Fitch downgrades Pick n Pay

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Fitch Ratings on Tuesday, 20 September 2011, downgraded SA-based retailer Pick n Pay's (PIK) national long-term rating to 'A(zaf)' from 'A+(zaf)'.

At the same time, the agency has affirmed its short-term rating at 'F1(zaf)'. The outlook on the national long-term rating is stable.

"The downgrade primarily reflects our expectation that Pick n Pay's weakened credit profile will recover at a slower pace in FY12/13 than the agency previously anticipated.

"We believe Pick n Pay's net lease-adjusted leverage metrics will remain above 2.3x over the medium term - a guideline previously set by Fitch as a maximum level consistent with a 'A+(zaf)' rating considering the tough competitive environment and the execution risk in the turnaround strategy," the ratings agency said.

The cash flow effect from significant working capital outflows in 2011 and costs associated with the group's transformation strategy is reflected in the group's net debt position of R1.2 billion in FY2011 compared with a net cash position in FY2010, Fitch said.

Adding that it expected investment levels to rise over the next two years as the group embarked on improving its supply chain through central distribution centres and by rolling out new stores.

"Pick n Pay's ratings continue to reflect the group's business profile, including its leading market position in the domestic food retail industry and the diverse range of its product mix, including both branded and private products. However, we believe the company's ability to deleverage organically will be constrained by weak free cash flow generation, after dividends due to high capex - as this is deemed necessary to secure its business position in the long term," it said.

Furthermore, Fitch said the stable outlook reflected its expectation that sustainable steps taken by management in 2010/2011, such as the focus on reducing costs, better working capital management and supply chain focus should provide operating cash flow relief and EBITDA margin protection over the long term.

The ratings agency said it recognised that the key challenge in the near term remained the successful execution of the company's domestic transformation strategy in a competitive food retail environment and more subdued economic growth prospects in 2011.

"Although there is some uncertainty about the timing of the completion of the sale of its Australian business, we notes that asset sale proceeds should help strengthen the liquidity position and finance expected capex levels," Fitch said.

It warned that it could take future negative rating action if the turnaround strategy failed to deliver real benefits in terms of market share gains and better profits, resulting in sustained negative free cash flow generation and lease-adjusted net leverage weakening around 3.0-3.5x.

"In contrast, sustained profitability improvement along with a prudent financial policy balanced with a more conservative shareholder return policy and net leverage below 2.0x would be positive for the ratings," Fitch concluded.