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## Research Update:

# Spanish Retailer DIA Downgraded To 'BB-', Put On Watch Negative On Profit Warning And Large Short-Term Debt Maturities

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## Overview

- Following very weak trading in the first half of 2018, Spain-based food retailer Distribuidora Internacional de Alimentación S.A. (DIA) announced a profit warning, some board changes, and a potential downward restatement of its equity position by around €70 million following an accounting review. All this is compounded by diminished headroom under the financial covenant on DIA's revolving credit facility and short-term debt maturities in excess of €700 million.
- Due to weak sales volumes and higher costs, DIA has announced that its EBITDA for 2018 will be €350 million-€400 million, up to 30% lower than its previous guidance. The slump in profits and the possible accounting restatement of equity are testing our assessment of DIA's business risk profile and governance.
- We now anticipate negligible free operating cash flow and a significant deterioration of DIA's credit metrics, with adjusted funds from operations to debt dropping to around 17% and adjusted debt to EBITDA of around 4.6x by year-end 2018.
- We are therefore lowering our long-term issuer credit rating on DIA and our issue rating on its unsecured notes to 'BB-' from 'BBB-'.
- We are also placing all our ratings on DIA on CreditWatch with negative implications.
- The CreditWatch negative placement reflects short-term pressures on DIA's liquidity. If DIA does not address these pressures over the next few months, we cannot rule out further negative rating actions. The CreditWatch placement also reflects the potential outcomes of our assessment of the results of both a strategic review under DIA's new management and a review of its financial statements. The potential outcomes range from an affirmation of the 'BB-' issuer credit rating to a downgrade of up to two notches.

## Rating Action

On Oct. 19, 2018, S&P Global Ratings lowered to 'BB-' from 'BBB-' 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 'BB-' from 'BBB-'.

We assigned a recovery rating of '3' to these notes, indicating our expectation of meaningful (50%-70%, rounded estimate: 60%) recovery in the event of a payment default. Finally, we placed all our ratings on DIA on CreditWatch with negative implications.

## Rationale

The downgrade follows a decline in DIA's sales volumes in Spain during 2017 and the first half of 2018, and as a result, a severe weakening in the group's operating margins. DIA's management under the new CEO has indicated that EBITDA in 2018 will be €350 million-€400 million, up to 30% lower than its previous guidance of €500 million. This compares to EBITDA of €568 million in 2017. In addition, DIA has announced a potential downward restatement of its equity position by around €70 million following an accounting review, and has significant short-term debt maturities of over €700 million within the next year. The group has also initiated a strategic review of its business in order to stem its weak operating performance.

The profit warning follows very weak trading performance from 2017, with soft like-for-like sales, declining margins, and significant restructuring costs reducing profitability. 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 half of 2018, the group's S&P Global Ratings-adjusted EBITDA fell by 14.6%, excluding the negative impact of currency movements in its Latin America operations. Furthermore, we expect 2019 to be a tough year for DIA, with a continuation of competitive pressures and heavy reinvestments in prices.

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 exceptional competition from its main peers, particularly Mercadona, and its ongoing high capital expenditure (capex) on the refurbishment of its stores, we expect a significant increase in its leverage. We now forecast that DIA's adjusted debt to EBITDA will rise to 4.6x, resulting in a much weaker financial profile in the remainder of this year and 2019.

In addition to weak topline performance, adjusted margins suffered from 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 the market leader, 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 the cash-and-carry subsidiaries of Carrefour and Casino, especially in Brazil. Like them, DIA has suffered from food price deflation and transport strikes in Brazil and significant currency weakness in Brazil and Argentina.

Our ratings reflect our view of DIA's position as one of the main 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 franchise-focused operating model.

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 in general allows for higher overall profitability and a more-efficient capital allocation.

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 in the region of at least €100 million in 2018, we forecast that DIA's adjusted EBITDA margin will now drop to about 5% for 2018 and 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 potential accounting restatement of equity. The group's new CEO came in only in August 2018 and a new chairperson has recently been appointed on a provisional basis.

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. In our view, despite recent operating issues, DIA's business model benefits from 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.

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 a degree of increased operating flexibility.

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 2.0% in 2018, and remaining flat in 2019 following growth of 2.9% in 2017. Very high inflation, which we expect to be around 40% in 2018 and more than 20% in 2019, will hamper the country's recovery.
- Continued economic turnaround in Brazil, with real GDP growth of about 1.5%-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 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.
- 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 remodeled 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 2%-3% in Iberia over 2018 and 2019, due to the abovementioned macroeconomic conditions, together with the store development plan.
- 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 around 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 around €150 million over 2018 and 2019, despite management's efforts to manage its inventory and trade payables tightly.
- A cut in capex to below €150 million from 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 of around 4.6x; and
- Adjusted FFO to debt of around 16%-17% in 2018 and 2019.

The lowering of capex and suspension of dividends in response to the profitability pressures will likely stem the cash outflow and result in broadly breakeven free cash flow in reported terms in 2019.

Our forecasts do not include the impact from the imminent application of IAS 29 financial reporting in hyperinflationary economies. This application will be mandatory as of the third quarter of 2018 due to DIA's presence in Argentina.

As result of the review of its financial statements, management anticipates certain adjustments to the 2017 consolidated financial statements. We understand that such adjustments may have an estimated negative impact on equity of approximately €70 million.

Under its new CEO, DIA 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 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 around €100 million, after factoring in about €300 million of seasonal working capital variation, which traditionally peaks at midyear;
- €394 million of undrawn available credit facilities; and

- About €210 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 €145 million-€150 million, offset by moderate assets sales; and
- €411 million of short-term debt maturities and €306 million bonds maturing in July 2019.

DIA's short-term debt maturities include local bank facilities and bilateral loans, which the group renews on a yearly basis. We understand that management is in discussions with several banks to actively refinance its short-term debt maturities, which account for more than €700 million. We also expect the group to renegotiate the covenants under its €350 million revolving credit facility (RCF), headroom under which we expect to be very narrow by year-end 2018.

Our liquidity assessment is based on the group's well-established and good relationships with banks and a track record of access to different financing sources.

## 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, renegotiation of its RCF covenants, and the results of both the strategic review under its new management and the review and restatement of its financial statements. Our assessment will also include a review of the new management's plans to stem the decline in the group's profitability, stabilize its operations, and generate cash flow.

We would consider removing the 'BB-' 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 around 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, if there is further weakness in its operating performance or liquidity position, or if there are any material issues in its financial statements, we could lower the issuer credit rating by one or two notches, depending on our assessment of the group's resulting liquidity, leverage, and governance. In addition, any further weakness in operating performance would test our assessment of the group's business risk profile and could also put pressure on the rating.

## Ratings Score Snapshot

Issuer Credit Rating: BB-/Watch Neg/--

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

Financial risk: Aggressive
- Cash flow/Leverage: Aggressive

Anchor: bb

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

## 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 'BB-'. 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.
- 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: 2022
- Minimum capex (percentage of last three years' average sales): 2%
- Cyclicality adjustment factor: +5% (standard sector assumption)
- Operational adjustment: -10% due our expectation of operating weakness and continued restructuring costs
- Jurisdiction: Spain

**Simplified waterfall**

- EBITDA at emergence €210 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: €1,155 million
- Net enterprise value after administrative costs (5%): €1,097 million
- Value available post settling priority claims: €1,025 million
- Total senior unsecured debt: €1,602 million [1]
- Recovery rating: 3 (50%-70%; rounded estimate: 60%) [2]

[1] All debt amounts include six months of prepetition interest. Revolving credit facility 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; CreditWatch/Outlook Action

| | To | From |
|---|---|---|
| Distribuidora Internacional de Alimentacion S.A. | | |
| Issuer Credit Rating | BB-/Watch Neg/-- | BBB-/Negative/-- |
| Senior Unsecured | BB-/Watch Neg | BBB- |
| Recovery Rating | 3(60%) | NR |

NR--Not rated.

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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.