Research Update:

Spanish Retailer DIA Outlook Remains Negative On Still-High Leverage As It Negotiates Refinancing; 'CCC' Rating Affirmed

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Rating Action Overview

- Spanish food retailer Distribuidora Internacional de Alimentacion S.A. (DIA) has not yet established a sustainable long-term capital structure, although it is advancing in obtaining a capital injection from main shareholder LetterOne Group and is in the process of refinancing its debt.
- DIA's operating performance has been weak in the first half of 2019, and we expect the group's leverage to remain elevated over the next two to three years, as its business model will need to undergo heavy transformation to regain competitiveness and restore margins.
- We are keeping our outlook on DIA negative, and affirming our 'CCC' ratings on DIA and its unsecured notes.
- The negative outlook reflects near-term pressures on DIA's liquidity, the execution risk of its recapitalization plan, and uncertainties around the group's ability to turn the business around.

Rating Action Rationale

Our rating on DIA reflects the uncertainties that remain around its capital structure and liquidity, and our expectation that the group's leverage will remain elevated in the medium term.

In the first quarter of 2019, DIA reported a 4.3% like-for-like sales decline and 85.8% drop in adjusted EBITDA (as calculated by the company) compared with €84.8 million reported in the same period last year. Its operating performance was affected by a contraction of trade insurance and supplier volumes granted to the group, which led to a substantial increase in out-of-stock levels in stores. It was also affected by the first initiatives the group took to reposition its business model, such as the de-franchising process.

We anticipate that DIA's business model will need to undergo heavy transformation to regain competitiveness and restore margins. Such a transformation will likely carry some execution risks, especially with regard to the pace and scope of the proposed implementation. DIA is likely to incur sizable restructuring costs that will further weigh on the group's profitability. This is in a context of extreme competitive pressure, in particular in Spain from market leader Mercadona, forcing the group to be very competitive on prices. We also factor in the ongoing negative impact of currency movements in its Latin American operations that more than offset the healthy underlying trend of its operations in that region.

As such, we anticipate DIA's leverage will remain elevated over the next two to three years. At the end of the first quarter of 2019, the group's financial net debt amounted to €1.7 billion.

LetterOne Group, which now controls DIA with a 69.8% ownership, announced on May 20 that it had reached a "lock-up" agreement with DIA's syndicated banks, which paves the path to a long-term refinancing of its existing bank debt and facilities.

This lock-up agreement includes a term sheet that establishes, among other things:

- An extension of the maturity date of all DIA's existing syndicated credit facilities until March 31, 2023;
- Permission to raise new super senior facilities of up to €380 million;
- A financial covenant holiday until Dec. 31, 2020 (subject to a minimum cash level of €30 million starting Dec. 31, 2019); and
- New guarantees and security for the syndicated credit facilities' lenders.

However, the lock-up agreement contains a number of events that would terminate the agreement it the events are not fulfilled, including:

- The signing of a long-form documentation between DIA and its lenders in respect of all new facilities, on or before June 15; and
- DIA receiving at least €490 million following completion of a share capital increase, on or before July 19.

Hence, the completion of the share capital increase and the longer-term refinancing transactions are conditional on the occurrence of several events. We understand that if the lock-up agreement is not implemented or if there is any disagreement among the banks, LetterOne Group, or other stakeholders, DIA could soon be in default, as its existing bank debt and facilities under the December 2018 financing agreements have an initial maturity on May 31.

Since the banks have signed the lock-up agreement, the debt did not have to be repaid on May 31. However, we understand that it would become due immediately if any termination event is triggered and the lock-up agreement is terminated.

Once the recapitalization and the refinancing transaction have been approved, we will look into the implications of these agreements. In particular, we will assess the resulting capital structure and liquidity, the ranking for the different debt categories, the credit metrics for the company, its latest operating performance, and the company's plans as regards the repayment of its €300 million bonds due in July 2019, €300 million bonds due April 2021, and €300 million bonds due April 2023.

Outlook

The negative outlook reflects near-term pressures on DIA's liquidity and funding profile, and the high execution risk of the group's plan to raise equity and recapitalize. It also reflects the group's weak earnings and cash flow generation profile, and the obstacles it faces to turn its operations around with its new strategic plan in the unfavorable market context in Spain, Brazil, and Argentina.

Downside scenario

We will lower the rating if DIA faces difficulties in executing its recapitalization plan, leading us to assess that a default, distressed exchange, or restructuring have taken place or are inevitable within six months.

Upside scenario

We could revise the outlook to stable and review the issuer credit rating if DIA is able to put in place a sustainable and longer-term capital structure.

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Retail And Restaurants Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009

Ratings List

Ratings Affirmed

Issuer Credit Rating	CCC/Negative/--
Senior Unsecured	CCC

Ratings Affirmed

Recovery Rating	4(35%)