S&P Global Ratings

RatingsDirect®

Research Update:

Spanish Retailer DIA Downgraded To 'CCC+' On Increased Refinancing Concerns And Liquidity Pressures; Outlook Negative

Primary Credit Analyst:
Solene Van Eetvelde, Paris (33) 1-4420-6684; solene.van.eetvelde@spglobal.com

Secondary Contact:
Raam Ratnam, CFA, CPA, London (44) 20-7176-7462; raam.ratnam@spglobal.com

Table Of Contents

Research Update:

Spanish Retailer DIA Downgraded To 'CCC+' On Increased Refinancing Concerns And Liquidity Pressures; Outlook Negative

Rating Action Overview

- In our view, Spain-based food retailer Distribuidora Internacional de Alimentación S.A. (DIA's or the group's) plan to achieve a sustainable long-term capital structure entails significant execution risk and an uncertain outcome.
- Without a timely refinancing, we believe there is a heightened risk of a liquidity shortfall over the next seven months.
- We are therefore lowering our long-term issuer credit rating on DIA to 'CCC+' from 'B' and removing it from CreditWatch negative.
- We are also lowering our issue rating on DIA's unsecured notes to 'CCC+' from 'B' and removing it from CreditWatch negative. The recovery rating remains at '3', reflecting our expectation of about 60% recovery for shareholders in the event of a default.
- The negative outlook reflects near-term pressures on DIA's liquidity, the execution risk of its recapitalization plan and uncertainties around the group's ability to turnaround the business.

Rating Action Rationale

The downgrade reflects DIA's very weak liquidity and funding profile, with more than €760 million short-term debt due within the next seven months and significant uncertainty and execution risk linked to the group's plans to achieve a sustainable capital structure through a €600 million rights issue and a new long-term bank refinancing agreement of its €1.0 billion outstanding debt. DIA also faces a very likely breach of its financial covenant at the next testing date, in February 2019.

We understand that the group is in advanced negotiations with banks to secure a refinancing agreement that will address its short-term liquidity needs, including factoring, commercial paper, and revolving lines. We also understand that in another phase, the group will undertake negotiations to put in place a long-term bank-funded capital structure, including a capital increase. In the event of such a decision, on which DIA's board has not yet taken any resolution and which would need the approval of DIA's general shareholder meeting, DIA has entered into a standby underwriting commitment with Morgan Stanley & Co International PLC for an amount of €600 million, under which and subject to certain conditions Morgan Stanley would undertake to place and, failing that, to subscribe 100% of such amount. DIA is also considering a divestment plan that would affect the cash and carry business (Max Descuento) and potentially Clarel.

We believe that, even if DIA managed to close the refinancing of its short-term funding needs and to amend the covenant of its €525 million revolving credit facility (RCF) in the short term, it faces a very challenging and uncertain time within the next seven months, reflected in our 'CCC+' rating level. In particular, in the next seven months, DIA needs to achieve a sustainable capital structure by way of long-term refinancing of its bank facilities and of its €306 million bonds due July 22, 2019, and to successfully place (or to have Morgan Stanley subscribe) a €600 million rights issue. DIA will also have to manage the significant operating pressures affecting its operations, including a very competitive marketplace in Spain and significant currency weakness in Brazil and Argentina, while management is spending significant time and resources in achieving its recapitalization plan.

In particular, in 2018 we expect a sharp contraction of about 40% of DIA's EBITDA, to €270 million-€300 million (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 to regain competitiveness and restore margins. Such a transformation will likely carry some execution risks, especially with regard to the pace and scope of the proposed implementation. DIA is likely to incur sizable restructuring costs that will further weigh on the group's profitability. This is in a context of extreme competitive pressure, in particular in Spain from market leader Mercadona, forcing the group to lower prices. We also factor in ongoing negative impact of currency movements in its Latin American operations that more than offset the healthy underlying trend of its operations in that region.

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, the accounting restatement, and significant delays in refinancing its debt maturities. The group's new CEO started only in August 2018 and a new CFO appointed recently in December 2018.

Outlook

The negative outlook reflects near-term pressures on DIA's liquidity and funding profile, and the high execution risk of the group's recapitalization plan. It also reflects the group's weak earnings and cash flow generation profile, and the challenge it faces to turn around its operations with its new strategic plan in such unfavorable market context in Spain, Brazil and Argentina.

Downside scenario

We could consider a negative rating action if DIA breaches its financial covenant, fails to undertake its recapitalization plan, or pursues any debt restructuring.

Upside scenario

We could revise the outlook to stable and reevaluate the issuer credit rating if DIA is able to refinance its near-debt maturities, execute its rights issue plan, and put in place a sustainable and longer-term capital structure. We would also need to see a stabilization of DIA's operating performance and at least neutral reported discretionary cash flow generation.

Company Description

DIA engages in the retail sale of food products in Spain, Portugal, Brazil, and Argentina. Its stores also offer household, health, beauty, hygiene, and personal care products. As of Dec. 31, 2017, the group operated approximately 7,388 stores, 80% of which are discount convenience stores; 4% supermarkets; and 16% personal care, cosmetics, and perfume business. It reported €8.7 billion of sales in fiscal 2017. DIA primarily operates its owned or franchised stores under the DIA Market, DIA Maxi, Minipreço, La Plaza de DIA, City DIA, Clarel, Max Descuento, Cada DIA, and Mais Perto names. DIA was incorporated in 1966 and is headquartered in Madrid, Spain. It is listed on the Madrid stock exchange.

Our Base-Case Scenario

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

- A reduction in Spain's GDP growth to 2.7% in 2018 and 2.4% in 2019 from more than 3% over the past three years (2015-2017). 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, owing 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 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 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 near 5.0x in 2018 and 2019; and
- Adjusted funds from operations (FFO) to debt of 14%-15% in 2018 and 2019.

Liquidity

We view DIA's liquidity as weak, reflecting a material liquidity shortfall over the next 12 months without a timely refinancing of its short-term debt. Our assessment also hinges on the high likelihood of a breach of DIA's net debt to EBITDA covenant at its next testing date in February 2019.

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.

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 'CCC+'. 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 that DIA is unable to refinance its short-term debt, leading to a payment default in 2019.
- 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: 2019
- 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 | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Retail And Restaurants Industry, Nov. 19, 2013
- Criteria - Corporates - 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: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Spanish Retailer DIA Downgraded To 'B' On Heightened Refinancing Risk And Operating Pressure; Remains On Watch Negative, Nov. 23, 2018
- Spanish Retailer DIA Downgraded To 'BB-', Put On Watch Negative On Profit Warning And Large Short-Term Debt Maturities, Oct. 19, 2018

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Distribuidora Internacional de Alimentacion S.A.		
Issuer Credit Rating	CCC+/Negative/--	B/Watch Neg/--
Senior Unsecured	CCC+	B/Watch Neg
Recovery Rating	3(60%)	3(60%)

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com