MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades DIA's ratings to B2; negative outlook

22 Nov 2018

Paris, November 22, 2018 -- Moody's Investors Service has today downgraded the long-term corporate family rating (CFR) of Spanish grocer Distribuidora Internacional de Alimentacion (DIA) to B2 from Ba2 and its probability of default rating (PDR) to B2-PD from Ba2-PD. Moody's has also downgraded to B2 from Ba2 DIA's senior unsecured long-term ratings. The outlook is negative.

"Our downgrade of DIA's ratings and outlook change reflect the company's earnings trajectory and weakened liquidity," says Vincent Gusdorf, a Moody's Vice President - Senior Analyst and lead analyst for DIA. "DIA has yet to refinance its upcoming debt maturities and amend its covenants, which we believe could pressure its liquidity in the coming months, although we acknowledge that DIA continues to negotiate with its banks," Mr Gusdorf added.

RATINGS RATIONALE

Today's rating action reflects Moody's view that DIA's credit quality has deteriorated sharply, reflecting a set of circumstances which will weigh on its earnings and liquidity such that DIA's ratings are no longer commensurate with a Ba2 rating. DIA's profits and cash flows will contract significantly over the next 12 months because of declining market shares in Iberia and adverse currency effects.

As a result, DIA's liquidity could come under significant pressure if it does not find new sources of financing and reset its covenant. The company had EUR132 million of cash on 30 September 2018 compared to EUR757 million of short-term debt. While it also had EUR460 million of undrawn credit facilities, EUR376 million were made of syndicated facilities subject to a reported net debt to EBITDA covenant of 3.5x that the company will likely breach at the next testing date, around February 2019.

Liquidity has depleted quickly in recent weeks because of a profit warning and the revelation of accounting errors. On 15 October 2018, DIA announced that its company-adjusted EBITDA would drop to EUR350-400 million in 2018 from EUR568 million in 2017. Moody's foresees that earnings will continue to fall in 2019 as well, albeit at a slower pace, because DIA faces headwinds in all of its markets, which will not be fully offset by cost-cutting measures. In addition, DIA indicated on 22 October that it will restate its 2017 equity by EUR57 million, mostly because of incorrect accounting of commercial discounts and invoices from suppliers.

While DIA has started negotiating new sources of financing with its banks, the outcome of this process remains uncertain at this stage. The current B2 rating assumes that DIA will not attempt to restructure its debt or take any action that the rating agency would consider as a distressed exchange.

In addition, the rating agency estimates that DIA's gross debt/EBITDA ratio will rise significantly to nearly 6x in 2019, compared to 3.7x in 2017, on a Moody's-adjusted basis. Because of the competition of market leader Mercadona and German discounter Lidl, DIA's market share in Spain declined by 70 basis points in August 2018, based on an average of the previous three months, according to research firm Kantar Worldpanel. As a result, the company-adjusted EBITDA fell by 12% in Iberia during the first nine months of 2018. In Latin America, the company-adjusted EBITDA margin fell by 50 basis points, excluding the effects of the new accounting standard IAS 29, owing to adverse currency effects, although the Brazilian real and the Argentinean peso have partly recovered in recent months.

To stabilize its market shares and earnings, DIA unveiled a wide-ranging strategic plan on 30 October. The company will review its product offering, strengthen its private label, change its pricing, modify franchise agreements and cut costs, among other measures. It will also lower capital expenditures (capex) in 2019 which, together with the cancellation of the dividend, should support cash flow generation: the rating agency estimates free cash flow to be around negative EUR75 million in 2019, on a Moody's-adjusted basis, compared to a forecast of about negative EUR400 million for 2018. However, Mercadona and Lidl are investing heavily and so DIA will likely be under pressure to increase capex in subsequent years. Turning operations around will take time and will depend on the company's ability to preserve good relationships with its franchisees and its suppliers despite financial difficulties.

Moody's thinks that the profit warning and the accounting errors point to weaknesses in DIA's governance. It has started addressing these governance issues by changing its management team, notably its Chief Executive Officer, its chairman of the board and part of its finance team. However, significant management changes add to the execution risks associated with the transformation plan.

RATIONALE FOR THE NEGATIVE OULOOK

The negative outlook reflects Moody's view that DIA's liquidity could come under significant pressure if it does not find new sources of financing and reset its covenant in a timely manner. It also reflects the weaker competitive and earnings profile as well as the execution risk related to the implementation of the new strategic plan and the possibility that competition may increase further in the Spanish market.

WHAT COULD CHANGE THE RATING UP/DOWN

Moody's could lower DIA's ratings if it appeared unable to refinance its short-term debt maturities, notably the EUR300 million bond (outstanding amount) maturing in July 2019, and to put in place a long-term capital structure. Failing to restore adequate covenant headroom could also cause a negative rating action. Moreover, Moody's could downgrade DIA's ratings if it appeared unable to gradually stabilize its earnings and improve its Moody's-adjusted free cash flows.

Although a positive rating action is unlikely for the moment in light of today's downgrade, Moody's could upgrade DIA's ratings if it restored an adequate liquidity position, with substantial headroom under its covenants and limited short-term debt maturities. A positive rating action would also be contingent on an improvement in Moody's-adjusted EBITDA and free cash flows as well as a financial policy supportive of higher ratings.

LIST OF AFFECTED RATINGS

..Issuer: Distribuidora Internacional de Alimentacion

Downgraded after being on review for downgrade:

.... LT Corporate Family Rating, Downgraded to B2 from Ba2

.... Probability of Default Rating, Downgraded to B2-PD from Ba2-PD

....Senior Unsecured Medium-Term Note Program, Downgraded to (P)B2 from (P)Ba2

....Senior Unsecured Regular Bond/Debenture, Downgraded to B2 from Ba2

Outlook Actions:

....Outlook, Changed To Negative From Rating Under Review

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Retail Industry published in May 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

COMPANY PROFILE

Based in Madrid, Spain, DIA is one of the main food discounters in Europe, with EUR8.6 billion of revenue in 2017. Excluding its Chinese operations, which it sold in August 2018, the company operated 7,388 stores as of 31 December 2017. Of those, 4,713 were in Spain, 630 were in Portugal, 1,115 in Brazil and 930 in Argentina. In 2017, Spain and Portugal accounted for 64% of revenue and 75% of company-adjusted EBITDA.

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