S&P Global Ratings

RatingsDirect®

Research Update:

Spanish Retailer DIA Outlook To Negative On Weaker Profitability; 'BBB-' Ratings Affirmed

Primary Credit Analyst:
Raam Ratnam, CFA, CPA, London (44) 20-7176-7462; raam.ratnam@spglobal.com

Secondary Contact:
Solene Van Eetvelde, Paris (33) 1-4420-6684; solene.van.eetvelde@spglobal.com

Table Of Contents

Research Update:

Spanish Retailer DIA Outlook To Negative On Weaker Profitability; 'BBB-' Ratings Affirmed

Overview

- Spain-based food retailer DIA's first-half trading performance was weaker than we expected. Like-for-like sales were weak and reported EBITDA margins fell by 14.6% (excluding currency movements) due to tough price competition, end of a procurement partnership in Iberia, and the transport strike in Brazil.
- The sharp drop in profits is testing our views on the resilience of DIA's business. We now forecast weaker credit metrics and negative free operating cash flow (FOCF), amid continued high capital expenditure on stores and tough competition in its key markets.
- We are revising our outlook on DIA to negative and affirming our 'BBB-' ratings.
- The negative outlook reflects strong pressure on DIA's sales and profitability, and diminishing headroom under its credit metrics with adjusted funds from operations to debt below 30% and adjusted debt to EBITDA approaching 3x, despite its various strategic and cost management initiatives.

Rating Action

On July 31, 2018, S&P Global Ratings revised to negative from stable its outlook on Spain-based food retailer Distribuidora Internacional de Alimentación S.A. (DIA, or the group). At the same time, we affirmed our 'BBB-' long-term issuer credit rating on DIA and our 'BBB-' issue rating on its senior unsecured debt.

Rationale

DIA reported weaker first-half trading performance than we expected, with weak like-for-like sales and declining margins. Following a sharp drop in reported EBITDA in 2017, by 16% in Iberia and 8.9% across the whole group, to €569 million, DIA's profitability has continued to decline significantly in 2018. During the first half of 2018, its adjusted EBITDA fell by 14.6%, excluding the negative impact of currency movements in its Latin America operations.

In addition to weak topline performance, adjusted margins suffered from the end of the procurement joint venture with Eroski in Spain and high restructuring costs. DIA also had to invest heavily in reducing prices to secure its price perception in a highly competitive market. Like other European food retailers that operate in Spain, such as Carrefour and Auchan, DIA faces intense price competition in the Spanish market from the market leader, Mercadona, which holds nearly a quarter of the market in terms of sales.

DIA also faces strong competition in Latin America from the cash and carry subsidiaries of Carrefour and Casino, especially in Brazil. Like them, it has suffered from food price deflation in Brazil and, more recently, from the operational impact of the recent transport strikes.

Our rating affirmation reflects our view of DIA's established position as one of the leading hard-discount food retailers in Spain. DIA's business model benefits from the group's focus on the discount and convenience segment, growing presence in Latin America, purchasing partnerships, high private-label penetration of more than 50%, and its franchise-focused operating model, which helps it keep costs low.

Over 60% of DIA's stores are franchised, one of the highest proportions of franchised stores within the food retail sector across Europe. This lowers net sales and gross margins, but allows for higher overall profitability and a more-efficient capital allocation. Despite dropping from 7.3% in 2016, DIA's S&P Global Ratings-adjusted EBITDA margins are forecast to remain above 6.5% for the rest of 2018 and through 2019. This remains higher than that of several of its rated peers in the food retail sector, such as Europe-based Auchan (5%), Carrefour (5.3%), Casino (5.6%), U.K.-based Tesco (6.1%), and U.S.-based Kroger (6.0%) and Wegmans (6.3%).

Unlike other European retailers, such as Auchan and Carrefour, DIA does not have material exposure to the difficult superstore and hypermarket segment, which has experienced a huge structural shift as customers opt for smaller basket sizes and convenience-based shopping. We view favorably DIA's distinct business model, which is primarily based on a substantial market presence of proximity stores in urban areas.

The highly fragmented and competitive markets in which DIA operates somewhat offset these strengths. However, comparatively DIA is also a much smaller and less diversified business than its larger rated food retail peers--it generates close to 80% of EBITDA in Iberia.

Until the end of 2017, DIA's higher profitability and balanced financial policy supported its relatively moderate leverage, including adjusted debt to EBITDA of less than 2.5x and adjusted funds from operations (FFO) to debt above 33%. That said, given the rapid decline in its profits over the past few quarters and its ongoing high capital expenditure (capex) on stores, we expect its leverage to increase. We now forecast that DIA's adjusted debt to EBITDA will rise toward 3x. This will leave almost no rating headroom for any further operating weakness.

We view DIA's operating leases as artificially short, relative to the length of time it expects to use the leased stores. We therefore make analytical adjustments to reflect a more economically appropriate depiction of its lease obligations on a going-concern basis. That said, the short-notice exit options, which we understand exist in DIA's long-term operating leases, lend it some level of increased operating flexibility.

The following assumptions underpin our base-case scenario for DIA:

- Spain's GDP growth of more than 3% over the past three years (2015-2017) is forecast to reduce to 2.7% in 2018 and 2.3% in 2019. We expect the consumer price index (CPI) will be 1.6%-1.8%, with unemployment gradually trending down to about 15.6% in 2018 and 14.5% in 2019.
- Portugal's GDP to rise by 2.3% in 2018 and by a further 1.9%-1.8% in 2019-2020 due to strong exports and improving investments in the country. We expect CPI will increase by 1.5%-1.8% due to a rise in food, clothing, and fuel prices.
- Argentina's GDP grew by 2.9% in 2017 but the pace of growth is expected to slacken to 1.0%-2.0% in 2018. Very high inflation, which we expect to be more than 25%, will hamper the country's recovery.
- Continued turnaround in Brazil, with real GDP growth of about 2.0%-2.5% due to a faster-than-expected recovery from recession as government narrows down its budget deficit. Despite CPI of about 3.5%-4.0%, food prices fell, triggered by a record agricultural harvest. We expect food price deflation to end gradually while the economy strengthens.
- The group will maintain its focus on proximity and multibanner store formats, which appeal to a diverse customer base.
- DIA actively manages its store network through refurbishment--it remodeled more than 900 stores in Iberia during the first half of 2018--while continuing its rent negotiations.
- We expect DIA will continue to expand its presence in Latin America by opening approximately 150 net stores per year, bringing it closer to its target of 2,600 stores in emerging markets by 2020.
- Over 2019 and 2020, the group's market performance will benefit as the positive impact of store upgrade activity sets in and food price inflation gradually returns. The group expects to recover store space growth.
- These macroeconomic conditions, together with the store development plan above, should enable DIA to limit the decline in its top line to 1%-2% in Iberia over 2018 and 2019.
- In the emerging markets of Argentina and Brazil, revenue growth in 2018 and 2019 will likely be broadly stable in local currency terms, given positive like-for-like growth, improved space contribution, and continued efficiency improvement. However, reported revenue growth will remain closely linked to foreign exchange rates. The Brazilian real and Argentine peso have both seen significant depreciation against the euro, which is DIA's reporting currency.

- The group's S&P Global adjusted EBITDA margin should stabilize at 6.6%-6.7% on the back of a stronger focus on managing margins through improved buying terms with suppliers, increased store productivity, and the implementation of cost-efficiency measures.
- Working capital will continue to have a net negative impact on cash flows of about €50 million over 2018, despite management's efforts to tightly manage its inventory and trade payables.
- Capex will remain high due to significant investment in store improvement and expansion. It will be in line with management's guidance of 4% sales at around €350 million.
- Due to the decline in profitability, the dividend payout should drop below the €128 million paid in 2017, toward €100 million in 2018.

Based on these assumptions, we arrive at the following credit measures over 2018 and 2019:

- Adjusted debt to EBITDA of 2.8x-3x; and
- Adjusted FFO to debt of 27%-29%.

High capex, combined with profitability pressures, will likely result in negative reported free cash flow of up to €50 million in 2018, improving marginally in 2019.

The group is in the process of updating its strategy, which it intends to present to various stakeholders in October 2018. Any significant shift in the group's operating strategy could cause us to adjust our forecasts and will likely carry some execution risks, especially with regard to the pace and scope of the proposed implementation. There is a risk that a new strategic plan will result in the group incurring sizable restructuring costs, which could further weigh on its earnings and cash flows in the near term.

Liquidity

We view DIA's liquidity as adequate. We forecast liquidity sources will cover uses by more than 1.2x over the next 12 months.

We estimate that DIA's liquidity sources over the 12 months from June 30, 2018, include:

- Cash and short-term investments of around €170 million; after factoring about €300 million of seasonal working capital variation, which traditionally peaks at midyear;
- €420 million of undrawn available credit facilities; and
- About €350 million of cash FFO.

We estimate DIA's liquidity uses over the same period include:

- €315 million-€350 million of capex;

- €352 million of short-term debt maturities; and
- About €80 million-€100 million of cash dividends.

DIA's short-term debt maturities include local bank facilities and bilateral loans, which are renewed on a yearly basis. We understand that management is in the process of actively refinancing its short-term debt maturities of €352 million and the bonds of €306 million maturing in July 2019.

We anticipate that DIA will be able to refinance these debt maturities and renegotiate its covenants over the coming months, which will enable its liquidity sources to exceed funding needs by about 1.2x over the next 12 months and maintain adequate covenant headroom (including on its syndicated loans, with total net debt to EBITDA remaining below 3.5x).

Our liquidity assessment is based on the group's well-established and solid relationships with banks and a track record of good access to different financing sources. We expect that in the event that operating cash flow generation falls short of expectations, management will adjust its capital spending on new site openings and refurbishment to preserve adequate liquidity headroom.

Outlook

The negative outlook reflects our view of the extreme competitive pressures in the Spanish food retail market, which, together with the rapid decline in DIA's profits over the past few quarters and continued high capex, has increased the group's leverage and weakened its credit metrics. Over the next year, we see the adjusted debt to EBITDA approaching 3x and this leaves almost no rating headroom for any further operating weakness.

Downside scenario

We could lower the rating if DIA's operating performance comes under further pressure, with continued weak top-line performance and the adjusted EBITDA margin continuing to decline below 6.5%. This scenario could occur if its competitors in Spain continue to pursue aggressive price tactics or if DIA is unable to cut costs, obtain favorable price terms with suppliers, or realize benefits from its extensive investment in remodeling its stores quickly enough within the very competitive Iberian food retail market.

In such a situation, the group's adjusted FFO to debt will remain below 30% and the adjusted debt to EBITDA will increase above 3x. This could also imply sustainably negative reported FOCF, if not met by further timely adjustments to the group's cost base or financial policy--particularly with respect to investments and shareholder returns.

Upside scenario

We could revise the outlook to stable over the next 18-24 months if the group reduces leverage significantly below 3x and improves its adjusted FFO to debt to more than 30%, on the back of strong cash flow generation. This could arise on the back of success of various operating initiatives as well as sound execution of its new strategic plan (to be announced over the next few months), resulting in a sustained improvement in top line and better profitability.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Negative/--

Business risk: Satisfactory
- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: bbb-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Issue Ratings--Subordination Risk Analysis

Capital structure

DIA's capital structure consists of €1.2 billion in senior unsecured debt in the form of bonds and bank debt, mostly issued at the parent level. Of the total debt, approximately €126 million of unrated bank debt is at the subsidiary level.

Analytical conclusions

DIA's debt is rated 'BBB-', mirroring the issuer credit rating, because no significant elements of subordination risk are present in the capital structure.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Retail And Restaurants Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, 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: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Distribuidora Internacional de Alimentacion S.A.		
Issuer Credit Rating	BBB-/Negative/--	BBB-/Stable/--

Ratings Affirmed

Distribuidora Internacional de Alimentacion S.A.	
Senior Unsecured	BBB-

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.