Research Update:

EssilorLuxottica 'A/A-1' Ratings Affirmed As Low Debt Leverage Mitigates Shareholder Arbitration Risks; Outlook Stable

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*(**Editor's Note:** We have republished this article, originally published April 16, 2019, to clarify that, based on new information from EssilorLuxottica, the scope of arbitration does not include the CEO selection as we initially stated.)*

Rating Action Overview

- Delfin, the largest shareholder of lens and eyewear maker EssilorLuxottica, has filed an arbitration request to verify that power sharing at EssilorLuxottica's board complies with the 2017 merger agreement.
- We believe this situation indicates friction within the board that could eventually hamper the group's strategic decision-making.
- Although Essilor and Luxottica continue to be run independently, their operational integration is proceeding, and we forecast adjusted debt leverage at 1.2x-1.3x in 2019-2020, with free cash flow of around €2 billion annually.
- We are affirming our 'A/A-1' ratings on EssilorLuxottica and all its senior debt instruments, incorporating a one-notch negative impact from our assessment of governance risk related to the arbitration.
- The stable outlook stems from our view that the group's underlying operating performance and cash flow generation should remain steady over the next two years, while acknowledging the potential for leverage to widen to 2x in the event of further mergers or acquisitions.

Rating Action Rationale

In our view, positive operating fundamentals reported for 2018 indicate EssilorLuxottica's inherent business strengths at the regional and divisional levels. This is notably thanks to the group's global leading market positions, strong research, production, and distribution capabilities, and large portfolio of brands and licenses. Since Essilor and Luxottica merged in October 2018, the combined entity has been making progress with high-level operational integration, although the two businesses are run largely independently of each other. We also note that the pace of in-fill acquisitions slowed down last year.

However, the group is yet to confirm its longer-term strategic direction and financial policy. In addition, the filing of an arbitration request to verify the compliance of power sharing at the board with the 2017 combination agreement indicates risks related to corporate governance. This situation could impede the effectiveness of the board as it attempts to steer EssilorLuxottica toward future profitable growth.

On April 17, 2019, the group publicly confirmed that EssilorLuxottica's nomination and compensation committee, after consulting with the two executive chairmen, initiated the search for a group CEO to be appointed by the end of 2020. We believe the appointment of a group CEO could take time since both executive chairmen will need to agree on the profile. We also think it could be postponed until a new board is elected, once the combination agreement expires in 2021.

Nevertheless, thanks notably to EssilorLuxottica's strong market positions in Europe and North America, and positive revenue growth prospects in emerging markets (in particular China), we forecast the group will generate about €2 billion of free operating cash flow (FOCF) in 2019-2020. The group's financial position should also strengthen in view of lower adjusted debt leverage of 1.2x-1.3x, versus 1.5x-1.9x in our previous base case. Our estimate of total debt for 2019 is lower than before because the amount of cash used to buy out Luxottica's shareholders (€640 million in 2019) is much lower than the previous maximum estimate of €2.8 billion.

We believe the group will consider acquisitions over the next few years as it seeks to consolidate the global lenses and eyewear industries, particularly in emerging markets like China. However, even assuming numerous bolt-on acquisitions, a stable dividend policy (maximum of 50% of net income excluding exceptional items), and limited share buybacks, our base-case scenario is that adjusted debt leverage should stay below 1.5x. We also view as positive the group's well-balanced debt maturity profile and diverse funding sources.

Outlook

The stable outlook reflects our view that, despite governance-related risks, EssilorLuxottica's operating performance and free cash flow generation should strengthen incrementally over the next two years. Notably, we view as positive the company's global leading market positions in lenses and frames, its ability to maintain a price premium thanks to innovation and strong brands, and its extensive distribution capabilities.

For the rating category, and factoring in our view of a high likelihood of new acquisitions, EssilorLuxottica's adjusted debt-to-EBITDA ratio should remain within the 1.5x-2.0x range.

Downside scenario

We could lower our ratings if we believe the friction at board level will continue, resulting in delays in business integration that obstruct the implementation of effective business strategy and result in weaker operating performance over the medium term.

A sustained decline in operating performance and FOCF generation could also lead to a downgrade. This could arise from heightened competition, loss of market share, and pricing pressures in key markets like Europe or North America.

We could lower the ratings if EssilorLuxottica's credit metrics weakened for a long period, with adjusted the debt-to-EBITDA ratio staying at 2.0x or higher and FOCF to debt declining below 25%.

Upside scenario

We could raise the rating if we are satisfied that the corporate governance problems have been resolved, enabling a clear decision-making structure, and if EssilorLuxottica achieves full integration, with prospects for profitable expansion in the long term.

Continued, solid operating performance in the changing retail environment would support an upgrade, as would EssilorLuxottica's public commitment to maintaining very low debt leverage, such that adjusted debt to EBITDA stays below 2x. We believe the group should continue to benefit from its leading global positions in lenses and frames, wide product range, and vertical integration of the business model.

Company Description

EssilorLuxottica is a global manufacturer of lenses and eyewear, generating €16.2 billion of revenues and €2.6 billon of operating profit on a pro forma basis for fiscal year ended Dec. 31, 2018. The group was created on Oct. 1, 2018, from the combination of France-based lens manufacturer Essilor and Italy-based eyewear manufacturer Luxottica. The Lenses & Optical Instruments segment contributed 40% of pro forma 2018 revenues, followed by Eyewear Retail (35%), Eyewear Wholesale (20%), and Other (5%).

By region, the group derived its 2018 pro forma revenue from:

- North America (52%),
- Europe (25%),
- Asia-Oceania and Africa (17%), and
- Latin America (6%).

Our Base-Case Scenario

- Over 2019-2020, we forecast revenues of €16 billion-€16.5 billion, fueled by low-single-digit organic growth and supported by solid growth in emerging markets, despite potential foreign currency volatility, moderate growth in North America, and low growth in Europe.
- An S&P Global Ratings-adjusted EBITDA margin of 24%-25%, thanks notably to the strong price premium in lenses, which should enable the group to offset higher raw material, selling, and integration costs.
- Adjusted FOCF of about €2 billion annually, assuming some working capital outflows and capital expenditure of around 6%.
- Adjusted debt of around €5 billion, which notably includes annual cash dividends of €950 million-€1 billion, annual acquisitions of €800 million, annual share buybacks of €300 million, and €640 million in payments to Luxottica's minority shareholders 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 1.2x-1.3x.
- Funds from operations to debt of 60%-65%.

- FOCF to debt of 40%-45%.

Issue Ratings - Subordination Risk Analysis

Capital structure

We rate EssilorLuxottica's long-term senior unsecured debt 'A', in line with the issuer credit rating. We see limited structural subordination, given little secured debt and low debt at operating companies relative to total debt.

Analytical conclusions

Despite the arbitration, it appears unlikely at this stage that Essilor and Luxottica will separate before the combination agreement expires in 2021. The majority of debt funding is at the combined holding company level. External debt directly at Luxottica is reducing, notably after the recent €500 million bond repayment.

Ratings Score Snapshot

Issuer Credit Rating: A/Stable/A-1

Business risk: Strong

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

Financial risk: Minimal

- Cash flow/Leverage: Minimal

Anchor: aa-

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Negative (-1 notch)
- Management and governance: Fair (-1 notch)
- 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 - 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: 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
- Criteria - Corporates - Industrials: Key Credit Factors For The Health Care Equipment Industry, 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

Related Research

- Lens And Eyewear Manufacturer EssilorLuxottica Rated 'A' On Combination With Luxottica; Outlook Stable, Oct. 2, 2018

Ratings List

Ratings Affirmed	
EssilorLuxottica	
Issuer Credit Rating	A/Stable/A-1
EssilorLuxottica	
Senior Unsecured	A
Commercial Paper	A-1
Luxottica Group SpA	
Senior Unsecured	A