Research

Research Update:

Leading Baltic Retailer Maxima Grupe UAB Assigned Prelim 'BB+' Rating On Planned Refinancing; Outlook Stable

Primary Credit Analyst:
Mickael Vidal, Paris + 33 14 420 6658; mickael.vidal@spglobal.com

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

Research Contributor:
Gregoire Rycx, Paris; gregoire.rycx@spglobal.com

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Overview

- We understand Maxima Grupe plans to refinance its existing bank funding that enabled its acquisition of Polish retailer Emperia group.
- We consider that Maxima has a relatively limited size and EBITDA base, but that its resilient operating model benefits from a dominant position in its domestic market, meaningful sales contribution from private labels, and diversified store formats.
- We are assigning our preliminary 'BB+' long-term rating to Maxima.
- The stable outlook reflects our expectations that Maxima will continue to consolidate its leading market position in the Baltic states and integrate its Polish acquisition, while maintaining a prudent financial policy, resulting in adjusted debt to EBITDA declining from a post-acquisition level in 2018 of 2.7x-2.8x toward 2.5x by end-2019.

Rating Action

On July 17, 2018, S&P Global Ratings assigned its 'BB+' preliminary long-term issuer credit rating to Baltic retailer Maxima Grupe. The outlook is stable.

Rationale

Maxima is a leading Lithuanian retail chain with a focus on food retail (over 75% of revenues) operating in the Baltics since 1998. In 2017, pro forma the recent acquisition of Polish retailer Emperia and the integration of Franchisee Franmax, it generated €3.4 billion of sales, with about €221 million of reported EBITDA. The company is fully owned by Vilniaus Prekyba--a holding company with other stakes in retail and real estate--and is the group's most important asset, with Maxima expecting to represent about 75% of the group's overall EBITDA in 2018.

The rating reflects our assessment of Maxima's leading position in the Baltics region, a market we deem less competitive than other European retail markets because of its relatively limited size and demographics. It also incorporates our view that the group's debt to EBTIDA, in particular on a reported basis, is somewhat lower than that of some other retail peers of comparable size, and

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further supported by a clear financial policy aimed at gradual deleveraging from the 2018 high point, due to the Emperia acquisition for €285 million, excluding transaction-related costs. This stems from our anticipation of an increasing EBITDA margin and positive discretionary cash flow, in spite of a material dividend distribution.

Maxima has maintained its leading position (28% market share) in the Baltics, despite the recent increase in pressures due to the arrival in Lithuania of large international discount retailer Lidl in 2016. In our view, this is thanks to Maxima's competitive price positioning and high brand awarness. We don't expect competition in the Baltics to escalate further, given the market's overall modest size, already competitive nature, and what we perceive as limited remaining growth avenues for new entrants.

We see the group's Baltic operations as a strength, given our expectation that Maxima's like-for-like growth in the region will remain in excess of 1.5%, driven by real GDP growth of about 3%-4% per year. That said, the Baltics combined GDP for 2018 is about 4x less than that of Poland, where the group aims to expand following the Emperia acquisition. We forecast that the supportive macroeconmics trends, alongside the group's expansion plan in Poland in particular, but also in the Baltics, will result in overall growth of about 7% per year. We also believe the resilience and relative predictability of the food retail industry, as well as the group's modest exposure to foreign exchange risk--in particular in comparison with other Eastern European peers' thanks to the Baltics' adoption of the euro--provides the group with some visibility on revenues and earnings.

The group also benefits from a resilient operating model. In particular, we note the meaningful sales contribution from private labels of about 17%, which is in line with that of Western European peers, as well as its diversified store formats. Proximity format as of end-2017, as per the company's definition and without taking into account Emperia's store network, already represented 45% of sales and about 77% of formats, and we expect thess shares will rise. Both factors, in our view, support margins and help maintain Maxima's strong competitive advantage over peers. We understand that the group has a local sourcing strategy that provides the group with fairly good bargaining power, despite its overall limited size. Additionally, we believe the group benefits from a partly owned real estate network, with a book value estimated by management at approximatively €500 million and a market value that is likely higher.

Lastly, while online sales still represent a very small part of the group's revenues (less than 1% of sales), we believe the group is well positioned in that space, since it faces little competition and already has an online dedicated offering through the Barbora website.

Our view of Maxima's business profile is constrained by its relatively small size, scale, and EBITDA base compared with other rated food retailers, as well as its still-substantial, but declining, geographic concentration (the Baltics represent over 75% of revenues). These factors tend to limit the group's

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bargaining power with suppliers, and its relatively narrow EBITDA base means less flexibility to adapt to potential disruptions, either from competition or unforseen operating events, without hurting credit ratios. Additionally, the group's concentration of revenues exposes it to potential macroeconomic headwinds in the Baltics, although this is not in our base case. Lastly, while the expansion into Poland will improve diversification, we see a degree of execution risk given the presence of several large competitors in Poland.

We anticipate a moderate increase in margins, in particular thanks to the integration of the highly EBITDA-accretive Franchisee Franmax, and also to synergies from the Emperia acquisition. Maxima's adjusted EBITDA margin was about 7.2% in 2017, and we forecast it will increase to about 8.0%-8.5% in 2018. While Maxima's adjusted EBITDA margin is somewhat higher than that of larger Western European peers, it remains modest, in our view, given that the group owns 45% of its store network (which should reduce fixed costs) and is of a much more moderate size, which we consider facilitates implementation of cost-control initiatives. Maxima's margins are below what we see for Russian retail peers, such as X5 and Magnit, who typically have adjusted EBITDA margins of about 11%-12%.

The group's debt increased in 2017 and 2018 from the Emperia acquisition. We understand the group plans to refinance part of the bank debt raised for that purpose, which could translate into €150 million of new funding from 2017 levels. We estimate that this will result in adjusted debt to EBITDA of about 2.7x-2.8x in 2018, and 2.4x-2.6x from 2019 as the group's EBITDA base increases. Our adjusted metrics incorporate our operating lease adjustment, which in the case of Maxima is significant, pro forma the Emperia acquisition, with about €496 million of operating lease adjustments for 2018 against €282 million based on 2017's audited figures. Mitigating this, we note the group's confortable EBITDAR ratio of over 3x and solid free operating cash flow (FOCF), despite high capital expenditures (capex).

That said, we expect the reduction of leverage will be slowed by the group's expansion plans, which entail annual investments of about €90 million-€100 million in 2018 and 2019 as well as planed annual dividends of about €90 million-€100 million. That said, excluding the 2018 Emperia acquisition, we expect discretionary cash flow generation will remain positive throughout the period, enabling the group to comply with its net leverage ratio threshold under the current financial policy. We also note that the business has working-capital-supportive characteristics.

In our base case, we assume:

- Real GDP growth in Lithuania of about 2.9%-3.1% from 2018 to 2020, buoyed by firming exports and strong investments, with inflation of 2.3%-2.6%, which is above the Eurpoean Central Bank's target range.
- Real GDP growth in Latvia of about 3%-4% over the next two years, supported by strong investments and favorable external environment. Wage growth will have inflationary implications, and we expect inflation of 2.6%-2.8% over this period.

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- Real GDP growth in Estonia, Bulgaria, and Poland of about 3%-4% over the next two years, driven by favorable external environment and uptick in exports.
- Revenue growth of about 5%-7% for 2018 and 2019, supported the abovementioned economic conditions, the group's store development plan, expansion in Poland, and our anticipation of like-for-like growth in excess of 1.5% in all of the group's geographies. That said, we expect price pressures in its main markets to remain, in particular as we perceive consumers as particularly price sensitive.
- Moderate gross margin improvement by about 30-50 basis points on a pro forma basis, driven by the group's centralization efforts, improved negotiating terms thanks to increased size, and development of private label offerings. Mitigating this, competitive conditions in the food retail market and potential for cost inflation could constrain any meaningful uplift.
- A reported EBITDA margin of about 6.0%-6.5% for 2018 and 2019, broadly stable from the 6.3% pro forma reported in 2017 and increasing from historical levels, thanks to contributions from Franchisee Franmax in particular. This should translate to an adjusted EBITDA margin of about 8%-9% in 2018 and 2019. While we expect some economies of scale from the Emperia acquisition, we also expect a rise in restructuring costs could weigh on the EBITDA margin in particular in 2018.
- Capex to remain around 2.5%-2.7% of sales through 2019 (excluding the Emperia acquisition), equating to about €90 million-€100 million of capex per year, which should translate into reported FOCF generation in excess of €120 million per year. We expect a material portion of this capex to be dedicated to the expansion in Poland.

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

- An adjusted debt to EBITDA of about 2.7x-2.8x in 2018, declining to 2.4x-2.6x in 2019, together with funds from operations (FFO) to debt of 28%-32% in 2018 and 30%-32% in 2019; corresponding to a net reported leverage of about 1.3x in 2018 and 1.0x-1.1x in 2019.
- An EBITDAR ratio exceeding 3x, and remaining stable over the next few years.
- Most of the reported FOCF to be absorbed by the group's dividend distribution. That said, we expect discretionary cash flow generation to remain positive throughout the period at around €30 million in 2018, climbing to €40 million in 2019.

Importantly, Maxima Grupe is part of a wider group, Vilniaus Prekyba, whose main consolidated asset is Maxima. Vilniaus Prekyba also consolidates a pharmacy business Euroapotheca, which we expect will generate about €45 million of reported EBITDA in 2018, and consider has fairly good geographic diversification. Vilniaus Prekyba also owns a real estate business, Akropolis, which we expect will generate about €22 million of EBITDA. Vilinius Prekyba is

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slightly more leveraged than Maxima alone on a net reported basis, by about 0.2x to 0.3x as per our estimates. That higher level of leverage results from the acquisition of ApoteksGrupen in Sweden by Euroapotheca for a €334 million cash consideration. Offsetting this, we understand Vilnius Prekyba is looking at various alternatives to deleverage the business and to reduce debt at the holding level. We expect the gross reported debt at the Vilniaus Prekyba level to stand at around €1 billion for 2018, with about €446 million of cash immediately available and a comparable operating leases adjustment. Thanks to incremental EBITDA provided by the group's other businesses, adjusted leverage stands around 2.5x-2.7x, slightly lower than that of Maxima.

Given that Maxima contributes the bulk of the overall group revenues and earnings and also because we consider Maxima is the largest business of founder Nerijus Numavicius, we believe it is a core entity to the wider group. We also understand there is no plan for a partial listing of Maxima and that main shareholders intend to keep clear control of the company going forward.

Lastly, we also note that Vilniaus Prekyba services a very modest dividend to entities sitting on top, which we understand are debt free on a stand-alone basis. We assess the wider group credit profile (GCP) at 'bb+', which is driven by and consistent with our assessment of Maxima's stand-alone credit profile (SACP) at 'bb+'. Hence, our preliminary rating on Maxima is in line with its SACP and the GCP.

Liquidity

We assess Maxima's liquidity as adequate based on our assessment of its expected sources of liquidity over the next 12 months being at least 1.2x of its expected uses, and our expectations that the sources would be able to cover liquidity uses even if the EBITDA were to decline by 15%. Our liquidity assessment of the group is further underscored by management's strong commitment to maintain liquidity of at least €100 million, and by the group's committed bilateral lines available. We do not include these lines in our sources, given that we understand that they mature in less than 12 months, but are still available in case of need.

Over the next 12 months, we expect principal liquidity sources to include:

- Cash and liquidity investments of about €330 million;
- About €200 million of FFO;
- Working capital inflows of about €15 million; and
- Funds from refinancing of about €400 million.

For the same period, we expect principal liquidity uses to include:

- Debt amortization of about €150 million;
- Seasonal working capital requirements of €60 million;
- About €100 million of capex outflows;
- Acquisition costs of €285 million, primarily related to Emperia; and

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- Dividends up streamed to Vilniaus Prekyba of €90 million-€100 million.

We forecast comfortable headroom under the covenants for the existing senior secured debt.

Outlook

The stable outlook reflects our expectation that Maxima will defend or strengthen its already sound position in the Baltic food retail markets, and maintain its revenues and earnings, underpinned by the recent strengthening in operating margins stemming from the Franchisee Franmax integration and cost-control efforts.

We think the group will gain some upside from acquisition-related synergies, partially offset by the impact of restructuring costs and inflationary pressures.

In our base case, we forecast S&P Global Ratings-adjusted FFO to debt at about 30% and adjusted debt to EBITDA of about 2.7x-2.8x in 2018 and trending toward 2.5x by end-2019

Our stable outlook is also derived from our anticipation of balanced financial policies, particularly related to capex and dividends, and comparable credit metrics at the Vilniaus Prekyba group level, namely FFO to debt of around 30% in 2018 and above 35% in 2019.

Downside scenario

We might consider a negative rating action if the company increases its adjusted debt to EBITDA to above 2.8x in 2018, or if FFO to debt is meaningfully lower than 30%.

We could also consider a downgrade if there was a significant decline in operating performance, with profitability deteriorating substantially because of stiff market competition, or a weaker market environment in the Baltics or Poland, or because of a difficult integration of Emperia weighing on margins. Deviations from the company's current financial policy in the form of increased dividend distribution or large-scale, debt-funded acquisitions might also put pressure on the rating, but we don't see this as a near-term risk.

A downgrade could also result from a weakening in credit metrics from what we currently anticipate at the group level, in particular FFO to debt dropping below 30%, stemming from either weaker profitability or higher dividend distributions resulting in increased debt.

Upside scenario

An upgrade is remote at this stage, since we see Maxima's overall size and narrow EBITDA base as a constraining factor to our overall assessment of its

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credit quality.

Over the next 18-24 months, our 'bb+' assessment of Maxima's SACP might benefit from a marked improvement in trading, resulting in an EBITDA margin in excess of 10%. This could translate into improved credit metrics stemming from stronger free cash flow generation, causing adjusted FFO to debt to move closer to 45%, with adjusted debt to EBITDA decreasing toward 2x on a consistent basis. Even if we were to revise upward our assessment of Maxima's SACP, an upgrade would then still hinge on our view of there being low risk of releveraging at both Maxima and the Vilniaus Prekyba group level, based on our assessment of the group's financial policy. Additionally, we would need to see similar improvement in the group's credit metrics, and the financial policy remaining supportive.

Ratings Score Snapshot

Issuer Credit Rating: BB+(prelim)/Stable/--

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

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: bb+

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

Stand-alone credit profile: bb+
- Group credit profile: bb+
- Entity status within group: Core (no impact)

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Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- 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: 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

New Rating

Maxima Grupe UAB

Issuer Credit Rating	BB+(prelim)/Stable/--

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

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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