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Research Update:

Koninklijke FrieslandCampina 'BBB/A-2'Rating Affirmed On Successful Deleveraging Below 4x; Outlook Negative

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Rating Action Overview

- Dairy company Koninklijke FrieslandCampina N.V.'s (Royal FrieslandCampina [RFC]) operating margins rebounded in 2019, thanks to a successful turnaround strategy implemented for its less profitable businesses (consumer dairy and dairy essentials), despite operational headwinds on the specialized nutrition division.
- Therefore, our adjusted debt to EBITDA significantly decreased to 3.9x in 2019 from 4.6x at year-end 2018; however, we expect a ratio between 4x-4.5x over the next 12-24 months because the global environment remains uncertain due to the COVID-19 outbreak, which could disrupt logistics or production throughout 2020.
- Consequently, we are affirming our 'BBB' rating on RFC.
- The negative outlook reflects our view that RFC's operating performance may be hampered by the COVID-19 outbreak weighing on global consumption. Margins may be hurt by cost overruns in logistics, as well as temporary site closures in Europe. There might be a further negative impact on cash flows from greater working capital volatility.

Rating Action Rationale

The company's deleveraging path will be challenged in 2020 by the COVID-19 outbreak, as profitability will be squeezed about 50 bps after a robust rebound in 2019 of over 100 bps. Despite positive signs of the group's turnaround strategy implemented throughout 2019, with profitability increasing to 8.6% from 7.5% in 2018, further margin recovery in 2020 is unlikely. We anticipate profitability to be hampered and to decrease by 50 basis points (bps) in 2020, mainly owing to cost overruns due to temporary site closures or some disruption in logistical flows.

Deleveraging trends started in 2019 should stop in 2020 given the challenging global economic environment stemming from the coronavirus crisis, which has quickly spread worldwide. With debt to EBITDA decreasing to 3.9x at end of December 2019, versus 4.6x one year before, we anticipate the outbreak will challenge recovery in 2020. With the U.S. and EU borders mostly closed until at least the end of April and many European countries on mandated lockdowns, consumption will drop dramatically. However, we believe access to food is a priority for governments and RFC's sales should remain resilient. Hence, the impact on the group should be again limited to a 50-bps margin squeeze. The company's ingredient business will support margins and remain a growth driver in the coming years.

Free cash flow generation will be pressured by upcoming operational headwinds and higher working capital requirements over 2020. Profitability should be squeezed in 2020 and will translate to lower free operating cash flow (FOCF) to debt of less than 5%. FOCF will likely be additionally depressed by the group's working capital outflow because it might need to increase inventories and accept less favorable payment terms. However, protecting its suppliers (farmers) financially is key, since they provide the group's essential raw material (milk) enabling a sufficient level and quality of input to continue production. Also, logistical difficulties might materialize and somewhat disrupt milk inflow in the short term in Europe, leading to higher cost of goods sold (COGS). The company should spend low level of capital expenditure (capex) similar to last year in order to protect cash flow generation resulting from above-mentioned factors.

Despite our revised anticipation of debt to EBITDA above 4x by end of 2020 versus 3.6x a year earlier, the company has demonstrated its ability to deleverage in line with last year's base case. We foresee a higher debt to EBITDA of about 4.15x for 2020, but in spite of operational headwinds in 2019 the company reduced debt to EBITDA in its last fiscal exercise and met our April 2019 base case, with debt to EBITDA slipping below 4x in 2019 at 3.9x. The current situation is a unique and unprecedented event that we could not foresee in our previous forecast back in April 2019, and hence it was not embedded in it. We continue to consider the company's business model and current credit metrics still relevant for our current 'BBB' rating. If the company can continue its turnaround strategy in its consumer dairy and dairy essentials product ranges while maintaining market share and resilience to competitive pressure in specialized nutrition (infant formula) in promising markets such as China, Indonesia, Malaysia, Vietnam, and Thailand, our forecast should materialize. Therefore, credit metrics should strengthen in 2021, with debt to EBITDA decreasing to 3.6x. However, if the company cannot contain competitive pressure or deliver a sufficient level of product innovations, resulting in market share losses, current base-case forecasts and rating could come under pressure.

Outlook

The negative outlook reflects our view that RFC's operating performance might be hampered by the current COVID-19 outbreak, weighing on global consumption volumes and margins, as well as leading to higher working capital volatility. In addition, the negative outlook reflects that competitive pressure on the high-margin specialist nutrition division is expected to continue in Hong Kong and China, while logistical flows might be disrupted. Therefore, we see at least a one-in-three chance that RFC will not be able to maintain an adequate margin and debt to EBITDA commensurate with our rating.

Downside scenario

We could lower the 'BBB' long-term rating if RFC faces decreased consumption globally owing to the impact of COVID-19. Any margin shrinkage exceeding our forecasts could also put pressure on credit metrics and ratings. If RFC cannot maintain its EBITDA margin around 7% and leverage within the 3.5x-4.5x range by the end of 2020 we could consider lowering the rating.

Upside scenario

We could revise the outlook to stable if RFC's profitability improved in the next 12-24 months following the successful implementation of the group's strategy to turn around less profitable operations. Also, a faster return to more normal consumption patterns after the COVID-19 outbreak could help achieve such a scenario. Moreover, a return to a stable outlook would be subject to debt to EBITDA well anchored in the 3.5x-4.5x range, coupled with solid free cash flow generation.

Company Description

Netherlands-based, RFC is an agricultural cooperative group with revenues of €11.3 billion and reported EBITDA of €976 million. RFC remains the fifth-largest global dairy group, and ranks No. 2 in the global dairy cooperative industry. The group produces and sells consumer milk, milk powder, dairy-based beverages, infant nutrition, cheese, butter, and desserts. RFC operates through four business divisions: consumer dairy, specialized nutrition, ingredients, and dairy essentials. The group's product diversification toward higher-value-added products like infant nutrition formula is largely exposed to Asia (Hong Kong and mainland China), where competitive pressure remains tough. Margin recovery should remain limited in 2020 because the company is expecting very tough conditions in its specialized nutrition, although some profitability improvement should come from the lower-margin divisions of consumer dairy and dairy essentials.

RFC's vertically integrated business model enables it to control and manage volume inflow of raw materials at all times but also push farmers toward more quality milk (Meadow premium) and to maintain what could be considered one of the most exclusive industry quality standards, the "From the Grass to Glass" approach.

Currently, the group is still working on turning around its dairy essentials division, which was originally loss making and focused on allowing the company to process large volumes of milk collected from cooperative members' farms. Moreover, the group's ambitious increase in marketing spending will enable it to gain market share by expanding and strengthening its core brands, such as Frisian Flag, Dutch Lady, or Friso, in the Chinese market and the Asia-Pacific region.

Friesland Campina is fully owned by a cooperative Zuivelcoöperatie FrieslandCampina, with 11,476 member dairy farms (supplying approximately 10.2 billion kilos of milk in 2019) in the Netherlands, Germany, and Belgium, with a total of 17,413 members.

RFC has branch offices in 34 countries and exports dairy products to more than 100 countries worldwide from the Netherlands.

Our Base-Case Scenario

In our base case for 2020, we assume:

- Revenue increase of about 3.4% in 2020, primarily driven by higher pricing in the specialized nutrition segment, while volumes should remain flat. Similarly, we expect price increases in the other divisions, with stable volumes overall. Increased marketing spending should support market share gains, notably in the consumer dairy division, but this would only materialize toward the end of 2020. Despite the currently volatile macroeconomic environment, we assume that staple goods will be relatively sheltered, as measures taken by authorities around the globe are insuring that people can still access food for their primary needs. We might see an increase in demand for basic goods because some people might develop irrational consumption behaviors, especially for food.

- Adjusted EBITDA margin of 8.1% in 2020, which represent a margin squeeze of about 50bps mainly owing to higher COGS. Given that the company could face some difficulties operating its facilities as COVID-19 rapidly spreads in Europe, we could see restrictive measures that lead some of the group's facilities to temporarily close.
- Capex remaining at about €500 million annually.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted debt to EBITDA of about 4.15x in 2020, and about 3.9x in 2021.
- FOCF to debt of about 2.7% in 2020 and about 5% in 2021.
- EBITDA interest coverage of about 15x-16x in 2020 and 2021.

Liquidity

We assess RFC's liquidity position as adequate under our criteria for agricultural cooperatives. We forecast that liquidity sources to uses will exceed 1.2x over the next 12 months and that sources would exceed uses even if EBITDA declines 20%. RFC has significant headroom under the financial covenants on its senior debt.

We estimate that principal liquidity sources for the 12 months from Dec. 31, 2019, include:

- Cash and cash equivalents of €342 million as of Dec. 31, 2019;
- An undrawn revolving credit facility (RCF) of €1,000 million maturing in more than a year; and
- Our forecast of cash funds from operations of about €552 million for the next 12 months.

For the same period, we estimate that principal liquidity uses include:

- Short-term debt maturities of about €579 million, comprising €275 million of commercial paper drawn at Dec. 31, 2019;
- Maximum seasonal working capital requirements of about €350 million and anticipated annual outflow of €75 million.
- Capex of €420 million for 2020;
- Non-controlling interests payments of about €63 million in 2020
- Cash outflow of €60 million, mainly tied to performance payments on member bonds.

Ratings Score Snapshot

Issuer credit rating: BBB/Negative/A-2

Business risk: Strong

- Country risk: Low

- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Significant

- Cash flow/leverage: Significant

Anchor: bbb

Modifiers

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

Stand-alone credit profile: bbb

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | Industrials: Key Credit Factors For Agricultural Cooperatives, March 17, 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: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed	
Koninklijke FrieslandCampina N.V.	
Issuer Credit Rating	BBB/Negative/A-2
Analytical Factors	

Ratings Affirmed	
Local Currency	bbb
Koninklijke FrieslandCampina N.V.	
Commercial Paper	A-2

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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.