Retail investments: winning models during crisis and preferred targets

May 2020

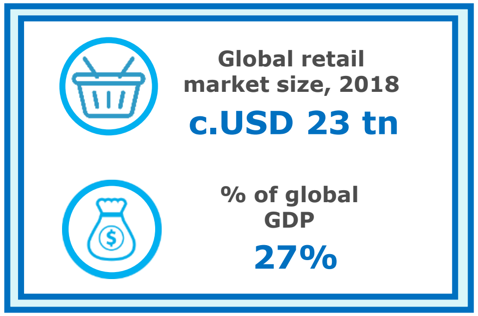
Disclaimer

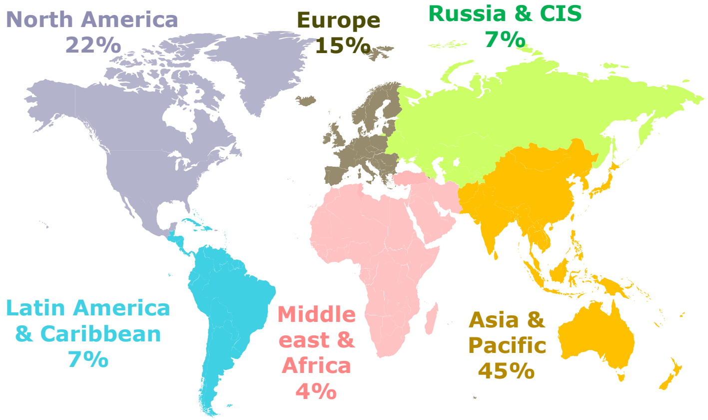
- ✓ This document has been prepared by Beragua Capital S.L. (from now on “Beragua”). The information contained in this presentation cannot be supplied nor used by another party or for a different purpose, without the prior written consent of Beragua.
- ✓ Beragua assumes no liability whatsoever in connection with a possible independent verification of all or part of the information contained herein, which is assumed to be correct and accurate, therefore impeding any statement or warranty, express or implied, about truthfulness, completeness, adequacy or accuracy of the information or opinion contained herein.
- ✓ Neither Beragua nor any directors, members, managers, consultants or employees, contract any liability of any kind arising from any claim or loss derived from any use of this document or its contents, or that would otherwise arise under the same.

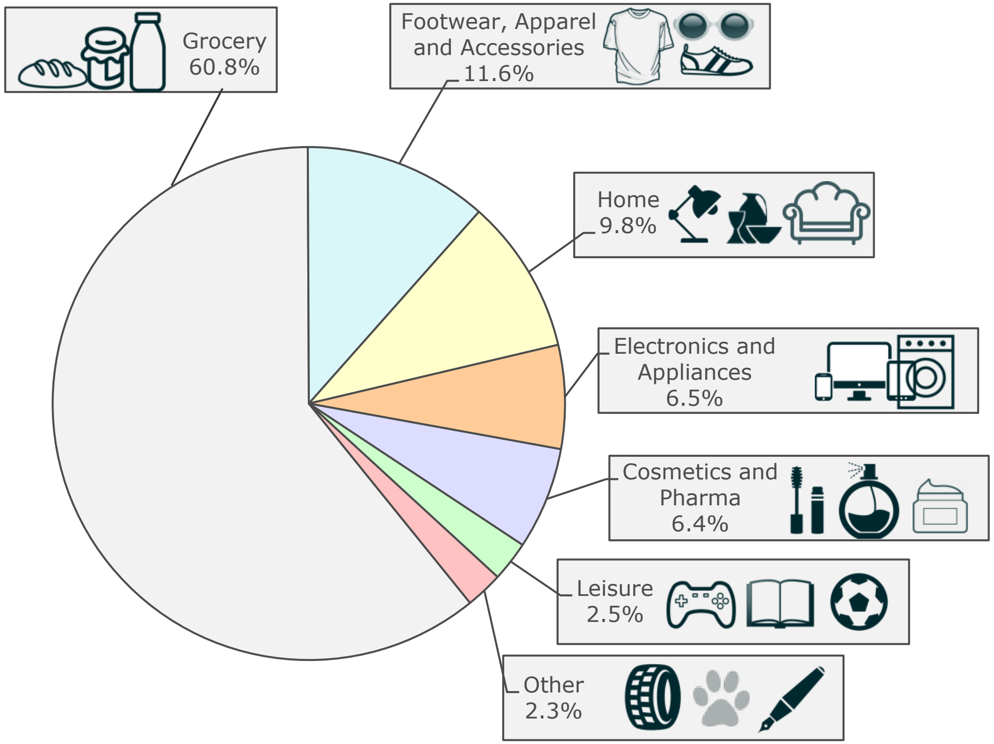
1. The Retail Sector

Retail industry represents 27% of global GDP

The **global retail sector** reached **c.USD23 trillion of sales** in 2018, c.27% of the world's GDP, with **Asia and North America** being the **most relevant markets**. **Grocery** is the **largest segment** accounting for 61% of that total.



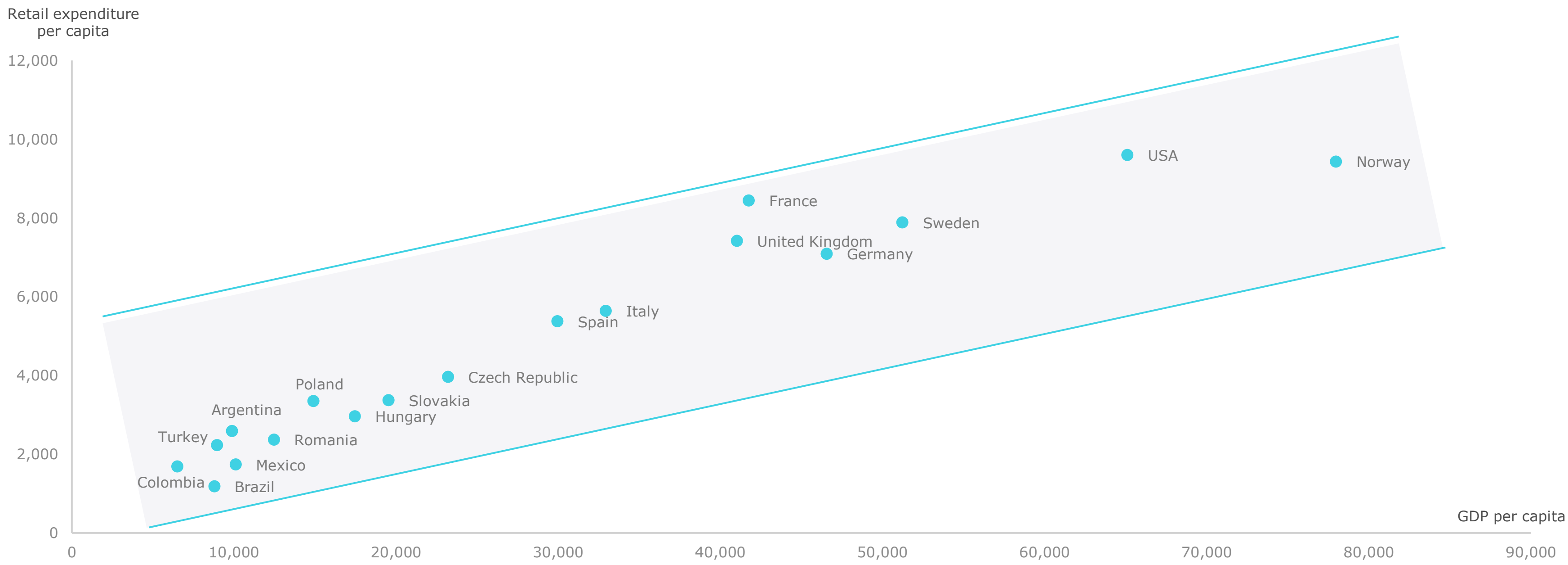




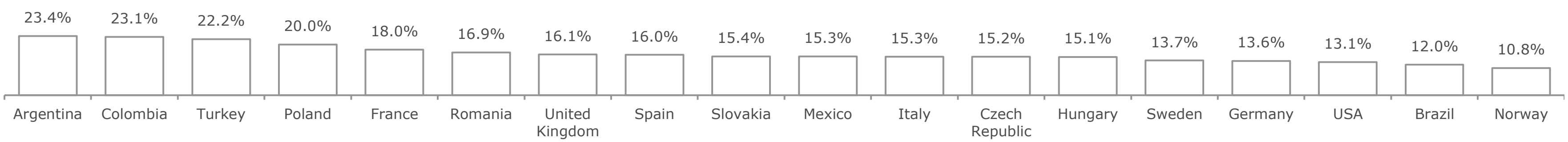
Retail expenditure is highly correlated with GDP per capita

Economic growth is a **key driver** to explain the progression of all retail segments in different countries.

GDP and retail expenditure per capita correlation | EUR



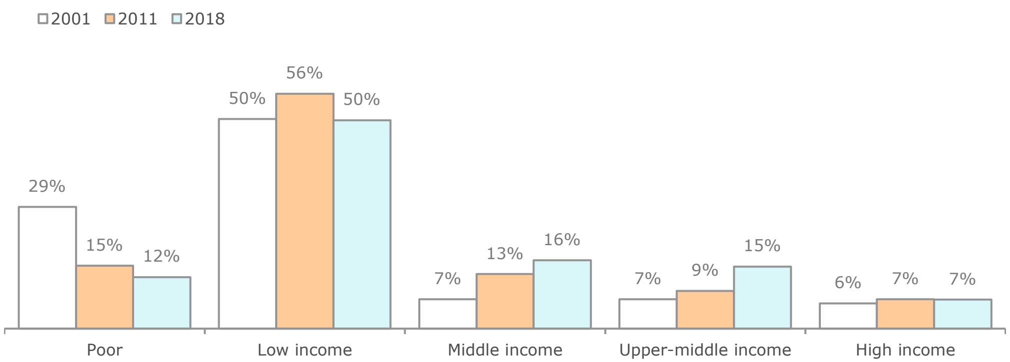
Retail as a proportion of GDP | %

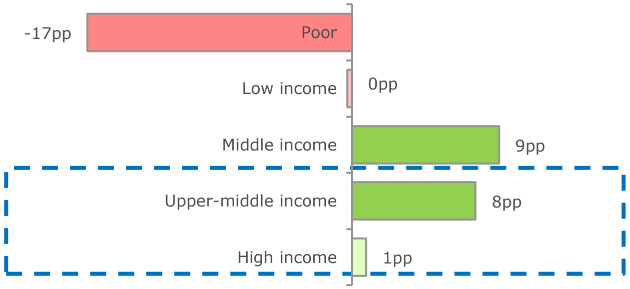


Retail expenditure is boosted by growing population and by the access to modern consumption of the raising middle class

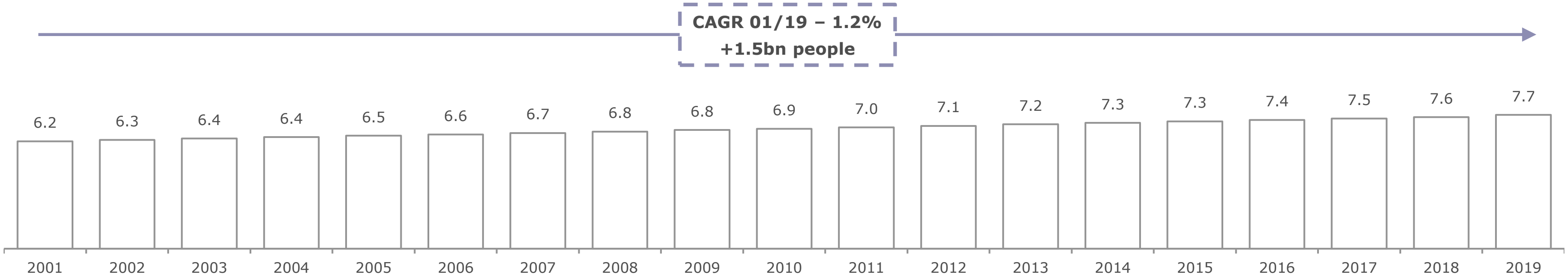
- **Middle class** population experienced the **biggest increase in the last years** (+17pp), **however**, above **half of the world inhabitants are still below the "low income" segment.**
- The **improvement of the economic capacity of this segmen**t will **support** the global **growth of the retail sector**.

World population by income level | % - 2001-2011-2018





World population evolution | bn inhabitants - 2001-2019

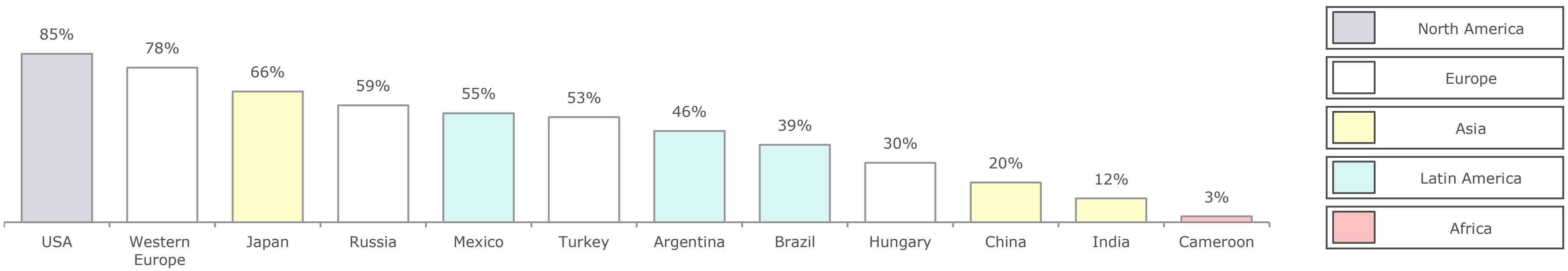


Source: World Bank

Modernization of traditional retail and market consolidation are key growth drivers for retailers

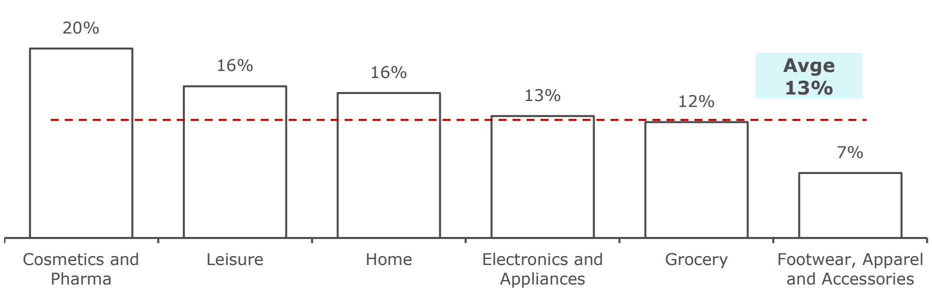
The **reduction** of the market **share of traditional retailers** is a **key growth driver for modern players**, not only in emerging countries, but also in developed economies where non-organized retail still has a significant weight in the total market.

Share of organized retail | %

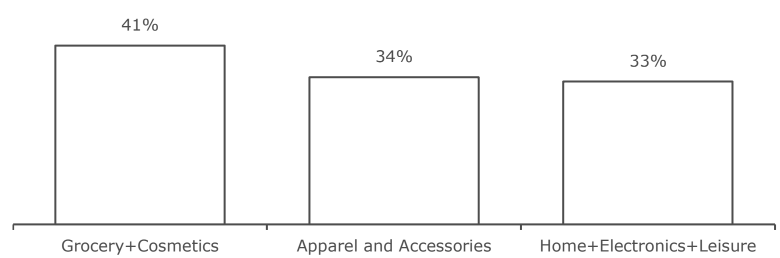


The **consolidation of the market** (still very fragmented in all segments) and a **profitable internationalization** of winning business models are **additional elements to support the growth of retail companies.**

Fragmentation by sector | % share of top 10 groups over total sector



Domestic only Companies(1) by sector | %

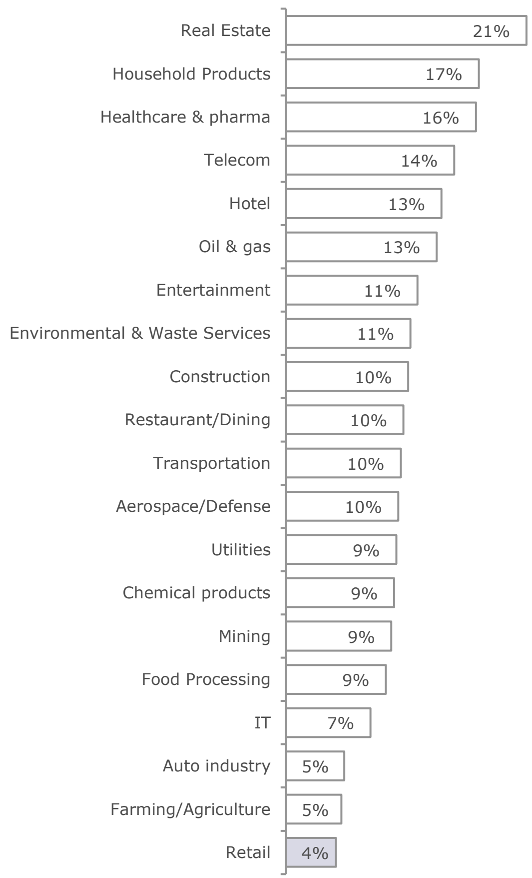


Note(1): Companies listed in the "Top 250" biggest retail companies

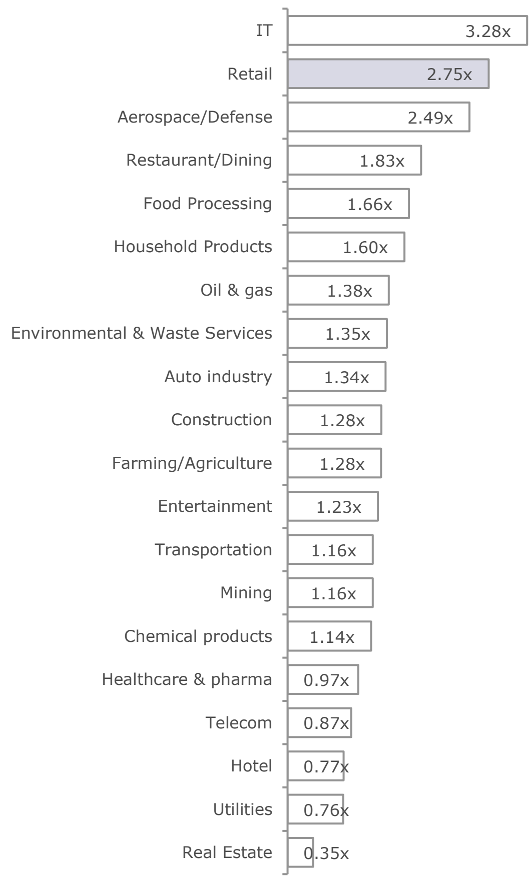
Low margins + high capital turnover yielding an attractive ROCE

Retail formats typically operate with a **low EBIT margin** but have very **limited capital requirements**. This allows to **yield on average a 12% ROCE.**

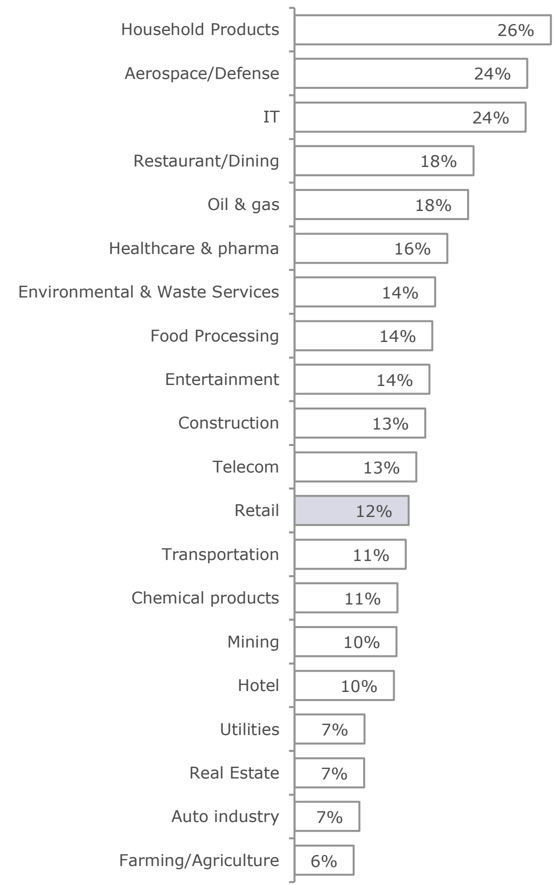
EBIT margin | % - 2019



Sales/Capital employed | x - 2019



ROCE | % - 2019



Source: Damodaran

Main reasons for choosing to invest in retail

Retail industry is one of the most relevant consumer sectors and has exciting attributes from an investor perspective:

Large and dynamically evolving sector	▪ 27% of global GDP with strong growth prospects
Supported by solid trends	▪ Demographic growth ▪ Access to modern way of consumption by the increasing middle class ▪ Modernization of traditional retail ▪ Consolidation of the market, yet fragmented in all retail segments
Unique features	▪ Strong growth rates ▪ Low capital intensity ▪ Funding from suppliers, high cash flow generation ▪ Low margins, yet high capital turnover yielding attractive returns ▪ Low volatility

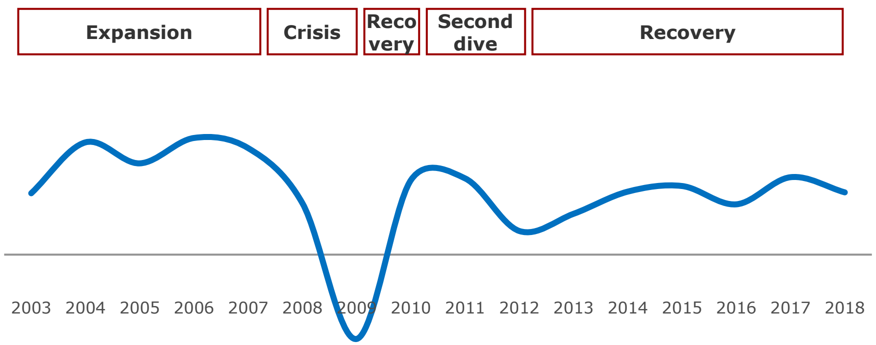
Retail sector's resiliency to economic downturns makes it an attractive investment opportunity during crises

2. Winning retail formats in crisis

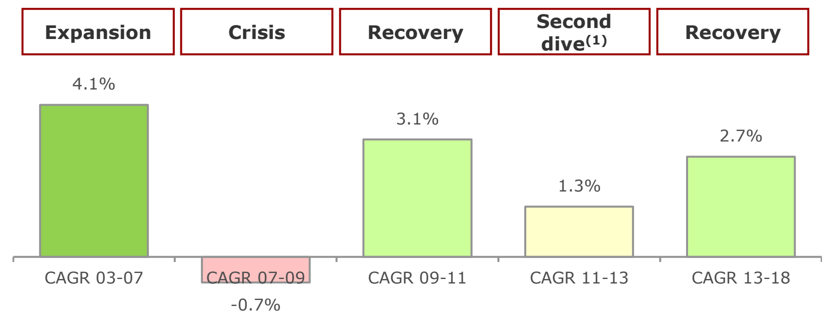
Economic downturns suffered in the last two decades

The 2008-2009 crisis had the largest economic impact, although we faced a second crisis dive in 2011-2013(1).

GDP evolution (in real terms) | Average of selected countries y-o-y evolution – % – 2003-2018

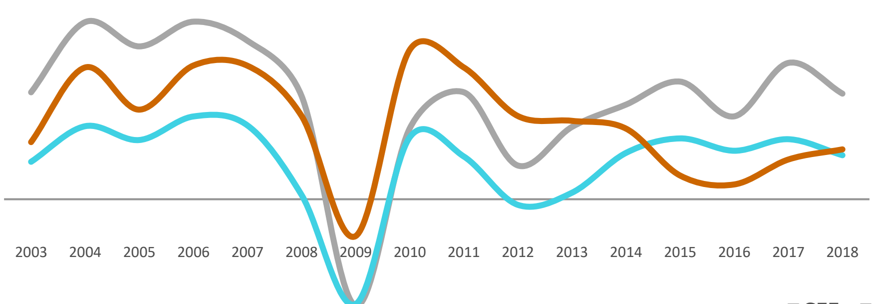


GDP evolution (in real terms) by periods | % CAGR – 2003-2018

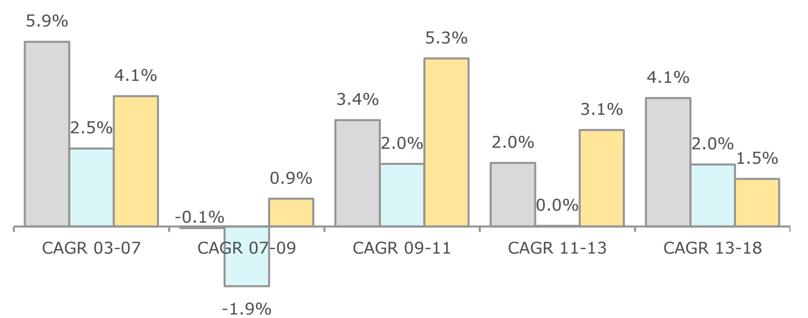


Western Europe was more impacted, followed by CEE, while the economy of LATAM countries only suffered in 2009.

GDP evolution (in real terms) by geographies | Average of selected countries y-o-y evolution – % - 2003-2018



GDP evolution (in real terms) by periods and geographies | % CAGR – 2003-2018



CEE WE LATAM

Note: Including the following: WE: Spain, France, Germany, Italy, France, UK, Sweden, Norway; CEE: Czechia, Hungary, Poland, Romania, Slovakia; LATAM: Brazil, Colombia, Mexico
Note(1): Second dive stroke between 2011-2013 in WE, 2011-2012 in CEE and 2012-2016 in LATAM.

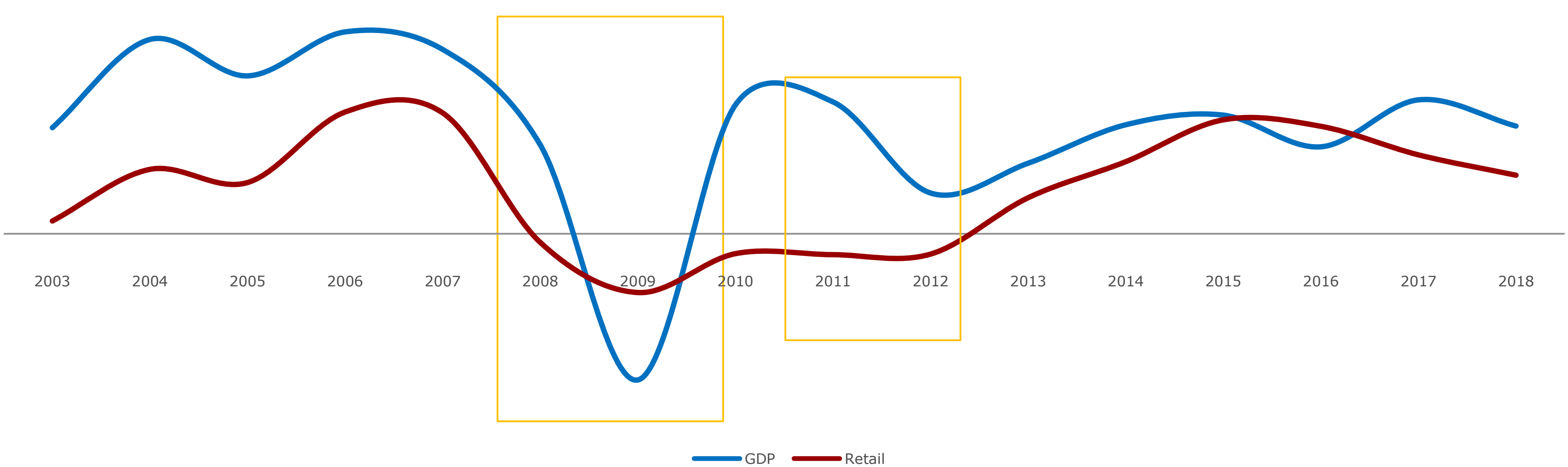
Retail sector was relatively resilient during the crisis

- **Retail followed the GDP’s decline during the deep economic crisis of 2008, however, its performance was better than the one of the economy.**
- **After the crisis, the sector started to recover and its positive trend only flattened in the second dive.**

GDP vs. total retail evolution (in real terms) | Average of selected countries y-o-y evolution – 2003-2018

GDP Retail

	Crisis		Second dive	
	GDP	Retail	GDP	Retail
Growth pre crisis year	4.4%	2.9%	3.2%	-0.5%
Growth peak year of crisis	-3.5%	-1.4%	1%	-0.5%
Diff pp	**-8pp**	**-4.3pp**	**-2.2pp**	**-**
	+3.7		**+2.2**	



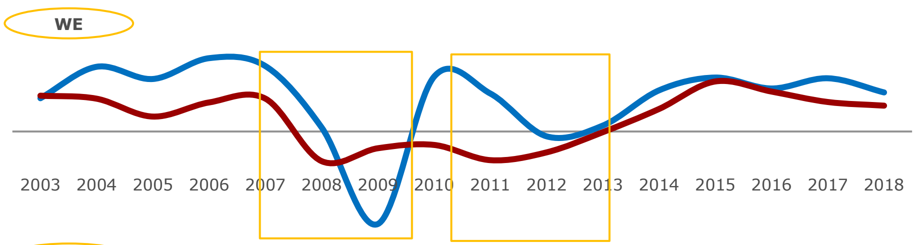
Note: Including the following: WE: Spain, France, Germany, Italy, France, UK, Sweden, Norway; CEE: Czechia, Hungary, Poland, Romania, Slovakia; LATAM: Brazil, Colombia, Mexico

Different impacts between geographies and development levels

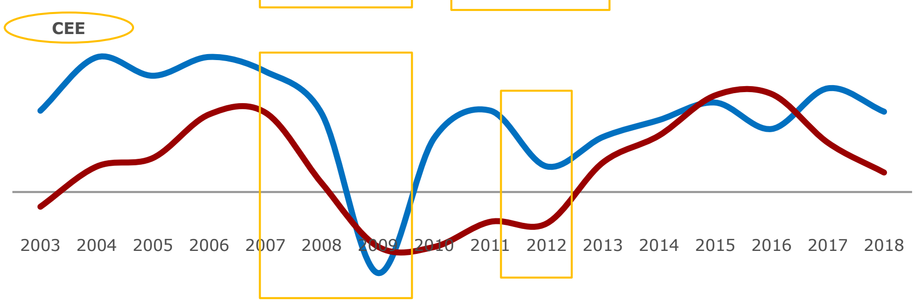
- Retail sector **resiliency to the crisis** was **higher in more developed Western European countries than in CEE or LATAM** (retail in these emerging regions suffered more as the proportion of customers’ disposable income spent on food and basic goods is notably higher than in more developed countries).
- This situation **remained unchanged in the second dive: WE and CEE were the most resilient geographies.**

GDP vs total retail evolution (in real terms) | Average of selected countries y-o-y evolution – 2003-2018

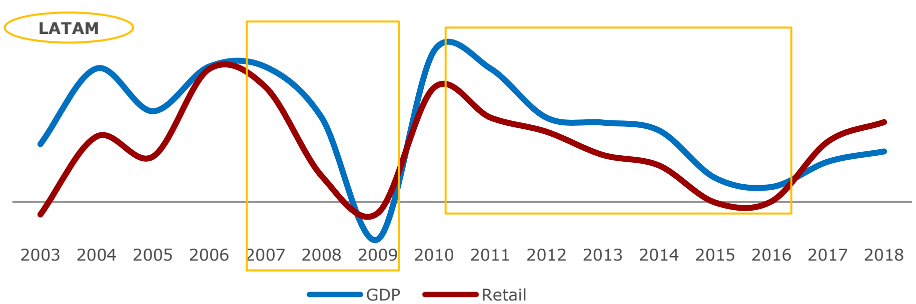
GDP Retail



	Crisis		Second dive[1]	
	GDP	Retail	GDP	Retail
Growth pre crisis year	2.8%	1.4%	2.3%	-0.6%
Growth peak year of crisis	-4%	-0.7%	-0.2%	-0.9%
Diff pp	**-6.8pp**	**-2.1pp**	**-2.6pp**	**-0.3pp**
	+4.7		**+2.3**	



	Crisis		Second dive[1]	
	GDP	Retail	GDP	Retail
Growth pre crisis year	6%	4%	4.1%	-1.5%
Growth peak year of crisis	-4%	-2.7%	1.3%	-1.6%
Diff pp	**-10.1pp**	**-6.7pp**	**2.8pp**	**-0.1pp**
	+3.4		**+2.7**	



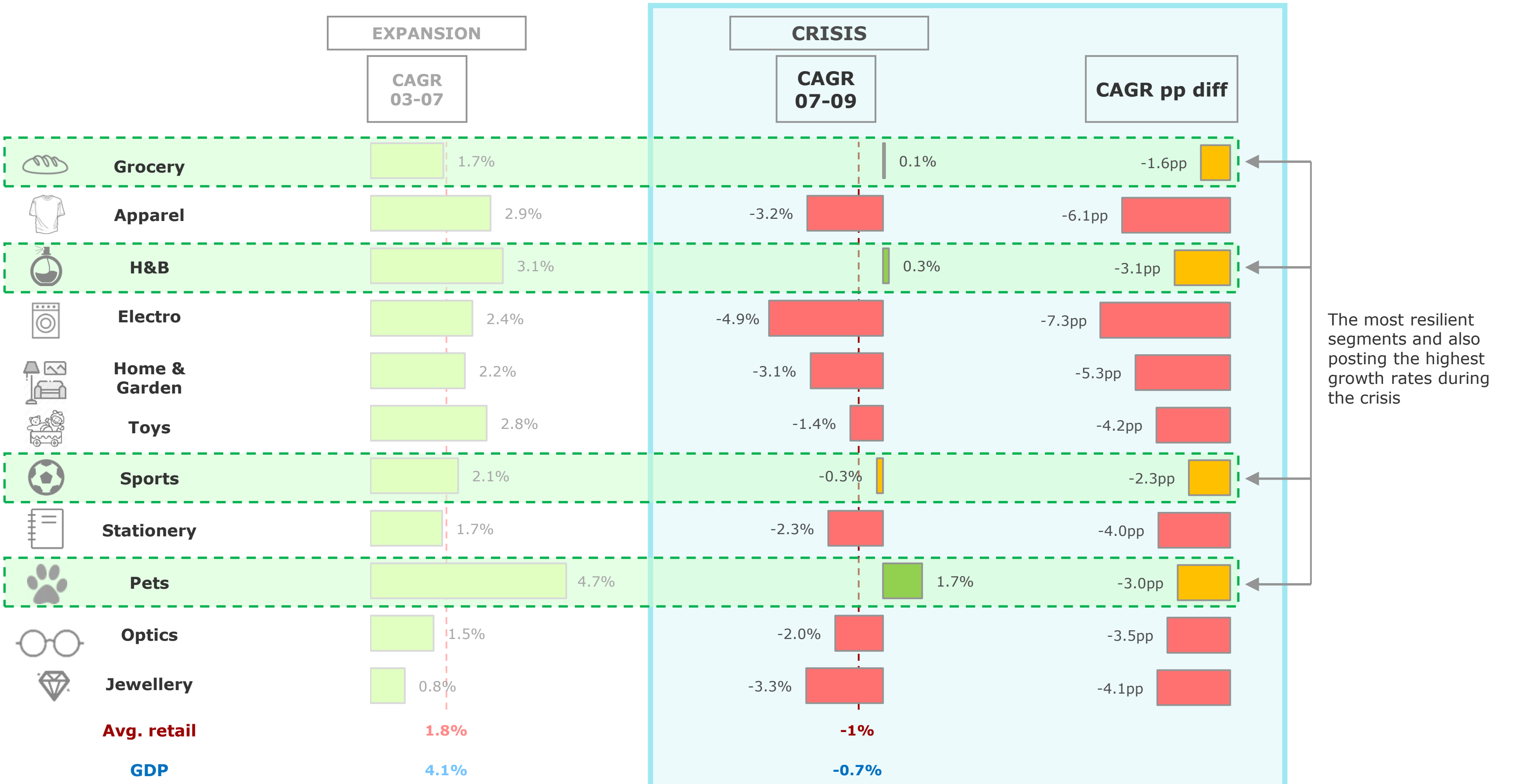
	Crisis		Second dive[1]	
	GDP	Retail	GDP	Retail
Growth pre crisis year	5.1%	4.3%	5.7%	4.3%
Growth peak year of crisis	-1.4%	-0.4%	0.6%	0%
Diff pp	**-6.5pp**	**-4.7pp**	**-5.1pp**	**-4.3pp**
	+1.8		**+0.8**	

Note: Including the following: WE: Spain, France, Germany, Italy, France, UK, Sweden, Norway; CEE: Czechia, Hungary, Poland, Romania, Slovakia; LATAM: Brazil, Colombia, Mexico
Note(1): Second dive stroke between 2011-2013 in WE, 2011-2012 in CEE and 2012-2016 in LATAM.

Level of resiliency varied between retail segments (i)

- **Grocery and sports followed by pet and H&B were the most resilient retail segments during the crisis.**
- **These segments posted the highest growth rates** (they remained flat or grew slightly Vs. avge. 1% decline of the retail industry).

Retail segments evolution (in real terms) by periods | Average of selected countries CAGR – Expansion and crisis

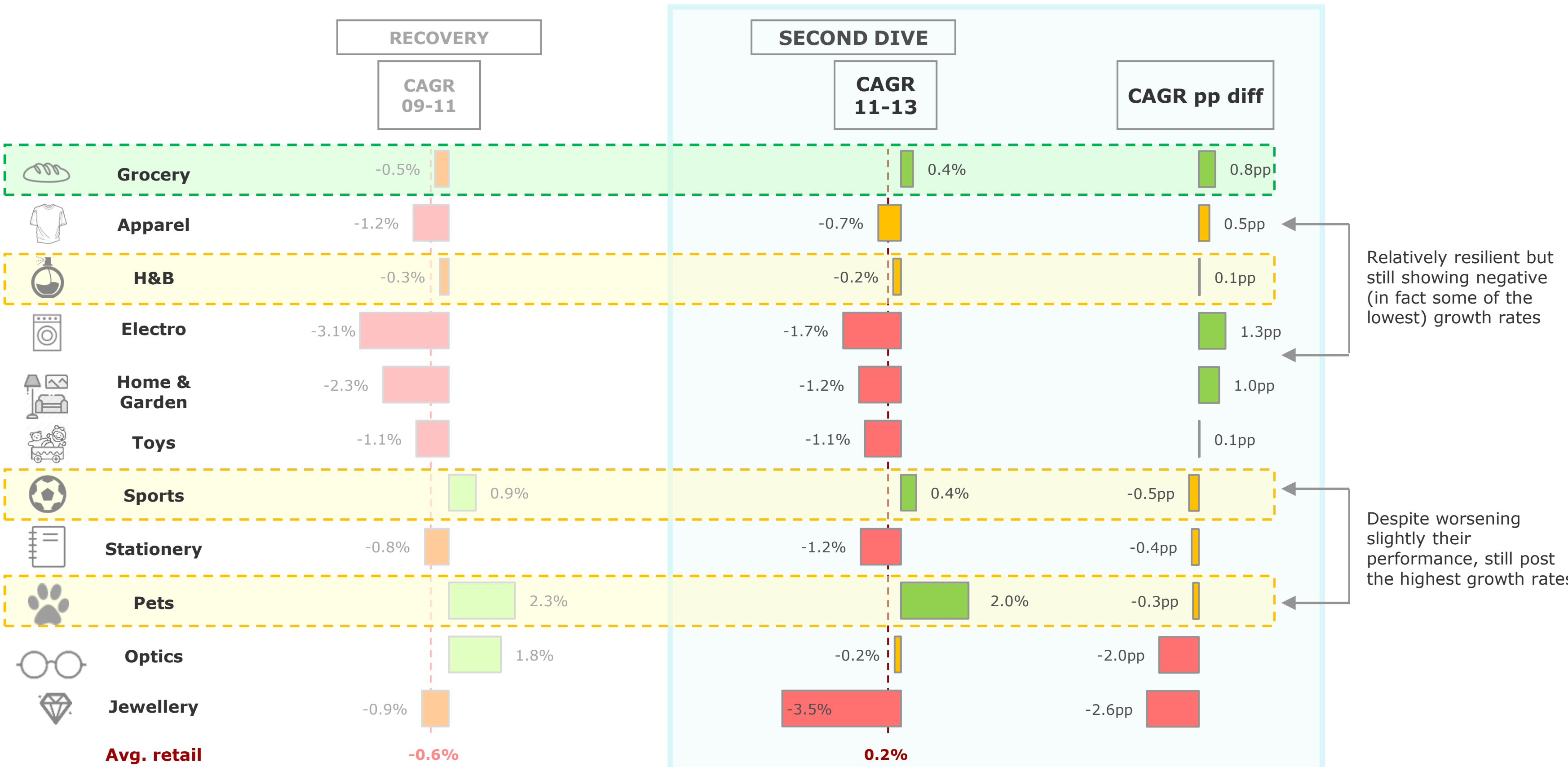


Note: Including the following: WE: Spain, France, Germany, Italy, France, UK, Sweden, Norway; CEE: Czechia, Hungary, Poland, Romania, Slovakia; LATAM: Brazil, Colombia, Mexico

Level of resiliency varied between retail segments (ii)

- **Grocery was also one of the most resilient retail segments during the second dive** (below electro and home & garden, however, these industries' growth only allowed to slowdown their strong decline). **Other industries with a relatively good resiliency during the crisis (i.e. H&B, sports and pets) showed an almost flat performance Vs. the recovery period.**
- **Grocery, H&B, sports and pets continued as the segments with the highest growth rates.**

Retail segments evolution (in real terms) by periods | Average of selected countries CAGR – Recovery and second dive



Note: Including the following: WE: Spain, France, Germany, Italy, France, UK, Sweden, Norway; CEE: Czechia, Hungary, Poland, Romania, Slovakia; LATAM: Brazil, Colombia, Mexico

Level of resiliency varied between geographies (i)

- **Grocery was one of the industries with the highest resiliency in all geographies analysed.**
- **H&B and pets were less affected by the crisis in WE and LATAM while sports performed better than the avge. in WE and CEE.**
- **These four segments were consistently among the fastest growing in all geographies.**

Retail segments evolution (in real terms) in the crisis by geographies | Average of selected countries CAGR – Crisis peior

CAGR expansion vs. crisis pp diff

	WE		CEE		LATAM	
Grocery	0.5%	-0.6pp	-0.5%	-2.5pp	0.4%	-2.5pp
Apparel	-4.1%	-5.0pp	-4.1%	-9.2pp	0.4%	-2.5pp
H&B	0.8%	-1.8pp	-0.4%	-5.2pp	0.2%	-2.2pp
Electro	-6.2%	-6.8pp	-5.5%	-7.2pp	-0.6%	-8.8pp
Home & Garden	-3.9%	-4.9pp	-3.5%	-7.2pp	-0.3%	-2.9pp
Toys	-3.1%	-3.3pp	-0.1%	-4.1pp	-0.1%	-6.2pp
Sports	0.5%	-2.1pp	-1.7%	-2.1pp	0.8%	-3.3pp
Stationery	-2.6%	-3.0pp	-3.2%	-4.7pp	0.0%	-5.2pp
Pets	1.3%	-0.4pp	1.8%	-6.1pp	2.3%	-2.7pp
Optics	-0.9%	-1.1pp	-4.4%	-6.9pp	-0.1%	-2.8pp
Jewellery	-5.3%	-5.1pp	-1.5%	-4.1pp	-2.2%	-1.8pp
Avg. retail	**-1%**	**-2.2pp**	**-1.7%**	**-3.1pp**	**0.3%**	**-2.8pp**

Note: Including the following: WE: Spain, France, Germany, Italy, France, UK, Sweden, Norway; CEE: Czechia, Hungary, Poland, Romania, Slovakia; LATAM: Brazil, Colombia, Mexico

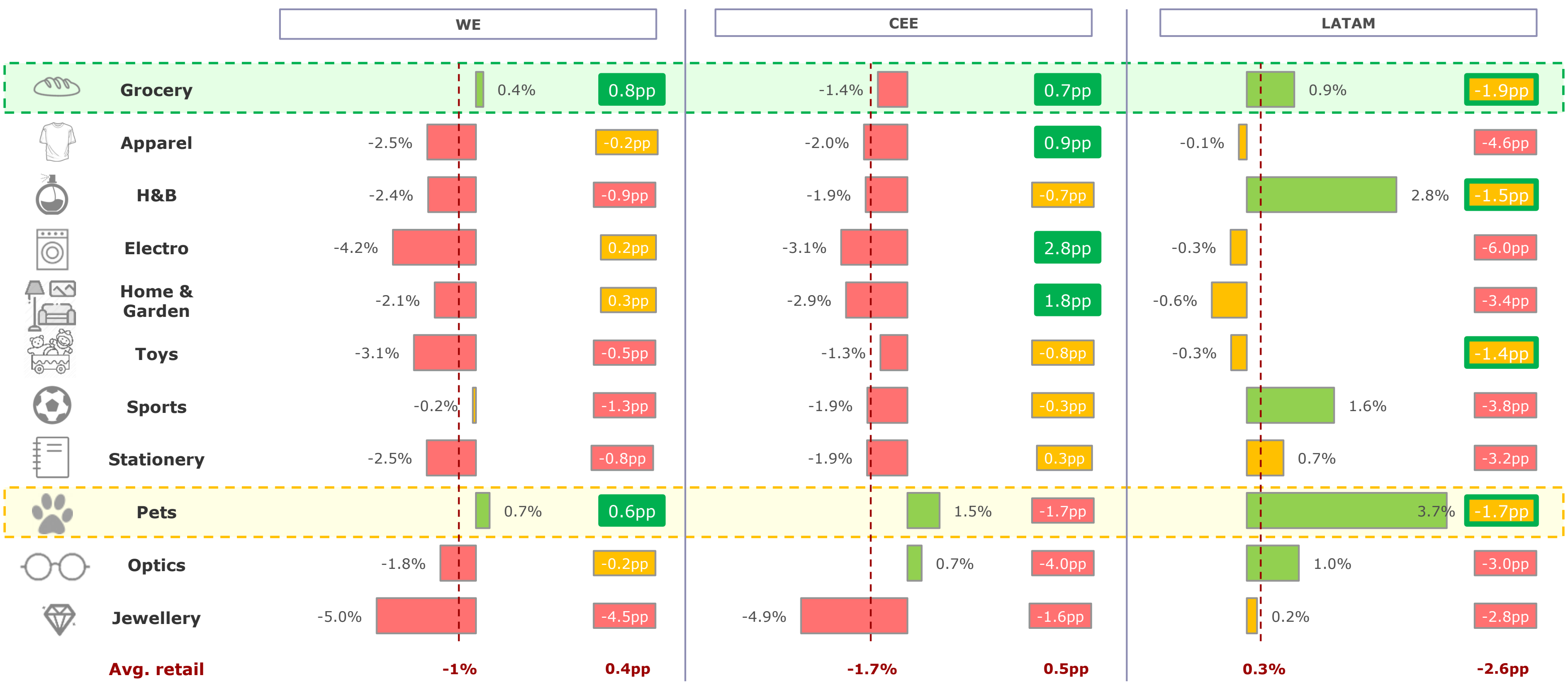
Source: IMF, Euromonitor and Beragua

Level of resiliency varied between geographies (ii)

- **Grocery was also one of the most resilient industries during the second dive in all regions analysed**. Apparel, electro and home & garden experienced a relatively good performance in WE and CEE, however, this only allowed to decelerate their declines.
- **Pet** (only sector growing consistently in all geographies) **showed a good resiliency** (especially in WE).
- **H&B and sports specialists exhibited a heterogeneous performance (but worse than the average).**

Retail segments evolution (in real terms) in the crisis by geographies | Average of selected countries CAGR – Second dive[1] period

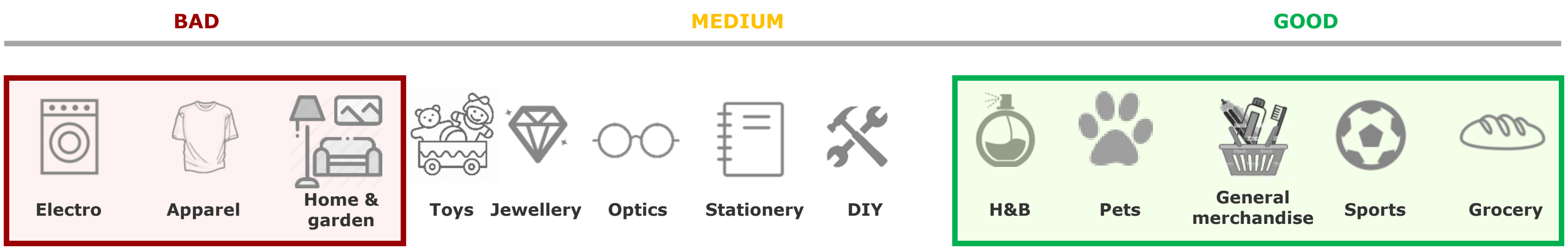
CAGR recovery vs. second dive pp diff



Note: Including the following: WE: Spain, France, Germany, Italy, France, UK, Sweden, Norway; CEE: Czechia, Hungary, Poland, Romania, Slovakia; LATAM: Brazil, Colombia, Mexico
Note(1): Second dive stroke between 2011-2013 in WE, 2011-2012 in CEE and 2012-2016 in LATAM.

Summary – the most resilient retail segments

Grocery, sports, pet and heath & beauty specialists are the most resilient retail subsectors. Despite still being incipient in most geographies analysed, general merchandisers(1) also show a good resiliency. These five segments are also underpinned by a favourable growth momentum.



The least resilient retail subsectors are electro, apparel and home & garden.

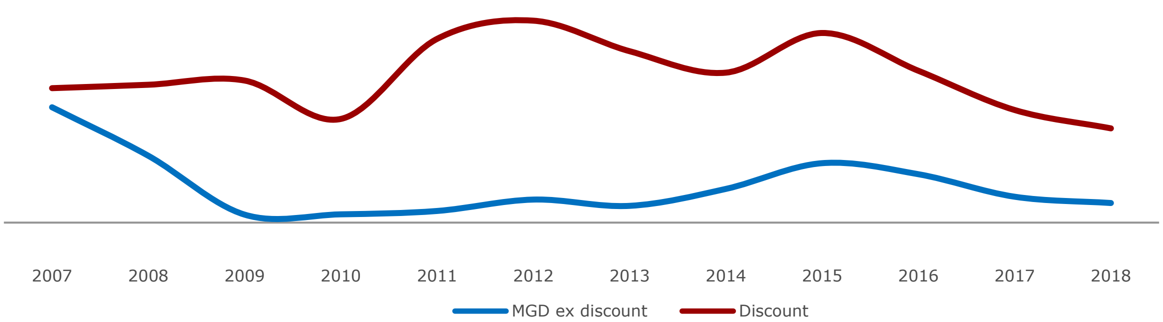
Note(1):

- *Due to the limitations of information in certain geographies and for specific sectors, there are some segments which cannot be analysed using our methodology (i.e. DIY or General Merchandise stores).*
- *However, we have included them based on available information and our experience in previous projects.*

Value models outperform in crisis

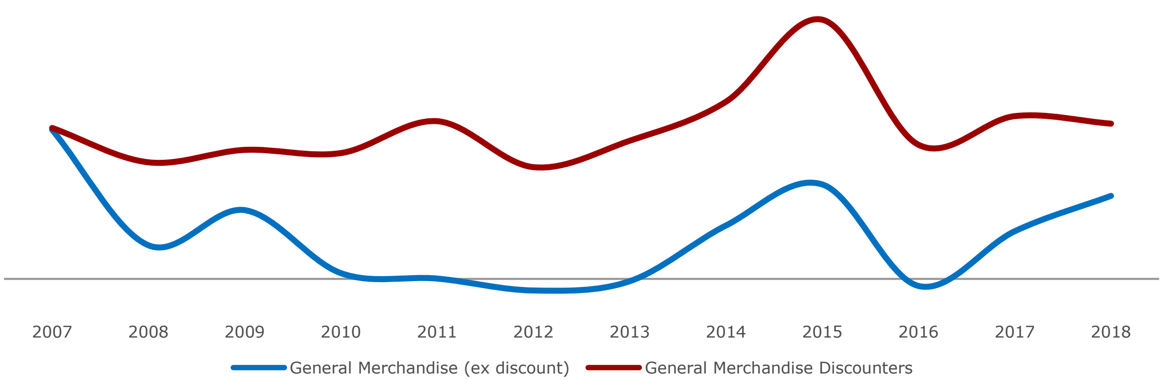
In both retail subsectors analysed (grocery and general merchandise), **discount models did not suffer** (and even improved their performance in some cases) **during the crisis, while the rest of the formats experienced a sustained decrease.**

Illustrative example of the performance of the **grocery discount vs. the rest of grocery formats**



	Growth pre crisis year (2007)	CAGR 07-09	Pp diff vs. pre crisis	
MGD (ex discount)	+6.3%	+2%	**-4.3**	**+4.6**
Discount	+7.4%	+7.7%	**+0.3**	

Illustrative example of the performance of the **general merchandise discount vs. the rest of general merchandise formats**



	Growth pre crisis year (2007)	CAGR 07-09	Pp diff vs. pre crisis	
General Merchandise (ex discount)	+14.7%	+5%	**-9.7**	**+6.9**
General Merchandise Discount	+14.9%	+12.1%	**-2.8**	

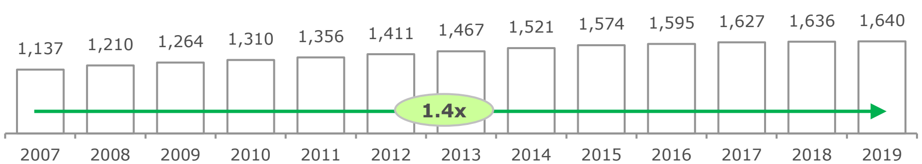
Note: Including the following countries in the grocery analysis: WE: Spain, France, Germany, Italy, France, UK, Sweden, Norway; CEE: Czechia, Hungary, Poland, Romania, Slovakia; LATAM: Brazil, Colombia, Mexico. For the GMD case the analysis is performed only in Germany, the UK and France.

Case study – Mercadona's adaptation to increasing its value approach has proven successful

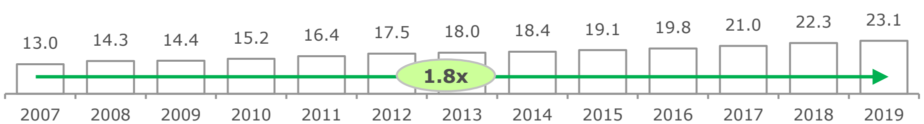
MERCADONA

- *At the **beginning of 2008's crisis, Mercadona** was **already the leader of the Spanish grocery retail market** with **c.1,150 supermarkets** and **c.EUR13bn of sales.***
- ***In this moment**, the company took a **strategic decision** (anticipating that the crisis would have a strong impact on Spanish consumers) and **repositioned** its model, **becoming a more value-oriented supermarket** (closing the gap Vs. discounters, in terms of prices, PL penetration and assortment size).*

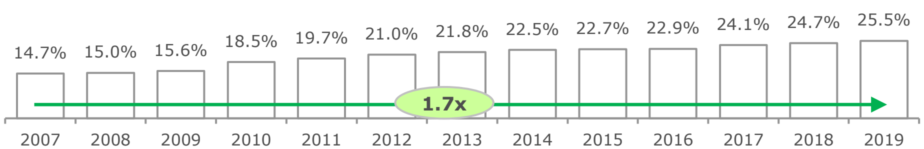
Network evolution | # stores – 2007-2019



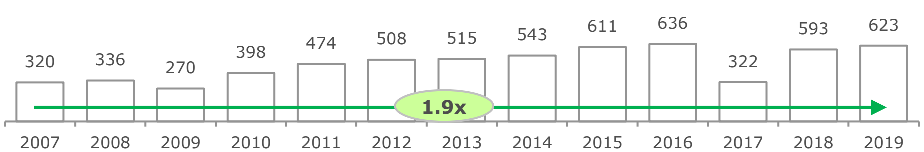
Sales evolution | EUR bn – 2007-2019



Market share evolution | % – 2007-2019



Net income evolution | EUR mn – 2007-2019



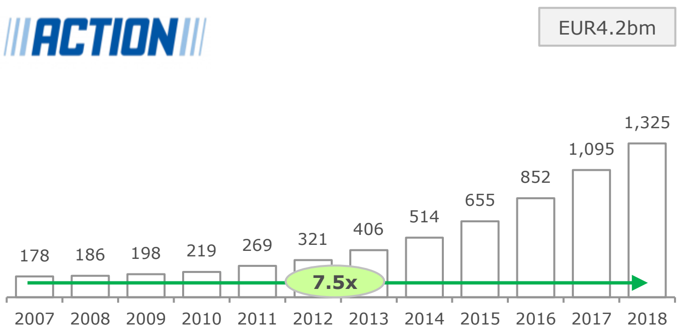
- When the crisis stroke, Mercadona decided to carry out a strong repositioning. This decision involved changes in a number of key elements of its value proposition:
  - Assortment reduction: from more than 9,000 SKUs in 2007 to c.7,500 in 2010.
  - Impulse of private label: PL penetration increased from c.40% to c.60%.
  - Strong investment on prices: the Company performed continuous price reductions, especially in 2008 and 2009, which together with the increase in PL penetration resulted in a reduction in comparable baskets of -25%.
  - Reduction of the number of assisted sections.
- This movement towards a more value concept, impacted the company's results in the first years, but proven successful overall, as it allowed to continue expanding (c.500 new stores between 2007-2019, +40%) and especially improving results (+80% of sales and +90% of net income), and market share (+70%).

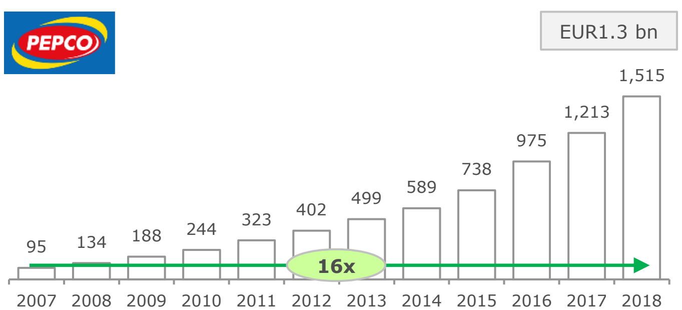
Source: Company, press releases and Beragua

Case study – Leading General Merchandise Discount players' growth in Europe has been extraordinary

- ***Action and Pepco*** *are the* ***main General Merchandise Discount players in Europe with networks of c.1,300 and c.1,500 stores and posting sales of c.EUR4 bn and c.EUR1.5 bn respectively.***
- *Both models have* ***grown sales significantly in the last years (7.5x and 16x between 2007-2018), expanding*** *from* ***single-country concepts towards pan-European companies, benefiting*** *from the* ***customer appetite for affordable products during times of crisis.***

Network evolution | # stores – 2007-2018





- Both models share some characteristics: they offer a range made up of different categories (including apparel, stationery, home decorations, toys, sports…) at very affordable prices (the lowest in the market).
- These concepts saw the unmet opportunity to satisfy the needs of customers with limited disposable income and carried out a strong bet. They expanded rapidly using models with limited adaptations (in terms of real estate, commercial model, pricing strategy, etc.), proving that value models with well-developed assortments could be successful across different geographies (as they are appealing to customers despite the different consumer habits between countries).

3. Retail industry in the post-COVID era

Our preliminary views

COVID impact on the retail industry

- The **COVID-19** has caused an **unparalleled shock around the globe** with **still uncertain consequences.**
- In our view, its **impact** will go **beyond any other crisis** faced in history as it will have a **macroeconomic effect** (recession, increasing unemployment, lower disposable income and therefore lower consumption, etc.) but it will **change also the way citizens behave, customers shop, people move..**
- **Retail**, as one of the most relevant consumer segments, will be challenged. However, crises represent also a **great opportunity for those who are well-prepared to readapt to new 'market rules'.**

COVID first impacts (lock-down period) affected retail heterogeneously:

SHORT-TERM

Grocery

- It has been, together with H&B, the **only brick&mortar retail format** in which **operations were not interrupted. Sales peaked** due to a **first wave of purchases for stock-up**, **followed by** an **increasing demand of indulgence products.** Moreover, the **transfer of sales from** the **HoReCa channel** also contributed to **boost LFLs.**
- **However**, the **positive impact** was **not homogeneous across the segment**: **proximity** formats **outperformed** (especially those with higher value orientation), **while some large attraction models** (which imply long distances travelled, more agglomerations of customers…) **struggled.**

Rest of segments

Virtually the rest of retail subsectors (with limited exceptions such as pharmacies) **were severely affected** by the shutdown and their **sales were limited to their e-commerce sites** (if in place), which **i) usually are not well prepared** to **satisfy this increasing demand** and **ii) did not absorb** the revenue **plummet in physical stores.**

Winning models in the post-COVID era

Despite the upcoming impacts still being uncertain, in our view, the 'new normality' post-COVID will benefit some retail models:

LONG-TERM

1 Value

- Customer's **propensity to save** money during **crises** is **notably higher** than in expansion periods. This, together with a **higher unemployment, lower disposable income, etc. will very likely increase price sensitivity** (as we have seen in previous crises). In our view, **value and discount players will be benefiting from this trend.**
- Moreover, **we expect** to see a **trade-down** in the majority of retail sectors: with the increasing price sensitivity, **customers will look for cheaper options satisfying their shopping needs**. In this context, **private label** products play a very relevant role and **will very likely increase their relevance, benefiting especially** those **peers** with **already high PL shares.**

2 Proximity

- COVID will **contribute to reinforce trends (such as proximity)** that already started a few years ago.
- We believe **the 'new normality' will** come together with a **change in the way people interact, customers travel and especially with increasing concerns on safety/cleanliness procedures.**
- We believe **customers will be less willing to perform their purchases in large attraction formats** (more prone to show big agglomerations of people, that require longer and more difficult transportation and that will face stricter regulations and controls) **and will shift towards more convenient proximity-oriented models.** Food retail has been the paradigm of this trend: during the lock-down customers favoured notably stores close-by their homes and LFLs in large formats suffered.

3 Online

- The **COVID lock-down** has been the **online momentum:** a good number of **customers have tried online platforms** for the **first time** and probably some of the **main 'psychological/technological entry barriers' have disappeared.** Customers had the possibility to **test retailers' online services** and are now **more likely to repeat their purchases** (despite all the very relevant issues that most retail companies faced in their e-commerce supply chains due to peaks in demand, which point out the substantial room for improvement in the segment).
- **This trend** will **benefit pure online players** but **also** those **traditional retailers with better online value proposals.** Despite a good proportion of customers shifting-back to brick&mortars after the lock-down, we strongly believe **COVID has and will impulse online penetration substantially.**

4. Key investment thesis

Roadmap to identify potential targets

After our longstanding experience advising retail companies, **we have detected a number of factors that usually underpin successful cases. We favour investment strategies based on the search of opportunities to:**

- Take advantage of the **growth drivers and trends** of the sector.
- **Uncover 'hidden gems'** that can generate value through a disruptive model, a new strategy or a leadership position…

Modern retail market

- Economic and demographic growth
- Strong weight of traditional retailers
- Fragmentation
- New formats

Company specific

- Differentiation
- Profitable internationalization
- Operational excellence
- Profitable multiformat able to generate synergies

Untapped opportunities

- New strategic orientation
- Business model repositioning
- New top management
- Internationalization
- Spin-offs
- Disruptive models

Market trends

- Value / discount
- Proximity / convenience
- Franchising
- Online

What we are looking for in the Retail Industry

Retail is very diverse and includes segments with different dynamics, growth prospects, competitive pressures and threats. We favour models showing the following key characteristics:

1 Growth

Through differentiated commercial models	Price, assortment, private label and model improvements driving LFL sales
And organic growth	Models which are homogeneous and easy to scale organically

2 Profitability made up of efficiency and competitiveness

Lowest EBIT in the segment	Competitive price/cost structure edge in the Company's DNA
High capital turnover	Segments where efficient companies can grow with low CAPEX

3 Low risk

Limited dependence on the economic cycle	Looking for stable sectors with controlled exposure to economic downturns
Low exposure to technological obsolescence	Avoiding rapid obsolescence and product deflation

4 High market protection

Segments not dominated by suppliers	Avoiding sectors with unbalanced power situations favouring suppliers
Low dependence on fashion	Except 'once in a life-time' opportunities we disregard sectors heavily dependent on fashion (or in products subject to rapid change of consumer preferences)
Protected from '*Amazons*'	Protected from competition of large global online retailers and strong specialists

How to play these themes?

1 Growth

GDP growth and modernisation of retail markets		Playing on GDP growth and demographics Looking for strong weight of traditional retailers and market consolidation Disruptive models in developed markets
Key trends	**Proximity / Convenience**	Supported by structural socioeconomic and demographic factors: ageing populations, reduction of household sizes, increasing participation of women in the labour market, move to ready-to-eat products, lack of time, instant gratification
	Value	Building the most competitive prices through the most efficient cost structure
	Wellness	Addressing increasing concerns about ageing, healthy eating and living
	Specialty	Unique product and deep know-how embedded in a vertically integrated supply chain

2 Profitability made up of efficiency and competitiveness

Management skills	The single most important and differential factor
Operational excellence and simplicity	Cost leadership as the key to operational excellence

3 Low risk

Resilient segments	Value formats operating in those segments with better performance in downturns offering products not easily out-of-fashion

4 High market protection

Specific segments	Less affected by online or where online has not found the winning model
Low fashionability	We do not favour sectors with a strong fashion risk, highly exposed to changes in market trends

beragua

Triana, 31 - 28016 Madrid

Tel.: +34 91 535 7518

Fax: +34 91 536 2895

E-mail: info@beragua.com

www.beragua.com