

Research Update:

Jacobs Douwe Egberts Outlook Revised To Positive On Accelerated Deleveraging; 'BB' Ratings Affirmed

May 14, 2019

Rating Action Overview

- Netherlands-incorporated coffee and tea producer Jacobs Douwe Egberts International B.V. (JDE) is deleveraging faster than before thanks to improved profitability and lower mergers and acquisitions (M&A) activity.
- We think that continued product innovation, decreasing integration costs, and low global green coffee prices will continue to support the group's current profitability levels, enabling further deleveraging to below 4.0x within the next 12 months.
- We are therefore revising our outlook on JDE to positive from stable, and affirming our 'BB' ratings on the group and its senior secured debt.
- The positive outlook indicates the possibility of an upgrade if JDE maintains solid profitability and free cash flow generation, with S&P Global Ratings-adjusted debt-to-EBITDA falling comfortably below 4.0x, while sustaining free operating cash flow (FOCF) to debt of above 10%.

Rating Action Rationale

The outlook revision reflects our view that JDE's credit metrics will continue to improve in 2019 on the back of accelerated deleveraging thanks to improved profitability and lower investments in external growth through M&A. In the fiscal year ended Dec. 31, 2018, JDE posted S&P Global Ratings-adjusted debt to EBITDA of about 4.0x--materially stronger than our previous expectations of 4.7x for the year and down from 5.2x in fiscal 2017. The group's adjusted EBITDA margins improved significantly by 360 basis points year-on-year to 22.4%, and it reported sizable net working capital inflows of €284 million related to the deployment of its working capital playbook across the group. This has enabled the group to voluntary repay debt of €380 million under its credit facilities agreement.

We project that, absent any sizable debt-funded transactions, JDE's credit metrics over the coming 12 months will reach levels commensurate with a higher credit rating, notably S&P Global Ratings-adjusted debt to EBITDA falling below 4.0x and FOCF to debt staying well above 10.0% over the next 12 months. We forecast stable adjusted EBITDA margins of 22%-23% over the next 12-24 months, supported by continued positive contribution from new product rollout and

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reducing restructuring costs, despite higher advertisement, promotion, and distribution costs related to these new products. At the same time, we anticipate that lower financing costs, following the latest repricing of its credit facilities in November 2018 and contained working capital requirements, will further support the strong free operating cash flow (FOCF) generation and deleveraging, despite somewhat elevated capital expenditure (capex) needs in 2019. We note that JDE has made further debt repayment of €150 million in first-quarter 2019, with intentions to complete additional voluntary repayments over the next three quarters.

During 2018, JDE's profitability benefited from the full-year effect of the global rollout of the aluminum capsules, first launched in its core European markets in mid-2017. We anticipate stable profitability over the next 24 months, on the back of continued healthy pipeline of new products. On the proprietary-brand side, JDE plans to launch globally its premium two-cup espresso coffee machine L'OR Barista, manufactured under a long-term agreement with Philips. JDE will also start in the first half of 2019 the production and distribution of Illy-branded Nespresso-compatible aluminum capsules across retail channels (outside Italy), under a trademark licensing agreement with Illycafe. We understand JDE is also exploring ways to collaborate with companies within the wider portfolio of JAB Holding (JAB), its majority shareholder, and we believe joint projects will likely emerge. This could enable JDE to diversify its distribution channel through coffee outlets and office space after last year's acquisitions of OldTown in Asia and JOBmeal in Sweden.

We think that JDE's top-line growth and profitability should benefit from these partnerships and product launches. In particular, the group should benefit from Illy's strong brand equity, particularly in Europe, and its own superior production and distribution capabilities, while continuing to strengthen its leading market position in coffee pod systems, which includes Tassimo and Senseo. These potential collaborations could be setback, however, by JDE's slight dependence on coffee pod systems in Europe, where the group has invested in recent years to expand but still faces tough competition from Nestlé, its biggest rival. We also observe an increasing need to invest more in advertising and promotion due to the rising pressure from private labels that are trying to gain a foothold over branded players, particularly in the mature retail coffee market in Europe. In our base case for the next 12-18 months, we assume JDE will maintain strong FOCF, demonstrated with a FOCF-to-debt ratio well above 10%. This is despite a somewhat more capex-intensive 2019 due to a sizable investment of about €80 million in a new freeze-drying coffee facility in Europe and increased production lines to support capacity expansion related to product launches.

Our issuer credit rating on JDE is not linked to that on JAB (A-/Negative/--), its majority shareholder (73.11% stake as of Dec. 31, 2018). This is because we consider JDE to be nonstrategic to the holding company. As such, we do not expect that JAB would jeopardize its own credit quality by providing extraordinary support to JDE. Although we anticipate that JAB will be involved in setting JDE's financial policy and overall business strategy, we expect the holding company will maintain an arms-length relationship with JDE. We also note that there are no cross-default clauses under the credit agreements.

Outlook

The positive outlook reflects the possibility that we could raise the ratings on JDE within the next 12 months if the group maintains solid profitability and strong FOCF generation, owing to contained working capital requirements despite some elevated capex needs. In particular, adjusted debt to EBITDA falling below 4.0x and FOCF to debt remaining materially above 10% on a sustained basis would be in line with a higher rating. We think these metrics would stem from the group's top-line growth and pronounced benefits on profitability from the rollout of new products over the next 12 months. This would offset the anticipated rise in operating expenses related to

these product launches, while effectively managing competitive pressures across key categories.

Downside scenario

We could revise the outlook to stable if, contrary to our base case, we see a weakening in JDE's operating performance, likely stemming from increased competition or failure to materialize sufficient benefits from continued product rollout. Alternatively, an outlook revision to stable could occur if JDE embarked on significant debt-financed acquisitions, such that adjusted debt-to-EBITDA remained above 4.0x with little prospect for a rapid improvement.

Company Description

JDE, formed in July 2015 through the merger of the coffee business of Mondelez and DE Master Blenders 1753, is the world's second-largest coffee and tea company. The group is majority-owned by Acorn Holdings (a subsidiary of JAB Holdings B.V.), and Mondelez retains a minority stake of 26.36%. Developed markets (mainly Europe) account for a sizable proportion of JDE's sales (about 47% of sales in fiscal 2018). The group also has a significant presence in Brazil, Australia, and Russia, and it has increased its footprint in Southeast Asia following recent acquisitions of Super Group (2017) and OldTown (2018).

JDE's product portfolio includes roast and ground coffee, single serve, instant, and other types of coffee-related products and tea. The group's brand names include Jacobs, Douwe Egberts, Pilao, Moccona, Gevalia, Kenco, L'Or Espresso, Tassimo, Senseo, Super, Essenso, OldTown, and OWL. The group reported revenue of about €5.9 billion in 2018 (about €5.8 billion in 2017) and adjusted EBITDA of €1.3 billion (€1.08 billion in 2017) implying a margin of 22.4% (18.8%).

Our Base-Case Scenario

In our base case, we assume:

- Annual sales growth of around 2.5% in fiscal 2019 and 3.0% in fiscal 2020, fueled primarily by new products, including the Illy-branded aluminum capsules and L'Or Nesspresso-compatible pods espresso machine. Improved category mix with positive effects from increased investment in marketing (especially for premium products) and, to a lesser extent, bolt-on M&A activity will also contribute to sales growth.
- Broadly stable adjusted EBITDA margins in the 22%-23% range in fiscals 2019 and 2020 on the back of reduced integration costs. We think that these should broadly offset the anticipated rise in advertisement, promotion and distribution costs related to continued product innovation and rollout.
- Slightly elevated capex needs in fiscal 2019, representing 4.3% of sales, related to the new freeze-drying facility in Europe and additional lines to support the rollout of aluminum capsules and espresso machine, reducing to about 3.5%-4.0% of sales thereafter.
- Broadly neutral working capital, against likelihood of higher inventory build-up related to continued product rollout offset by favorable supplier payment profile.
- Annual dividend distribution of €245 million in fiscal 2019, rising by 5%-7% thereafter.
- Small bolt-on acquisitions of between €200 million-€300 million in fiscals 2019 and 2020, since we think that the group will continue expansion efforts in Asia-Pacific and Latin America through small local and regional champions.

- We have not factored in further debt repayments in our base case beyond the latest €150 million completed in first-quarter 2019, although there is a strong commitment from management to continue to repay debt, these are of discretionary nature, and not contractual.

Liquidity

We assess JDE's liquidity profile as adequate, reflecting our calculation that the group's cash sources will cover uses by more than 1.2x for the next 12 months. Although sources are likely to exceed uses by more than 1.5x, which is typically associated with a stronger liquidity assessment, we continue to assess JDE's liquidity as adequate, because we think that the group would prioritize excess cash flows to fund additional capex investments or discretionary investments such as acquisitions.

Principal liquidity sources over the next 12 months include:

- €364 million of unrestricted cash balances available as of April, 1, 2019;
- €500 million of committed undrawn revolving credit facilities maturing beyond the next 12 months; and
- S&P Global Ratings-forecasted cash funds from operations (FFO) of €900 million-€1,000 million.

Principal liquidity uses over the next 12 months include:

- €13 million of short-term debt maturities;
- S&P Global Ratings' estimate of intra-year working capital outflows of about €100 million;
- Neutral annual working capital outflows;
- S&P Global Ratings' forecast of capex requirements of about €255 million; and
- Annual dividends of €245 million.

Covenants

Under the credit agreement, JDE is subject to a maintenance financial covenant linked to total net leverage not exceeding 5.95x, which is tested quarterly. We expect the group to maintain comfortable headroom under this covenant, in line with the indentures.

Issue Ratings - Recovery Analysis

Key analytical factors

- The senior secured facilities include a €500 million revolving credit facility (RCF) due 2023; €4,321 million term loan A due 2023; €401 million euro-denominated term loan B due 2025; and a \$773 million U.S. dollar-denominated term loan B due 2025.
- The facilities are rated 'BB', the same as the issuer credit rating on JDE. The '3' recovery rating indicates our expectation of meaningful (50%-70%, rounded estimate: 60%) recovery in the event of payment default. This is supported by the limited amount of priority ranking debt in the

group's capital structure.

- Our hypothetical default scenario envisages a decline in operating performance owing to lower-than-expected demand and a sharp and long-lasting increase in raw-material prices, leading to the group's inability to refinance its maturing debt.
- We value the group as a going concern, given its strong brands and solid position in the global coffee market.

Simulated default assumptions

- Year of default: 2024
- Jurisdiction: Netherlands

Simplified waterfall

- EBITDA at emergence: Approximately €695 million (capex represents 3.0% of sales based on our recent and forward-looking growth expectations for the group, cyclicality adjustment is 0%, in line with the specific industry sub-segment. A 10% operational adjustment is applied to reflect the strong improvement in EBITDA, as a result of continued product rollout and synergies from recent acquisitions, and the attractive margins achieved in the recent refinancing).
- EBITDA multiple of 6.0x in line with standard industry assumption and reflecting the strong brand equity of the group's existing portfolio.
- Adjusted gross enterprise value: about €4.2 billion
- Net enterprise value (after 5% administrative costs): about €4.0 billion
- First-lien secured debt claims: about €6.3 billion*
- Recovery range: 50%-70% (rounded estimate: 60%)
- Recovery rating: 3

*All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating: BB/Positive/--

Business risk: Satisfactory

- Country risk: Low
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bb

Modifiers

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

Stand-alone credit profile: bb

- Group credit profile: bbb+
- Entity status within group: Nonstrategic (no impact)

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | Industrials: Key Credit Factors For The Branded Nondurables Industry, May 7, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Issuer Credit Rating	BB/Positive/--	BB/Stable/--
Senior Secured	BB	
Recovery Rating	3(60%)	

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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