Research Update:

Leading Baltic Food Retailer Maxima Grupe Outlook Revised To Negative On Likely Slower Deleveraging; Affirmed At 'BB+'

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Rating Action Overview

- Maxima Grupe is deleveraging slower than expected despite resilient operating performance in 2020.
- Furthermore, we anticipate that Maxima's leverage, as adjusted by S&P Global Ratings, will remain elevated for the current rating level in 2020-2021, and that funds from operations (FFO) to debt will be below our threshold of 30% over the same period, due to potentially stagnant earnings next year because of increasing competition.
- We are therefore revising our outlook on Maxima to negative from stable, and affirming our 'BB+' ratings on the company and its senior unsecured debt.
- The negative outlook reflects our expectations that, over the next 12-18 months, Maxima's adjusted leverage and FFO to debt could get stuck between 2.9x and 3.1x and 27% and 29.5%, respectively. The outlook also reflects our view that Maxima's sluggish deleveraging could weigh on the financial strengths of sole shareholder Vilniaus Prekyba.

Rating Action Rationale

Expected weak cash flow in 2020 and a likely intensification of market challenges in 2021 will probably slow deleveraging. In 2020, the group should report a material increase in profitability thanks to improving earnings generation. This stems from an absence of significant integration expenses in Poland and further cost-optimization, sound cost control in the Baltics, and gradual strengthening of earnings in Bulgaria. This would translate to an S&P Global Ratings-adjusted EBITDA of €350 million-€360 million, versus €328 million in 2019. However, this is likely to be offset by negative reported discretionary cash flow after lease payments of €25 million-€50 million, largely due to exceptional working capital related cash outflows related to a change in payment terms in Poland, yielding leverage between 2.9x and 3.1x. In our view, leverage this high brushes the upper bounds for the rating level and is likely to remain there due to heightened competition in the group's third- and fourth-largest geographies, Latvia and Estonia, in 2021. For instance, Lidl's arrival in these two markets will most likely push prices down, which would then constrain margins. That said, growing earnings and cash flows in other markets should counter most of the pressure. For instance, Maxima has already posted stronger EBITDA in Poland and Bulgaria in the first half of 2020. We expect that Maxima's EBITDA generation will remain flat in 2021 versus in 2020.

Consequently, over the next 12-18 months, Maxima's deleveraging could stagger below the thresholds for the 'BB+' rating. So far this year, Maxima has deleveraged slower than what we anticipated in our 2019 base case and when we first assigned the rating in 2018. Against a relatively high point of 3.2x in 2019, we expect S&P Global Ratings-adjusted leverage at 2.9x-3.1x in 2020-2021 compared with our previous leverage expectation of 2.7x-2.9x for the same period. Similarly, FFO to debt could remain below 30% in 2020-2021, versus our previous expectations of about 30% in 2020, and exceed 30% in 2021. Furthermore, we note that even though the application of International Financial Reporting Standards (IFRS) 16 resulted in a higher lease liability than anticipated, deleveraging is still slower than our initial forecasts.

The Baltics market has felt more strain than we anticipated from competition from large international food retailers, accentuating the group's potential volatility in earnings. We used to view the market's overall modest size and its saturation as limiting potential competitive pressure. However, in 2016-2021, Lidl will have entered all three Baltic countries, materially disrupting the competitive landscape. After Lidl entered the Lithuanian market, we understand that Maxima is losing its market share, with its market share in its home country declining to about 32% in 2020 from 33% in 2019. Lidl will now enter Latvia and Estonia in 2021, where Maxima holds dominant market shares (about 25.5% and 17.0%, respectively in 2019). This makes Maxima more sensitive to Lidl's push in these markets, as Maxima is building some of its competitive advantage on price positioning and price perception. In our view, this could create volatility in earnings and profit margins, since Maxima will have to defend its positions.

Vilniaus Prekyba's financial strength could weaken if Maxima's deleveraging doesn't pick up. Maxima is part of Vilniaus Prekyba, a wider group that includes a fairly well geographically diversified pharmacy business, Euroapotheca UAB, real estate business Akropolis Group UAB (essentially operating in the Baltics), as well as ERMI Group UAB, retail operations of construction, finishing materials, and household products in Lithuania and Estonia. These entities were positive contributors to the group's overall profitability and cash flow in 2019. This is shifting in 2020, however, due to strained profitability in some of the businesses, because of recessionary conditions (for example, in the Lithuanian real estate market in 2020). As such, in 2020, we expect the group's profitability to remain rather flat. We anticipate that the wider group's leverage will be 2.9x-3.1x in 2020. In 2021, because we think that Maxima's earnings will remain flat and its cash flow will be below our previous expectations, alongside some uncertainty on the development of the group's other businesses, we see a risk that Vilniaus Prekyba will not deleverage to well below 3.0x. This is why we think deleveraging at Vilniaus Prekyba may also slow down.

Positively, Maxima's creditworthiness remains supported by the business' resilience and sound market position amid competitive headwinds and COVID-19-related setbacks. We consider food retail nondiscretionary and less cyclical than other sectors. This leads us to assume that Maxima's operating performance should remain afloat despite the weak macroeconomic conditions caused by the pandemic. We expect that Maxima will post positive like-for-like sales (LFL) in 2020 driven by a sound performance of its existing store bases, although we expect LFL sales growth to slow in the second half of the year, after 1.2% growth in the first half of the year. That said, we believe that Maxima's competitive pricing and attractive assortment will help the group to maintain its customer base. We understand that Maxima will increase its focus on growing its e-commerce business under the Barbora brand, which remains small at less than 1% of 2019 consolidated revenue. The group has already launched additional pick-up service in Lithuania in 2020, and plans to roll-out this service in Latvia and Estonia. We anticipate that total revenue could rise 3%-5% in 2020 from about €4 billion in 2019. In 2021 we expect further growth of the topline, albeit dimmed by competitive pressure in Latvia and Estonia, being offset by solid expected expansion of Polish and Bulgarian operations, resulting in revenue growth of 2%-4%. We also anticipate that Maxima will remain more profitable than its European peers in 2020-2022, which we regard as beneficial for the rating on Maxima. We expect S&P Global Ratings-adjusted margins be at 8.1%-8.6% in 2020-2022.

Maxima's discretionary cash flow should remain positive even within a more challenging market landscape in 2021, supporting the deleveraging prospects. Moderate working capital inflows, alongside stable earnings and growing capex, should translate into S&P Global Ratings-adjusted free operating cash flow (FOCF) expanding to €195 million-€205 million in 2021 from expected €150 million-€160 million in 2020, and from €193 million in 2019. We expect discretionary cash flow to grow from expected €60 million-€70 million (before lease payments) in 2020 to €95 million-€105 million (before lease payments) in 2021 considering the annual dividend of €85 million-€100 million, a per Maxima's dividend policy.

S&P Global Ratings acknowledges a high degree of uncertainty about the evolution of the coronavirus pandemic.

The current consensus among health experts is that COVID-19 will remain a threat until a vaccine or effective treatment becomes widely available, which could be around mid-2021. We are using this assumption in assessing the economic and credit implications associated with the pandemic (see our research at http://www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Outlook

The negative outlook reflects our expectations that over the next 12-18 months Maxima's deleveraging will take longer than we initially expected. Over 2020-2021, we forecast adjusted debt to EBITDA of 2.9x-3.1x and FFO to debt of 27%-29.5%, amid intensifying competition in Latvia and Estonia. In addition, the negative outlook reflects our view that the weaker performance of the Maxima Grupe could weigh on Vilniaus Prekyba's financial strength, since the food retailer represents more than 70% of group earnings. This would prevent deleveraging at the group level, suggesting that Vilniaus Prekyba's leverage would remain around 3.0x and that FFO to debt not improve above 30% in 2020.

Downside scenario

We could lower the ratings on Maxima if:

- Maxima significantly underperformed our base case including a material decline in operating performance, with dropping profitability because of intensifying market competition, or a weaker macroenvironment in the Baltics or Poland, weighing on margins and cash flows;

- Maxima's or Vilnius Prekyba's current financial policies became less prudent, either due to increased dividends or large-scale, debt-funded acquisitions that kept leverage at about 3.0x or above and FFO to debt below 30% at either Maxima or the wider group level; or
- Liquidity of both Maxima and Vilnius Prekyba were to deteriorate.

Upside scenario

We could revise the outlook to stable if Maxima deleveraged well below 3.0x on an adjusted basis while strengthening its FFO to debt above 30% on a sustained basis, supported by the financial policy. This could stem from Maxima's growing profitability on the back of cost control and efficiency measures more than offsetting competitive pressure on the group's profitability in Latvia and Estonia.

An outlook revision to stable would also hinge on Vilniaus Prekyba's progress deleveraging, such as its leverage reduces well below 3.0x and its FFO comfortably exceeds 30% sustainably, as well as low releveraging risk at both Maxima and Vilniaus Prekyba.

Company Description

Maxima Grupe is the leading food retailer in the Baltic countries, with a market share of about 27%. Operating since 1998, the group has experienced rapid growth in its home market and started to expand internationally in 2011 by entering the Bulgarian market and subsequently the Polish market. In 2019 Maxima generated almost €4.0 billion of sales, with about €340 million of reported EBITDA. The company is fully owned by Vilniaus Prekyba--a holding company with other stakes in retail and real estate. That said, Maxima Grupe is the group's most important asset, generating about 73% of its overall EBITDA in 2019.

Our Base-Case Scenario

Assumptions

- Real GDP contraction by 7%-8% in 2020 in Lithuania and Latvia after about 2.2% and almost 4% growth in 2019 respectively, and a recovery by 6%-6.4% in 2021. We also expect inflation of about 1% in 2020 in Lithuania and Latvia, from about 2.2%-2.7% in 2019, while picking up from 2021 onwards to 1.5%-2.4%. Poland's real GDP will contract by 4% in 2020 versus 4.1% growth in 2019, before recovering by 5% in 2021. Inflation rate will most likely increase to 3.0% in 2020 from 2.1% in 2019, and moderate to 2.6% in 2021.
- Revenue to increase by 2%-5% in 2020-2022, reflecting improving LFL sales growth and moderate store openings.
- S&P Global Ratings-adjusted EBITDA margins to expand somewhat to 8.3%-8.6% (including IFRS 16 impact) in 2020 versus 8.2% in 2019 due to cost reduction across Maxima's countries of operations and absence of integration costs related to the Polish food retail business. In 2021 we expect EBITDA margins of about 8.1%-8.4% reflecting improving margins in Poland and Bulgaria that will offset lower profitability margins in Latvia and Estonia following anticipated competitive pressure due to Lidl entering these markets in 2021. We expect the margin to improve somewhat in 2022 to 8.2%-8.5% on further cost efficiency measures while Maxima will continue to deleverage thanks to its leading market position and will be able to

prevent further margin decline.

- Annual working capital outflow of up to €45 million in 2020 due to shortening of payment terms in Poland, and moderate annual working capital inflows from 2021 onwards of €5 million-€15 million.
- Capital expenditure (capex) of €100 million-€120 million in 2020-2022, of which about €50 million-€60 million is maintenance capex, compared with €126 million capex in 2019.
- Annual dividends of €87 million-€110 million in 2020-2022, in line with the company's policy, after about €82 million distributed in 2019.
- Marginal acquisitions.
- Ongoing annual debt repayments of €50 million-€100 million in 2020-2022.

Key metrics

Maxima Grupe UAB Key Metrics*

	--Fiscal year ended Dec. 31--				
(Mil. €)	2018a	2019a	2020e	2021f	2022f
Revenue	3,451	3,993	4,150-4,200	4,270-4,320	4,390-4,440
EBITDA	300	328	350-360	350-360	360-375
EBITDA margin (%)	8.7	8.2	8.3-8.6	8.1-8.4	8.2-8.5
Debt/EBITDA (x)	3.1	3.2	2.9-3.1	2.9-3.1	2.8-3.0
FFO/debt (%)	26.2	27.7	27.0-29.0	27.5-29.5	28.0-30.0
DCF/debt (x)	7.4	10.6	6.0-7.0	9.0-10.0	9.0-10.0

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess Maxima's liquidity as adequate. This is based on our calculation that its sources of liquidity will exceed uses by more than 1.2x over the next 12 months, and our expectations that the sources would cover liquidity uses even if EBITDA were to decline by 15%. Our assessment is further supported by management's strong commitment to maintain sound liquidity of at least €100 million, and by the group's available committed bilateral lines not included in our sources given our understanding that they mature in less than 12 months, but are still available in case of short-term needs.

We calculate the following liquidity sources for the 12 months started Oct. 1, 2020:

- Cash and liquidity investments of about €110 million;
- About €50 million of committed credit lines maturing beyond 12 months; and
- Forecast FFO of €175 million-€225 million.

We estimate the following liquidity uses for the same period:

- Debt repayments of €70 million-€100 million

- Seasonal working capital requirements of €50 million;
- €100 million-€110 million of capex, of which only €50 million-€60 million is maintenance capex; and
- Dividends upstreamed to Vilniaus Prekyba of €90 million-€100 million.

Covenants

There are restrictive covenants applicable to the senior unsecured bond, including a net leverage covenant (calculated excluding lease liabilities). If the company's net leverage covenant exceeds 3.0x, the company would not be allowed to incur additional debt. We forecast comfortable headroom under this covenant for the next 12 months.

Issue Ratings - Subordination Risk Analysis

Capital structure

Maxima's capital structure comprises about €597 million of financial debt, of which €300 million refer to senior unsecured bond issued in October 2018. In addition, the group still has about €257 million of the secured debt and/or unsecured debt standing at the subsidiaries level.

Analytical conclusions

The 'BB+' issue rating on the senior unsecured €300 million bond is in line with the issuer credit rating. The issue rating is supported by the limited amount of priority-ranking liabilities in the capital structure, comprising secured debt and unsecured debt both at the group and subsidiaries level. We estimate the priority debt ratio at about 43% being below 50% threshold, supporting our view that there are no significant elements of subordination risk in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating: BB+/Negative/--

Business risk: Fair

- Country risk: Intermediate
- Industry risk: Intermediate
- 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 rating analysis: Neutral (no impact)

Stand-alone credit profile: bb+

- Group credit profile: bb+
- Entity status within group: Core

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Full analysis: Maxima Grupe UAB, Oct. 29, 2019

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Maxima Grupe UAB		
Issuer Credit Rating	BB+/Negative/--	BB+/Stable/--
Senior Unsecured	BB+	BB+

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