

Research Update:

Koninklijke FrieslandCampina N.V. Downgraded To 'BBB/A-2' On Weak Operating Performance; Outlook Negative

April 19, 2019

Rating Action Overview

- Dairy company Koninklijke FrieslandCampina N.V. (Royal FrieslandCampina or RFC) has reported lower-than-anticipated operating margins for two years in a row, owing to high milk prices and competitive pressure on the infant formula segment in Hong Kong and China.
- Therefore, our adjusted debt to EBITDA dramatically increased to 4.6x as of year-end 2018 and we expect the ratio to stay above 3.5x over the next 12-24 months.
- Consequently, we are lowering our ratings on RFC to 'BBB' from 'BBB+'.
- The outlook is negative, reflecting our view that RFC's turnaround strategy for its Dairy Essentials division might take longer than expected and that pressure on the Specialized Nutrition division could further weigh on margin recovery.

Rating Action Rationale

The downgrade follows RFC's weaker operating results than anticipated in 2018, in the context of high milk prices, RFC's obligations to cooperative members to commercialize high milk volumes, and competitive pressures in Asian markets for infant formula. In addition, the negative outlook reflects our anticipation that RFC's profitability might be below our base-case assumptions in the next two years if market trends are negative. We consider that the company might not be able to restore margins, and this could both demonstrate a weaker business model than previously factored into our ratings and translate into weaker credit metrics than anticipated in our current base case, prompting us to lower the ratings.

Last year, member farmers produced a higher volume of milk, which the company had to process in its Dairy Essentials (DE) division, resulting in a €100 million rise in costs, heavily depressing operating margins owing to unfavorable dairy commodity prices. In addition, the group defended its infant formula market shares in Hong Kong and Greater China after one of its closest peers entered into a price war. This translated into another €60 million negative impact on the group's

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profitability. In addition to disappointing sales volumes, these events weakened the group's credit metrics beyond our expectations, with S&P Global Ratings-adjusted debt to EBITDA peaking at 4.6x as of year-end 2018. However, we view that the group managed to improve its working capital, translating into still robust free cash flow generation for a 'BBB' category rating.

RFC's turnaround strategy is to focus on revamping the less-profitable Consumer Dairy (CD) and loss-making DE divisions while maintaining a comfortable margin for its Specialized Nutrition (SN) and Ingredient (IN) divisions. The enhancement of the group's product mix toward more profitable products should stem from both a higher degree of product diversification, and premiumization of its cheese offering, enabling the DE and CD divisions to become more profitable.

In light of weak profitability in 2018 and still volatile commodity prices, we think that the turnaround strategy might take longer than expected or could fail in the event of a tougher price environment. This could lead the company's credit metrics to deviate again from our base case for year-end 2019.

The group's profitability was heavily hit in 2018, with reported EBIT dropping by more than 20%. This decrease in profitability is partly explained by the lag between the inflation of raw materials and the effective price increase passed onto customers, as well as the factors mentioned above (high milk supply from members and infant formula competition in Asia).

However, RFC's good working capital management and ability to reduce the performance premium paid to farmers remains cash-flow-protective and it illustrates the group's ability to generate positive free cash flow while continuing to invest in the revamping of its CD and DE divisions and other growth initiatives.

Despite lower profit returns to members, we still believe the cooperative will be able to retain farmers in the coming years, thanks to its milk valorization model that enables RFC to continue to create value for its cooperative members.

Across its divisions, the group still enjoys what we consider a well-balanced product portfolio, with a value-creation proposition for its farmers, which underpins our business risk profile assessment, along with historically high margins.

Like other agricultural cooperatively owned companies, RFC is vertically integrated and engaged to buy all the raw materials (milk) produced by its member farmers.

Outlook

The negative outlook reflects our view that RFC's turnaround strategy for its DE and CD divisions might take longer than expected and could be jeopardized by tough milk prices. In addition, the negative outlook reflects that ongoing pressure on the high-margin SN division in Hong Kong and China could further weigh on margin recovery. Therefore, we see at least a one-in-three chance that RFC will not be able to restore its profitability over the next 12-24 months, which would lead us to lower our ratings.

Downside scenario

We could lower the 'BBB' long-term rating if RFC's operating performance remains constrained by operational headwinds. For example, if it is unable to cope with high milk supply while ramping up profitability or to rapidly pass on price increases to customers. If RFC is not able to restore its margin and deleverage below 4x by end of 2020, this would reflect a weaker business model than previously factored into our ratings. Finally, any significant change in financial policy, notably

regarding debt-financed acquisitions, could be negative for the rating.

Upside scenario

We could revise the outlook to stable if we saw improvement in RFC's profitability in the next 12-24 months following the successful implementation of the group's strategy. Moreover, a return to a 'BBB+' rating would be subject to significant improvements in the EBITDA margin, translating into credit metrics falling comfortably and sustainably in the 2.5x-3.5x range for debt to EBITDA. We would also seek to observe the group's maintenance of a conservative financial policy.

Company Description

Netherlands-based Royal FrieslandCampina (RFC) is an agricultural co-operative group with revenues of €11.6 billion and reported EBITDA of €719 million. RFC remains the sixth-largest global dairy group and ranks No. 3 in the global dairy cooperative industry.

The group produces and sells consumer milk, milk powder, dairy-based beverages, infant nutrition, cheese, butter, and desserts. RFC operates through four business divisions (effective as of Jan. 1, 2018): Consumer Dairy, Specialized Nutrition, Ingredients, and Dairy Essentials. The group's product diversification and its exposure to more than 170 countries, coupled with its product focus toward higher-value-added dairy products should drive limited margin recovery in 2019. It also sells ingredients and half-finished products to manufacturers of infant nutrition, the food industry, and the pharmaceutical sector around the world.

RFC's vertically integrated business model enables it to control and manage at all times the quality of its products and to maintain what we could consider the industry's most exclusive quality standard, the "From the Grass to Glass" approach. Currently, the group's strong product pipeline, with an important initiative on organic products, should fuel growth in mature markets. Moreover, the group's ambitious increase in marketing spending will enable it to gain market share by expanding and strengthening its core brands, such as Frisian Flag, Dutch Lady, or Frizo, in the Chinese market and the Asia-Pacific region.

Friesland Campina is fully owned by a cooperative, Zuivelcoöperatie FrieslandCampina, with 12,104 member dairy farms (supplying approximately 10.4 billion kilos of milk in 2018) in the Netherlands, Germany, and Belgium, with a total of 18,261 member dairy farmers. It has branch offices located in 34 countries and exports dairy products to more than 100 countries worldwide from the Netherlands.

Our Base-Case Scenario

In our base case for 2019-2020, we assume:

- Revenue decline of about 0.5% in 2019, primarily driven by lower prices for its SN division, while volumes are decreasing at the group level. Increased marketing spending should support market share gains, notably in CD, but this would only materialize in 2020, with an anticipated growth of 1.5%.
- Adjusted EBITDA margin of 9% in 2019, gradually recovering in 2020 and 2021. We assume profitability will benefit from an enhanced product mix and the high-margin SN business in China and Southeast Asia. Measures to significantly lower fixed costs will also support margin recovery in the next two years. However, we forecast the EBITDA margin will be restored to its five-year historic average of 10% only at the end of 2021.

- Capital expenditure (capex) remaining at about €500 million annually.
- Stable returns to shareholders of €63 million in the next two years via payments of performance premium and additional members' bond distribution.

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

- Adjusted debt to EBITDA of about 4x in 2019 and about 3.50x-3.75x in 2020.
- Free operating cash flow to debt of about 7% in 2019 and about 9.5% in 2020.
- EBITDA interest coverage of about 16x-17x in 2019 and 2020.

Liquidity

We assess RFC's liquidity position as adequate under our criteria for agricultural cooperatives. We forecast that liquidity sources to uses will exceed 1.2x over the next 12 months and that sources would exceed uses even in case of a 20% EBITDA decline. We note that RFC has significant headroom under the financial covenants on its senior debt.

We estimate that principal liquidity sources for the 12 months from Dec. 31, 2018, include:

- Cash and cash equivalents of €356 million as of Dec. 31, 2018;
- An undrawn revolving credit facility (RCF) of €1,000 million maturing in more than a year; and
- Our forecast of cash FFO of about €866 million for the next 12 months.

For the same period, we estimate that principal liquidity uses include:

- Short-term debt maturities of about €661 million comprising €221 million of commercial paper drawn as of Dec. 31, 2018;
- Maximum seasonal working capital requirements of about €350 million and anticipated annual outflow of €50 million;
- Capex of €450 million for 2019;
- Dividend payments of about €63 million in 2019 and 2020; and
- Cash outflow of €171 million, mainly tied to return payments and interest on member bonds.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Negative/A-2

Business risk: Strong

- Country risk: Low
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | Industrials: Key Credit Factors For Agricultural Cooperatives, March 17, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, 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: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded; Ratings Affirmed

	To	From
Koninklijke FrieslandCampina N.V.		
Issuer Credit Rating	BBB/Negative/A-2	BBB+/Negative/A-2

Ratings Affirmed

Koninklijke FrieslandCampina N.V.		
Commercial Paper	A-2	

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.

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