Next plc Stress-Test: A Case Study on the Credit Rating Impact of Coronavirus

In their most recent results statement Next plc provided a range of stress scenarios of the impact on their business of Covid-19 and the policies to suppress it. To the best of our knowledge, Next was the first company to share their scenario planning with investors and they deserve praise for doing so. Next is a profitable business, which we think to be both well governed and one of the best managed companies in the UK.

The purpose of this note is to take those scenarios and the various mitigations proposed by Next to see what they imply for its balance sheet and its credit quality. We build on our more general note, which discussed the extent of credit downgrades and defaults that one might expect if Covid-19 were assumed to be a 1 in a 100 year event.

We believe the value of this exercise is in working through the extent of actions required by companies to preserve the fabric of their business and ensure that they have the balance sheet strength to support the recovery.

The conditions in which Next operate have moved very rapidly in the weeks since it published its stress tests. Given the changed circumstances, we have examined some of the assumptions underlying their proposed mitigating strategies.

In the rest of this note we first reproduce Next's three stress scenarios and work out the implications for its balance sheet. This allows us to calculate a range of ratios that are commonly used in assessing the credit quality of an issuer. We then use these in a simple credit scoring model to estimate what the credit rating of Next might be in each stress scenario before and after mitigation.

Next's Stress Test

Next look at three scenarios in which annual revenue declines by 10%, 20% and 25%. The revenue declines in each scenario are dependent on the length and severity of the economic restrictions imposed by the government. Although they model the impact using two-week windows, as shown in Figure 1, they emphasize that the overall liquidity and solvency needs of the company are principally determined by the annual revenue impact.

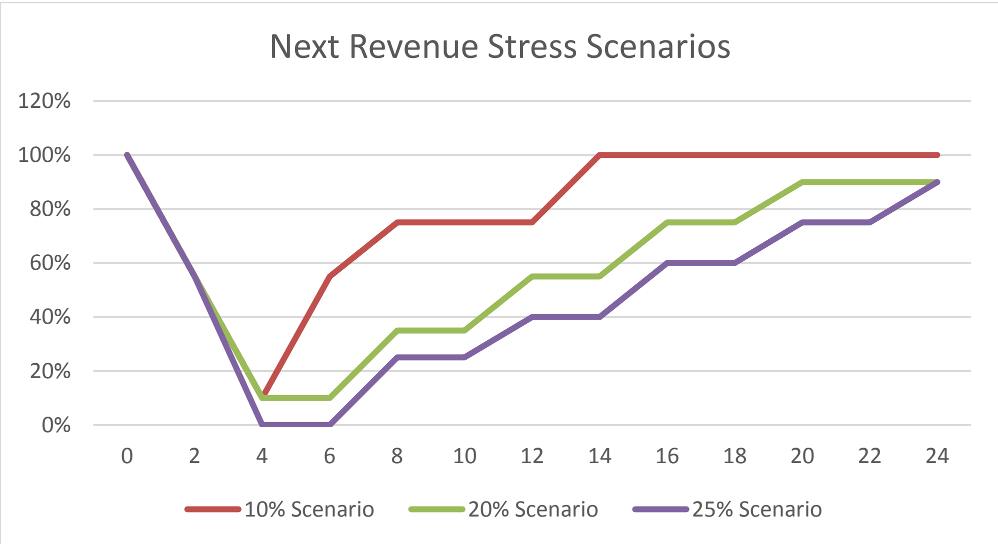

Figure 1: Next Revenue Stress Scenarios (Source: Next plc)

In addition to their revenue scenarios, they set out their assumptions on variable costs as:

- 15% of their cost of sales can be recovered; and
- that warehouse, retail assistant wages and distribution costs are 20%, 30% and 65% variable with reduction in revenue respectively.

The overall impact of the three scenarios are shown in Figure 2.

£m (e)	Scenario -10%	Scenario -20%	Scenario -25%
Lost full price sale (VAT ex)	-445	-820	-1010
Cash from additional clearance sales	0	0	0
Operational cost savings	55	80	90
Reduced stock purchases	15	50	65
Inflow from reduction in Online lending	55	120	150
Corporation tax saving and rates holiday	130	180	215
Cash cost of lost sales	**-190**	**-390**	**-490**
Implied Group EBITDA	665	375	230
Profit before tax	490	200	55

Figure 2: Cash Losses per Scenario (Source: Next plc)

Next have set out four levels of actions that they could take to mitigate the effects of the assumed revenue losses:

Level 1

If taken, then these measures are expected to have little or no short-term impact on the operation of the business. They are all actions that Next had previously expected to take and were to be funded by earnings after both interest and the dividend were paid. If revenue drops by 10% or more, Next plan to take the following actions.

- Suspending share buybacks – estimated impact: GBP 260m
- Suspending employee share option trust (ESOT) purchase - estimated impact: GBP 40m
- Deferring non-essential capital expenditure – estimated impact: GBP 45m

The effect of these is to make debt lower than it would have otherwise been.

Level 2

If taken, then these measures are expected to be mildly earnings-dilutive in future years. If revenue drops by between 10% and 20%, Next plan to sell the following assets.

- Warehouse sale and leaseback - estimated impact: GBP 100m
- Securitisation of some customer receivables – estimated impact: GBP 100m
- Recall part of the loan to ESOT - estimated impact: GBP 70m

The sale proceeds will lead to debt being lower than it would have been otherwise have been. However, as the gross assets will shrink, as the proceeds are applied to meet outgoings, this will lead to a decline in both their Asset Coverage and Leverage ratios.

Level 3

If taken, then Next would delay paying their second interim dividend. In the scenarios in which revenue declines by between 20% to 25%, this delay would avoid them exceeding existing banking facilities at the seasonal peak of their debt in August. Next have announced that they are in advanced discussions to increase the banking facilities by GBP 200m.

Level 4

If taken, then Next will not pay their second interim dividend.

- Suspension of dividend – impact GBP 220m

This would result in debt being less and net assets being greater than they would otherwise have been.

Under their most severe scenario, Next's mitigating actions are sufficient to meet the expected reduction in cash flow with no increase in debt and only a marginal decline in their asset coverage and leverage ratios. Next concludes that their balance sheet could take the strain of a 25% reduction of revenue over the course of a year without exceeding their current bond and bank facilities.

Our Credit Rating Model

Credit Rating Agencies assess key balance sheet ratios as part of their credit rating process. We have used 7 key accounting ratios to build a simple credit scoring model. The model was calibrated using these ratios and the credit ratings of 47 peer companies.

We then applied Next's three stress tests and estimated the effect of each of these on the 7 ratios. We did this before and after the mitigating actions identified by Next. In addition, we estimated the effect of more severe 35% and 50% declines in annual sales but did not assume any further mitigations beyond those proposed by Next. These stressed but mitigated ratios can be seen in Figure 3.

Stress	Interest Coverage	Asset Coverage	Leverage	Cashflow /Debt	Return on Assets	Profit	Liquidity	Mitigating Action
0%	7.75	1.18	0.88	0.12	18.82	14.30	2.36	None
-10%	6.07	1.18	0.88	0.08	14.18	11.97	2.36	Level 1
-20%	3.36	1.07	0.94	0.02	6.47	5.89	2.54	Level 1 & 2
-25%	2.05	1.07	0.94	0.04	2.18	2.12	2.54	Levels 1 to 4
-35%	-0.56	1.01	0.97	-0.02	-6.39	-7.16	2.54	Levels 1 to 4
-50%	-4.49	0.75	1.03	-0.10	-19.23	-28.03	2.54	Levels 1 to 4

Figure 3: Next Ratio Estimations given their Stresses and Mitigating Actions (Source: Cameron Hume)

These ratios were then used in our credit rating model to estimate the post Covid-19 credit rating under each scenario. We stress that our credit rating model is simple and that credit ratings are also influenced by qualitative factors and planned actions. The simplicity is evident in the breadth of the estimation error bounds shown in Figures 4 and 5.

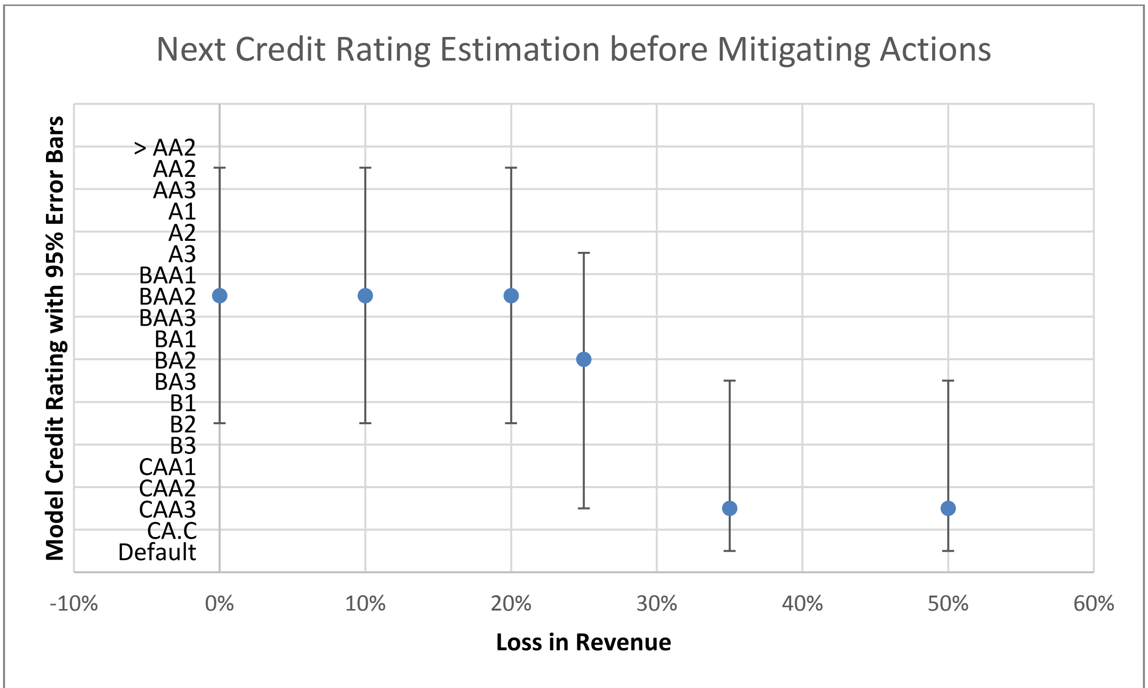

Figure 4: Next Credit Rating Estimation before Mitigating Actions. (Source: Cameron Hume)

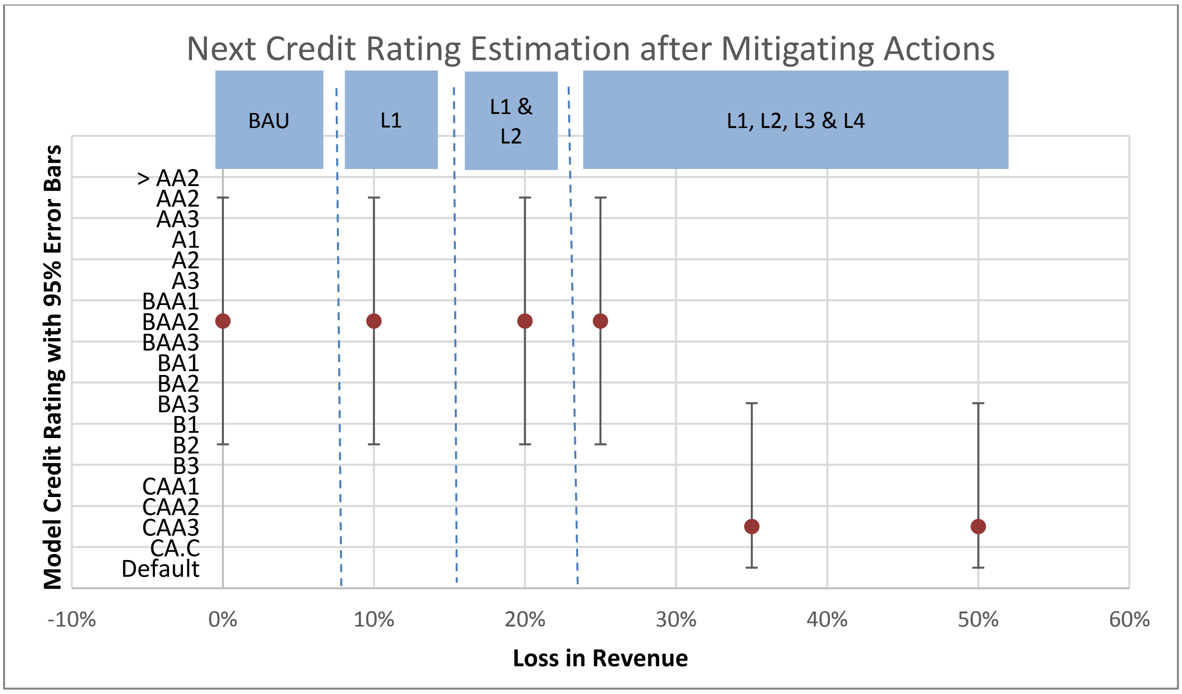

Figure 5: Next Credit Rating Estimation after Mitigating Actions. (Source: Cameron Hume)

Figure 4 shows that the revenue stresses cause Next's credit rating to deteriorate, which the mitigating actions shown in Figure 5 partially offset. This can be seen by comparing the 25% revenue stress between the two Figures. Next mitigating actions appear likely to have little negative effect either on future earnings capacity or to their balance sheet. However, in the case of a stress to revenue that is greater than 25%, Next's credit quality will deteriorate unless they take further action. It is possible that Next's credit rating will be higher than our model suggests, if it emerges in a stronger competitive position, owing to a reduction in competition, and if the Credit Rating Agencies expect a rapid return to previous revenue levels.

How Fair are Next's Assumptions?

Next based their stress assumptions on the information known at the beginning of March 2020. In all three scenarios, Next have assumed that revenue will collapse quickly and then return slowly over the course of the lockdown stress. This may not be the case. They assumed that their online business would continue to operate throughout the lockdown period. However, on 26th March, Next decided to close their online business to ensure the health of their workers.

The stresses assume a 3 to 6-month impact on revenue. The UK government has stated that they will assess the effectiveness of a lockdown on a week by week basis. However, the outlook from other countries suggests that the lockdown itself may last months.

Caveats also attach to Next's planned mitigating actions. Their Level 2 mitigating actions envisage a securitisation of their receivables. Next has not brought such a securitisation to the market before. Whether there would an appetite for this sort of instrument from a new issuer in current market conditions is not certain. The same goes for finding a sale and leaseback partner on terms that Next would have thought reasonable in March.

It is also moot whether these assets can be sold sufficiently quickly. If Next's net debt peaks in August, as they have suggested, they may not be able to launch the securitisation or exercise their leaseback plan in time; especially as all parties are currently practising social separation. If they are unable to execute their Level 2 plan, a delay or suspension of their dividend is more likely even under the less severe scenarios.

More positively, Next's stress analysis does not take into account the subsequently announced government support package. The announcement on the 20th of March offers to pay 80% of employees' wages up to GBP2500 a month for all furloughed staff. This may have a sufficiently material impact on Next's operational costs to offset the effects of a more severe revenue decline than envisaged and, in any event, it is likely to make their financial position better than it would have been otherwise.

A Going Concern

Next is one of the more likely retailers to survive the coronavirus pandemic. Publishing their internal stress tests is indicative of good governance. This is to be expected given their strong ESG credentials. They clearly believe that they are able to take a 25% loss in annual revenue without breaching their current debt facilities.

It is possible, given the potential for an extended lock down and the closure of both high street and online commerce, that the worst-case outcome may be a revenue loss significantly greater than 25%. Next has not revealed how it will manage such a stress, but they do have options to extend their credit lines and to obtain government backed loans. In this scenario the likely outlook for Next's credit quality is negative and the company may have to look to shareholders for further support.

Nevertheless, Next has been a very profitable company and appears likely to be so again. Our analysis shows that Next maintains its credit standing under their stress scenarios by taking the suggested mitigating actions with minimal long-term impact to their earnings capability. In more adverse scenarios, Next's credit metrics do deteriorate, but its credit rating is unlikely to track this deterioration provided they maintain both access to capital markets and their potential profitability post-pandemic.

Disclaimer