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Research Update:

Spanish Retailer DIA 'BBB-' Ratings Affirmed Despite Marked Decline In Profitability; Outlook Remains Stable

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Overview

- Spain-based food retailer DIA faced very tough competition in 2017 in its home market, causing it to lower its prices in Spain, which resulted in its reported EBITDA for 2017 falling by 8.9%, with a 16% decline in Iberia.
- DIA previously benefited from some headroom under its current ratings because of its relatively high margins by industry standards, and its moderate leverage. However, the sharp drop in profits in 2017 is testing our views on the resilience of DIA's business and has absorbed substantial rating headroom.
- The sizable investment in prices has enabled the group to regain positive like-for-like sales growth in the last quarter of 2017. We expect this recovery, combined with negotiations with suppliers and continuing cost cutting, will allow DIA's S&P Global Ratings-adjusted EBITDA margins to exceed 6.5% over 2018.
- Accordingly, we are affirming our 'BBB-' ratings.
- The stable outlook reflects our expectation that the group's leadership in proximity stores in Spain and established market positions in Brazil and Argentina, together with active margin management initiatives, will enable DIA to maintain an adjusted debt-to-EBITDA ratio below 2.5x and an adjusted funds from operations-to-debt ratio of more than 35%.

Rating Action

On March 26, 2018, S&P Global Ratings affirmed its 'BBB-' long-term issuer credit rating on Spain-based retailer Distribuidora Internacional de Alimentación S.A. (DIA, or the group). The outlook is stable.

At the same time, we affirmed our 'BBB-' issue rating on DIA's senior unsecured debt.

Rationale

DIA's reported EBITDA contracted significantly in 2017, dropping by 16% in Iberia and 8.9% across the whole group to €569 million. Its adjusted EBITDA margin also declined by 60 basis points to 6.7% in 2017. This fall in

profitability is because DIA had to make severe price investments to secure its price perception in a highly competitive market. Like other European food retailers such as Carrefour and Auchan, DIA faces intense price competition in the Spanish market, mainly 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 subsidiaries of Carrefour and Casino, and, like them, has suffered from food price deflation in Brazil.

Notwithstanding the above, we are hereby affirming the group's ratings, since DIA has benefited from some headroom under its current rating, a function of its relatively high operating margins by industry standards and of its moderate financial leverage. However, we note that the rapid decline in profit has tested our views on the resilience of DIA's business and has absorbed a substantial part of this rating headroom.

We believe that the Spanish retail market will remain very competitive during 2018, particularly in the convenience and proximity store formats in city centers, where DIA has a strong leadership position. In particular, we expect the first part of 2018 to be a difficult period for DIA, given significant restructuring costs, the remodeling of more than 800 stores in Iberia, and the opening of new stores in Latin America. That said, we expect that DIA's repricing and cost-cutting initiatives, combined with new negotiations with suppliers, should allow the group to manage its margins and maintain S&P Global Ratings-adjusted EBITDA margins at the higher end of its peer group of Western European food retailers and exceed 6.5% over 2018.

Our rating affirmation continues to reflect our view of DIA's established position as one of the leading hard-discount food retailers in Spain, with a growing presence in Latin America. 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 and the group has one of the highest numbers 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 the drop from 7.3% in 2016, DIA's adjusted EBITDA margins stood at 6.7% over 2018. This is higher than several of its rated peers in the food retail sector, such as Europe-based Auchan (5%), Carrefour (5.3%), Casino (5.6%), and 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. DIA is also a much

smaller and less diversified business than its peers--it generates close to 80% of EBITDA in Iberia.

We expect that DIA's balanced financial policy should support its relatively moderate leverage, including adjusted debt to EBITDA of less than 2.5x and adjusted FFO to debt above 35% in 2018 and 2019. We view DIA's operating leases as artificially short, relative to the length of expected use of the leased assets. We therefore make an analytical adjustment to reflect a more economically appropriate depiction of the lease obligation on a going concern basis. That said, the short-notice exit options in DIA's long-term operating leases increase its operating flexibility, which supports its overall financial risk profile.

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 2.1% in 2019. We expect the consumer price index (CPI) will be 1.5%-2.0%, with unemployment gradually trending down to about 15.6% in 2018 and 14.5% in 2019.
- Portugal's GDP to rise by 2.0%-2.5% over the next two years due to strong exports and improving investments in the country. We expect CPI will increase to 1.5% due to a rise in food, clothing, and fuel prices.
- Argentina's GDP to grow by 2.8% in 2018 and 3.0% in 2019. However, the very high expected inflation level of 22.6% in 2018 will hamper the recovery.
- Continued turnaround in Brazil, with real GDP growth of about 2.2% in 2018 and 2.4% in 2019. That said, a high debt burden and low level of investment will continue to constrain growth prospects. Despite CPI of about 3.5% in 2017, food prices fell in 2017, triggered by a record agricultural harvest. We expect food price inflation will pick up somewhat in 2018 and 2019 while the economy strengthens.
- Ongoing focus of the group on proximity and multi-banner store formats to appeal to a diverse customer base. DIA continues to focus on its proximity stores. The group actively manages its store network with refurbishment and the remodeling of more than 800 stores in Iberia, while continuing its rent negotiations. It should also 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 by 2020 in emerging markets.
- These macroeconomic conditions, together with the store development plan above, should broadly support moderate topline growth of up to 2% in constant currency. However, reported revenue growth will remain closely linked to foreign exchange rates, in particular the Brazilian real and Argentine peso.
- We also expect the topline will benefit as the positive impact of store upgrade activity will set in, food price inflation will see a gradual return, and the group expects it will recover store space growth. For Iberia, we forecast 0.6% decline for financial year (FY) 2018 in revenues

marked by closure of underperforming stores, store upgrading activity, reduced store selling space, and lower food price inflation. In the emerging markets of Argentina and Brazil, we expect revenue growth of approximately 8% from 2018, given positive like-for-like growth, improved space contribution, and continued efficiency improvement.

- We expect the EBITDA margin should stabilize in the range of 6.7%-6.8% on the back of higher focus on managing margins, through buying terms with suppliers, improved store productivity, and cost efficiency measures.
- We expect working capital requirement will be €80 million-€100 million in forecast years.
- Capital expenditure (capex) in line with management's guidance of €315 million-€350 million for 2018, which amounts to 3.5%-4.0% sales.
- A dividend payout of €128 million in 2018, increasing by 2% a year thereafter. This is in line with the historical distribution of the group's net profits of 40%-50%.
- A credit-supportive financial policy commitment to investment-grade ratings that balances capex, shareholder returns, and merger and acquisition activity.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted debt to EBITDA close to 2.3x in 2018 and 2.2x in 2019.
- Adjusted FFO to debt close to 35% in 2018 and 2019.
- Adjusted FOCF to debt at about 18% in 2018 and about 15%-20% in 2019.
- Adjusted discretionary cash flow (DCF) to debt at about 9% in 2018 and about 5%-10% in 2019.

Liquidity

We view DIA's liquidity as adequate. We base our opinion on our estimate that liquidity sources will exceed funding needs by about 1.2x in the next 12 months.

We estimate that DIA's liquidity sources over the 12 months from Dec. 31, 2017 include:

- Ongoing cash and short-term investments of about €340 million;
- €525 million of undrawn credit facilities; and
- About €400 million of cash FFO.

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

- About €270 million of debt coming to maturity in 2018;
- €315 million to €350 million of capex;
- €300 million of seasonal working capital variation, which traditionally peaks at midyear; and

- About €130 million of cash dividends.

We forecast that DIA will maintain adequate headroom under its financial covenant on its syndicated loans, with total net debt to EBITDA remaining below 3.5x.

Outlook

The stable outlook reflects our expectation that, despite a highly challenging trading environment, the group will implement its turnaround plan to stem the decline in its profitability, in particular with regard to its operations in Spain. We anticipate that the group's adjusted EBITDA margins should stabilize in 2018, near the 2017 levels of 6.7%, and that it will implement a financial policy that balances investment and dividends, consequently maintaining adjusted debt to EBITDA at about 2.2x-2.3x and adjusted FFO to debt at about 35% in 2018 and 2019.

Downside scenario

Following the sharp decline in margins, we see limited headroom under the current ratings. Further material decline in profitability over the next few months--which is not in our base case--could prompt us to lower our assessment of the strength of the group's business and competitive position.

More specifically, we could see rating pressure if the group's adjusted EBITDA margin continues to decline and drops below 6.5% over 2018, or its market share in Spain and topline performance continue to erode over time. This could arise due to continuing aggressive price tactics from competitors in Spain, or DIA's inability to cut costs or obtain favorable price terms with suppliers.

If such a margin decline were not mitigated by capex or dividend moderation, we could see the group's credit metrics weaken considerably, with FFO to debt falling below 30%, accompanied by weak FOCF generation.

Upside scenario

Owing to the recent sharp decline in margins, continued price competition in Spain, and ongoing investment in stores, which constrains FOCF generation, we consider an upgrade unlikely over the next two years.

However, we could consider a positive rating action if DIA's sales and profitability increase materially more than we currently anticipate, and if, as a result of this, there is a very strong improvement in the group's DCF on a sustainable basis. This would have to be supported by our adjusted FFO to debt approaching 45% on a sustainable basis.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Stable

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: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Issue Ratings--Subordination Risk Analysis

Capital structure

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

- General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017

- General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Industrials: Key Credit Factors For The Retail And Restaurants Industry, Nov. 19, 2013
- General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- 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

Distribuidora Internacional de Alimentacion S.A.

Corporate Credit Rating	BBB-/Stable/--
Senior Unsecured	BBB-

Additional Contact:

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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 the 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.

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