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Research Update:

Spanish Retailer DIA Downgraded To 'B' On Heightened Refinancing Risk And Operating Pressure; Remains On Watch Negative

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Rating Action Overview

- We see heightened refinancing risk concerning DIA's short-term debt, and although the company is working on a refinancing plan, we believe there is significant timing and execution risk.
- In our view, there is a very high likelihood of a covenants breach at year-end 2018, with further operating pressure expected through 2019.
- We are therefore lowering our long-term issuer credit rating on DIA and our issue rating on its unsecured notes to 'B' from 'BB-'.
- The CreditWatch negative reflects near-term pressures on DIA's liquidity and if DIA does not make concrete progress regarding refinancing over the next two to three months, we could consider a further downgrade.

Rating Action

On Nov. 23, 2018, S&P Global Ratings lowered to 'B' from 'BB-' its long-term issuer credit rating on Spain-based food retailer Distribuidora Internacional de Alimentación S.A. (DIA, or the group).

At the same time, we lowered our issue rating on DIA's senior unsecured notes to 'B' from 'BB-'. The notes have a recovery rating of '3', indicating our expectation of meaningful recovery (50%-70%, rounded estimate: 60%) in the event of a payment default.

We maintained all our ratings on DIA on CreditWatch with negative implications.

Rating Action Rationale

The downgrade reflects our view of a heightened refinancing risk for DIA, which had €760 million of short-term debt at the end of September 2018, including €306 million bonds due in about eight months. It also reflects a very high likelihood of covenants breach at year-end 2018, together with ongoing operating pressure that is likely to continue through 2019.

We understand that the company is working on a comprehensive refinancing plan with several banks. We believe that any bank refinancing will likely require some kind of recapitalization of the company and the sale of assets, a transaction that will entail significant execution risk and an uncertain outcome.

We also note the company's status in the capital markets has weakened, as reflected in the significant fall of its share price and bond trading levels in the last few weeks. This, in our view, also indicates limited prospects for refinancing in the bond market, thereby increasing the group's reliance on its banks for refinancing the upcoming maturities.

If DIA does not renegotiate the covenants under its €525 million revolving credit facility (RCF) in a timely manner, we believe that there is a very high likelihood of a covenants breach at year-end 2018. This is because we expect a sharp contraction of about 40% of DIA's EBITDA, to €270 million-€300 million in 2018 (including restructuring costs in the region of €100 million) from €496 million in 2017. We also forecast an increase of €370 million-€400 million in the group's net debt, due in particular to the continuing net impact of working capital on cash flows of about €150 million and high capital expenditure (capex) for store refurbishment in 2018.

We anticipate that DIA's underperformance will continue through 2019. The group's business model will need to undergo heavy transformation in order to regain competitiveness and restore margins. Such transformation will likely carry some execution risks, especially with regard to the pace and scope of the proposed implementation. DIA might also continue to incur sizeable restructuring costs that could further weight on the group's profitability on an ongoing basis. This is in a context of extreme competitive pressure, in particular in Spain from the market leader Mercadona, forcing the group to lower prices. We also factor in ongoing negative impact of currency movements in its Latin America operations that more than offset the healthy underlying trend of its operations in that region.

Earlier this year DIA announced a profit warning. After a sharp drop in reported EBITDA in 2017 of 16.0% in Iberia and 8.9% across the whole group, DIA's profitability has continued to decline significantly in 2018. During the first nine months of 2018, the group's EBITDA fell by 33.1% (including restructuring costs).

DIA's margins were affected by a weak top-line performance and the end of a 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 Mercadona, which holds nearly one-quarter of the market in terms of sales, and also from German discounter Lidl. Mercadona in particular has aggressively cut its prices and improved its product offerings, which has forced DIA to respond, thereby resulting in much lower margins.

DIA also faces strong competition in Latin America from Carrefour's and

Casino's cash-and-carry subsidiaries in Brazil. Like them, DIA has suffered from food price deflation and transport strikes in Brazil and significant currency weakness in Brazil and Argentina.

After falling from 7.3% in 2016, DIA's adjusted EBITDA margin remained at 6.7% for 2017. Despite the decline, this margin was still higher than that of several of DIA's rated peers in the food retail sector, such as Europe-based Auchan (5.0%), Carrefour (5.3%), Casino (5.6%), U.K.-based Tesco (6.1%), and U.S.-based Kroger (6.0%) and Wegmans (6.3%). However, following the recent profit warning and including restructuring costs that we estimate to be at least €100 million in 2018, we forecast that DIA's adjusted EBITDA margin will now drop to about 5% for 2018 and 2019.

Until the end of 2017, DIA's higher profitability and balanced financial policy supported relatively moderate leverage, including adjusted debt to EBITDA of less than 2.5x and adjusted funds from operations (FFO) to debt above 33%. However, given the rapid decline in DIA's profits and cash generation over the past few quarters, due to its extremely weak operating performance, and its ongoing high capex for the refurbishment of its stores, we expect a significant increase in its leverage. We now forecast DIA's adjusted debt to EBITDA will rise to 4.5x-5.0x, resulting in a much weaker financial profile in the remainder of this year and in 2019.

We assess DIA's management and governance as weak in view of the significant strategic, operational, and financial missteps that have led to losses, the profit warning, and the accounting restatement. The group's new CEO came in only in August 2018 and a new chairperson has recently been appointed on a provisional basis.

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

- A reduction in Spain's GDP growth of more than 3% over the past three years (2015-2017) to 2.7% in 2018 and 2.4% in 2019. We expect the consumer price index (CPI) will be 1.9%, with unemployment gradually trending down to about 15.5% in 2018 and 14.3% in 2019.
- A rise in Portugal's GDP of 2.3% in 2018 and a further 1.9% in 2019, due to strong exports and improving investments in the country. We expect the CPI will be 1.2%-1.5% in 2018-2019 due to a rise in food, clothing, and fuel prices.
- A decrease in Argentina's GDP by 2.5% in 2018, and by a further 0.8% in 2019 following growth of 2.9% in 2017. Very high inflation, which we expect will be about 35% in 2018-2019, will hamper the country's recovery.
- Continued economic turnaround in Brazil, with real GDP growth of about 1.4%-2.2% in 2018-2019, due to a faster-than-expected recovery from recession as the government reduces its budget deficit. Despite a CPI of about 4.0%, food prices fell, triggered by a record agricultural harvest. We expect food price deflation to end gradually while the economy strengthens.
- DIA's continued focus on proximity and multibanner store formats, which

appeal to a diverse customer base.

- DIA's active management of its store network through refurbishment--it remodelled more than 900 stores in Iberia during the first half of 2018--while continuing its rent negotiations.
- DIA's continued expansion of 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.
- Some positive impact on trading over 2019 and 2020 from the store upgrade activity already undertaken and the gradual return of food price inflation.
- A decline in DIA's top line of 3%-4% in Iberia over 2018 and 2019, due to further price reductions and temporary store closures for refurbishment.
- In the emerging markets of Argentina and Brazil, broadly stable revenue growth in 2018 and 2019 in local currency terms, given positive like-for-like growth, improved space contribution, and continued efficiency improvements. However, reported revenue growth will remain closely linked to foreign-exchange rates. The Brazilian real and Argentine peso have both depreciated very significantly against the euro, which is DIA's reporting currency.
- Likely stabilization of the group's adjusted EBITDA margin at the lower level of about 5%, 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.
- Continuing net impact of working capital on cash flows of about €200 million over 2018 and 2019, in aggregate, despite management's efforts to manage its inventory and trade payables tightly.
- A cut in capex to below €200 million in 2019, a significant reduction from previous annual spending levels.
- No dividend payouts in 2019, following the board's recent decision to put dividend distributions on hold.

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

- Adjusted debt to EBITDA close to 5.0x in 2018 and 2019; and
- Adjusted FFO to debt of 14%-15% in 2018 and 2019.

Liquidity

We view DIA's liquidity as less than adequate. Without timely refinancing, we forecast that liquidity sources will not cover uses over the next 12 months.

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

- Cash and short-term investments of about €132 million, after factoring in about €200 million of seasonal working capital variation, which traditionally peaks at midyear;
- €490 million of undrawn available credit facilities; and
- About €175 million of cash FFO.

We estimate that DIA's liquidity uses over the same period include:
Year-end working capital outflow of €10 million-€50 million.

- Reduced capex of €190 million, offset by moderate assets sales; and
- €455 million of short-term debt maturities and €306 million bonds maturing in July 2019.

CreditWatch

We aim to resolve the CreditWatch within the next 90 days. During this time, we expect to assess the progress of the group's refinancing and renegotiation of its RCF covenants.

We would consider removing the 'B' issuer credit rating from CreditWatch and affirming it if DIA is able to refinance its near-term debt maturities, put in place a sustainable and longer-term capital structure, and maintain adjusted leverage below 4.5x. For an affirmation of ratings, we would also need to see a stabilization of performance, resilience of operating margins above 5%, and at least neutral reported discretionary cash flow generation.

Conversely, if DIA is unable to refinance its debt maturities or covenants in the short term, or if there is further weakness in its operating performance or liquidity position, we could lower the issuer credit rating by one or two notches, depending on our assessment of the group's resulting liquidity.

Ratings Score Snapshot

Issuer Credit Rating: B/Watch Neg/--

Business risk: Fair

- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Fair

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less Than Adequate (-1 notch)
- Financial policy: Neutral (no impact)
- Management and governance: Weak (-1 notch)
- Comparable rating analysis: Neutral (no impact)

Issue Ratings - Recovery Analysis

Key analytical factors

- The issue rating on the senior unsecured bonds (comprising three bonds of a total nominal value of €900 million, issued at the parent level under the euro medium-term note program, and maturing between 2019 and 2023) is 'B'. The recovery rating is '3', reflecting our expectation of average recovery prospects (50%-70%; rounded estimate: 60%) in the event of default.
- The recovery rating is constrained by the lack of a comprehensive security and guarantee package.
- The group's priority debt mainly comprises unrated bank debt at subsidiaries. We have included the reverse factoring lines of about €350 million as part of the unsecured debt.
- Our hypothetical default scenario assumes intensifying competition and a significant weakening of brand and price perception in the Spanish and Latin American retail market, accompanied by a deterioration of the group's operating efficiency and a contraction in discretionary consumer income following an economic downturn.
- We value DIA as a going concern, given its strong brand and market position in the food retail market in Latin America and Iberia.
- We note that any refinancing with debt secured with collateral could have negative implications for the rating on DIA's existing debt.

Simulated default assumptions

- Year of default: 2021
- Minimum capex (percentage of last three years' average sales): 2%
- Cyclicality adjustment factor: +5% (standard sector assumption)
- Operational adjustment: +5%
- Jurisdiction: Spain

Simplified waterfall

- EBITDA at emergence €245 million
- Implied enterprise value multiple: 5.5x, which is 0.5x higher than our standard sector assumption and comparable with similarly rated peers with

similar growth and profitability prospects

- Gross enterprise value at default: €1,349 million
- Net enterprise value after administrative costs (5%): €1,281 million
- Value available post settling priority claims: €1,209 million
- Total senior unsecured debt: €1,951 million [1]
- Recovery rating: 3 (50%-70%; rounded estimate: 60%) [2]

[1] All debt amounts include six months of prepetition interest. RCF of €525 million assumed 85% drawn on the path to default. [2] Rounded down to the nearest 5%.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, 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

Downgraded

	To	From
Distribuidora Internacional de Alimentacion S.A.		
Issuer Credit Rating	B/Watch Neg/--	BB-/Watch Neg/--

Senior Unsecured	B/Watch Neg	BB-/Watch Neg
Recovery Rating	3(60%)	3(60%)

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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 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.