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Research Update:

Lens And Eyewear Manufacturer EssilorLuxottica Rated 'A' On Combination With Luxottica; Outlook Stable

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Overview

- The combination of Essilor (optical lens manufacturing) and Luxottica (eyewear producer) is effective from Oct. 1, 2018, now that all necessary regulatory approvals and boards' approvals have been obtained.
- The new group, EssilorLuxottica, should benefit from world-leading positions in lenses and eyewear (frames, glasses), with a wide and complementary product range and a vertically integrated business model from design to retail stores. Still, we see some integration risks, notably in terms of corporate culture.
- We forecast the group to generate annual free operating cash flows (FOCF) of €1.7 billion-€2.1 billion annually with adjusted debt leverage of 1.5x-1.9x over the next two years. We see the group as generating steady cash flow but likely to pursue external growth opportunities.
- We are therefore assigning our 'A' long-term issuer and issue ratings to EssilorLuxottica. We are affirming the short-term ratings at 'A-1'.
- The stable outlook reflects our view that the group's operating performance will likely be supported by its leading global market positions and the wide product range.

Rating Action

On Oct. 2, 2018, S&P Global Ratings assigned its 'A/A-1' issuer credit ratings to France-headquartered EssilorLuxottica (formerly called Essilor International Compagnie Generale d'Optique S.A.). The outlook is stable.

We affirmed our 'A-1' short-term issuer credit rating.

At the same time, we assigned our 'A' long-term issue rating to the senior unsecured debt issued by EssilorLuxottica, in line with the issuer credit rating on EssilorLuxottica. We also affirmed the 'A-1' rating on EssilorLuxottica's commercial paper programs.

Rationale

Our rating on EssilorLuxottica reflects that its combined optical lenses and frames activities should enable the group to maintain its global leading position in its business segments, which have positive growth prospects. We see potential integration risks, notably in terms of corporate culture and on execution of the business strategy while the senior management structure has yet to be fully defined.

We calculate that the combination is relatively credit neutral because we assume that debt leverage should remain between 1.5x-1.9x over the next two years despite a potential maximum €2.8 billion of cash outflow to buy out shareholders in Luxottica.

Its world-leading positions in optical lenses, glasses, and frames are positives for the business. These segments are growing by the low- to mid-single digits globally, notably with positive growth prospects in Asia. The group has a large scale of operations compared to its main competitors in terms of revenue base and distribution footprint. It benefits from good geographical diversification, and is well-balanced between main consumer markets like North America and Europe and increasingly in large, fast-growing markets in Asia (notably China).

We also view positively the wide product range and strong brand portfolio (RayBan, Varilux, Oakley). The group also distributes its products through various channels, including franchise stores. That said, some of the product segments are relatively niche; they depend on discretionary spending and carry high price tags. We also see competitive pressures in retail, notably in the U.S.

The large scale and complexity of the combination also means that there are uncertainties as to how successfully the combination will be executed. A difficult integration between two different corporate cultures, together with a senior management structure that's yet to be fully finalized (the CEO is not yet named) could possibly negatively affect the implementation of the business strategy, notably around synergies. That said, we see a severe disruption of the local operations as unlikely as the two activities are complementary.

We also think that potential board-level conflicts are mitigated by Luxottica and Essilor having equal representation (eight board members apiece for Essilor and Delfin). Seven independent board members have been nominated to the board, and the new largest shareholder (Mr. Del Vecchio) will have a maximum of 31% of voting rights.

Despite some pricing pressures in retail channels and lower growth in Europe, we believe the combined group should be able to generate solid free cash flows of €1.7 billion-€2.1 billion annually due to the leading market positions and complementary nature of the product offerings despite some capital intensity due to R&D (about 6% of revenues). The shareholder remuneration policy should not be more aggressive than at Essilor or Luxottica but we see EssilorLuxottica continuing to grow externally through acquisitions, especially in new geographies (notably in Asia) and in new distribution channels (especially in North America).

In terms of the debt structure, most of the debt is senior unsecured and denominated in EUR and USD, which reflects the two largest geographical regions. There are no large debt maturities over the next five years and debt sources are well diversified between senior notes, bank lines, CP, and U.S. private placements.

Assumptions

Our base-case for 2018-2019 is:

- Revenues of about €16.5 billion-€17.5 billion, driven by low-single-digit to flat growth in large product segments like lenses and eyewear in 2018. We see a slight rebound in 2019 to about 3% revenue growth, thanks notably to eyewear in North America.
- S&P Global Ratings-adjusted EBITDA margin of 24%-25%, thanks notably to the price-premium associated with main products, which should enable the group to offset higher raw materials costs and integration costs.
- FOCF of about €1.7 billion-€2.1 billion annually, assuming some working capital outflows and capital expenditure (capex) close to 6%.
- Adjusted debt of €6.5 billion-€7.5 billion, reflecting total debt, net pension deficit, and operating lease commitments. We assume cash dividends of about €830 million in 2018 and €930 million in 2019.

Based on these assumptions, we arrive at the following credit measures, which we see gradually improving over the next two years:

- Adjusted debt to EBITDA of about 1.5x-1.9x.
- Funds from operations (FFO) to debt of 45%-55%.
- FOCF to debt of 25%-30%.

Liquidity

We assess liquidity as strong because we project that EssilorLuxottica's sources of liquidity will likely cover the uses by more than 1.5x over the next 12 months, and would sustain a 30% EBITDA stress.

We understand that there was significant (>30%) headroom under the financial covenants as of June 30, 2018 for the limited portion of the debt that is covenanted. We believe there is a good diversity of debt sources, strong banking relationships, and good access to capital markets. We exclude liquidity sources and uses for the combination transaction because we are measuring the funding needs of the ongoing business.

Main liquidity sources:

- Cash balances of €1.6 billion at June 30, 2018, on a combined basis.
- Combined undrawn committed credit lines of €2.3 billion maturing in more than one year
- Our projection of cash FFO of €3.0 billion-€3.5 billion in next 12-24 months

Main liquidity uses:

- €1.5 billion of debt due within one year and €159 million due in 12-24 months as of June 30, 2018.
- Our estimate of about €1.0 billion of capex annually.
- Our estimate of €850 million-€950 million of cash dividends annually.

Outlook

The stable outlook reflects our view that EssilorLuxottica should be supported by a stable operating performance with solid FOCF generation overall over the next two years. We believe the group should benefit from stable cash flow generation thanks to its leading global positions in growing product categories such as lenses and frames, as well as its wide product range and vertical integration of the business model. That said, we see some integration risks, notably in its corporate culture and increasing competitive pressures in the U.S.

The current rating assumes EssilorLuxottica will maintain adjusted debt to EBITDA of about 1.5x-2.0x and FOCF to debt of 25%-40%.

Downside scenario

Rating downside could arise from a sharp and sustained increase in debt leverage due notably to acquisitions. We would also view negatively a sustained decline in operating performance and FOCF generation, which could arise from heightened competition entailing loss of market share and pricing pressures in key growing markets like the U.S or China.

Overall, we could lower rating if credit metrics weakened sustainably such that adjusted debt-to-EBITDA rises to over 2.0x and FOCF to debt declines to below 25%.

Upside scenario

Rating upside would most likely arise from management taking a conservative stance on acquisitions and shareholder remuneration, such that adjusted debt leverage remains below 1.5x over the next two years. We think this is unlikely because we understand that EssilorLuxottica's business strategy is to grow externally in new distribution channels and geographical markets.

Over the longer term, we could also raise the ratings should the group exhibit a strong and lasting track-record of high revenue growth and above-par profitability. We would also need to see evidence of the group overcoming combination-related integration risks (notably relating to corporate culture, management of key customers, and integration of supply-chain and IT) and continuity in terms of strategic direction.

Other Credit Considerations

Subordination risk

The long-term senior unsecured debt of EssilorLuxottica is rated 'A', in line with the issuer credit rating on EssilorLuxottica. This is because we calculate a limited structural subordination, given total secured debt and debt held at operating companies is below our 50% criteria threshold.

Ratings Score Snapshot

Issuer Credit Rating: A/Stable/A-1

Business risk: Strong

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

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: a+

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Negative (-1 notch)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Health Care Equipment Industry, 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: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

New Rating;	
EssilorLuxottica	
Issuer Credit Rating	A/Stable/--
Senior Unsecured	A

Ratings Affirmed;	To	From
EssilorLuxottica		
Issuer Credit Rating	-/--/A-1	--/--/A-1
Commercial Paper	A-1	
Essilor International S.A.S.		
Commercial Paper	A-1	

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.