MOODY'S
INVESTORS SERVICE

Credit Opinion: Distribuidora Internacional de Alimentacion, S.A.

Global Credit Research - 06 Jul 2015

Madrid, Spain

Ratings

Category	Moody's Rating
Outlook	Positive
Issuer Rating -Dom Curr	Baa3
Senior Unsecured -Dom Curr	Baa3
Other Short Term -Dom Curr	(P)P-3

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Key Indicators

[1]**Distribuidora Internacional de Alimentacion, S.A.**

	12/31/2014	12/31/2013	12/31/2012	12/31/2011	12/31/2010
Scale (Revenue in USD Billions)	$10.6	$10.6	$12.5	$13.5	$12.7
Efficiency: EBIT / Avg. Book Capitalization (Net of Cash)	18.8%	18.6%	15.7%	16.4%	15.6%
Debt / EBITDA	2.6x	2.7x	2.8x	2.9x	2.0x
RCF / Net Debt	33.0%	24.7%	27.5%	14.2%	6.4%
EBITA / Interest Expense	4.2x	4.8x	4.2x	3.5x	3.4x

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- One of Europe's leaders in food discount retailing

- High geographic concentration on Iberia

- Sales growth supported by franchises, international expansion in emerging markets and acquisitions

- Weak like-for-like sales in Iberia in recent years, improvement expected

- Good profitability compared to rated food retailers albeit weaker in emerging markets

- Financial ratios in 2014 are strong for the rating category...

- ... but weaker ratios expected in 2015 driven by recent acquisitions and share buy-back announcement

Corporate Profile

Headquartered in Madrid, Spain, Distribuidora Internacional de Alimentacion SA (DIA, S.A.) is a leading discount retailer operating through two main store formats, DIA Market and DIA Maxi. Outside of its main markets of Spain and Portugal, DIA has expanded to Argentina, Brazil and China.

In 2014, DIA had a total of 7,306 stores and its net sales reached EUR8,011 million. The company has a mixed development strategy of opening both wholly-owned stores and franchise stores. At year-end 2014, DIA had 3,085 franchises in five countries.

In February 2013, DIA purchased Schlecker's household and personal care discount retail business in Spain and Portugal. With this transaction, DIA has diversified its product range by taking over a chain of over 1,100 stores in Spain and Portugal. The company is currently in the process of rebranding these stores into its new Clarel brand with more than 900 stores already operating under the Clarel banner at the end of Q1 2015.

In October 2014, DIA acquired the regional Spanish supermarket chain El Arbol that operates over 400 stores and has a strong presence in Aragon and Castilla y Leon for an enterprise value of EUR114 million.

In November 2014, DIA completed the sales of its French business which was classified as "discontinued operations" in its 2014 accounts. DIA sold the business with 865 stores and annual sales of around EUR1.9 billion which was challenged by a low market share and operating underperformance to Carrefour S.A. (Baa1 stable) for an enterprise value of around EUR600 million.

In April 2015, DIA closed the acquisition of 144 supermarkets from Eroski for EUR135.3 million and plans to convert around 100 of these stores to its new "La Plaza" supermarket format.

Rating Rationale

DIA's Baa3 rating is supported by the resilience of its food retail operations, its expertise with city center stores and discount price positioning. In addition, DIA's good market position in Iberia, its growing franchise in Brazil, Argentina and China and the cost efficient business model which, together with the extensive use of franchises, has resulted in solid profitability. Moreover, following the changes to Moody's lease methodology, the company's financial ratios (with Moody's adjustments, including capitalised operating leases) are strong for the Baa3 rating category. For example, DIA's lease adjusted gross debt to EBITDA ratio was 2.6x and its retained cash flow to net debt ratio was 33.0% in 2014. We note that DIA's financial ratios would have improved slightly without the impact of the lease methodology changes largely owing to the stable operating performance as well as the disposal of the French operations.

We expect DIA's key credit ratios to deteriorate somewhat in 2015 driven by the impact of the two acquisitions that are initially margin dilutive, the cash outflow for the 144 Eroski stores that occurred in April 2015 as well as a EUR200 million share buy-back program announced in February 2015.

The rating is constrained by DIA's smaller market positions in certain areas where it operates, and weak like-for-like sales in Iberia since 2013, although this did not prevent some margin progression in the region. The company is committed to growing shareholder value and its shareholder policy includes dividend payments and share buybacks. Moody's nevertheless expects that DIA will maintain a low reported net debt to `adjusted' EBITDA ratio (as calculated by the company), supportive of an investment-grade financial profile (this ratio was 1.1x as of 31 March 2015). DIA intends to continue to participate in the consolidation of the Spanish supermarket sector, which creates some event risks on the rating.

DETAILED RATING CONSIDERATIONS

ONE OF EUROPE'S LEADERS IN FOOD DISCOUNT RETAILING

With 7,306 stores, total gross sales under banner of EUR9,400 million and net sales of EUR8,011 million in 2014, DIA is one of the leading discount operators in Europe. In its core markets of Spain and Portugal, DIA is the second largest player behind Mercadona and the third largest supermarket chain behind Pingo Doce and Lidl, respectively. Moreover, DIA has smaller, albeit improving, overall market positions, in Argentina, Brazil and China where it is growing mostly through franchises. In specific regions, the company's market share can be much higher such as in the Sao Paolo area.

The company's focus on price and proximity and its high emphasis on franchises have been key success factors in recent years especially against the backdrop of weak economies in Iberia where customers have become more price conscious. In this regard, we understand that DIA's loyalty card, called ClubDIA, has been an effective tool, funded at more than 80% by the company's suppliers, to support customer loyalty (c.75% of sales through ClubDIA) and footfall.

HIGH GEOGRAPHIC CONCENTRATION ON IBERIA

In the first quarter of 2015, DIA generated 63% of its gross sales under banner and 85% of its `adjusted' EBITDA (as calculated by the company) in Spain and Portugal with the remainder in emerging markets. In particular, a large part of the company's earnings are generated in Spain.

Retail sales in these two countries have been fairly weak in the last three years as a result of depressed macroeconomic conditions and high unemployment rates. Looking ahead, we expect the gradual economic recovery already observed in 2014 to strengthen which we believe should support retailers' sales. Whilst we would expect pressure on the basket size to ease which is likely to support retailers' sales performance, we cannot exclude that discounters may not benefit fully from that upside if customers decide to trade up.

SALES GROWTH SUPPORTED BY FRANCHISES, INTERNATIONAL EXPANSION IN EMERGING MARKETS AND ACQUISITIONS

DIA has been expanding fast in recent years largely on the back of the development of franchise stores, expansion to emerging markets and acquisitions. The acquisition of Schlecker and the contribution of emerging markets were the largest drivers of sales growth in 2013, even after negative currency effects. In 2014, sales growth of 4.8% in emerging markets more than offset the 1.2% sales decline in Iberia as the acquisition of El Arbol closed in October 2014 and contributed only EUR133.5 million to sales in Iberia.

DIA has been expanding to emerging countries such as Argentina, Brazil and China where it has increased its investments. Emerging markets represented 37% of DIA's gross sales under banner and 15% of its `adjusted EBITDA' (as calculated by the company) in the first quarter of 2015. They were the company's largest organic sales growth drivers in recent years. For 2015 we expect that the acquisitions of El Arbol and Eroski will lead to a strong growth in sales and subsequently to a temporarily higher share of sales derived from Iberia.

While the acquisition of EL Arbol and the 144 Eroski stores fits the company's strategy to further grow in Spain and improve DIA's Spanish market position where the company has very profitable operations in part owing to its scale and efficient logistics, they are also a slight divergence from DIA discount focus. EL Arbol is a supermarket format with a different proposition than DIA's discount formats as it has a large fresh food offer. With the El Arbol acquisition, DIA aims to acquire know-how in the fresh fish and meat categories. DIA has indeed applied some of the knowledge gained when it remodeled 6 "DIA Maxi III" stores in Q1 2015 - DIA targets to remodel more than 100 DIA Maxi stores with the new concept in 2015.

DIA has given priority to the development of its franchise network. Franchisees account for at least 50% of its stores in each of the emerging markets where it operates. We believe that franchises can accelerate DIA's store openings in territories where it has a fairly small market presence especially through master franchise agreements as it did in Argentina in 2012 and more recently in Brazil. Overall, the company operates over 54% of its global DIA banner stores under the franchise regime making DIA one of Spain's largest franchisors.

Furthermore, we believe that DIA could continue making acquisitions if opportunities arise, in particular in Spain where the company participates in the consolidation of the supermarket sector. In 2013, DIA purchased Schlecker for approximately EUR70 million and in 2014 the company acquired El Arbol, and agreed to purchase 144 Eroski stores - this transaction being closed in April 2015. While we believe that the integration of El Arbol and the 144 Eroski stores alongside the not yet rebranded Schlecker stores require management's full attention making another larger transaction in the current year unlikely, further acquisition opportunities could arise in the still relatively fragmented Spanish food retail market.

WEAK LIKE-FOR-LIKE SALES IN IBERIA IN RECENT YEARS, IMPROVEMENT EXPECTED

DIA's like-for - like sales have declined in Iberia in 2013 and 2014 by 3.3% and 5.9%, respectively. This is a stark contrast to high like-for-like sales growth achieved in emerging markets of 16.4% in 2013 and 20.7% in 2014. The weak like-for-like sales trend in Iberia has improved somewhat in Q1 2015 with a 4.5% decline. We believe that DIA will continue to report negative like-for-like sales in Iberia in 2015 but at a slowing pace with a return to positive like-for-like sales during in 2016.

We believe that DIA's like-for-sales performance suffered from a combination of competition, lower basket size, lower inflation, a decline in population and, to some extent, cannibalization effects. Going forward, the company should benefit from an improving economic environment in Spain with rising GDP growth, gradually falling unemployment albeit from a very high level and improving consumer confidence. In addition, DIA will profit from its own measures such as its DIA Maxi III remodeling plan that puts a stronger emphasis on fresh food, the conversion of around 100 of the 144 Eroski stores to its new proximity supermarket banner "La Plaza de DIA" and the completion of the rebranding of the Schlecker stores to Clarel.

GOOD PROFITABILITY COMPARED TO RATED FOOD RETAILERS ALBEIT WEAKER IN EMERGING MARKETS

DIA's Moody's adjusted EBIT margin was 5.2% in 2014 (5.4% in 2013 and 4.3% in 2012). This positions the company well amongst Moody's universe of rated food retailers. As a predominately discounter, DIA's business model is highly focused on efficiency and productivity both in its stores and across its supply chain in order to ultimately offer lower prices to its customer. Amongst others, the DIA store concept is articulated around limited service in store and on a narrow number of products. Both DIA Market and DIA Maxi carry a reduced number of SKUs estimated to be between 2,800 to 3,500. Moreover, there is a high proportion of private label products in DIA stores representing c.45% of the company's total purchases (excluding fresh produces), which are negotiated centrally. In our opinion, a high proportion of private label brands support DIA's profitability because retailers tend to have higher pricing power thus higher margins than on national brands.

However, DIA displays much lower operating margins in emerging markets than in Iberia where it is highly efficient as indicated by an unchanged `adjusted' EBITDA margin (as calculated by the company) of 9.6% in 2014. In emerging markets, DIA's margins are well below the company's average because it has a more modest scale than in its core Iberian market and it is building its infrastructure there, albeit as capex are lower in emerging markets the ROI/return on investments is higher in emerging markets than in Iberia. As the company's sales grow in these markets, we expect profitability to continue to gradually improve. After a 20 basis points increase in DIA's `adjusted' EBITDA margin (as calculated by the company) in emerging markets in 2013, the company improved its margin by another 20 basis points in 2014 to 3.1%.

FINANCIAL RATIOS IN 2014 ARE STRONG FOR THE RATING CATEGORY...

Following the changes to Moody's lease methodology, the company's financial ratios (with Moody's adjustments, including capitalised operating leases) are strong for the Baa3 rating category. For example, DIA's lease adjusted gross debt to EBITDA ratio was 2.6x and its retained cash flow to net debt ratio was 33.0% in 2014. This compares favorably with our upgrade rating guidance as well as with other rated European food retailers such as Koninklijke Ahold N.V (Baa3 under review for upgrade) and Delhaize Group (Baa3 under review for upgrade).

We note that DIA's financial ratios would have improved slightly in 2014 without the impact of the lease methodology changes, despite weaker operating cash flow generation, largely owing to the stable operating performance as well as the disposal of the French operations. Based on the old lease methodology, the company's debt to EBITDA ratio improved by 30 bps compared with 2013 and the RCF / net debt metric rose by 6.5%. The RCF / net debt metric improved despite DIA's reduced cash flow from operations as the driver for this reduction, negative working capital cash flow, is not included in Moody's RCF measure. DIA reported a working capital related cash outflow of EUR188 million in 2014 mainly related to weaker sales in Iberia that led to higher inventories and lower trade payables. However, the working capital outflow and the EUR114 million cash consideration for EL Arbol were more than offset by the disposal of the French operations leading to a small reduction in adjusted gross debt.

It is worth noting that the changes to Moody's lease methodology have lowered DIA's adjusted gross debt to EBITDA ratio materially by around 1.0x and have increased the RCF / net debt ratio by around 11%. Despite the changes to the lease adjustments, DIA's Moody's adjusted leverage metric remains somewhat affected by Moody's capitalised operating lease adjustment - while DIA operates mostly in city centers with long-term operating lease arrangements, it often has short-notice exit options in the lease contracts.

... BUT WEAKER RATIOS EXPECTED IN 2015 DRIVEN BY RECENT ACQUISITIONS AND SHARE BUY-BACK ANNOUNCEMENT

Looking ahead, we expect DIA's key credit ratios to weaken somewhat in 2015 driven by (i) the purchase of the 144 Eroski stores for EUR135.3 million, (ii) the margin dilution effect of the El Arbol and Eroski stores acquisitions that will take time to turnaround, and (iii) the EUR200 million share buy-back announced in February 2014.

DIA's Q1 2015 results were in line with our expectations with a reduction in the `adjusted' EBITDA margin (as calculated by the company) to 5.6% from 6.0% in Q1 2014 as a result of the integration of El Arbol. Sales rose by 17.0% from EUR2,135.5 million in Q1 2014 (excluding France) to EUR2,497.5 million with EUR173.8 million of the EUR362.0 million increase explained by El Arbol. DIA made progress with the integration of EL Arbol reporting an 8% sales improvement and more than EUR30 million of run-rate synergies that were achieved already but El Arbol has not yet reached a positive EBITDA. Owing to non-recurring items of EUR15.8 million largely related to the integration of El Arbol and the remodeling of Clarel and DIA Market III formats, reported EBIT lowered to EUR51.8 million from EUR57.9 million in Q1 2015.

Absent any material acquisition, we believe that DIA's financial metrics could improve in 2016 putting upward pressure on the rating. Nevertheless, there is a degree of event risk associated with the rating of DIA which could hamper the improvement of its financial ratios. We believe that the risks of integration of acquisitions and migration in financial ratios is relatively modest on the assumption that DIA would focus its acquisition strategy on Spain, its largest core market.

Liquidity Profile

DIA has a solid liquidity position supported by a cash balance of EUR196 million as of 31 March 2015, recurring cash flows from operations and access to two syndicated revolving credit facilities (RCF) with a total volume of EUR700 million. The 2014 EUR400 million RCF matures in 2019 and in addition, DIA signed in April 2015 a new 3 year (plus two one-year extension options) EUR300 million RCF that replaced the previous EUR350 million RCF signed in 2011. At the end of Q1 2015, DIA had drawn EUR100 million under the two RCFs. There is a financial covenant attached to the syndicated facilities: (i) adjusted net debt to `adjusted' EBITDA of no more than 3.5x. DIA's adjusted net debt to adjusted EBITDA was 1.4x at FYE2014 and we expect that the company's headroom remains comfortable going forward. In addition to its revolvers, DIA has access to various other committed short term credit facilities which are used to fund its day-to-day requirements in the areas where it operates.

DIA's sales are subject to a moderate degree of seasonality, even though there is a peak in working capital needs in the first quarter of each calendar year. Moreover, we expect that DIA's free cash flow will be limited this year because of the announced EUR200 million share buy-back program as well as the acquisition of the 144 Eroski stores for EUR135.3 million.

DIA's liquid resources compare favorably with the much improved debt maturity schedule following the EUR500 million bond issuance in July 2014. Besides short term debt of EUR336.3 million at the end of Q1 2015, DIA has no material debt repayments until the EUR500 million bond matures in 2019.

Rating Outlook

The positive outlook reflects Moody's expectations that DIA will improve its operational performance in 2016 following some deterioration in the current year, mostly on the back of a successful integration of El Arbol and the 144 Eroski stores, further expansion in emerging markets and a gradual turnaround in like-for-like sales growth in Iberia. Its financial profile would also benefit from a balanced approach between creating shareholder value and maintaining an adequate financial structure such that its net debt to EBITDA ratio (as computed by the company) does not deviate materially from the level that the company has achieved historically (between 1.0x and 1.5x).

What Could Change the Rating - Up

Moody's could upgrade DIA's rating if the company continues to successfully execute its strategy such that it further improves its market position in Iberia and emerging markets and sustains its solid profitability. In addition, a successful integration of the two recent acquisitions is a prerequisite for a potential upgrade. Quantitatively, an upgrade would require the company's

adjusted debt/EBITDA metric to be sustainably below 3.0x and its

adjusted retained cash flow/net debt to remain at least in the low-to-mid 20s in percentage terms (with Moody's standard adjustments).

What Could Change the Rating - Down

DIA's rating could be lowered if there was an erosion in the company's market shares in its key markets and/or if its operating margins deteriorate, as a result, for example, of sustained negative like-for-like sales performance in Iberia, more intense competition or operational difficulties in emerging markets. An aggressive shareholder return policy and/or a large debt-funded acquisition could also create downward pressure on the rating. Quantitatively, Moody's could downgrade the rating if DIA's

adjusted debt to EBITDA increases above 4.0x and its

adjusted retained cash flow to net debt falls below 15% (with Moody's standard adjustments), for a prolonged period of time.

Other Considerations

We used Moody's Global Retail Industry rating methodology (published in June 2011) to assist in our assessment of DIA's credit quality. But the grid does not include all the factors reflected in our rating.

On the basis of DIA's 2014 financial statements (including Moody's standard adjustments), the grid-indicated rating is Baa2, one notch above the issuer rating assigned to the company. The 12-18 months forward looking grid which entails our expectations of weaker key credit metrics in 2015 and some improvement in 2016 maps to a Baa3 rating.

Rating Factors

Distribuidora Internacional de Alimentacion, S.A.

Retail Industry Grid [1][2]	**Current FY 12/31/2014**		[3]**Moody's 12-18 Month Forward ViewAs of 6/29/2015**	
Factor 1: Business and Cash Flow Volatility (10%)	**Measure**	**Score**	**Measure**	**Score**
a) Segment Vulnerability to Changes in Consumer Demand (n.b. - Product Type, Product Breadth, Stability of Concept)	A	A	A	A
Factor 2: Market Presence (25%)				
a) Scale (Revenue in USD Billions)	$10.6	Baa	$11 - $12	Baa
b) Market Concentration and Company's Presence in that Product Category	Ba	Ba	Ba	Ba
c) Company Geographic Presence	Baa	Baa	Baa	Baa
Factor 3: Execution Ability (15%)				
a) Quality of Execution	Ba	Ba	Ba	Ba
b) Efficiency: EBIT / Avg. Book Capitalization (net of cash)	18.8%	A	18% - 20%	A
Factor 4: Financial Ratios (50%)				
a) Debt / EBITDA	2.6x	Baa	2.4x - 2.6x	Baa
b) RCF / Net Debt	33.0%	Baa	23% - 25%	Ba
c) EBITA / Interest Expense	4.2x	Baa	3.5x - 4x	Ba
Rating:				
a) Indicated Rating from Grid		Baa2		Baa3
b) Actual Rating Assigned				Baa3

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2014; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

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