FitchRatings

Fitch Places Natura's 'BB' Ratings on Negative Watch Following Avon Acquisition Announcement

Fitch Ratings-Chicago-23 May 2019: Fitch Ratings has placed Natura Cosmeticos S.A.'s (Natura) ratings on Negative Watch following the company's announced plan to acquire Avon Products, Inc. (Avon; Issuer Default Rating B+/Negative). A full list of rating actions follows at the end of this release.

On May 22, 2019, Natura announced that it had reached an agreement with Avon Products, Inc. to acquire Avon through in an all-share merger. Natura Holding S.A. (Natura & Co) will become the new holding company for the group and will wholly own Natura and Avon shares. Once the transaction is complete, 76% of Natura & Co will be held by Natura's existing shareholders and the remaining 24% by Avon's shareholders.

The Negative Watch reflects the execution risks associated with the integration of these businesses, challenges to improve profitability against a dynamic and changing landscape, and higher than anticipated medium-term refinancing risks. On a pro forma basis, Fitch estimates Avon's EBITDA represents around 39% of the combined entity. Natura is still working on the turnaround of The Body Shop (TBS), a EUR1 billion debt-funded acquisition completed in late 2017. Like TBS, Avon is a very large and complex global company with declining reps/volumes; FX risk is high due to its emerging market concentration. Avon and Natura have high exposure to declining direct sales business, which is an additional negative consideration, as they attempt to switch to an omni-channel strategy.

The transaction is mostly equity financed and does not materially impact Natura's consolidated leverage profile. On a pro forma basis, Fitch expects Natura's debt adjusted debt/EBITDAR to reach 4.5x, excluding IFRS 16 impact. It represents an increase from the 4.0x ratio as of 2018 and threatens to inhibit the company's goal of reaching 3.5x by 2020, which is a threshold for the company's 'BB' rating. Incorporating USD150 million of synergies, the pro forma adjusted leverage would drop to 3.9x. Natura's access to medium- to long-term funding will be another key to reducing near-term ratings downgrade pressure.

This transaction significantly increases business scale (2018 pro forma revenues USD9.1 billion), enhances the company's consultants base, product portfolio and market presence in Latin America. In addition, it should allow Natura to leverage its existing business platform (manufacturing, distribution centers and logistics), which could lead to operating and financial synergies. Natura expects around USD150 million-250 million in synergies, but has mentioned that it will need to reinvest part of these savings in digital and social selling, R&D and brand initiatives, which are key drivers of business and brand sustainability.

KEY RATING DRIVERS

High Execution Risks: Natura will face challenges as it attempts to digest Avon's global operation outside of Latin America (47% of revenues), which has been pressured by declining active reps and sales volumes in complex markets such as Russia. The timing of this transaction is not ideal, as the company continues to work on the turnaround and integration of TBS and a digital transformation. Both TBS and Avon have large businesses in regions/markets where Natura does not operate, and TBS operates primarily through traditional retail operations. Positively, Natura has been showing some improvement in TBS margins during the last few quarters with EBITDA margins expected in the 10%-11% range during 2019, an increase from 8.4% in 2016.

Weak Results: Avon's business has been under intense pressure. During the 2018, its EBITDA margin was 6.6%, a decline compared with its average of 10% between 2014 and 2018. In comparison, Natura had a 14% margin in 2018 and a 17% average EBITDA margin between 2014 and 2018. The purchase of Avon will slightly improve the company's geographic diversification. Brazil represents the bulk of Natura's current operations and accounts for 45% of revenues and 55% of EBITDA generation; this compares with 68% and 74%, respectively during 2016, before the acquisition of TBS. Brazil and Argentina represent 45% of Avon's operating profit, while Europe, the Middle East and Africa accounts for 39%, North Latin America, 10%, and Asia/Pacific approximately 6%.

Strong Natura Brand: Natura has shown a favourable track record and business position in the Cosmetics, Fragrances and Toilette (CF&T) sector in Brazil and Latin America due to its strong brand value and recognition, large operating scale, and extensive direct sales structure. Natura has historically had a solid capital structure with solid liquidity position. The global, but small operations of the premium brand Aesop, as well as the ongoing positive turnaround of TBS, are also incorporated into the ratings.

New Industry Dynamics: The CF&T industry is attractive due to its resilience throughout economic cycles. Nevertheless, there is a new business dynamic in the market, which is bringing more volatility to results and altering traditional business models. With the channel shifting toward e-commerce and specialty stores, direct sales and traditional consumer companies are facing intense competition from multi-national beauty giants that have implemented omni-channel strategies, as well as smaller, nimbler, fast-growing companies. To compete against this challenging backdrop, Natura will not only have to manage two large integration projects, but maintain a strong pipeline of innovation to compete in the fast changing beauty trends and digitalize to engage more directly with end consumers.

Challenge to Deleverage: The Avon transaction will likely postpone Natura's deleveraging efforts until 2021. Excluding IFRS 16 impacts, Fitch expected Natura's net adjusted leverage, measured by net adjusted debt/ EBITDAR to move toward 3.6x during 2019 prior to this transaction. Once the transaction is approved, pro forma leverage would increase to around 4.2x-3.7x by 2020, depending on synergy gains. Fitch's leverage calculation includes adjustments related to operating lease rentals. Fitch expects dividends to fall to the minimum required by Natura's bylaws (30%) as the company seeks to lower its leverage.

Higher Refinancing Risks: Natura will face a combined amount of USD2.1 billion of bond coming due until 2023 plus the USD500 million of preferred shares at Avon. Natura has announced a bridge loan of USD1.6 billion to support immediate refinancing risks in case Avon's USD1.1 billion bondholders do not grant a waiver for the breach of the change of control clause. Nevertheless, Natura will have to seek long-term funding to avoid higher refinancing risks by 2021-2023, when its USD750 million bonds is also due.

DERIVATION SUMMARY

Natura's 'BB/AA(bra)' ratings reflect its good business position in the CF&T industry, underpinned by strong brand recognition, with a focus on sustainability, large scale enabling a competitive cost structure and a large direct-sales structure. Natura's brand and product portfolio, with its higher-ticket products is well positioned against its main competitor in the direct sales segment, Avon Products, Inc. (IDR B+/Negative). The company also has a track record of less volatile operating cash flow and more conservative credit metrics. Even at this time, when Natura's leverage has deteriorated following the debt-financed acquisition, it shows lower leverage compared to Avon. Natura has the challenge to continue to conduct its activities on a profitable basis while preserving its strong market position in Brazil, within the context of increasing competition. Natura's market share in the Brazilian market has been recovering supported by pricing initiatives and increasing consultant productivities. Despite the regular beauty&co multinationals, Natura also faces strong competition from a local player, O Boticario (not rated), which presents a stronger financial profile and solid business profile, supported mainly by its bricks-and-mortar franchise chain.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Its Rating Case for the Issuer
Low-single-digit growth in volumes;
--Consolidated EBITDA margins moving around 15%-16%, excluding AVON and around 10%-12% with AVON;
--Increase in Capex levels to around BRL550 million;
--Dividend payouts at 30%;
-- Natura to maintain its proactive approach on refinancing its local debt avoiding refinancing risks

RATING SENSITIVITIES

Developments that May, Individually or Collectively, Lead to Positive Rating Action
The Negative Watch will be resolved after the successful completion of Natura's acquisition of Avon. The most likely outcome of this resolution would be a one-notch downgrade of Natura's ratings, as this transaction heightens existing execution risk, delays the deleveraging process related to the earlier acquisition of TBS, and increases the company's exposure to the direct sales channel. Improvements in Natura's margins, including TBS, in the next three to four quarters and a stabilization of the performance of Avon could be mitigating factors. Natura's IDR would be affirmed at 'BB' if the acquisition does not proceed.

The regulatory approvals for the transaction are not likely to be resolved during the next six months; this could result in a prolonged period for the Rating Watch Negative status of Natura's ratings.

LIQUIDITY

Natura has a track record of maintaining adequate liquidity and solid access to local credit market. The company had BRL1.4 billion in cash and marketable securities compared to BRL1.3 billion of short-term debt, including forfait operation, leading to a cash/short-term debt ratio of 1.0x, as of March 31, 2019. This compares to an average ratio of 1.4x from 2014 to 2018. On March 31, 2019, the company had total debt of around BRL8.1 billion, excluding long term on balance leasing obligations (BRL1.8 billion). Natura's debt is mainly composed of local debentures (58%) and cross-border bonds at (37%).

Fitch expects Natura will remain disciplined with its liquidity position and will maintain a proactive approach in liability management to avoid exposure to refinancing risks. Natura faces long term debt amortization of BRL1.2 billion in 2020, BRL2.2 billion in 2021, BRL324 million in 2022, and BRL2.9 billion in 2023 that mostly relates to its USD750 million bonds.

Considering Avon's deal, Natura's refinancing risks increases in the medium term. Natura will face a consolidated amount of USD2.1 billion of international bonds coming due until 2023 plus the USD530 million of preferred shares at Avon. Natura has announced a back stop facility/bridge loan of USD1.6 billion to support immediate refinancing risks in case some of Avon's bondholders (USD1.1 billion out of USD1.5 billion)do not grant a waiver for the breach of the change of control clause. Nonetheless, the company will need to rollover this bridge loan with a long-term debt alternative to avoid exposure to refinancing risks.

FULL LIST OF RATING ACTIONS

Fitch Places the following on Rating Watch Negative:

Natura Cosmeticos S.A.
--National Scale Long-Term rating 'AA(bra)';
--Long-Term Foreign and Local Currency IDRs 'BB' ;
--Senior Unsecured Notes of 'BB'.

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Summary of Financial Statement Adjustments -
- Debt was adjusted by forfait and net derivatives;
- Cash flow was adjusted by forfait transaction;
- EBITDA was adjusted by expenses related to asset impairments and acquisition costs.

For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

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Additional information is available on www.fitchratings.com
Applicable Criteria
Corporate Rating Criteria (pub. 19 Feb 2019)
National Scale Ratings Criteria (pub. 18 Jul 2018)

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