# Economic Outlook no.1233-1234

Spring 2017

Special Report

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# Retail, Disrupted

## Pressure and Potential in the Digital Age

Economic Research

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# Contents

Economic Research
Euler Hermes Group

**Economic** Outlook
**no. 1233-1234**

**Special Report**



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**Publication Director and Chief Economist:** Ludovic Subran
**Macroeconomic Research and Country Risk:** Ana Boata, Stéphane Colliac, Mahamoud Islam, Dan North, Daniela Ordóñez, Manfred Stamer (Country Economists)
**Sector and Insolvency Research**: Maxime Lemerle (Head), Farah Allouche, Marc Livinec, Didier Moizo (Sector Advisors)
**Support:** Laetitia Giordanella (Office Manager), Ilan Goren (Content Manager), Julien Aymé-Dolla, Georges Dib, Laura Mesbahi (Research Assistants)
**Editor:** Martine Benhadj
**Graphic Design:** Claire Mabille
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**For further information**, contact the Economic Research Department of Euler Hermes Group at 1, place des Saisons 92048 Paris La Défense Cedex – Tel.: +33 (0) 1 84 11 50 46 – e-mail: research@eulerhermes.com > Euler Hermes Group is a limited company with a Directoire and Supervisory Board, with a capital of EUR 13 645 323, RCS Nanterre 552 040 594
**Photoengraving**: Talesca Imprimeur de Talents – Permit Spring 2017; issn 1 162–2 881 ■ *May 16, 2017*

EDITORIAL

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# Thinking Outside the Cube

LUDOVIC SUBRAN

*"One cannot escape from one's own epoch, however revolutionary one may be." - Georges Braque*

Connected, segmented, cross-channeled, omni-channeled, seamless, automated and optimized.

Whatever the adjective, whatever the angle, all of these seem to boil down to the one meta-buzzword of our epoch: Customer Experience (CX). It might be tempting to dismiss it as hype. But the quest for CX is reshaping the multi-billion industry that is retail. It is also threatening millions of jobs, as employees of insolvent giant chains sadly learn almost on a daily basis.

Sales are analyzed, broken up and reassembled; the customer is depicted from a multitude of angles. Digitalization is just like Cubism. The early-20th-century art movement pushed European painting and sculpture in one dramatic leap into the 20th century. Cubism was to impressionism what digitalization is to retail: a tool for fully exploring a customer, and catering to the multitude. It deconstructs and redefines. Amazon and Alibaba are the industry's canvasses. CX is a visit to the gallery.

The millennial - in each of us - does not care much about dusty and ancient museums; she is busy m-shopping on her smartphone, sharing impressions with her e-friends. This Customer 3.0 likes to write instant reviews, compare prices, and experience off and online: 80% of Gen Y and Z shoppers are more likely to visit a store that offers virtual reality. She is a locavore, puts family and friends first and prefers subtle and understated brands. Yet her spending power is projected to eclipse Baby Boomers' in 2018. That is the game changer. What does it mean for retailers out there? Outsiders have made forays into once-exclusive territories, gained market shares, and caught traditional retailers unaware. The latter must now elbow their way back in an ever-disrupted digitized world. The other option is daunting. Outdated and outpaced stores are closing as some retailers see large shops more as a burden than an asset.

Traditional Business-to-Business (B2B) and Business-to-Consumer (B2C) differences are overrated and superfluous. Everything is retail, exponential, and about People-to-People (P2P). Intermediaries must demonstrate their value-added. Is the future of brick-and-mortar behind it? Well, was impressionism thrown on the trash heap of history when futurism disrupted classical art? No is the answer to both. It is all a question of adapting. Granted, commerce is not akin to high-brow art. But the ability to connect to the zeitgeist is a key in both fields. As retail comes of age, so should retailers. A strong digital presence can strengthen a brand, at home and abroad. It can facilitate access to markets. It may help boost sales. Still, companies need to treat the online world as a mean, not an end; a strategic tool, not a strategy. Omni-channeling, mobility and big data are game changers. But more importantly, the mindset needs a reset.

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OVERVIEW

# Digital Retail
## **Pressure** and **Potential** for **Change**

FARAH ALLOUCHE, MAXIME LEMERLE, LUDOVIC SUBRAN

■ Retail sales have been expanding at a +4.8% rate per year over the last decade (in nominal terms). While online activity only represented 9% of sales in 2016, it is set to climb to 15% by 2020. Both demand- and supply-side forces fuel this acceleration, as digital natives and platform businesses[1] are disrupting and reshaping the industry. The removal of intermediaries generates exponential growth and risks.

■ Fierce price wars have drained the financial resources of many traditional players. Established players failed to adapt to supply chain digitization and address the ever-growing Consumer Experience (CX) challenge. Profitability declined to 5.7% in 2016, down from 8% in 2011. Large retailers - with a turnover of USD10mn and more - have paid a hefty price. Globally, the number of major bankruptcies have soared by +66% in 2016.

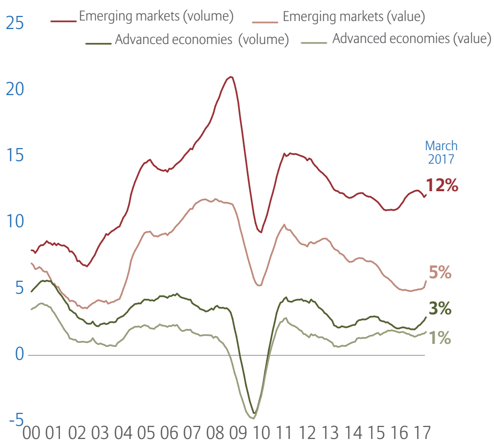
■ To preempt financial distress companies went on a shopping spree. In 2016 retailers spent a whopping total of USD2tn on acquisitions of tech companies, a sharp rise from USD148bn in 2014.

■ Euler Hermes' *Digitail* (Digital Retail) survey measures risks related to the rapid digitization of the retail sector. Our scorecard aims to gauge the digital pressure and digital potential based on ten indicators in twelve countries. It is derived from secondary data such as financials and national statistics, as well as in-house expert judgment from 1,500 credit analysts and underwriters around the world. Omni-channeling, cost of online presence, and mobility are perceived as the top three industry disruptors. Yet there is much regional and local divergence.

■ In-depth profiles are available for each of these 12 countries. Four groups of countries emerge from the study:

✓ First, the US, the UK, Germany and South Korea are under the most intense pressure to transform their business model. Yet most retailers in these markets are well positioned to deliver these changes.
✓ Second, France, Japan, and to a lesser extent Italy and Spain, face major pressures for change from customers. Yet their readiness is limited.
✓ China and India are keenly aware of the benefits of digitization but external pressures are kept at bay.
✓ Last, in Brazil and Russia, the retail sector is outdated, and market players struggle with structural difficulties.

**Chart 1** Retail sales in Advanced economies and Emerging markets
%, 12m/12m

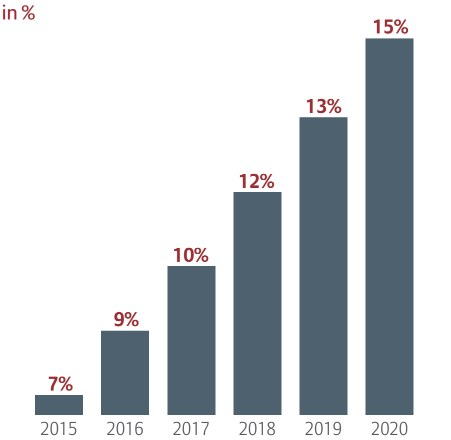



Sources: IHS, Euler Hermes

[1]A platform is a business model that creates value by facilitating exchanges between two or more interdependent groups, usually consumers and producers. In order to make these exchanges happen, platforms harness and create large, scalable networks of users and resources that can be accessed on demand. Platforms create communities and markets with network effects that allow users to interact and transact. Like Facebook, Uber, or Alibaba, these businesses do not directly create and control inventory via a supply chain the way linear businesses do. Platforms do not own the means of production— instead, they create the means of connection.

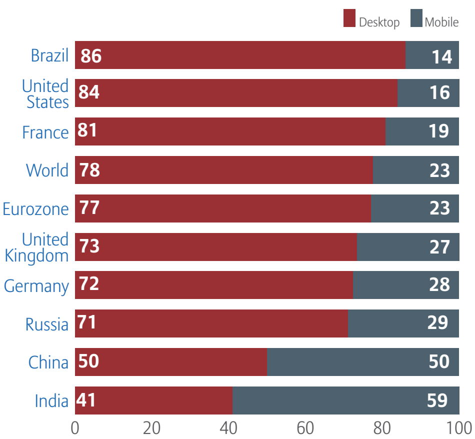

ourtesy of Michal Jarmoluk, pixabay.com. Under CC0

**Chart 2** E-commerce share of total retail sales
in %




Sources: Centre for Retail Research, eMarketer, Euler Hermes

**Chart 3** M-commerce vs. desktop ecommerce
% of total online sales




Sources: eMarketer, Euler Hermes

## Under Pressure: The rise of the value customer - and the collateral damage

Retail is at a defining moment: its entire business model requires a serious rethinking. After a decade during which global CAGR stood at +4.8% on average, a robust rate albeit the massive 2008-9 slump, the sector's expansion is just not fast enough.

In 2016, the mammoth industry raked in USD15tn. Yet the pace of sales' growth slowed down and reached +5% in value terms. 2017 should be a bit better, but the improvement (+6%) will be subtle and is mostly due to a price effect. Moreover, recovering prices are simply not enough to compensate for sluggish volume growth. In advanced economies, sales' volume growth is expected to remain capped below +1.5%, as it did for the most part of the last decade. Emerging markets will grow faster and reach a +7% rate. Yet the pace of growth stands at half of the average over the last decade (see chart 1). Softening growth serves as a warning sign. But plummeting growth means alarm bells are ringing worldwide.

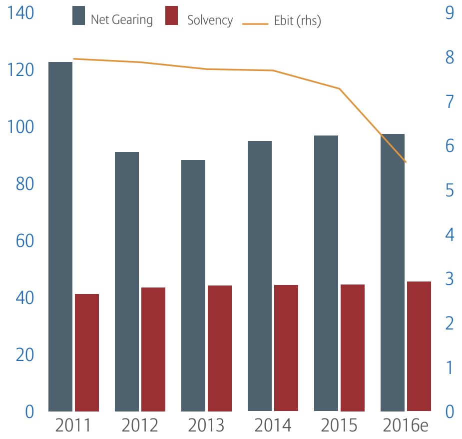
The rapid rise of online activities is another risk factor. E-commerce accounted for a mere 7% of total retail sales in 2015. We expect it to increase to 15% by 2020, following the fast expansion of Internet access, up from 7% of world population in 2000 to 44% nowadays. In advanced economies, internet penetration rates are above 80% of households (e.g. Germany 86%, South Korea 84%).

Some countries took a technological leap, skirting the desktop route and going directly for mobile. Russia is the world leader with 160 mobile subscriptions per 100 inhabitants. In India, where Internet penetration is low, mobile commerce is the preferred tool for online shopping (59% of e-shopping). Technology has transformed the 'Walmart' experience to an 'Amazon' one: faster, closer and in some cases easier.

### The Darwinian Effect: Adapt or close

Retail has undergone a profound change over the last 15 years. At first, worldwide chains of stores relied on **skyrocketing volumes and debt** as part of a size-does-matter business model. As the Walmart effect rippled across the world major players rushed to conquer and dominate emerging markets in Asia, Brazil or Russia on the back of a pile of debt (122% net gearing ratio in 2012). Yet the effort to compensate for low unit margins proved trickier than expected and the sector was facing some harsh realities. Big box retailers had massively invested in

**Chart 4** Key financial ratios of listed retailers in twelve countries*
in %




* US, UK, Germany, France, South Korea, Japan, China, India, Italy, Spain, Russia, India
Sources: Bloomberg, Euler Hermes

**5.7%**

Retailers' EBIT in 2016 (down from 8% in 2011)

countries that had quickly become the main **contributors to profitability – but not revenue.** To meet the "less for more" expectations of the so-called Customer 2.0 and address the slowdown in household wealth growth, retailers descended into cutthroat **price wars.**

Rock bottom prices obliterated the differentiation between actors and drove a sudden downturn in several markets where large investments were still not fully amortized. But the direct and crucial consequence was **a sharp deterioration in profitability.** Earnings Before Interest and Taxes (EBIT) tumbled to 5.7% in 2016 down from 8% in 2011 (see chart 4).

The failure to fully grasp the shift in consumer behavior meant that price wars were, in fact, a rearguard action. This resulted in an ever-growing pressure to join forces in the hunt for economies of scale. The other option was extinction. **Mergers and acquisitions** grew at a CAGR of +6.2% per year between 2010 and 2016.

**Bankruptcies**, on the other hand, meant bigger losses than before. The cumulated revenues of the ten biggest insolvent companies totaled an impressive USD5.2bn in 2016, after USD6.7bn in 2015. Even worse, the number of insolvent retailers with a turnover of USD10mn or more soared +66% y/y in 2016. One prominent example is Australian electronics retailer Dick Smith, which was bought out by online service Kogan.com. Another is the American company Golfsmith which did not succeed in overcoming its waning popularity among younger customers.

**USD5.2bn**

Cumulated revenues of top 10 major retailers' insolvencies in 2016

Now retail must undergo a painful-yet-necessary consolidation phase. As Consumer Experience (CX) takes center stage **value** becomes the key word.

The revolution that led from the mass consumer, through bargain hunter, to the current value seeker forced giant retailers to adapt or face extinction. The mammoths must evolve to survive.

Most retailers have to rethink their business model as pure players enter the market aggressively. Pushed to invest in online activities, companies often failed to reshape the entire **supply chain** journey and deliver the seamless experience that customers had grown to expect.

In 2015, awareness clicked in. **Acquisitions of tech companies** by retailers boomed with 41 deals (+173% y/y) worth USD786bn. The number of acquisitions stabilized in 2016 (40), but the value of deals soared to USD2000bn.

Euler Hermes is confident the trend will continue in 2017 as retailers resort to artificial intelligence (AI) to harness the power of big data and deliver customized experiences.

In addition, platform companies mushroom and pose a direct competition to classic retail. An estimate by Accenture put the market capitalization of the top 15 public platform companies at USD2.6tn in 2016.

Retailing now means more than the selling of goods to individuals. It entails every imaginable service from renting, through delivering and informing to financing. Retailers are hence incentivized to either create or build a **platform strategy.**

**USD2 trillion**

Total value of tech companies' acquisitions by retailers in 2016

The crucial question is whether retailers – be they traditional, online or both – can determine how to upgrade their business models in the most efficient way before it is too late, bridging brick and mortar and online sales, old tricks and new needs. That's the new Digitail equation.

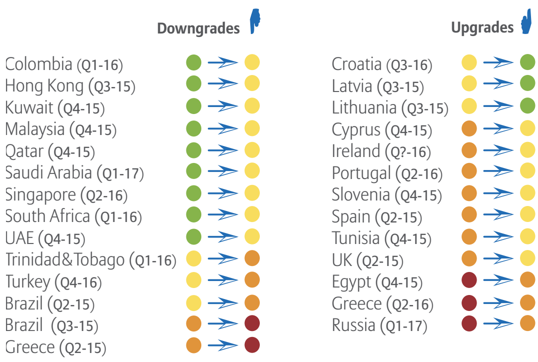
## Measuring Digitail Risk

In this section, we first provide a brief account of non-payment risk in the retail sector. Then, using in-house experts and new data, we analyze what digitalization means for the industry (Digitail risk) and create a scorecard. The objective is to complement the traditional and gradual view of risks weighing on retailers with a disruptive dimension.

### Non-payment risk: On the rise

At the end of every quarter, Euler Hermes updates its sector risk ratings, which measure the

**Chart 5** Retail Sector Risk changes
Q1 2015-Q1 2017




Legend:
- **Low risk:** Sound fundamentals; very favorable or fairly good outlook
- **Medium risk:** Signs of weaknesses; possible slowdown
- **Sensitive risk:** Structural weaknesses; unfavorable or fairly bad outlook
- **High risk:** Imminent or recognised crisis

Source: Euler Hermes

**Chart 6** Top Challenges faced by Retailers worldwide

Based on ranking by Euler Hermes' retail risk experts in 12 countries
(Averaged score from 1 – the less important- to 10 – the most important )

| | US | UK | France | Germany | Spain | Italy | Japan | Brazil | Russia | India | China | South Korea | Global |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Master omni-channeling | 10 | 8 | 10 | 3 | 5 | 6 | 9 | 7 | 9 | 10 | 9 | 6 | 7.7 |
| Cost of online presence | 7 | 9 | 9 | 9 | 9 | 4 | 8 | 10 | 8 | 7 | 8 | 3 | 7.6 |
| Mobile customer journey | 9 | 10 | 1 | 8 | 10 | 7 | 2 | 6 | 5 | 9 | 10 | 8 | 7.1 |
| Tap into big data | 8 | 7 | 7 | 4 | 4 | 10 | 3 | 9 | 10 | 6 | 5 | 4 | 6.4 |
| Redefine market positioning | 6 | 6 | 8 | 7 | 6 | 5 | 7 | 4 | 7 | 2 | 6 | 7 | 5.9 |
| Mitigate reputational risk | 3 | 3 | 6 | 10 | 8 | 9 | 1 | 2 | 3 | 4 | 3 | 9 | 5.1 |
| Leverage marketplaces | 4 | 5 | 4 | 6 | 7 | 3 | 6 | 5 | 6 | 3 | 7 | 5 | 5.1 |
| Integrate new payment methods | 5 | 2 | 4 | 5 | 2 | 2 | 4 | 8 | 4 | 5 | 4 | 10 | 4.6 |
| Sustainable sourcing | 2 | 1 | 3 | 2 | 3 | 8 | 5 | 3 | 2 | 1 | 2 | 2 | 2.8 |
| Other | 1 | 4 Cash generation | 5 Marketing innovation | 1 | 1 | 1 | 10 Ageing population | 1 | 1 | 8 Branding | 1 | 1 | 2.9 |

risk of non-payment for 20 sectors in 70 countries, with a view of demand, profitability, financing and competition risks in each country. The result is a 4-scale risk level from Low - sound fundamentals with a very favorable or fairly good outlook - to High - imminent or ongoing crisis. As of Q1 2017, the overall retail sector risk is Medium. This means there are signs of weaknesses and a possibility of slowdown in the majority of the countries analyzed (55%; see retail risk map), close to the average across all industries. It is less risky than Pharmaceuticals, Aeronautics and Agrifood but riskier than Metal, Construction and Textile. Still, a gradual deterioration has been observed since Q1 2015. Retail risk was downgraded in 14 countries - and upgraded in 13.

## Omni channeling, cost of online presence, and mobility: Three game-changers for retailers worldwide

Euler Hermes's 1500 risk experts track 70 million companies worldwide. In a first-ever Digitail Survey, we interviewed our credit analysts and underwriters in 12 countries: France, Germany, the UK, Italy, Spain, the US, Brazil, Russia, South Korea, Japan, China and India. The aim was to reflect on challenges for the retail sector going forward. When asked to rank the most important challenges retailers are coping with now and in the coming 5 years, omni-channeling, the cost of online presence, and mobility were ranked as top three challenges:

#1. **Omnichanneling** is a cross-channel approach to sales. It seeks to provide customers with a seamless shopping experience online (mobile or desktop), by phone, or in-store at a brick and mortar shop. Retailers struggle to tackle this massive challenge, break silos and de-compartmentalize both digital and in-store channels of distribution. The concept revolves around the consumers' desire for flexibility and experience. It is about where and what to shop, but also how to pay and where to be delivered. Refunds and returns are a particularly thorny problem. The latter are often offered for free and take place immediately after the purchase.

#2. **The cost of online presence** has become a major problem for transitioning retailers. Mortar and digital are too often compartmentalized, though the hybrid customer wants both a store footprint and online selling platforms. This duality could mean heavy costs (infrastructure, soft and hard, double marketing budget and so forth) without growth levers to offset them in a price war environment. In addition the cost of acquisition (leads generation), churn, and advertising have increased massively. If one adds planned obsolescence (search engine optimization and referencing, payment systems e.g.), the necessary investments for traditional retailers represent a major challenge.

#3. Flexibility primarily relates to **mobility**. It provides answers to two important questions: 'where' to shop or be delivered and 'how' to pay or get informed. Developing a mobile customer journey can be achieved by digitalizing the offer and the spread of Internet of Things (IoT). Mobile devices are more affordable than desktop or laptop computers, compatible with nearly all platforms thanks to the proliferation of applications, and require less infrastructure development.

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Interesting to note two of the top three challenges are about growing the top line and only one about the costs (of online presence). Big Data is an important challenge for the respondents. Indeed, connected objects, digital platforms and customer journeys generate immense amounts of information but a seamless experience requires strong analytics (see chart 6).

Many of the issues listed above are common to most retailers worldwide. Retailers must not only embrace a borderless approach but also juggle with local peculiarities. They need to develop and implement ad-hoc 'glocal' strategies. Looking at the heat map one can see that while effective omni-channeling is perceived as a critical mission in many key markets, notably the US, UK, France, China, Japan, India, and Russia, it is not deemed a top priority in Germany (very low actually), Italy, Spain and South Korea. In these countries, reputational risk comes in very high, along with ensuring mobility.

While the cost of online presence was almost unanimously mentioned as a top priority, this was not the case in Italy and South Korea. Last, mobility was not an issue for France and Japan. Big data, ranked 4 as a priority overall, was not deemed as important in Germany, Spain, Japan and South Korea. From the verbatim, some interesting insights came up: cash generation has been daunting in the UK; marketing innovation is a struggle in France; the ageing consumer is a major game changer for retail in Japan; and brand stickiness and awareness is an important issue in India.

FOCUS

# Methodology of the **Digitail Risk Scorecard**

Our scorecard aims to measure risks related to the rapid digitization of the sector. It is based on ten sub-scores in twelve countries, using secondary data (financials and national statistics) as well as the results of a first in-house survey of 1,500 credit analysts and underwriters. Each sub-score is on a scale ranging from 1 (very low) to 10 (very high). Sub-scores have been computed into two key scores dedicated to evaluate on one hand the **digital pressure** for change and on the other hand the **digital potential** to change.

✔ **The first score assesses the exogenous impetus for change or Digital Pressure.** It analyzes the extent to which current forces outside the companies push businesses to reshape their strategies and operations. The score is based on three elements:

**i) The intensity of price wars.** When margins are pushed below sustainable levels, retailers must act. It combines two indicators, assessed qualitatively by in-house retail experts: (i) level of concentration in a given country from 1 (low) to 10 (high); and (ii) discounters' market share (also from 1 to 10). Germany and the UK are the countries experiencing the fiercest price wars, according to Euler Hermes experts.

**ii) The likelihood of market reshuffle** is represented by the probability of new players entering the market and the threat of substitute. In other words, these are competition forces that could put existing retailers in danger. Euler Hermes retail risk analysts see China and India as the markets where a reshuffle is most likely, mainly because of the substitution threat.

**iii) The frequency of online shopping** provides a quantified assessment of how accustomed internet users are to new ways of purchasing. The main sources for analysis are Ecommerce Europe and Statista (with Euler Hermes data harmonization). Italy and Brazil, for example, report similar low levels of e-shoppers (34% and 35% respectively). The various reasons are illustrated in the second part of this report.

✔ **The second score evaluates retailers' readiness to change over the next two years or Digital Potential.** It is based on three sub-components:

**i) Retailers' financial strength**, summarized by profitability (using EBIT) compared to indebtedness over time. The latter relates to net gearing ratio, calculated as the sum of short and long term financial debts, minus cash and cash equivalent, divided by shareholders' equity. The highest scores are found in China and India – although "organized" retail is still minor in the former. The higher the score, the stronger the retail players.

**ii) Logistic efficiency** (1=very low; 10=very high) is based on the World Bank's international Logistic Performance Index (iLPI). It provides qualitative evaluations of a given country in six areas - customs, infrastructure, international shipments, logistic quality, tracking and timeliness. The evaluations are done by partners—logistics professionals working outside the country. Russia reports the weakest LPI score, opening the door to huge opportunities for improvement in a longer-run.

**iii) Awareness of digital challenges** evaluates the gap between local perceptions of top priorities compared to the global average, as reported by in-house experts. The higher the score, the more aware the retailers in the country. Perhaps unsurprisingly, the US leads. India is ranked second, before the UK.

Two limitations are worth noting: First, the availability of corporate financial information varies across countries and segments since we used listed companies only. The minimum number of companies for a country was set at 5; and second, e-commerce does not exist as a stand-alone segment. Many bricks and mortars retailers derive part of their revenue from online activities, thus making the distinction irrelevant. ■

**Chart 7** The Digitail Risk Scorcard

| | Intensity of price wars | | Likelihood of market reshuffle | | Frequency of online shopping** | DIGITAL PRESSURE | Awareness of digital challenges* | Logistic efficiency *** | Financial strength *** | DIGITAL POTENTIAL |
|---|---|---|---|---|---|---|---|---|---|---|
| | Level of concentration* | Discounters'- market share* | Probability of new players* | Threat of substitue* | | | | | | |
| UK | 10 | 10 | 4 | 1 | 10 | **8** | 10 | 8 | 7 | **8** |
| US | 4 | 10 | 7 | 7 | 7 | **7** | 10 | 8 | 7 | **8** |
| South Korea | 7 | 7 | 1 | 7 | 10 | **7** | 1 | 7 | 10 | **6** |
| Germany | 7 | 10 | 1 | 7 | 10 | **8** | 1 | 8 | 7 | **5** |
| China | 4 | 4 | 7 | 10 | 1 | **5** | 7 | 7 | 10 | **8** |
| India | 4 | 1 | 4 | 10 | 1 | **4** | 10 | 7 | 10 | **9** |
| France | 7 | 7 | 4 | 7 | 7 | **7** | 4 | 8 | 4 | **5** |
| Japan | 7 | 4 | 4 | 7 | 7 | **6** | 1 | 8 | 4 | **4** |
| Italy | 10 | 4 | 4 | 4 | 4 | **5** | 7 | 8 | 1 | **5** |
| Spain | 7 | 7 | 4 | 4 | 4 | **5** | 4 | 7 | 4 | **5** |
| Russia | 7 | 4 | 1 | 4 | 1 | **3** | 7 | 5 | 1 | **4** |
| Brazil | 4 | 1 | 1 | 4 | 4 | **3** | 4 | 6 | 1 | **4** |
| **Global** | **7** | **6** | **4** | **6** | **6** | **5** | **6** | **7** | **6** | **6** |

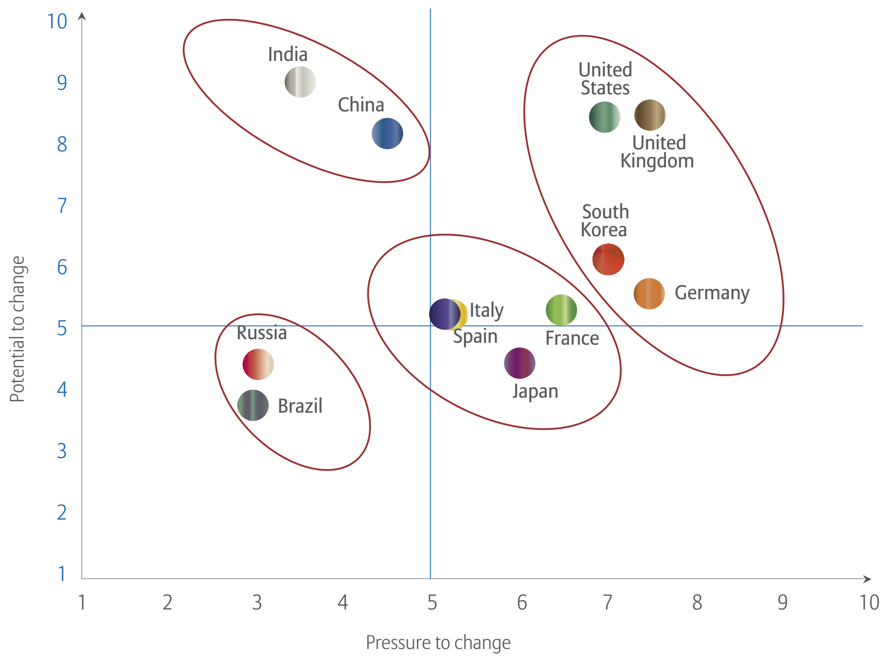
* Assessment from local retail risk experts (survey May-Sept 2016), from 1=Low to 10=High
** % e-shoppers, Statista and Ecommerce Europe 2016, data harmonization Euler Hermes, 1=less than 30%, 4=between 30 and 50%, 7=beetween 50 and 70%, 10=more than 70%
*** World Bank, international LPI
**** Bloomberg, Financial statements of 922 listed companies in 12 countries from FY 2011 to FY 2015, 2016 estimations Euler Hermes

## The Digitail Risk Scorecard and P&P matrix

It is essential to measure whether retailers are well-equipped to deal with the shifting landscape of their markets, especially those related to digitization. To answer this question, we put together: (i) a scorecard, which uses secondary information on the changing landscape, proprietary information on company financials, and experts' judgment from our Digitail Survey; and (ii) a Digital Pressure and Digital Potential (to change) or P&P matrix to summarize our findings.

The aim is to capture: first, the intensity of the pressure retailers face to reshape their models; and second, their ability to undertake the needed changes over a two-year period.

**Chart 8** The P&P matrix of *Digitail* Risk




Source: Euler Hermes

The results indicate that:

**# 1.** Retailers in the US, UK, Germany and South Korea face the most intense pressure to transform their business model. Yet most of these are well positioned to embrace and act on changes. Some actors, however, can be left out of the accelerating digitization trend – or in some cases crushed under the stampede.

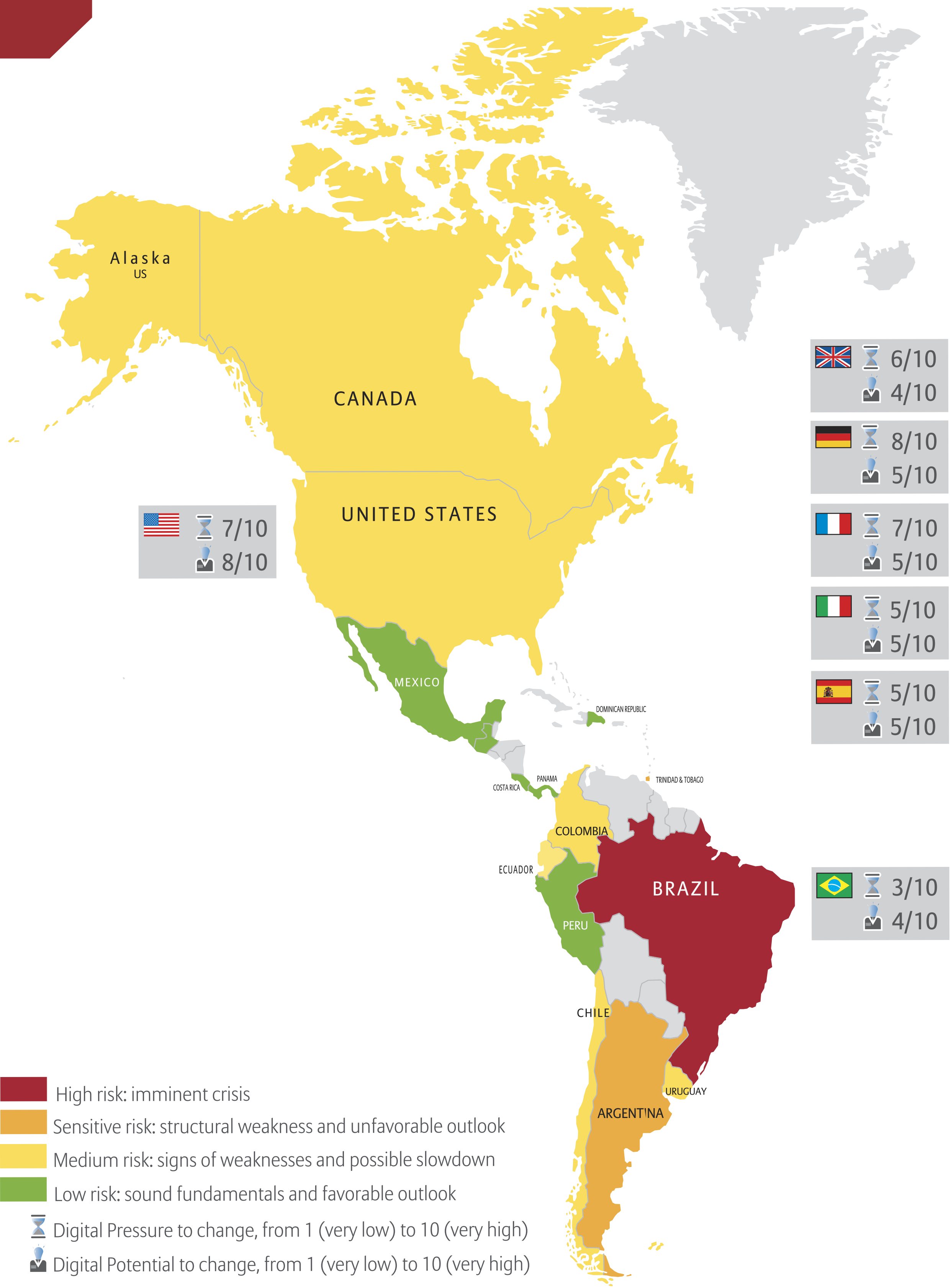
**# 2.** France, Japan, and to a lesser extent Italy and Spain, experience major pressure for change from customers and markets players. Yet the readiness to undertake the necessary transformation and adapt is limited. There is a high risk of a messy and costly restructuring.

**# 3.** China and India benefit from astute players with a heightened awareness of digitization's potential to gain massive market shares. Yet, barriers to entry are high and well-guarded by major actors.

**# 4.** In Brazil and Russia, the retail sector experiences limited pressure from newcomers and consumers. This may be a blessing in disguise as retailers have limited capacity to embrace change because of structural financial difficulties. ■

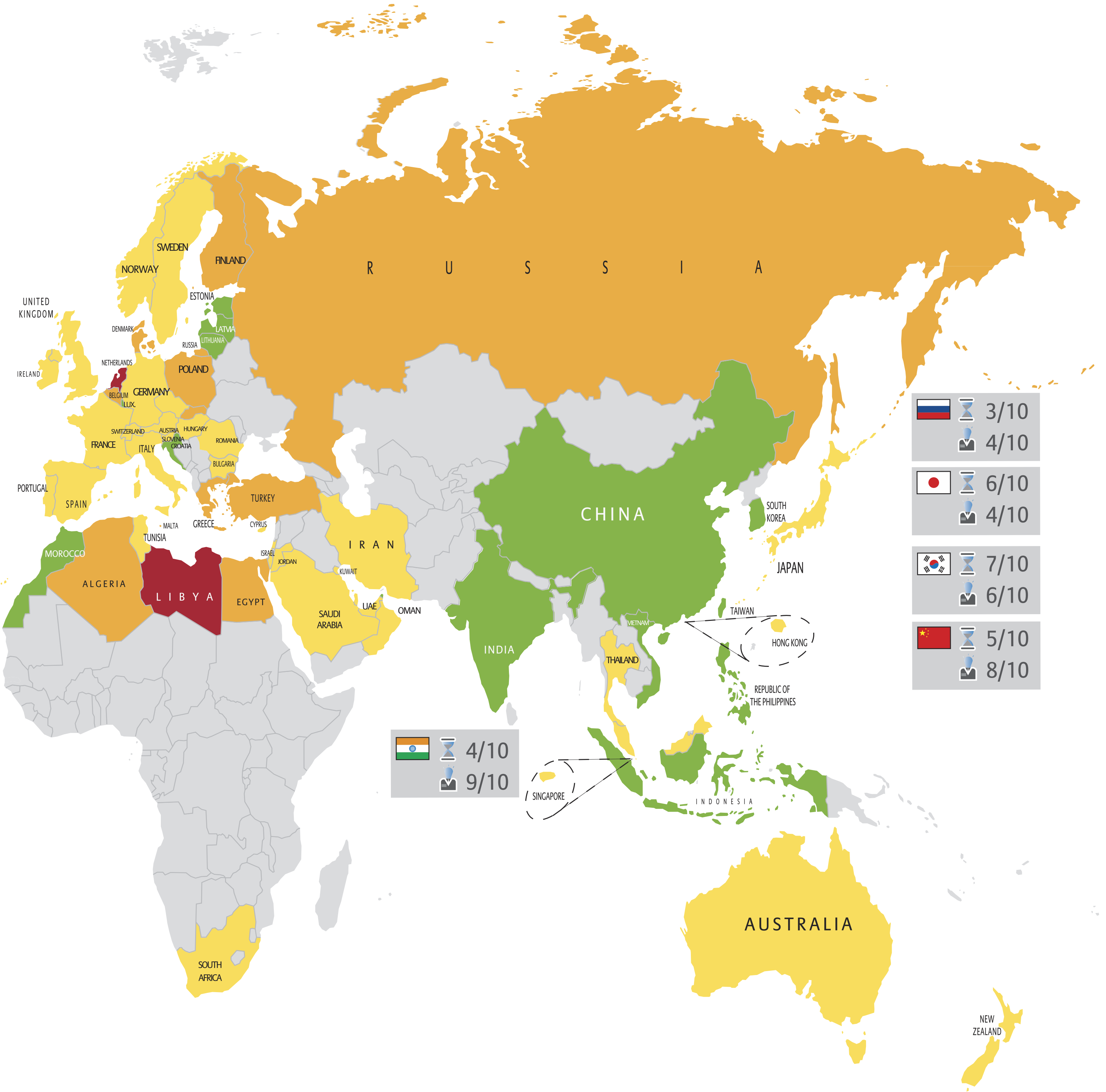
# Retail Risk
## Map
## 2017

**Q1 2017**



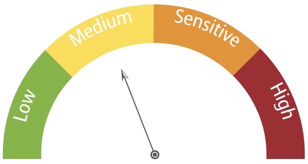

Source: Euler Hermes

# Retail Risk Map, Q1 2017

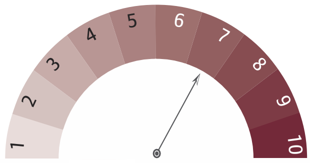


# Retail in the US

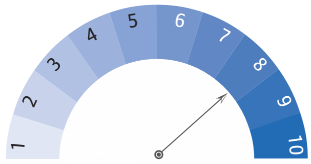
## To thrive you must first survive




Retail Non-Payment Risk (Q1 2017)




Digital Pressure




Digital Potential

- **Nominal retail sales in the US bounced to +3% y/y end of 2016. They should accelerate in 2017-18 thanks to boosted household consumption and recovering retailers' pricing power. Yet a rise in import costs could offset the fiscal stimulus's benefits.**
- **Publicly listed retailers deleveraged in 2016. Net gearing was down to 95% (-15pp vs. 2015), while EBIT recovered at around 8%.**
- **The groceries segment has been so far spared by most of the disruptive impact, unlike Apparel and Electronics the main victims of restructuring and failures.**

### No-frills is not enough

Nominal retail sales have bounced at the end of 2016 reaching +3.0% y/y in December, after stagnating at below +2.5% since end of 2015. This trend could be supported by the return of inflation. Euler Hermes's core scenario for the US forecasts an inflation rate of +2.5% in 2017 and 2018 (after a mere +1.4% in 2016) with three Fed hikes per year. The promised fiscal stimulus, corporate and personal income tax cuts, if implemented, should boost wages growth (+3.3% in 2017 and +4.1% in 2018) and household disposable income.

Renewed pricing power and increased consumer spending power should promise a bright future. Yet at the same time, if the new administration imposes tariffs and other non-tariff barriers, USD appreciation would not be enough to offset the rise in import costs. Retailers could pay a hefty price.

Therefore, American retailers must develop a differentiation strategy – other than no-frills – to increase margins and survive in an uncertain environment. Those who failed to do so in 2016 and early 2017 ended up failing themselves. American retailers are closing stores or failing at a record pace: Women's clothing retailer Bebe, Hancock Fabrics -one of the largest fabric sellers in the US-, Golfsmith, a golf-gear retailer… Past-dues activity has seen a steady increase since September 2016 with a knock-on effect along the supply chain on buyers in textiles, electronics, and manufacturing. In the meantime, US customers, of whom 70% are e-shoppers with Millennials leading the trend, have moved to the next level: they are eager to experience virtual and augmented reality in-store.

### Ready for disruption

Retailers focused on deleveraging in 2016, pushing net gearing down to 95% (-15pp) and improving cost management allowing EBIT to recover up to around 8%. Euler Hermes estimates that non-payment risk in the sector stands at 'Medium' on average.

Moreover, American retailers are well aware of the long-run challenges. Interestingly, the top three challenges US participants named in our survey - mastering omni-channeling, mobile customer journey, and tapping into big data – accurately reflect the responses worldwide. In other words, as the US goes, so does the world.

The country also benefits from efficient logistics. It is ranked 10th out of 160 in the World Banks' LPI index and excels in tracking and tracing of goods. Local companies are well positioned to embrace disruptive supply chain and delivery models.

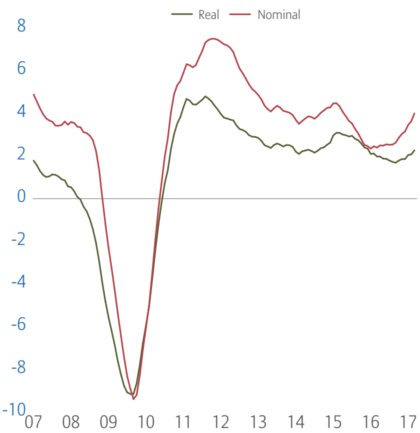
### Looking forward: What does it all mean for businesses?

US retailers should focus on providing quality and innovative customer experiences and disruptive delivery formats.

✓ Promising sub-sectors: Grocers are relatively secure due to their critical size and the industry's must-have quality – food is always a necessity.

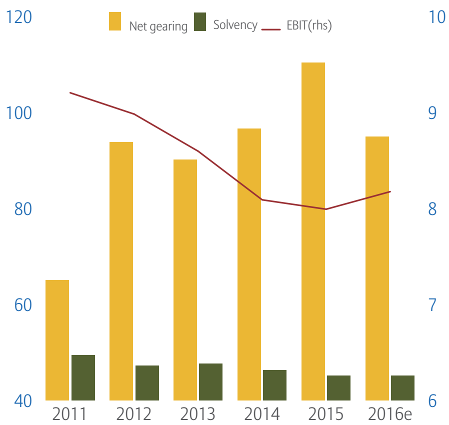
✓ Sensitive sub-sectors: Apparel and electronics will continue to experience the highest failure rates. ■

**Chart 1** Retail sales in the United States
in %, 12m/12m, as of March 2017




Sources: IHS, Euler Hermes calculations

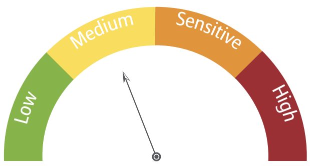
**Chart 2** Financial performances of American listed retailers



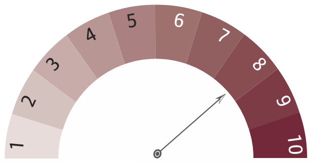

Sources: Bloomberg, Euler Hermes calculations

# Retail in the UK

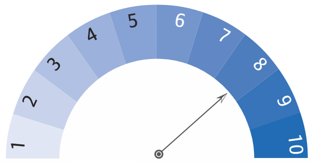
## No room for **complacency**



Retail Non-Payment Risk (Q1 2017)



Digital Pressure



Digital Potential

- **In the context of Brexit, the macroeconomic outlook for 2017 and 2018 is uncertain as consumer spending is expected to slow down, weighing on retail sales.**
- **Intense competition, namely from online activities, is putting businesses at stress: EBIT was down -1.4pp to 5.6% and net gearing picked up in 2016 to 66%, from 55% the year before.**
- **Although it is not all bright major grocers and apparel e-players should remain on track in 2017, while department stores and high-street apparel retailers would keep suffering from consumption downturn.**

### Uncertainty weighs on British retailers

Nominal retail sales have picked since end of 2016 (+3.0% y/y) after stagnating at about +1% since Q3 2015. Severe price pressures and low inflation (+0.7% in 2016), both played their part in the fierce price wars.

Yet, in a post-Brexit environment, we forecast inflation to rise by +2.5% in 2017 and +2.6% in 2018 on the back of depreciated sterling and National Minimum Wage has been revised up to GBP7.5/hour in April 2017 (from GBP7.2). A full-time worker stands to gain an extra GBP 1,400 a year. This could mean additional GBP4bn might be available for UK consumers.

A potential rise in inflation and income could foster retailers' pricing power, and compensate the likely deceleration in volumes. Indeed, real consumption growth is set to slow down (+1.9% in 2017 and +1.3% in 2018) and the rise in minimum wage offers only partial relief to low earners that are the most affected by higher food and fuel prices.

Another important factor is high concentration: only five grocers dominate the market. But threats abound: the discount format has made big gains, with up to 10% market share. At the same time, in 2016 a whopping 81% of customers were e-shoppers, a rate twice higher than the European average. This highly disruptive force sounded the death knell for many high-street retailers that failed to adapt. Two major failures were reported in the apparel segment in 2016. A Levy and Gajan Holdings could not withstand the competition from TM Lewin, Moss Bros, and the giant Marks & Spencer.

### Well equipped for the ultimate de-compartmentalization

After several years of continuous improvement, British retailers' financial standing deteriorated in 2016. Net gearing ratio increased by +10pp to 66%, while EBIT slid -1.4pp to 5.6%. In the backdrop of worsening macroeconomic prospects, Euler Hermes estimates the UK retail sector faces a medium risk level for non-payment.

British retailers' top priorities are mostly aligned with our survey's overall digital challenges for the sector. The top three challenges experts chart include the mobile customer journey, the cost of online presence and mastering omni-channeling.

The UK enjoys an advantageous logistic environment, ranking 8th out of 160 on the World Bank's LPI. Retailers are well positioned to face the above-mentioned challenges, provided they succeed in stabilizing financials.

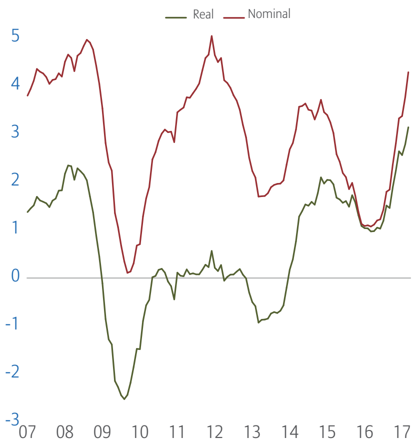
### Looking forward: What does it all mean for businesses?

The ultimate de-compartmentalization of digital and in-store will be supported by leveraging IoT and cutting-edge payment methods. This should limit Brexit's expected negative impact on retail.

✓ Promising sub-sectors: Big grocers & discounters; fashion retailers with an online presence and overseas operations.

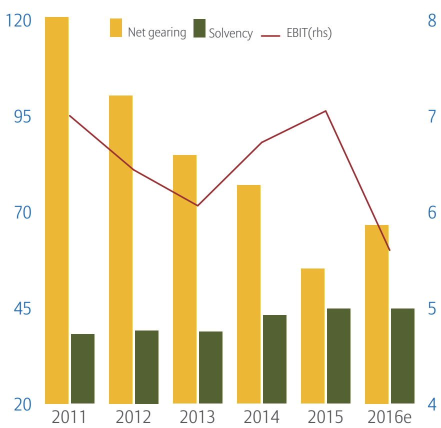
✓ Sensitive sub-sectors: Department stores and traditional fashion retail are the first to suffer from declining traffic. ■

**Chart 1** Retail sales in the United Kingdom
in %, 12m/12m, as of March 2017



Sources: IHS, Euler Hermes calculations

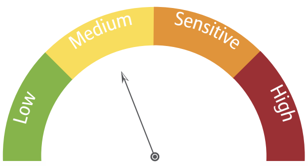
**Chart 2** Financial performances of British listed retailers



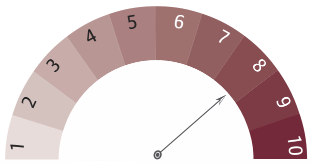
Sources: Bloomberg, Euler Hermes calculations

# Retail in Germany

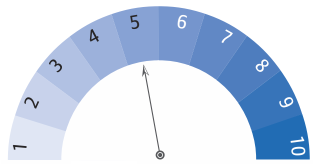
## The march of the **discount giants**




Retail Non-Payment Risk (Q1 2017)




Digital Pressure




Digital Potential

- **In 2017 and further on, the return of inflation and the slowing growth of real consumer spending suggest modest nominal retail sales growth in Germany.**
- **German retailers have suffered a dramatic decline in profitability: from 7% in 2011 to 2.9% in 2016. At the same time, indebtedness is down -6pp compared to the previous year, reaching a yet significant 95%.**
- **Discounters and online pure players are well placed to keep the growth momentum while the fashion and electronics sub-sectors face pressure.**

### Mission almost impossible

Nominal retail sales growth in Germany has slightly regained momentum in Q1 2017. Yet it has not recovered to the pace observed at the end of 2015. This downturn results from the almost non-existent inflation (+0.5% in 2016) and stagnating households' disposable.

Discounters' big hit overwhelmed the local market. The format accounts for more than 40% of the total grocery market. The top five European discounters are German. Crucially, these mega-players tend to expand their foreign activity very fast achieving a 10% market share in the UK and 2% in the US where the growth potential is immense. Supermarket chain Lidl, for example, is gearing up to open stores in the US ahead of schedule in summer 2017.

As a result, escaping the price war is almost Mission Impossible for German retailers. The return of inflation in 2017 (+1.8%, forecast) and 2018 (+2.1%) could hint at a relative improvement of German retailers' pricing power. One reason being is that German customers have by and large already adopted digitalization. 86% of the population uses the Internet and 27% of online retail is carried out on mobile devices. E-commerce, often more affordable than in-store purchases, resonates well with price-savvy customers. Online sales represented 14% of retail sales in Germany in 2016 (compared to 9% in the World), up from 10% in 2010.

### Time to get going

In an almost-deflationary context, retail profitability dramatically plunged: EBIT declined to 2.9% in 2016, compared to nearly 7% in 2011. Food & drug and the apparel segments report the weakest profits at 2.2% and 2.3% respectively.

However, the overall equity level remained steady while net gearing decreased to 95% in 2016), down from 102% in 2015. This is reflected in the limited number of major insolvencies (three companies with a turnover above EUR50mn in 2016). Euler Hermes non-payment risk rating stands at 'Medium'.

German retailers' perceptions of the sector's top priorities are well-aligned with local peculiarities. Respondents in the Euler Hermes Digital Retail survey feel that 'mitigating reputational risk' is a top priority, followed by the cost of online presence and the mobile customer journey. Companies find it difficult to address the German population's grave concerns about data privacy because of multiple data sources and flows. Add to that the complexity of legal frameworks in various countries. With no overall data strategy in place, this will remain a thorny issue.

The other two priorities should be easier the tackle. The World Bank's international LPI ranks Germany first out of 160 on logistics. Rolling out mobile device journeys will require a fully-fledged data strategy, based on adequate infrastructures.

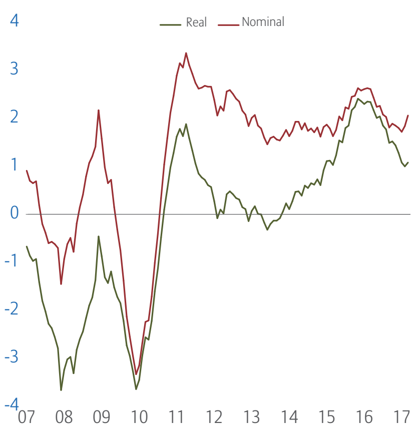
### Looking forward: What does it all mean for businesses?

Clinging to price battles and outdated 'traditional' e-commerce is the single biggest threat to German retail. Upgrading the delivery and selling strategies will be key.

✓ Promising sub-sectors: Discounters and online pure players

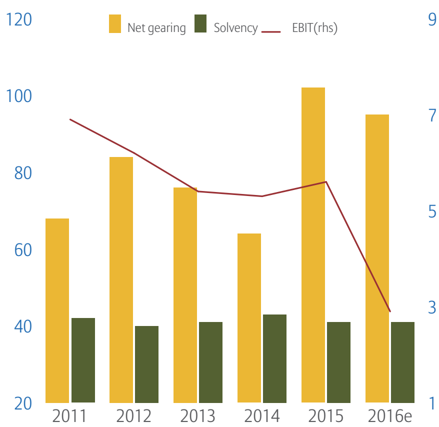
✓ Sensitive sub-sectors: All segments, particularly fashion and electronics. ■

**Chart 1** Retail sales in Germany
in %, 12m/12m, as of March 2017




Sources: IHS, Euler Hermes calculations

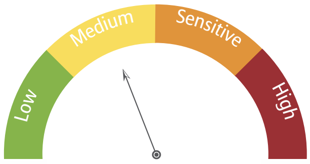
**Chart 2** Financial performances of German listed retailers



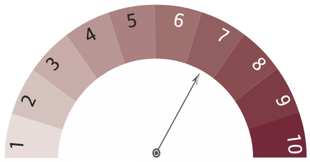

Sources: Bloomberg, Euler Hermes calculations

# Retail in France

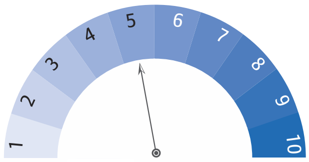
## In search of lost innovation




Retail Non-Payment Risk (Q1 2017)




Digital Pressure




Digital Potential

- **The slight pick-up of inflation (+1.1% expected in 2017) and acceleration of consumer spending (+2%) may offer retailers a one-time opportunity to boost pricing power eroded by three years of an intense price war.**
- **EBIT plunged in 2015 and 2016 to 3.7% and 2.6% respectively while net gearing soared to 95%. This hindered French companies' ability to adjust their offers to satisfy digital-ready consumers.**
- **Grocery, pure-players and organic segments are expected to resist better while the apparel segment might come under further strain.**

### Mired in stagnation

Although the penetration of the discounting format is less important in France (less than 10% market share) than in Germany (40%), price wars escalated four years ago. This was a desperate attempt to offset the threat of recession (+0.2% GDP growth in 2012). Since then, nominal sales have never exceeded a +1.5% growth rate y/y. The relative acceleration of real private consumption in 2016 (+1.8%) was countered by stagnating prices with inflation close to 0%.

While macroeconomic drivers indicate brighter prospects for retailers (inflation above +1% and stronger private consumption), deeper changes will be required to turn opportunities into earnings. The unfettered hunt for economies of scale and escalating price cuts has run its course. Big companies paid the price: seven French retailers with a turnover higher than EUR100mn went bankrupt in 2015 and one more was reported in 2016. French customers - 64% are e-shoppers - are open to new ways of shopping. Despite some success stories that cater to the needs of millennials – such as the private sales site vente-privée.com, booming local coops, and the online fashion brand Sézane - generally speaking, retailers fail to meet new shoppers' expectations.

### Lost in customer relations

The mismatch between big box French strategy and shifting customers' expectations has resulted in a dramatic deterioration of the financial standing across the entire sector. EBIT plummeted in 2015 and 2016 to 3.7% and 2.6% respectively while net gearing soared to 95%. The economic adjustment in China and recessions in Brazil and Russia landed a blow on French grocers who invested massively in these regions. Euler Hermes assesses the risk of non-payment as Medium.

Added to the weakening financial standing, French retailers' perception of the sector's biggest challenges diverges from the global picture as portrayed by the Euler Hermes Digital Retail survey. Respondents felt that local companies must first master omni-channeling, followed by the cost of online presence. Finally, French retailers should redefine market positioning. Indeed, the price war led to a blurred positioning as retailers manage e-commerce as a parallel channel. Only now do companies invest in differentiation in an effort to catch up with the digital race. What does seem to function properly are logistics: France is ranked 16thout of 160 in the World Bank LPI index. Still, international shipments and logistics quality and competence are relative underperformers.

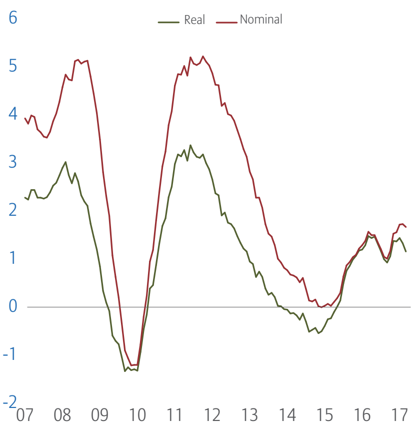
### Looking forward: What does it all mean for businesses?

Vertical integration - rather than horizontal concentrations - as well as offering unique organic products or limited collections, enabled some retailers to differentiate and survive the price battles. The discounts race has drained companies' ability to adapt to consumers' expectations. The rebound of the French economy can boost retailers with pricing power. This should be used to invest and innovate.

✓ Promising sub-sectors: Grocers, online pure players, organic segments

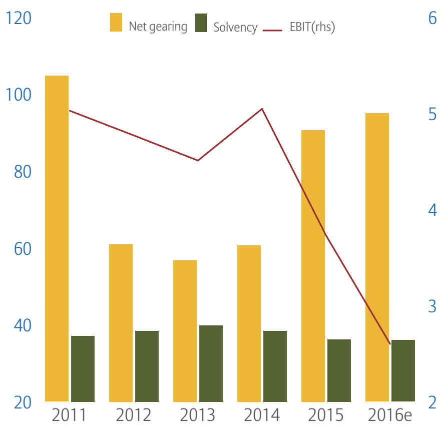
✓ Sensitive sub-sectors: Apparel and electronics retailers are most at risk, as they are affected by foreign online retailers. ■

**Chart 1** Retail sales in France
in %, 12m/12m, as of March 2017




Sources: IHS, Euler Hermes calculations

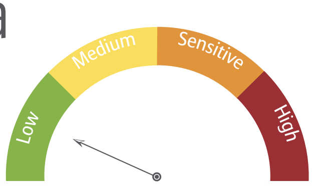
**Chart 2** Financial performances of French listed retailers



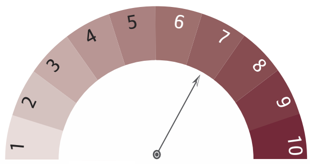

Sources: Bloomberg, Euler Hermes calculations

# Retail in South Korea

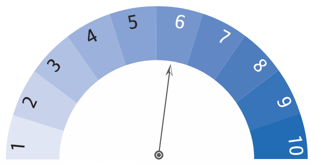
## Missing out on **data strategy**




Retail Non-Payment Risk (Q1 2017)




Digital Pressure




Digital Potential

- **A modest growth in nominal retail sales is expected for 2017-2018, a trend linked to a stabilization of real consumer spending (+1.3% in 2017, +1.2% in 2018).**
- **Retailers had a sound financial standing in 2016, backed by lowering debt and strong solvency (57%). This was achieved despite a continuous deterioration in profits as EBIT was down to 7% from 9.3% in 2011.**
- **General retail must-have format and offer prevent the segment from major risks. Food & drugs are victims of overcapacity while experiencing rising indebtedness.**

### Boosted consumption and digital appeal

After two years of barely any growth, nominal retail sales picked up in 2016 to reach +4.4% y/y (December 2016). This recovery was strongly supported by the government's fiscal stimulus and monetary policy aimed at boosting the domestic market. Sales' improvement should continue although it will rely on prices rather than volumes. Indeed, Euler Hermes forecasts real consumer spending to decelerate to +1.3% in 2017, +1.2% in 2018, weighing on real sales growth. But inflation (+2.2% expected in 2017 and in 2018) will offer a recovery of pricing power.

The large market concentration and penetration of discounters have resulted in severe price pressures. This left retailers with little choice but to move faster on digitalization. This will not be an easy task for some of the long-established players. 4 of the 10 top Korean retailers were established before 1990. At the same time, three unicorns/platform companies are already providing gaming, e-marketplace or mobile services. 72% of internet users in South Korea are e-shoppers, while the average in APAC stands at a humble 13%. Half of online shoppers use mobile devices, a figure that is expected to climb to 65% by 2019.

### Time to disrupt the 'supply chain journey'

In 2016 retailers focused on deleveraging. Net gearing reached a low 39% down from 59% in 2013, while solvency levels improved to 56.7%. This sound financial situation explains the Euler Hermes assessment of a Low non-payment risk, despite a continuous deterioration in profitability since 2011. EBIT declined to the acceptable ratio of 7%, down from 9.3% in 2011.

Korean retailers' perceptions of the main priorities to tackle in the long-run include (#1) integrate new payment methods, (#2) mitigate reputational risk, and (#3) mobile customer journey. While being digital-savvy, retailers might get side-tracked by the focus on customers and fail to address the need to leverage data and adapt the supply chain. A full-fledged data strategy is a prerequisite to security and confidentiality.

The country's LPI ranking -24th out of 160 in the World Bank logistics index - is under par compared to other countries this study analyzed. Some adjustments will be required, especially in customs and international shipments, to efficiently disrupt supply chain models.

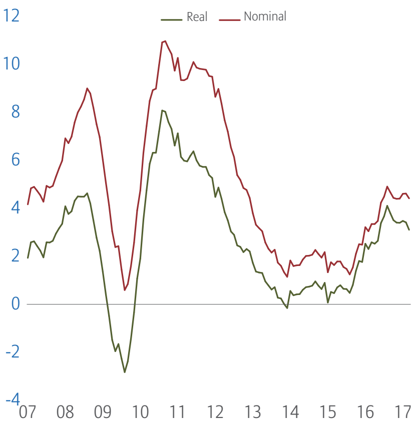
### Looking forward: What does it all mean for businesses?

South Korea is a digital savvy country with profitable key players and a mature mobile strategy. It should remain a country where pressure and potential to change are high provided it develops a fully-fledged data strategy. Upgrading logistics will be pivotal to achieve this goal.

✓ Promising sub-sectors: General retailers offer diversified lines of business and often belong to conglomerates.

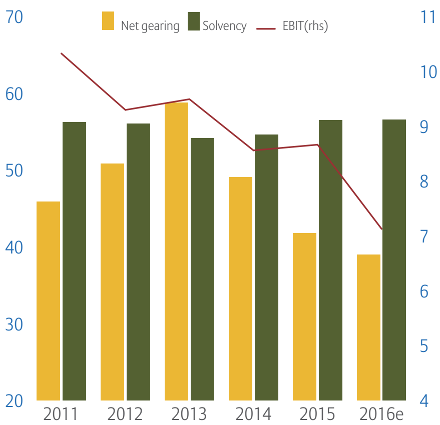
✓ Sensitive sub-sectors: Local experts warn against overcapacity in the food & drugs segment. A net gearing of 160% and only 3.5% EBIT in 2015 makes it the weakest segment. ■

**Chart 1** Retail sales inSouth Korea
in %, 12m/12m, as of March 2017

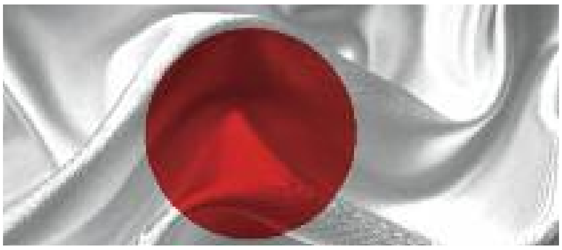



Sources: IHS, Euler Hermes calculations

**Chart 2** Financial performances of South Korean listed retailers

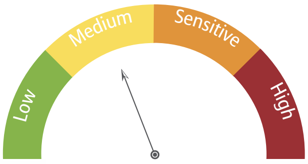



Sources: Bloomberg, Euler Hermes calculations

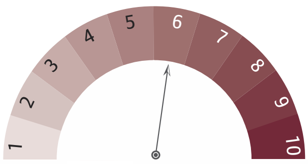


# Retail in Japan

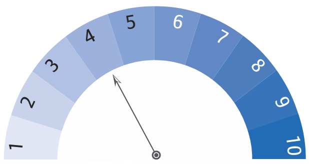
## The upside-down pyramid




Retail Non-Payment Risk (Q1 2017)




Digital Pressure




Digital Potential

- **Though still in negative territory, Japanese retail sales have been on an upward trend since October 2016. Yet the upside-down demographic and a rapidly aging population do not bode well for consumer spending growth.**
- **Japan's retail sector profits were down from 6% in 2013 to 5% in 2016 while net gearing has risen by +10pp to 75% over the same period.**
- **Convenience stores and online pure players are the least sensitive sub-sectors. General retail and home & office suffer from an unattractive positioning.**

### Moving up the aisle: New services and experience

Ever since September 2014 retail sales have suffered a continuous slide. The pace, however, slowed down after bottoming in March 2015 at -3.8% y/y. The stagnation if not the decline (-0.4% y/y in December 2016) in real wages is limiting real consumer spending, set to remain below +1% (+0.8% in 2017 and +0.9% in 2018). Deflationary pressures have undermined the market: the long-term CPI reached a mere +0.3% on a yearly average basis (2005-2015). The slight increase in producer prices by +0.5% y/y in January 2017 could, however, lead to a slight recovery in retailers' pricing power.

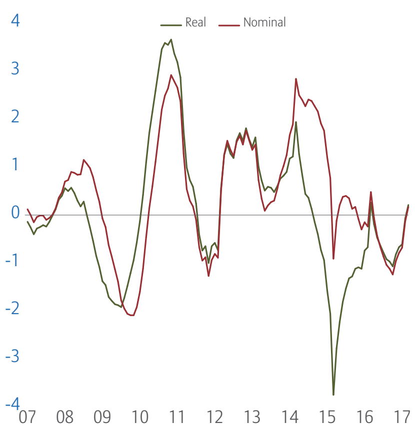
While being a mature market, Japanese consumers are quite digital-savvy: 55% shop online and in there were 125 mobile subscriptions per 100 inhabitants in 2015. However, population decline and aging negatively impact potential sales. The median age is much higher than the world figure - 46.5 and 30.1 years, respectively. To cope with the shrinking population (-1 million people in the past five years), some retailers - such as Seven & I and Aeon - have launched an internationalization strategy which seeks to expand business abroad in order to secure profits.

In such an adverse environment, retailers have no choice but to focus on in-store experience, shopping convenience and added services. Optimizing delivery is one such example.

### Senior citizens go digital

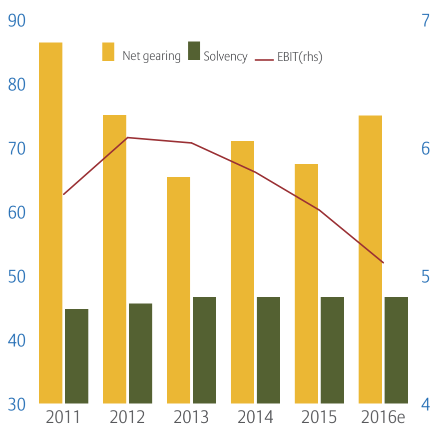
After three years of improving financial structure – both indebtedness and profit levels – Japanese retailers experienced deteriorations in 2016. Net gearing increased to 75% compared to 65% in 2013, while EBIT shrank from 6% to 5% over the same period. In this regard, Euler Hermes assesses retail in Japan to be in Moderate risk of non-payment.

**Chart 1** Retail sales in Japan
in %, 12m/12m, as of March 2017




Sources: IHS, Euler Hermes calculations

**Chart 2** Financial performances of Japanese listed retailers




Sources: Bloomberg, Euler Hermes calculations

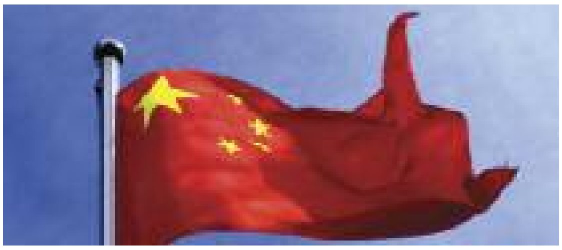
Demography explains why Japanese experts who participated in the Euler Hermes Digital Retail survey rank the top challenges for the local sector in the following way. Population decrease comes at the top, followed by mastering omni-channeling and tapping into big data. The efficient logistic system (ranked 12th out of 160 in the World Bank LPI benchmark) provides retailers with sound foundations. These can support the disruption of supply chains and the emergence of new delivery models that would be adapted to an aging population attracted to digital.

### Looking forward: What does it all mean for businesses?

Offering services through apps and delivery flexibility are two major opportunities for retailers in Japan. However, as prices play an important part in purchase decisions, investment should be well calculated to avoid triggering price hikes.

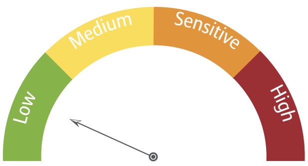
✓ Promising sub-sectors: Convenience stores and online pure players are well positioned to withstand pressures.

✓ Sensitive sub-sectors: General retail and home & office suffer from an unattractive positioning. ■

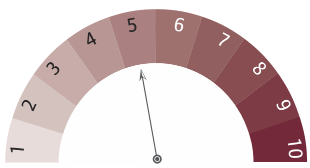


# Retail in China

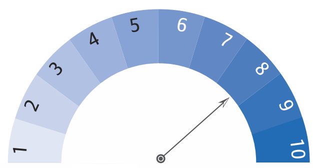
## An O2O breath of life




Retail Non-Payment Risk (Q1 2017)




Digital Pressure




Digital Potential

- **In 2017 and further Chinese real retail sales should stabilize at around +9% growth, slightly below the double-digit long-term average. Retailers are betting on an online-to-offline (O2O) strategy to leverage opportunities offered by the rise of a new middle class.**
- **Publicly listed Chinese retailers saw a notable decrease in their debt ratios. Net gearing declined to 42% in 2015-16, down from 51% (2014). Profitability has remained high at 10.5%.**
- **Electronics and online retailers should keep the momentum going, while the luxury segment is set to restructure, due to the impact of the anti-ostentatious policy.**

### Developing an online-to-offline (O2O) strategy to compensate slower but more qualitative demand

Nominal retail sales have displayed a strong +10.5% y/y growth in March 2017. Current performance may be lower than the ten-year average of +15% y/y because of China's economic readjustment. The rise in producer prices for the fifth consecutive month in January 2017 (+6.9% y/y up from +5.5% in December 2016) signals a budding reflation. This could boost retailers pricing power and provide an opportunity for wider margins.

Customers will drive the impetus for change. For now Chinese consumers are still torn between the search for the best deals – pushing retailers into aggressive pricing strategies – and the quest for quality and premium products. The latter is most related to the rise of the Chinese middle set to double by 2022. The digital savvy – half of the 30% internet users are in fact m-shoppers, they will be 72% by 2020 – and increasingly demanding customers force retailers to shift towards online-to-offline (O2O) retail models. This business strategy draws potential customers from online channels to physical stores. Consumers order and pay for products and services digitally. Orders are then fulfilled physically. Behemoths Alibaba and Bailian coming closer epitomizes how these two channels are being utilized as complements rather than competitors.

### Improve connectedness to move to the next level

Despite the deceleration in sales in 2016, companies have enjoyed a strong financial standing. Double digit EBIT (10.5%) was accompanied by a sharp debt decrease - net gearing was down to 42% in 2016 (from 51% the year before). On the basis of these fundamentals, Euler Hermes assesses retail risk in China as Low (Q1 2017).

Chinese retailers have a clear awareness of the challenges they need to tackle over the next years to fulfil customers' expectations. Participants named in the Euler Hermes Digital Retail survey identified mobile customer journey as the top priority, with mastering omni-channeling at second place, followed by the cost of online presence. Expanding online activities in rural areas is a big challenge – and so is the potential for expansion.

The top-notch performance of international shipments (China is ranked 12th out of 160 countries in the Word Bank's LPI) exemplifies the solid foundations of the Chinese supply chain and cross-country delivery model.

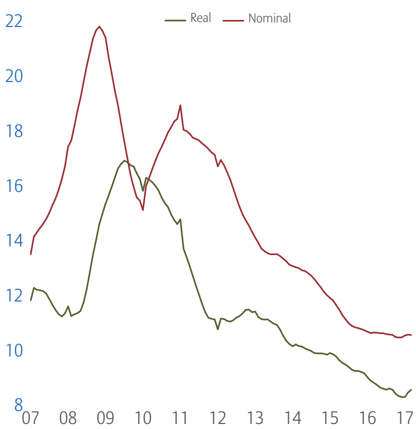
### Looking forward: What does it all mean for businesses?

China has already laid the groundwork for an astute digitail and customers' display readiness to embrace the shift. Chinese retailers would be wise to better integrate supply journey upgrading further infrastructure while optimizing store footage, particularly in less populated areas.

✓ Promising sub-sectors: Online pure players have gained the critical mass. They now offer customers imported trendy goods.

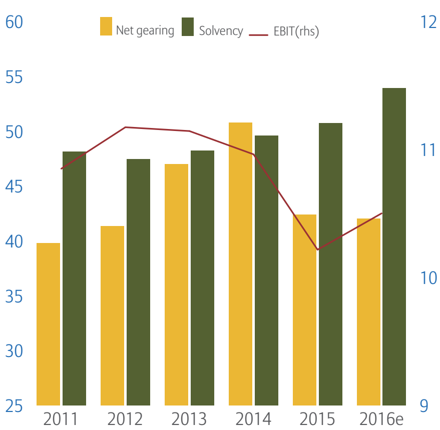
✓ Sensitive sub-sectors: Luxury brands are suffering from an austerity campaign launched in 2012. State workers are encouraged to neither offer nor receive luxury products. ■

**Chart 1** Retail sales in China
in %, 12m/12m, as of March 2017




Sources: IHS, Euler Hermes calculations

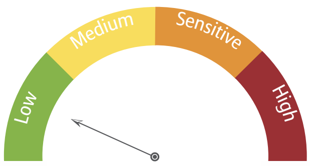
**Chart 2** Financial performances of Chinese listed retailers



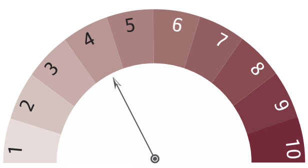

Sources: Bloomberg, Euler Hermes calculations

# Retail in India

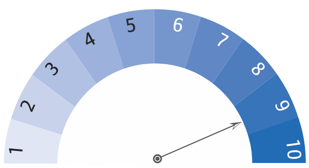
## All bets are off




Retail Non-Payment Risk (Q1 2017)




Digital Pressure




Digital Potential

- **Indian retail sales will be stabilizing at a +3/+4% growth rate in 2016 and beyond, supported by strong demand growth, accommodating government policies.**
- **Publicly listed retailers have deleveraged, pushing down the debt ratio from 86% in 2013 to 70% in 2016. At the same time, margins have recovered up from 4% in 2013 to 7% in 2016.**
- **The food segment will benefit from a volume effect with the rise in consumer spending. Fashion's profits reached 7.9% in 2016 while general retail enjoys only a modest 2% EBIT.**

### M-retail to support the digital in-store

Since November 2015, retail sales have recorded a rapid growth rate (exceeding +4% y/y) and enjoy bright prospects. Demand will be pushed up by expanding Millennials who make up a staggering two-thirds of the Indian population. Current consumer mindset is reflected by the break between the typically small, independent, family-owned "mom and pop stores" - currently 9 in 10 shops - and malls and hypermarkets. The latter's share is expected to account for 13% of the market by 2020, up from the current 8%. This trend is expected to spread to second and third tier cities such as Jaipur (3.5 million inhabitants) or Madurai (1.5 million), while adopting flexible models, considering the country's cultural diversity (780 languages, 6 major religions).

Yet, digital substitutes pose a major threat to Indian retailers. E-commerce is still making baby steps: only 10% of consumers shop online, while the APAC average stands at 13%. India was ranked at the bottom spot in our panel of 12 countries when it comes to technological penetration with only 0.01 server and 79 mobile subscriptions per 100 inhabitants. This leaves ample room for m-commerce development: mobile accounted for 59% of e-commerce in 2016. This opportunity was seized local online-only companies such as Flipkart and Snapdeal. These control, respectively, 46% and 23% of the e-market.

### Upgrade infrastructures before offering a digital retail journey

The remarkable improvement of the debt ratio (from 95% in 2012 to 70% in 2016) illustrates the strong financial standing of 'organized' retail and the sector as a whole. The leveraged balance sheet position often stems of debt-funded capital expenditures required to open new stores in underserved regions. Profitability, recording a decent 7% in 2016, should be monitored closely though given the slowing growth of consumer prices. Overall, Euler Hermes assessed non-payment risk as Low.

The Euler Hermes Digital Retail survey shows that Indian retailers have a keen perception of the main challenges they face. Respondents placed mastering omni-channeling as a top priority, followed by mobile customer journey and customer loyalty. However, the latter seems somewhat superfluous taking into account the sheer number of millennials and their lack of brand loyalty.

India's logistical performance is lacking, especially when it comes to timeliness, international shipments and customs. This hinders companies' ability to follow through the "retail journey" and weighs on the country's attractiveness.

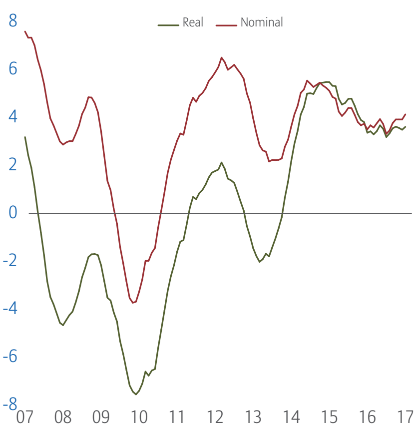
### Looking forward: What does it all mean for businesses?

Retail prospects in India are shaped by the opposing forces at play. Increased competition puts pressure on profits while developing omni-channeling and store networks require large cash flows. However, the powerful demographic forces can boost volumes' growth.

✓ Promising sub-sectors: The food and apparel segments will benefit from a volume effect (the latter's profits stand at 7.9%). Online pure players benefit from the remarkable growth rate of internet users (+24% in 2015).

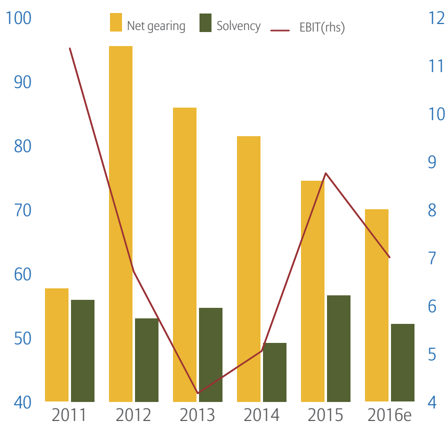
✓ Sensitive sub-sectors: General retail only enjoys 2% EBIT. Home & office also lacks disruptive impulse. ■

**Chart 1** Retail sales in India
in %, 12m/12m, as of March 2017




Sources: IHS, Euler Hermes calculations

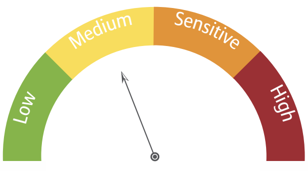
**Chart 2** Financial performances of Indian listed retailers



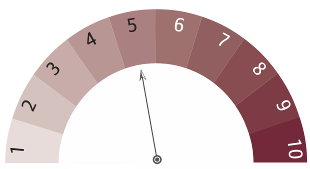

Sources: Bloomberg, Euler Hermes calculations

# Retail in Italy

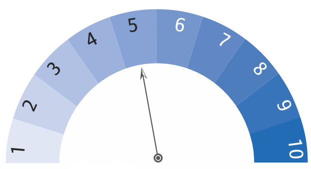
## **Push** and **pull**




Retail Non-Payment Risk (Q1 2017)




Digital Pressure




Digital Potential

- **Retail sales were back in negative territory starting 2017, due to declining consumer confidence and slowing private expenditures.**
- **The financial situation of Italian retailers has suffered a sharp deterioration: net gearing soared from 36% to 250% from 2011 to 2016.**
- **Luxury and niche retailers focusing on sustainability enjoy a sound outlook. But the home & office and electronics segments employed discounting strategies putting profitability at risk.**

### Resistance to digital

After a short period in positive territory, retail sales have decreased since December 2016 (-0.2% y/y end of March). Wages are set to stall (+1.1% in 2017 and 0% in 2018) and consumer confidence is forecast to deteriorate further. This gives little hope for a turnaround in 2017.

The Italian retail market is an extremely concentrated one, particularly in the food and drug segments. The well-established and integrated players have been in business for such a long time that disruption seems unlikely. For instance, the top 10 luxury fashion retailers' average establishment date is 1932. Unexposed to pressures from new entrants, top brands have little impetus to change.

Customers on their part are quite reluctant to experiment with new shopping formats and prefer a traditional shopping experience in-store. E-shoppers only represent 34% of the population, a figure significantly lower than the European average (43%), as the need for a human touch is real, even as users' journeys become digitized. Another stumbling block to online payments is Italians' entrenched fear of credit card fraud. To succeed, companies should focus on efficient and secure online experiences.

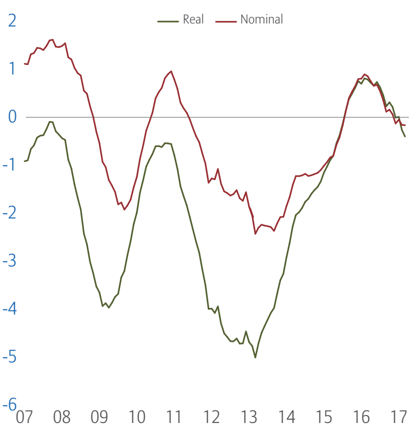
### Unsustainable company debts and a public passion for sustainability

The sharp deterioration in Italian retailers' financial situation over the last 6 years, is manifested in the indebtedness ratio peaking at 250% (up from 37% in 2011). Two major failures affected the food segment in 2016. Cedi. Sisa Centro Sud and Cedi. Sisa Sicilia was overwhelmed by high leverage and declining demand. Yet overall profitability remained at a satisfying level with an EBIT of 8.5% in 2016. In this context, Euler Hermes analysts see retail in Italy facing a Moderate risk of non-payment.

Given the reluctance to take the leap to digital and the strong feelings Italians have about sustainability, challenges prioritization from the Euler Hermes Digital Retail survey ranks as follow: (#1) tap into big data; (#2) mitigate reputational risk and (#3) sustainable sourcing, particularly in the apparel segment.

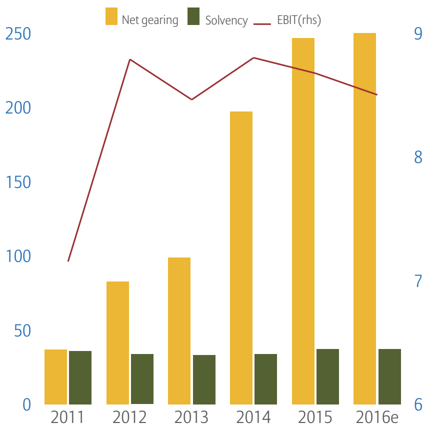
Italy's logistics – the country ranks 21st out of 160 in the World Bank LPI stressing a weakness in customs' operations - provide retailers room for improvement to implement an innovative supply chain and delivery model.

**Chart 1** Retail sales in Italy
in %, 12m/12m, as of March 2017




Sources: IHS, Euler Hermes calculations

**Chart 2** Financial performances of Italian listed retailers




Sources: Bloomberg, Euler Hermes calculations

### Looking forward: What does it all mean for businesses?

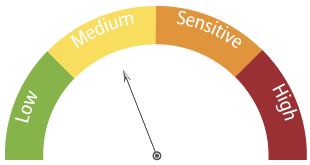
Currently, the Italian market is neither ready nor eager to change. Adding to the gloomy economic environment, companies are torn between a passive decline and disruptive investments that are likely to prove unprofitable. One solution could take the shape of improved advice for consumers, providing customers with intuitive digital device services in-store.

✓ Promising sub-sectors: Luxury and niche retailers focusing on sustainability are the best placed to meet future challenges

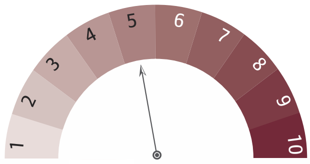
✓ Sensitive sub-sectors: Home & office and electronics segments suffered from discounting strategies which hurt their profitability. ■

# Retail in Spain

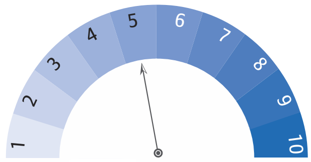
## Aging in the age of digital




Retail Non-Payment Risk (Q1 2017)




Digital Pressure




Digital Potential

- **Retail sales stabilized at +2% in 2016, after struggling to climb out of negative territory. Yet the deterioration in consumer confidence and an expected slowdown in expenditures pose serious challenges.**
- **Spanish retailers' financial situation considerably improved in 2016 (8.5% EBIT). Yet indebtedness remains high (100% net gearing).**
- **Apparel is the leading segment while food & drug is challenged by population decline.**

### The not-so-quick win: Converting senior citizens to digital shoppers

Retail sales in Spain saw a +2% growth on average in 2016, still half of pre-crisis levels. Looking forward, inflation is forecast to tick up +2.2% in 2017 and +1.7% in 2018 after several years of deflation. Yet this slight recovery in pricing power may be undermined by declining consumer confidence – the first since 2013.

In the long run, demography poses a real threat. The population could start to shrink as soon as 2024, which will pressure retail sales. By 2050, not only could Spain lose 11% of its current population, but over-65s would account for a third of it.

The Spanish customer profile and shopping culture still call for a traditional experience in -store. E-shoppers only represent 50% of the population while online retail made up a mere 4.1% of total retail in 2016, reflecting customers' skepticism of online payment services and delivery systems. No unicorn company has so far emerged out of Spain, a clear sign that neither digital culture nor customer experience has been fully embraced. Successful companies will be the ones that manage to provide efficient and secure digital services, while also continuing to offer some sort of human touch. Such services are critical in an economy where senior citizens play an ever- ng of 2017 the no growing role.

### Fighting for nothing?

Companies have managed to shed some weight off their balance sheets. While huge debts weighed down on retailers in 2011 (185% net gearing), the ratio now stands at an acceptable 100%. Profitability remained stable at around 8.5% over the last five years. Overall, at the beginning of 2017, the non-payment risk for the retail sector in Spain is assessed as Medium by Euler Hermes.

Spanish retailers' concerns diverge from the global picture portrayed by the Euler Hermes Digital Retail survey. The population's non-readiness for a 'shopping 3.0' customer journey drives the top three local challenges: (#1) mobile customer journey, (#2) cost of online presence,( #3) mitigation of reputational risk.s

The other reason why Spain just averages both potential and pressure to change is the poor logistics compared to the other countries covered by the Score. Timeliness is a particularly thorny issue. This deficiency strains retailers' productivity and feeds the Spanish households' little confidence of remote shopping. Delays and cancellations still plague the local industry.

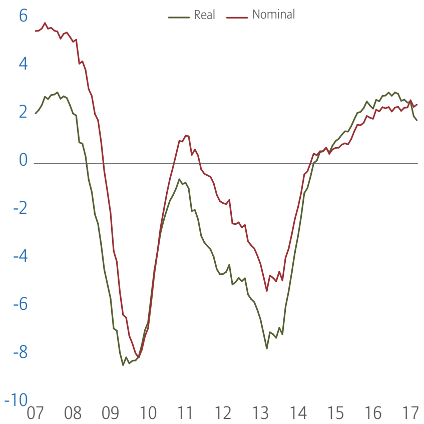
### Looking forward: What does it all mean for businesses?

Retailers' should prioritize a twofold strategy that mixes today (traditional) and tomorrow (digital). Companies must humanize the digital experience to reassure customers. This will not be an easy task: the country's structural weaknesses and high debt ratios leave little room for the needed investments.

✓ Promising sub-sectors: Apparel has been resilient to years of crises

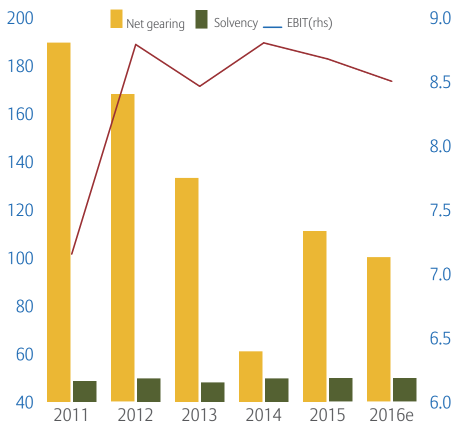
✓ Sensitive sub-sectors: Food & drug is most at risk with regards to demography concerns and sales price decrease. ■

**Chart 1** Retail sales in Spain
in %, 12m/12m, as of March 2017




Sources: IHS, Euler Hermes calculations

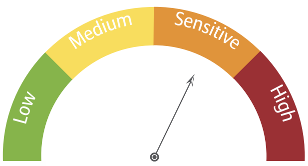
**Chart 2** Financial performances of Spanish listed retailers



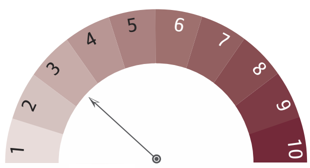

Sources: Bloomberg, Euler Hermes calculations

# Retail in Russia

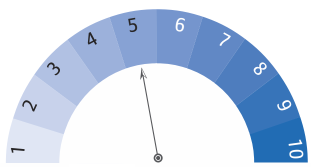
## The **capabilities** and **expectations mismatch**




Retail Non-Payment Risk (Q1 2017)




Digital Pressure




Digital Potential

- **After -4.5% in 2016, growth resurgence and inflation cooling will support the progressive recovery of retail sales in Russia in 2017-18, that may eventually find their way back in the positive territory.**
- **2016 witnessed the lingering struggle of Russian retailers: debt levels dramatically improved from 130% in 2016 from 258% in 2014, while the EBIT fell to 3% from 6.1% two years ago.**
- **Food grocers and discounters benefit from the essentiality of their offer while Electronics and Independent food retailers are the first victims of the 2015-2016 recession.**

### Catering to the needs of far-flung provinces and GenZers

Russia went through a series of simultaneous crises. Tense politics, a confidence shock, an oil-price tumble, and currency depreciation combined to make life difficult for local retailers. Retail sales sharply decreased during the recession years of 2015-2016, declining by -9.3% and -4.5% respectively. However, consumer spending is thus expected to grow by +1.5% in 2017 and +1.8% in 2018, signaling brighter prospects.

The country's vast size poses some serious challenges. Companies such as X5 or M-Video increased their footprint in under-served rural regions and smaller cities. Getting closer to the customer remains the best strategy to secure earnings and benefit from low rent and property prices, and avoid insolvency, a fate that befell companies such as Deti Zao and Planet Stroi in 2016. Although e-commerce represents only 2% of retail sales, digital plays an increasingly important part in Russia's economy. Whereas today, e-shoppers make up only 25% of the population, a number almost -20pp lower than the European average, it is clear online shopping is on an upward trend. The Russian population is relatively young: 15 to 34 make up 28% of the population. These millennials and GenZers can be attracted by online and mobile offerings. The rise of online giants such as Ozon and Ulmart make such investment needs all the more pressing.

### Fine-tuning local expansion and digital investment

The financial situation of Russian retailers deteriorated in 2016 as a direct consequence of the recession. Profits plummeted to 3% in 2016 down from 6.6% in 2013. This impacted equity levels, leading solvency down to a mere 25%. On top of that, the slight improvement of indebtedness was not sufficient to push debt to acceptable levels (net gearing of 130% in 2016 versus 258% in 2014). As a result, Euler Hermes assesses the risk of non-payment in the Russia's retail sector as Sensitive. However, retailers are well aware of the long-run challenges they face. Respondents to the Euler Hermes Digital Retail survey ranked tapping into big data as their top challenge to tackle, followed by mastering omni-channeling, and the cost of online presence.

Again, the sheer geography combined with a difficult economic background means that logistical efficiency suffers. Russia is ranked 141st out of 160 countries in the World Bank LPI index. Customs is a particularly thorny issue.

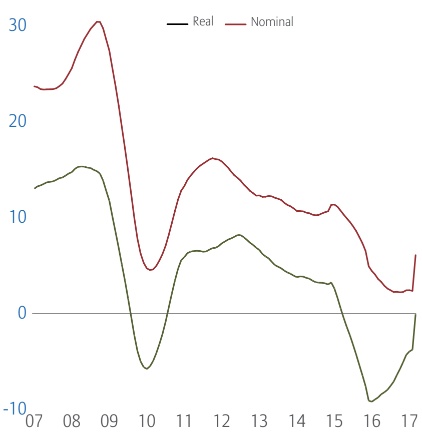
### Looking forward: What does it all mean for businesses?

The main question Russian retailers face is how to invest in an innovative and efficient way in rural areas expansion while embracing the next generation of digital and m-commerce customers. But the still-adverse economic environment and a tight financial situation can make it quite difficult to implement such an ambitious strategy in the short run.

✓ Promising sub-sectors: Food grocers and discounters benefit from their must-have status.

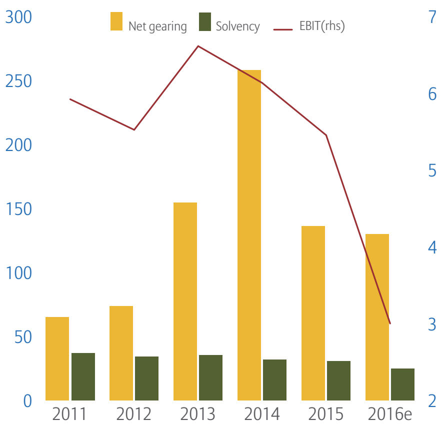
✓ Sensitive sub-sectors: Electronics and independent food retailers have paid the price for a two-year recession. ■

**Chart 1** Retail sales in Russia
in %, 12m/12m, as of March 2017




Sources: IHS, Euler Hermes calculations

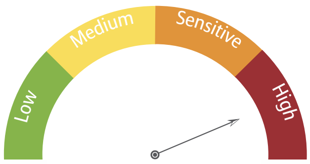
**Chart 2** Financial performances of Russian listed retailers



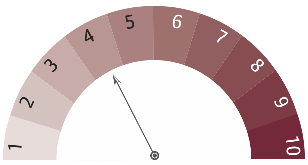

Sources: Bloomberg, Euler Hermes calculations

# Retail in Brazil

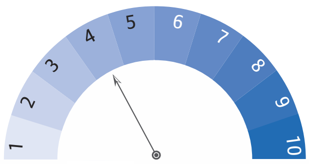
## No more beginners' luck




Retail Non-Payment Risk (Q1 2017)




Digital Pressure




Digital Potential

- **Retail sales are slipping into negative territory as Brazil goes out of recession because of the soaring unemployment rate. Given the poor consumption prospects, the situation is not set to improve in 2017.**
- **Brazilian retailers' financial standing dramatically deteriorated over the last two years. Net gearing (indebtedness) climbed to 110% in 2016, up from +70% in 2014.**
- **Apparel and food & drugs have shown resilience while electronics is most at risk starting 2017 with a staggering indebtedness of 300% and profits at a low 2.9%.**

### Out of recession, not yet out of the woods

For the first time in more than a decade, real retail sales slipped into negative territory in mid-2015. The almost doubling of the unemployment rate, from less than 7% starting 2015 to nearly 12% at the end of 2016, was the main reason for consumers' reduced appetite for shopping. Consumer confidence sharply declined at the end of 2016. The political uncertainty is likely to intensify ahead of 2018 and the next Presidential election. Therefore, in spite of the exit from recession and recovering consumer spending (+0.3% in 2017, +2.3% in 2018), the outlook remains gloomy for the Retail sector.Furthermore, Brazilian consumers show a moderate appetite for e-retail. Despite 127 mobile subscriptions per 100 inhabitants in 2015 (+8% y/y), only 35% of consumers are e-shoppers, of whom only 14% use their mobile phones for purchases. Thus, omni-channeling is yet to become the strategy of choice. Consumers prefer bargain-hunting and prioritize essential products, be it via an online or physical channel. One successful way to serve customers' needs could be an online-to-offline (O2O) approach, which combines e-shopping with brick-and-mortar. This strategy could appeal to Millennials, who account for a third of the population as of 2016.

### Tackle (infra)structural deficiencies first, then proceed to digital

The 2015-16 economic recession has dramatically affected Brazilian retails. All financial indicators have worsened since 2014, with net gearing (indebtedness) up to 110% (+40pp from 2014), solvency yielding -3pp down to 40% and EBIT (profits) down to 12.3% from 14% in 2014. Euler Hermes' a non-payment risk rating stands at High. Brazilian retailers' perception of top challenges in the longer run, includes the following top priorities: (#1) the costs of online migration and presence, (#2) tapping into big data, (#3) integrating new payment methods. Brazil is yet to join the global trend toward integration and ecosystems. Most retailers outsource fleets and even resort to dispatching centers to lower fixed costs.

The country suffers from poor logistic efficiency, a weakness illustrated by the decline in productivity growth from 1.8% in 1990-2001 to 0.2% in 2002-2011. This structural limitation hinders retailers' ability to benefit from a strong business model and invest in innovative activities.

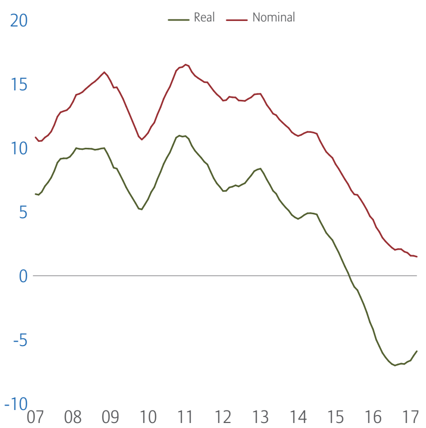
### Looking forward: What does it all mean for businesses?

The strained financial situation impacts firms and customers' ability to embrace digitalization. The best strategy retailers have going forward is to finance efficient investment, skip the laptop/desktop stage and move directly to m-retail.

✓ Promising sub-sectors: Fashion and food were the top performers with indebtedness level of 64% and 32% and EBIT reaching 10% and 3% in 2016, respectively.

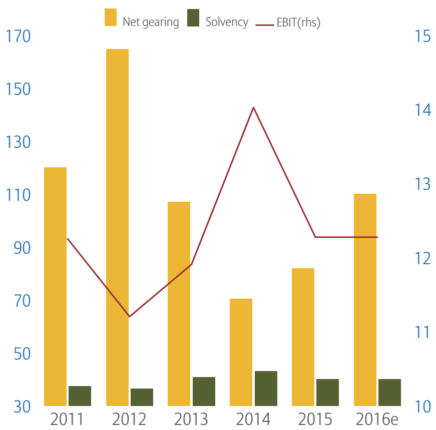
✓ Sensitive sub-sectors: The electronics sub-sector has taken a hit: net gearing peaked at 300% and profits were at a low 2.9%. ■

**Chart 1** Retail sales in Brazil
in %, 12m/12m, as of March 2017




Sources: IHS, Euler Hermes calculations

**Chart 2** Financial performances of Brazilian listed retailers

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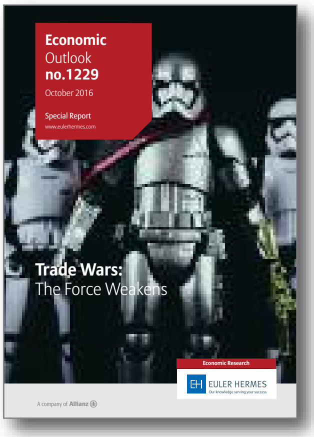


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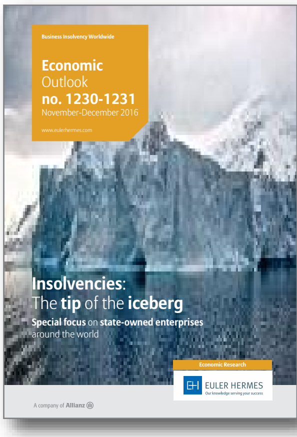


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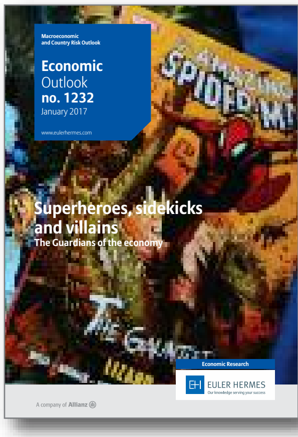


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# Subsidiaries

Registered office:
Euler Hermes Group
1, place des Saisons
92048 Paris La Défense - France
Tel.: + 33 (0) 1 84 11 50 50

www.eulerhermes.com

**▶Argentina**
Solunion
Av. Corrientes 299
C1043AAC CBA,
Buenos Aires
Phone: + 54 11 4320 9048

**▶Australia**
Euler Hermes Australia Pty Ltd
Allianz Building
2 Market Street
Sydney, NSW 2000
Tel. : +61 2 8258 5108

**▶Austria**
Acredia Versicherung AG
Himmelpfortgasse 29
1010 Vienna
Phone: + 43 5 01 02 1111

Euler Hermes Collections GmbH
Zweigniederlassung Österreich
Handelskai 388
1020 Vienna
Phone: + 43 1 90 22714000

**▶Bahrain**
Please contact United Arab Emirates

**▶Belgium**
Euler Hermes Europe SA (NV)
Avenue des Arts — Kunstlaan, 56
1000 Bruxelles
Phone: + 32 2 289 3111

**▶Brazil**
Euler Hermes Seguros de Crédito SA
Avenida Paulista, 2.421 — 3° andar
Jardim Paulista
São Paulo / SP 01311-300
Phone: + 55 11 3065 2260

**▶Bulgaria**
Euler Hermes Bulgaria
2, Pozitano sq.
"Perform Business Center"
Sofia, 1000
Phone: +359 2 890 1414

**▶Canada**
Euler Hermes North America Insurance Company
1155, René-Lévesque Blvd West
Suite 2810
Montréal Québec H3B 2L2
Phone: +1 514 876 9656 / +1 877 509 3224

**▶Chile**
Solunion
Av. Isidora Goyenechea, 3520
Santiago
Phone: + 56 2 2410 5400

**▶China**
Euler Hermes Consulting (Shanghai) Co., Ltd.
Unit 2103, Taiping Finance Tower, N°488
Middle Yincheng Road, Pudong New Area,
Shanghai, 200120
Phone: + 86 21 6030 5900

**▶Colombia**
Solunion
Calle 7 Sur No. 42-70
Edificio Fõrum II Piso 8
Medellin
Phone: +57 4 444 01 45

**▶Czech Republic**
Euler Hermes Europe SA
organizacni slozka
Molákova 576/11
186 00 Prague 8
Phone: + 420 266 109 511

**▶Denmark**
Euler Hermes Danmark, filial of
Euler Hermes Europe S.A. Belgien
Amerika Plads 19
2100 Copenhagen O
Phone: + 45 88 33 3388

**▶Estonia**
Please contact Finland

**▶Finland**
Euler Hermes SA
Suomen sivuliike
Mannerheimintie 105
00280 Helsinki
Phone: + 358 10 850 8500

**▶France**
Euler Hermes France SA
Euler Hermes Collection
Euler Hermes World Agency
1, place des Saisons
F-92048 Paris La Défense Cedex
Phone: +33 1 8411 5050

**▶Germany**
Euler Hermes Deutschland
Niederlassung der Euler Hermes SA
Friedensallee 254
22763 Hamburg
Phone: + 49 40 8834 000

Euler Hermes Aktiengesellschaft
Gaastraße 27
22761 Hamburg
Phone: + 49 40 8834 9000

Euler Hermes Collections GmbH
Zeppelinstr. 48
14471 Postdam
Phone: + 49 331 27890 000

Euler Hermes Rating GmbH
Friedensallee 254
22763 Hamburg
Phone: + 49 40 8 34 640

**▶Greece**
Euler Hermes Hellas Credit Insurance SA
16 Laodikias Street & 1-3 Nymfeou Street
Athens Greece 11528
Phone: + 30 210 69 00 000

**▶Hong Kong**
Euler Hermes Hong Kong Services Ltd
Suites 403-11, 4/F - Cityplaza 4
12 Taikoo Wan Road
Taikoo Shing
Hong Kong
Phone: + 852 3665 8901

**▶Hungary**
Euler Hermes Europe SA
Magyarrorszagi Fioktelepe
Kiscelli u. 104
1037 Budapest
Phone: +36 1 453 9000

**▶India**
Euler Hermes Services India Pvt. Ltd
5th Floor, Vaibhav Chambers
Opposite Income Tax Office
Bandra Kurla Complex
Bandra (East)
Mumbai 400 051
Phone: +91 22 6623 2525

**▶Indonesia**
PT Asuransi Allianz Utama Indonesia
Allianz Tower 32nd floor
Credit Insurance Division
Kawasan Kuningan Persada
Super block 2
Jln. H.R. Rasuna Said,
Jakarta Selatan 12980
Phone: +62 21 2926 8888

**▶Ireland**
Euler Hermes Ireland
Allianz House
Elm Park
Merrion Road
Dublin 4
Phone: +353 (0) 1 518 7900

**▶Israel**
ICIC
2, Shenkar Street
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Phone: +97 23 796 2444

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**▶Japan**
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10th Fl., New Otani Garden Court,
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Colonia Nueva Anzures
11590 Mexico D.F.
Phone: +52 55 52 01 79 00

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20 050 Casablanca
Phone: + 212 5 22 79 03 30

**▶The Netherlands**
Euler Hermes Nederland
Pettelaarpark 20
P.O. Box 70751
5201CZ's-Hertogenbosch
Phone: + 31 (0) 73 688 99 99 / 0800 385 37 65

Euler Hermes Bonding
De Entree 67 (Alpha Tower)
P.O. Box 12473
1100 AL Amsterdam
Phone: +31 (0) 20 696 39 41

**▶New Zealand**
Euler Hermes New Zealand Ltd
Tower 1, Level 11
205 Queen Street
Auckland 1010
Phone: + 64 9 354 2995

**▶Norway**
Euler Hermes Norge
Holbergsgate 21
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COSEC Companhia de Seguro de Créditos, SA
Avenida da República, nº 58
1069-057 Lisbon
Phone: + 351 21 791 37 00

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**▶Romania**
Euler Hermes Europe SA Bruxelles
Sucursala Bucuresti
Şoseaua Pipera 43
Bucharest 014254,
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Euler Hermes Credit Management OOO
Office C08, 4-th Dobryninskiy per., 8
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Euler Hermes Singapore Services Pte Ltd
12 Marina View
#14-01 Asia Square Tower 2
Singapore 018961
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**▶Slovakia**
Euler Hermes Europe SA, poboka poist'ovne z ineho clenskeho statu
2012: Plynárenská 7/A
82109 Bratislava
Phone: + 421 2 582 80 911

**▶South Africa**
Euler Hermes – South Africa
The Firs
32A Cradock Avenure
Rosebank 2196
Phone:+27 10 59348 01

**▶South Korea**
Euler Hermes Korea
Level 21, Seoul Finance Center,
136 Sejong-daero, Jung-gu
Seoul 04520
Phone: +82 2 3782 4920

**▶Spain**
Solunion
Avda. General Perón, 40
Edificio Moda Shopping
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28020 Madrid
Phone:+34 91 581 34 00

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Euler Hermes Sverige filial
Döbelnsgatan 24
Box 729
101 34 Stockholm
Phone: +46 8 555 136 00

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Euler Hermes SA
Zweigniederlassung Wallisellen
Euler Hermes Reinsurance AG
Richtiplatz 1
8304 Wallisellen
Phone: + 41 44 283 65 65
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**▶Taiwan**
Euler Hermes Taiwan Services Limited
Phone: +886 2 5550 0590

**▶Thailand**
Allianz C.P. General Insurance Co., Ltd
323 United Center Building
30th Floor
Silom Road
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Euler Hermes Sigorta A.S.
Büyükdere Cad. No:100-102
Maya Akar Center Kat: 7 Esentepe
34394 Şişli / Istanbul
Phone: +90 212 2907610

**▶United Arab Emirates**
Euler Hermes
c/o Alliance Insurance PSC
501, Al Warba Center
P.O. Box 183957
Dubai, U.AE.
Phone: +97142116000

**▶United Kingdom**
Euler Hermes UK
1 Canada Square
London E14 5DX
Phone: + 44 20 7 512 9333

**▶United States**
Euler Hermes North America Insurance Company
800 Red Brook Boulevard
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Phone: + 1 877 883 3224

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