable to macro-economic cycles and changes in purchasing behaviour by customers.

In addition, relatively low barriers to entry and reliance on brand recognition and customer loyalty for sustained sales growth make the sector extremely price competitive. The internet allows instant price comparisons and ever-faster delivery options, denying many retailers the opportunities for increasing selling prices.

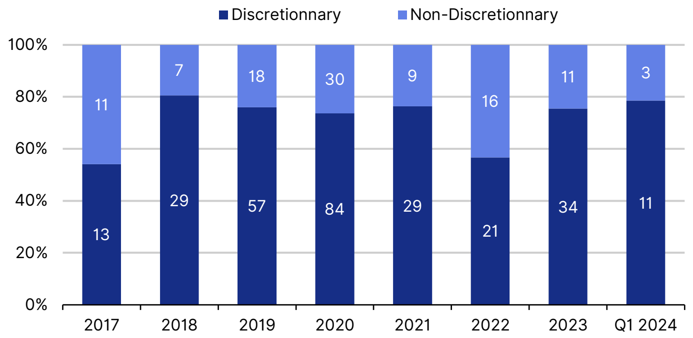
SMEs in the sector typically run into problems of scale as they grow, lacking the volumes of bigger rivals to negotiate low prices from consumer goods suppliers, limiting EBITDA margins and cashflow generation.

Internet remains big challenge… and opportunity

On the cost front, retailers must invest continually to enhance the consumer shopping experience as well as improve IT and logistics to compete in e-commerce and manage inventory. High capex, working capital requirements, and reliance on external funding can result in weak credit metrics, due to the sector's low inherent EBITDA margins which constrain free-operating cashflow.

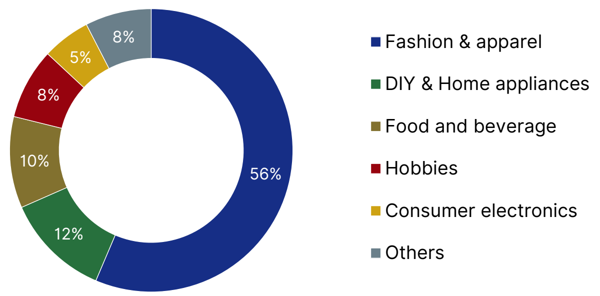
High profit margins are rare and increasingly precious commodities for retailers, vital for providing room for manoeuvre for management to finance investment for growth.

Figure 3: Bankruptcies (number of companies) by category of retailer in Europe 2017-24/Q1



Source: Scope

Figure 4: Proportion of bankruptcies by retailing sub-sector 2017-24/Q1



Source: Scope

Credit risks vary across industry's different subsectors

Fashion and apparel: the most vulnerable subsector

The fashion segment represents 57% of the total bankruptcies in our dataset, reflecting in part sector-specific risk[1]. Stores tend to be on or close to high streets, in close competition for visibility and footfall, and often require integrated or nearby warehouses to ensure continuous supply of goods. Real estate leasing costs are therefore relatively onerous compared with other retail subsectors.

Firms in DIY and home appliance segments also financially fragile

Other discretionary retailers – DIY stores and home appliance vendors -- are facing similar if less severe risks and exhibit slightly lower bankruptcies numbers than their fashion counterparts (13% of total). Firms in the category often have seasonal sales – think of gardening centres and DIY specialists reliant on summer trade – making for lumpy cashflow. They are also vulnerable to competition from multiproduct online retailers for which seasonality is not a problem such as Germany's Otto GmbH, Amazon.com and France's Cdiscount SA.

Food retailers remain high on the list of vulnerable firms

Vulnerability to financial distress tends to be limited for companies selling discretionary goods.

However, food retailing ranks relatively high on our list of bankruptcies. Some companies in our sample were long-term established business, like Iceland, UK frozen product retailer which filed for bankruptcy in several European countries in 2023, and Pepco, which filed for bankruptcy in Austria in February 2024. We believe the high inflation and lower consumer confidence have driven the exit, forcing more and more traditional food retailers to focus on few core markets to keep an efficient cost structure as well as preserve their market share.

Other troubled companies, like Flink which filed for bankruptcy and exited Austria, were relatively new to the market. They were mostly home delivery and online grocery services which boomed during the pandemic, but lost their appeal afterwards, and have struggled to cope with high operating and delivery costs.

Moreover, scaling up these new food retailing businesses is proving difficult as inflation has gathered pace, borrowing costs have risen, while larger incumbents have fought back with competitive product offerings of their own. In the background, there is also the continuing competition from hard-discount chains which tend to gain market share when the cost of living rises. As an example, Lidl and Aldi gained significant market share in UK[2] and have gained in popularity in the US following the increase in food prices.

[1] Due to the non-standardized aspect of most of fashion and apparel goods (composition, innovation, technology, colour, season, size, etc..), retailers are having a risk of not being able to sell their inventories in time or in full amount, leading to potential "stranded inventories".

[2] From Statista: "Prior to the popularity of the discounters, the grocery retail market was dominated by the 'big four' supermarkets: Tesco, Sainsbury's, Asda, and Morrisons. On the back of the post-Brexit uncertainty and growing inflation, consumer behavior has shifted in favor of cheaper alternatives such as Aldi and Lidl. In September 2022, Aldi took

Mapping Europe's retailing bankruptcies: UK remains an outlier

UK has one of the highest retail-vulnerability scores

Numbers of bankruptcies have varied considerably across different European countries between 2018 and 2023, even if a few broad trends are discernable (**Figure 5**).

Retailing firms went out of business in growing numbers in many countries between 2017 and 2019. Then the pandemic struck, putting extra pressure on the sector. However, numbers declined sharply in 2021 with only a small increase in 2022 if at all, as firms benefited from widespread government support for householders and business. As we expected, bankruptcies increased again in 2023, amid inflation and easing government support. The trend continued in Q1 2024.

UK remains outlier with high bankruptcy rates

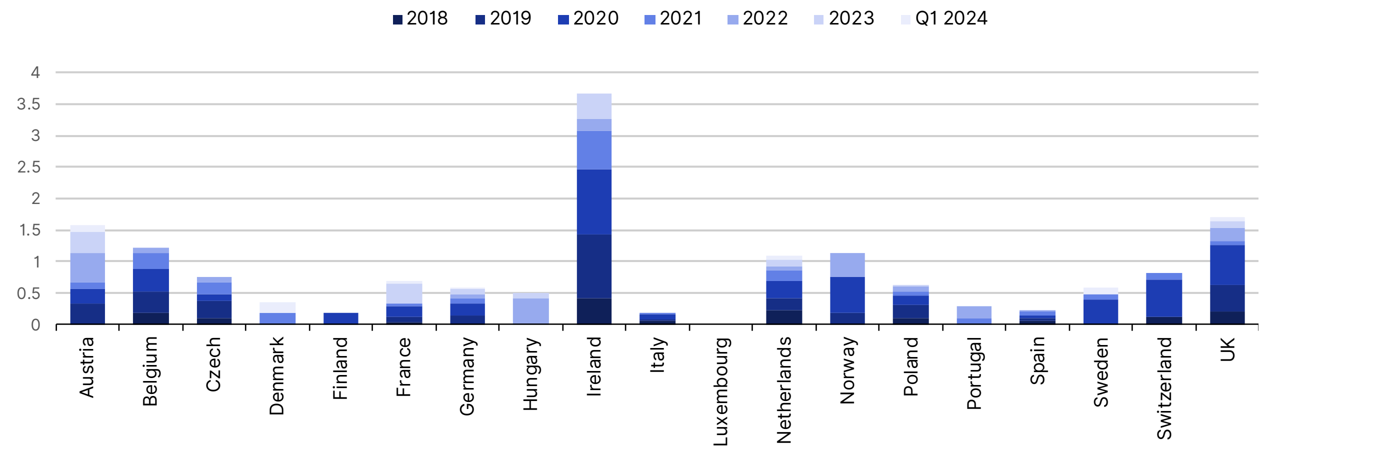
Regarding specific countries, the UK remains an outlier, with significantly higher number of insolvencies per capita than all other European peers. The country differs importantly through the much higher penetration of e-commerce, making consumers more price sensitive and providing tough competition for physical stores. This leads to significantly higher price competition among retailers as customers will favour lower prices over brand loyalty.

Brexit has further complicated the retail landscape, partly by exacerbating specific costs pressure (tariffs, cost of border controls, sterling's weakness against the dollar and euro). We expect the number of bankruptcies to remain high, but lower than in 2023, as inflation eases and consumer confidence stabilises.

Bankruptcies strongly increased in France

Based on our sample, there has been a significant increase in the number of retailers in default in France in 2023, particularly in the fashion subsector. Increased competition from e-commerce, combined with inflation and the easing of government support, has forced many long-established retailers that stick to their traditional business model to exit the market. We expect the risk in France to remain high and the market to move increasingly towards consolidation.

Figure 5: Number of bankruptcies per capita by selected countries in the period 2018-23



Source: Scope

over fourth place in the grocery store ranking from Morrisons for the first time. In April 2023, Aldi's market share reached double digits for the first time. In October 2023, this figure stood at 9.9 percent. April 2024 marked the month when Lidl reached eight percent of the market".

Problem of "zombie retailers" varies by country

European governments have increasingly withdrawn the extraordinary support for businesses and households, originally introduced during the pandemic and then the energy crisis, helping explain the rise in defaults amid persistent inflation and reduced consumer confidence even though some measures remain in some countries this year (see Table 1).

Table 1: Governments continue to phase out support for business, households in 2024

Country	Comments
Austria	Electricity price caps, initially due to expire on 30 June 2024, have been extended until December 2024.
Belgium	Government energy support measures expired at the end of 2023, but wage indexation might support purchasing power.
Czech Republic	For 2024, the government removed a price ceiling on electricity and gas. The additional support for companies exposed to higher energy prices in the context of Russia's war in Ukraine ended in 2023.
Denmark	Government supported households in 2023 with measures such as additional child benefit payments, partial energy-bill freeze and reductions in electricity taxes. No extra support is expected in 2024.
Finland	The government offered only modest support to households and business during the energy crisis.
France	Continued government support is likely be more targeted, temporary, and less generous than during pandemic, energy crisis. A price cap for electricity will be gradually removed.
Germany	The authorities removed caps on electricity and gas prices at end-2023.
Hungary	Hungary is characterised by a significant degree of state intervention to support the economy.
Ireland	The 2024 budget included several measures offering energy-cost related financial support to households and business, including a EUR 450 payment for households and reduced VAT tax rate on gas and electricity.
Italy	Italy's measures to shield households and firms from the energy crisis was sizeable vis-à-vis other EU countries at the equivalent of more than 5% of GDP. Support for electricity prices will end in July 2024.
Luxembourg	Price cap on gas prices and price freeze on electricity extended until December 2024. Other support to remain at least until this summer but phased out by end 2024.
Netherlands	Energy price cap was removed in January 2024.
Norway	Support measures implemented, include price support scheme for households, increased housing allowances and subsidies for agricultural and some industry, have been extended to the end of 2024.
Poland	Energy price cap for consumers, SMEs extended until the end of 2024.
Portugal	With relatively modest exposure to the energy crisis, support is limited to households with low incomes.
Spain	Relatively unaffected by Russia's war in Ukraine, Spain's economy has proved resilient, with a robust economic outlook compared with the rest of the euro area. An energy price cap was adopted in 2023 and was not renewed in 2024.
Sweden	In January 2023 the government introduced new measures to support households by compensating for high electricity prices during November and December 2022. No significant measures were adopted in 2024.
Switzerland	No measures expected for 2024.
UK	The government extended an energy price freeze for households until June 2024, while it has also offered cost-of-living support in 2023 and 2024 for some of those on benefits and for pensioners.

With governments removing or easing support measures last year and this, companies with particularly high energy costs are particularly at risk. In addition, 'zombie retailers"[3], which so far have benefited from the state support, could finally collapse.

Lower inflation will provide some relief for retail sector

The phasing out of government support has come out at a difficult time for all retailers. However, this could be partially offset by easing inflation and falling energy prices in many European countries. Inflation in the euro area will likely average 2.5% in 2024 and 2.1% in 2025 compared with around 5.4% in 2023, according to Scope's latest forecasts.

Overall, we expect number of insolvencies to continue to rise, with the impact being more pronounced for small-size and less diversified retailers, which have not adapted their business model to the changing consumer behaviour and will struggle to compete with online giants and cover fixed costs in the future.

Default risk looks relatively high in France, Germany

As state support in Germany and France is removed or reduced, we see increasing risk for retailers in these countries. Both countries have benefited from strong state support over the pandemic and the energy crisis, enabling vulnerable retailers to survive. They are now likely to see an increasing number of bankruptcies in 2024, with a higher concentration in the first half of the year, while from mid-2024 we expect declining inflation and more favourable energy prices to partially support the market.

On the other hand, we expect the number of bankruptcies in the UK to remain high but stable, driven by fierce competition, and the number of bankruptcies in other countries, such as Italy, Spain and Portugal, to be relatively low, as most bankruptcies in the past have occurred at the SME level, leading to increasing consolidation in these markets.

[3] Retailers which should have gone bankrupt but remain operational due to direct, indirect state support.

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