Research Update:

Eyewear And Eyecare Group EssilorLuxottica 'A/A-1' Ratings Affirmed On Agreement To Acquire Grandvision; Outlook Stable

July 31, 2019

Rating Action Overview

- EssilorLuxottica (EL) has agreed to acquire European optical retailer Grandvision for about €7.9 billion, including debt. The transaction is subject to antitrust review and may not close until the end of 2021.
- We think the acquisition is in line with the group's strategy and will strengthen its retail activities in Europe. That said, we see additional integration risks for the group.
- In our base case, we forecast that EL's leverage will approach 1.5x two years after closing, thanks to the equity raise, projected free cash flow of €2.5 billion-€2.8 billion annually, and very low debt before closing.
- We are thus affirming our 'A/A-1' issuer credit ratings on EL and all our issue ratings on its senior debt instruments.
- The stable outlook stems from our view that EL should be able to deleverage after the acquisition close, supported by a more accommodative financial policy.

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Rating Action Rationale

The affirmation reflects our view that the mostly debt-funded €7.9 billion acquisition of optical retailer Grandvision will not materially affect EL's overall credit quality. We consider that the acquisition fits with the group's vertical integration strategy and will strengthen its retail activities in Western Europe, one of its core markets.

Grandvision's optical retail activities (€3.7 billion of revenue with a 15.5% EBITDA margin in 2018) should account for about 20% of the combined group's revenue and be slightly operating-margin dilutive. The transaction closing remains subject to approval from regulators, and EL expects to close the transaction in the next 12 to 24 months.

The mostly debt-funded nature of the transaction (up to 25% equity) means that EL's adjusted debt leverage should rise to above 2.0x at transaction close. That said, we anticipate that EL's

leverage will approach 1.5x in the two years after closing. This is thanks to its currently very low debt level, up to €2 billion of the acquisition being funded by equity, and the group's strong free cash flow capacity of €2.5 billion-€2.8 billion annually, supported by the underlying positive growth prospects of the business and on-going synergies.

With this acquisition, EL is investing more in its downstream retail activities, and will benefit from a stronger foothold in the large and stable European optical retail market, notably in France, Germany, and the Benelux region (Belgium, the Netherlands, and Luxembourg). EL is already a leading player in North America and in parts of Europe like Italy. Grandvision should also enable EL increase the penetration of its manufactured products (lenses, frames, sunglasses) into its 7,100 physical stores, and thus reach new consumers. It will also strengthen its presence in the profitable eye health care (vision check) services segment and in online retail.

Despite its track record of successfully integrating numerous acquisitions (notably the U.S. optical retail chain LensCrafters) through Essilor and Luxottica, we note that EL is still in the complex process of integrating its own operations. We believe this will likely last for some years, possibly until the integration of Grandvision. The rating also continues to factor in a weakness in governance, given the past friction at EL's board level, which in our opinion has not yet been fully resolved.

Outlook

The stable outlook reflects our view that, despite integration and governance-related risks, EL's operating performance and free cash flow generation should strengthen incrementally over the next two years. 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, which will be strengthened by the Grandvision acquisition.

Additionally, EL's adjusted debt-to-EBITDA ratio should approach 1.5x within two years of the Grandvision acquisition close, supported by a moderate financial policy toward acquisitions and shareholder remuneration.

Downside scenario

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

A sustained decline in operating performance and higher-than-expected acquisition spending, while EL is deleveraging from the Grandvision acquisition, could also lead to a downgrade.

We could lower the ratings if EL's credit metrics weakened for a prolonged period, with adjusted the debt-to-EBITDA ratio at 2.0x or higher and FOCF to debt 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 EL achieves full integration of its operations, with prospects for profitable expansion in the long term.

Continued, solid operating performance in the changing retail environment would support an upgrade, as would EL's public commitment to maintaining very low debt leverage, such that

adjusted debt to EBITDA stays below 2x at all times.

Company Description

EL is a global manufacturer of lenses and eyewear, generating €16.2 billion of revenue and €2.6 billon of operating profit on a pro forma basis for the 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.

With the addition of Grandvision's optical retail activities that are mostly in Western Europe, the revenue breakdown by geography would be:

- North America (40%-45%);
- Europe (35%-40%);
- Asia-Oceania and Africa (15%-20%); and
- Latin America (5%-10%).

By business segment:

- Eyewear retail and wholesale (60%-65%); and
- Lenses and optical instruments (35%-40%).

Our Base-Case Scenario

- We forecast annualized revenues of €22 billion for the combined group post acquisition closing in 2021 and 2022. This is based on 2.5%-3.5% organic growth, supported by slightly higher growth in emerging markets, despite potential foreign currency volatility, and low to moderate growth in North America and Europe.
- An S&P Global Ratings-adjusted EBITDA margin of 25.0%-25.5%, supported by the strong price premium in lenses, the vertical integration between manufacturing and retail, which should enable the group to offset higher raw materials, selling, and on-going integration costs. We note that Grandvision has lower profitability than EL, but that the group should gradually benefit from synergies.
- Adjusted FOCF of about €2.5 billion-€3.0 billion annually, assuming some working capital outflows and capital expenditures (capex) of around 6% of revenue.
- Adjusted debt of around €10 billion declining thereafter to around €9 billion, which notably includes: the acquisition of Grandvision funded at 75% by debt and 25% by equity; €2.6 billion of operating lease commitments; annual cash dividends of €900 million-€950 million; a net pension deficit of about €380 million; and annual spending of €200 million-€400 million on acquisitions and share buybacks.

Based on these assumptions, we arrive at the following credit measures assuming the acquisition closes in 2021:

- Adjusted debt to EBITDA of 1.7x-1.9x (annualized) in 2021, declining to close to 1.5x-1.6x in 2022.
- Funds from operations (FFO) to debt of 45%-50% (annualized) in 2021, rising to 50%-55% in

2022.

- FOCF to debt of 25%-30% (annualized) in 2021, rising toward 30%-35% in 2022.

Liquidity

We assess liquidity as strong, because we project that EL'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, 2019, 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 announced acquisition of Grandvision, because we are measuring the funding needs of the ongoing business.

We estimate that EL's main liquidity sources for the 12 months from June 30, 2019, include:

- Cash balances of €1.5 billion at June 30, 2019.
- Undrawn committed credit lines of about €2 billion maturing in more than one year.
- Our projection of cash FFO of about €3.0 billion.

Over the same period, we estimate that EL's main liquidity uses include:

- €1.7 billion of debt due within one year and about €650 million due in 12-24 months as of June 30, 2019.
- Our estimate of about €1.0 billion of capex annually.
- Our estimate of €900 million of cash dividends annually.

Issue Ratings - Subordination Risk Analysis

Capital structure

We rate EL'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: 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: Neutral (no impact)
- Management and governance: Fair (-1 notch)
- Comparable ratings analysis: Positive (+1 notch)

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
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Health Care Equipment Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Retail And Restaurants Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, 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

- EssilorLuxottica 'A/A-1' Ratings Affirmed As Low Debt Leverage Mitigates Shareholder Arbitration Risks; Outlook Stable, April 24, 2019

Ratings List

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

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