

Research Update:

JAB Holding Co. Outlook Revised To Stable On Deleveraging And Announced Acquisition Of NVA Holdings; Affirmed At 'A-'

June 17, 2019

Rating Action Overview

- Investment holding company JAB Holding Company S.a r.l.'s (JAB's) loan-to-value (LTV) ratio has improved since we revised our outlook to negative in February 2019, thanks to a combination of a 89% increase in Coty's share price since Feb. 7, 2019, a capital return from Acorn Holdings of €864 million, and JAB's disposal of its stake in Reckitt Benkiser PLC for €0.4 billion.
- Despite taking into consideration JAB's recently announced acquisition of NVA Holdings (NVA), which we expect will cost JAB €1.1 billion, we have seen a material deleveraging of the portfolio to an LTV ratio of around 17% pro forma the acquisition from about 21% as of Dec. 31, 2018.
- Through the acquisition of a 35% stake in NVA, JAB is diversifying its portfolio into a new industry (veterinary health care), but as the investment will only be a small part (4.3%) of JAB's €25 billion total portfolio, we consider the diversification as only moderately positive for JAB's investment position.
- We are therefore revising the outlook on JAB to stable from negative, and affirming our 'A-' long-term issuer credit rating on the company.
- The stable outlook reflects our view that JAB will maintain its LTV sustainably below 20%, and that management remains committed to this LTV threshold for the next 12-18 months.

PRIMARY CREDIT ANALYST

Vittoria Ferraris
Milan
(39) 02-72111-207
vittoria.ferraris@spglobal.com

SECONDARY CONTACT

William P Buck
London
+ 44 20 7176 3606
william.buck@spglobal.com

ADDITIONAL CONTACT

Industrial Ratings Europe
Corporate_Admin_London@spglobal.com

Rating Action Rationale

We have revised the outlook to stable following a material deleveraging of JAB Holding Company S.a r.l.'s (JAB's) portfolio thanks to a strong share price improvement at Coty Inc., continued strong performance at Keurig Dr Pepper (KDP), and a number of management actions that have supported the loan-to-value (LTV) ratio. We believe that management has thereby demonstrated its commitment to lower the LTV ratio sustainably below 20%. This includes the complete sale of JAB's remaining shares in Reckitt Benkiser PLC for €0.4 billion and Acorn Holdings' disposals of 64

million of shares in KDP and subsequent €864 million capital return to JAB. At the same time, we acknowledge JAB's announcement of the acquisition of a minority stake in veterinary medical services provider NVA Holdings (NVA) for about €1.1 billion, which we believe benefits JAB's portfolio through a moderate increase in diversification from its current focus on food and beverages.

JAB's LTV ratio pro forma the acquisition of NVA and capital return from Acorn Holdings will stand around 17%, and we notice that the company has lowered its LTV ratio more quickly than we previously assumed. JAB's total portfolio value will be €25.4 billion post the acquisition of NVA, compared to €21.7 billion as of year-end 2017.

Today, JAB announced its intention to acquire 35% in NVA while JAB Consumer Fund (JCF), a fund managed by JAB managing partners, will acquire the majority of the remaining stake, with a minority to be acquired by NVA management. NVA is one of the largest independent operators of freestanding veterinary hospitals in the world, with over 688 facilities across 43 U.S. states, Australia, New Zealand, and Canada. The company operates general practice hospitals, specialty hospitals, and boarding and day-care centers.

We believe the acquisition of NVA serves to moderately diversify JAB's portfolio away from food and beverages, which we view as credit-positive. Additionally, NVA's revenues have continued to grow at more than 30% per year, driven by above-average organic growth rates and substantial debt-funded acquisitions. Over the past three years, NVA has averaged more than 100 acquisitions, increasing the total number of hospitals it operates to more than 680. These hospitals generate more than \$1.6 billion on a pro forma basis annually, making NVA the second-leading veterinary practice management (VPM) company in the U.S. after Mars Inc., which purchased leading veterinary practice company VCA Inc. in 2017.

We view the VPM industry as attractive because of secular tailwinds, significant consolidation opportunities to increase scale, and favorable payment dynamics. Pet ownership continues to increase in the U.S., and owners are spending more on animal health. In the U.S., 85%-90% of veterinary hospitals are independently owned, and while a large proportion of these hospitals are too small for consideration, the remainder provide a significant opportunity for NVA's acquisition-driven growth strategy. Most importantly, veterinary services are primarily paid for in cash, which means veterinary operators face very little health care reimbursement risk. While the discretionary nature of spending on veterinary services could leave companies more exposed to economic downturns than human health care service providers, NVA's operating performance was relatively stable through the most recent financial crisis.

Following our last publication in February 2019, JAB's offer to acquire Coty shares closed successfully in May 2019, and resulted in the purchase of 150 million shares at \$11.65 each, funded by a \$1.75 billion margin loan with a 70% LTV trigger. The shares and loan are placed in a special-purpose vehicle (SPV) with no recourse to JAB. In our LTV calculation, we net the value of the Coty shares with the debt at the SPV and subsequently apply a 30% haircut. We continue to view the transfer of the Coty shares into an SPV as negative for JAB's bondholders, leaving them at a temporary disadvantage during the life of the transaction. This is because, as long as the debt is outstanding, shares in Coty may not fully contribute to management's efforts to maintain the LTV ratio below 20%. Because of the debt's overcollateralization, we acknowledge that the SPV will have a positive net asset value as long as the Coty share price does not severely underperform the tendered share price. For the purposes of calculating JAB's LTV ratio, we treat the SPV as an unlisted asset in JAB's portfolio as we see the shares in Coty as immediately unavailable.

Since the closing of the tender offer for Coty shares, we have seen a significant improvement in Coty's share price to around \$13.30. In May 2019, Coty announced a stock dividend reinvestment program that we believe will free up for debt repayment approximately \$30 million of cash in fiscal

2019 and more than \$110 million in fiscal 2020, since JAB has elected to participate in the program. These figures could increase if additional shareholders take part in the program. The program gives shareholders the option to receive their full dividend in cash or 50% in cash and 50% in common stock. We view this as positive, as JAB, which owns a 60% stake in Coty, opted to receive 50% in cash and 50% in shares until Coty reaches its target leverage of 4x, compared with 5.9x at year-end 2018.

Outlook

The stable outlook on JAB reflects our expectation that the company will maintain its LTV ratio sustainably below 20%. We think management remains committed to this LTV threshold for the next 12-18 months. Under our base case, the acquisition of NVA is unlikely to hamper JAB's creditworthiness and serves to diversify the portfolio away from food and beverages.

Downside scenario

We would lower the rating on JAB if we believed that the LTV ratio would be sustainably above the level that JAB's management has committed to maintain of 20%. This could occur if JAB undertook further portfolio acquisitions without the sale of other portfolio assets. We could also lower the rating if JAB increased its use of alternative financing mechanisms, such as margin loans or equity collars, which we would view as being aggressive.

Upside scenario

Although unlikely in the near term, we could consider raising the rating on JAB if its portfolio characteristics improved, including a greater emphasis on asset diversity and higher liquidity of held shares. Assuming broadly unchanged portfolio characteristics, we could raise the ratings if JAB reduced leverage over time and committed to an LTV ratio sustainably below 10% over our rating horizon.

Company Description

JAB is an investment holding company with a focus on defensive and fast-moving consumer goods, consumer retail assets, and, following the completion of the NVA acquisition, veterinary health care services. JAB pursues an active management approach to build global champion and challenger companies. In contrast to other holding companies, JAB focuses on actively managing most of its assets, allowing it significant control and influence over their capital structure and dividend flows.

Another distinguishing factor is JAB's access to JCF, a separate equity portfolio managed by JAB executives that roughly mimics JAB's investments and provides third-party equity. Through such a partnership, JAB is able to undertake large and transformative transactions, such as the reverse takeover of KDP, while maintaining control over the dividend streams, and limiting the total leverage at JAB. In our base case, we believe that JCF represents not only an investment partner, but also an opportunity for JAB to address temporary market weaknesses and maintain its long-term LTV target below 20% without losing control over its assets. We see this as a unique advantage for JAB over its peers, and reflect this in the rating on JAB.

Liquidity

We assess JAB's liquidity as exceptional, as there are no debt maturities in the next two years. In liquidity sources, we include the large committed revolving credit facility (RCF), of which €2.6 billion was undrawn as of December 2018. We estimate that JAB's liquidity sources exceed its needs by 4.2x for the 12 months from May 31, 2019, and by 17.4x for the following 12 months.

We consider that JAB's strong ties with banks support its ability to quickly obtain bank financing, if needed. We also believe it likely that JAB would be able to absorb a high-impact event with limited need for refinancing. For JAB, such a scenario would likely be a severe correction of market values for its listed shares, which we consider manageable in view of its relatively low LTV ratio.

For the 12 months from May 31, 2019, we estimate that JAB's principal liquidity sources comprise:

- Cash and cash equivalents exceeding €1 billion;
- Capital return from Acorn Holdings of €864 million following the increase of the public float in KDP;
- Dividend inflow of about €400 million per year on average; and
- Access to a €2.6 billion of a committed RCF maturing beyond one year, currently undrawn.

For the same period, we estimate that JAB's liquidity uses comprise:

- Operating expenses of €30 million-€40 million;
- Interest expenses of €140 million-€150 million;
- Dividends of about €100 million; and
- Acquisition of a minority stake in NVA for €1.1 billion.

We view headroom under the RCF covenant as comfortable.

Issue Ratings--Subordination Risk Analysis

Capital structure

JAB Holdings B.V. is the financing subsidiary of JAB, and is 100%-owned through an intermediate holding company. On a holding company basis, gross debt, represented by bonds, totaled €6.0 billion on Dec. 31, 2018.

Analytical conclusions

JAB has a relatively low level of gross debt, and we assess its financial risk profile as modest. The syndicated RCF and unsecured bonds rank pari passu. As a result, there are no significant elements of subordination risk present in the capital structure, in our view, and we rate the senior unsecured debt 'A-', in line with the issuer credit rating.

Ratings Score Snapshot

Issuer Credit Rating: A-/Stable/--

Business risk: Satisfactory

- Country risk: Low
- Industry risk: Intermediate
- Investment position: Satisfactory

Financial risk: Modest

- Cash flow/Leverage: Modest
- Anchor: bbb+

Modifiers

- Liquidity: Exceptional (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)
- Stand-alone credit profile: a-

Related Criteria

- 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 | Industrials: Methodology: Investment Holding Companies, Dec. 1, 2015
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, 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

Related Research

- Research Update: Jacobs Douwe Egberts Outlook Revised To Positive On Accelerated Deleveraging; 'BB' Ratings Affirmed, May 14, 2019

- Bulletin: Keurig Dr Pepper Inc. Is On Track To Delever To The Mid-4x Area By Year-End, May 10, 2019
- Bulletin: Coty Inc. Dividend Option Frees Cash To Reduce Debt, May 8, 2019
- Research Update: NVA Holdings 'B' Rating Affirmed On Strong Growth; Outlook Stable, March 1, 2019
- Research Update: JAB Holding Company S.a r.l. Outlook Revised To Negative On Partial Tender Offer On Coty Shares; 'A-' Ratings Affirmed, Feb. 12, 2019

Ratings List

Ratings Affirmed

JAB Holdings B.V.

Senior Unsecured	A-
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Ratings Affirmed; CreditWatch/Outlook Action

	To	From
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JAB Holding Company S.a r.l.

Issuer Credit Rating	A-/Stable/--	A-/Negative/--
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