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Research Update:

Koninklijke FrieslandCampin Outlook To Stable From Neg On Upcoming Capital Contribution From Its Parent; Rtgs Affirmed

June 25, 2021

Rating Action Overview

- Thanks to implementation of a new member financing framework at the parent level (Zuivelcoöperatie FrieslandCampina U.A.), dairy cooperative group Koninklijke FrieslandCampina (Royal FrieslandCampina or RFC) will receive an equity injection of close to €800 million in January 2022 that will allow the company to reduce its debt burden.
- We expect RFC will post debt to EBITDA of 3.5x-4.5x in the next 12-24 month, which is lower than we previously anticipated and clearly supports the current 'BBB' rating, even in the event of further operating setbacks.
- We revised the outlook on RFC to stable from negative, and affirmed the 'BBB/A-2' ratings.
- The stable outlook indicates that, thanks to this cash contribution, RFC will be able to lower its overall debt notably by redeeming an important share of member bonds we treat as debt under our criteria.

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Rating Action Rationale

Thanks to the implementation of a new member financing framework at the parent level (Zuivelcoöperatie FrieslandCampina U.A.), we expect RFC will get a direct capital contribution enabling it to reduce its debt burden as of January 2022. The Members Council Of FrieslandCampina adopted the implementation of new financing system establishing a stronger linkage between capital participation and milk supply for the cooperative and its member farmers. The instruments should also serve as a mechanism to distribute discretionary operating income to farmers in line with an established financial policy. This new framework aims to create more transparency in members' milk deliveries to the cooperatives and their overall financial support of the company. To deliver a specific volume of milk, farmers will need to hold a certain level of certificates that match their output on a predefined basis. The company aims to put in place various mechanisms to give every farmer a similar opportunity either to reduce or increase their milk supply and largely adopt this new financing framework. Existing instruments (member bonds free and fixed) will continue to be part of the capital structure of the company; nevertheless, RFC aims to reduce substantially its member bonds thanks to the direct contribution from its parent. It will translate into improving the quality of its equity, and we anticipate debt to EBTIDA (leverage) will decrease substantially in 2022. Therefore, we expect that the group's total debt burden will be reduced by €800 million, which will push its leverage ratio to the lower end of the 4.5x-3.5x range by the end of 2022.

The company's prior focus on improving profitability through the implementation of its commercial strategy and cost-saving programs partially offset the impact of COVID-19 on margins. The group was severely hit by the pandemic due to disruptions to both its food service business and hotel, restaurant, and catering (Horeca) channel, since lockdowns were implemented in the first half of 2020 and border closure between Hong Kong and mainland China also created significant distribution challenges. Additionally, the oil price collapse resulted in the devaluation of the Nigerian currency. This heavily impeded the group's ability to operate in the country, which is an important market for them. As a result, the group's cash was trapped in the country at a time when there were sizeable foreign currency headwinds at the group level. However, the company's first area of focus was to ensure business continuity within its global footprint while keeping its supply chain up and running. After a difficult first half of 2020, RFC implemented an array of cost initiatives to contain sales, general, and administrative (SG&A) spending, including temporarily reducing marketing spending and streamlining the group's business division to find additional savings and increase operational agility between its division. This follows work it has been conducting to fix structural inefficiencies in the company since 2018, including restructuring its manufacturing footprint and reorganizing some divisions to improve the utilization rate of their facilities. These efforts limited the negative effects stemming from the pandemic on its margin to 140 basis points (bps). We believe the impact would have been worse if these measures and restructuring weren't implemented prior to the pandemic.

We expect RFC's profitability will remain stable in 2021 before gradually recovering over 2022 and 2023 as the company's reaps the full benefits of its cost-improvement initiatives. For 2021, we anticipate that profitability will be almost stable thanks to ongoing recovery of its Chinese operations, and that competitive pressure will remain very strong, while the company works to resolves its route-to-market challenges. Also, we consider that RFC's Horeca and food service divisions may recover more slowly than the company anticipates, and we only foresee a very gradual recovery toward fourth-quarter 2021. Management has highlighted a potential path to recovering profitability through several cost initiatives across all its businesses, and hopes to achieve more than 70% of these cost improvements in its consumer dairy and trading businesses. We believe these initiatives will be complex to deploy in the short term, given the current competitive environment. However, we consider that the company's profitability will recover to above 9% in 2023, if it successfully redesigns its route to market in the key regions of Hong Kong and China, and fully achieves its cost-improvement targets in all divisions. We are confident in the group's ability to continue to work actively on its cost-improvement program and to achieve significant savings in the next 12-18 months. The company plans to make gradual progress toward its goal of achieving €95 million in savings by 2023, and expects to see some savings already in 2021, but we believe it could take longer for savings to materialize.

We expect free cash flow generation will be slightly lowered in 2021, due to inventory build-up, but that it should remain commensurate with our current rating. This follows improved free cash flow generation in 2020, mainly owing to working capital inflow and despite lower profitability. The company's free operating cash flow (FOCF) to debt for 2020 was 8.2x versus our expectation of close to 5x. On an absolute basis, this translated into FOCF of close to €300 million versus only €200 million in 2019. This improvement was mainly driven by large destocking translating into a positive working capital inflow of more than €90 million. Despite relatively stable margins and capital expenditure (capex) in line with the previous two years of about €400 million, we anticipate that FOCF generation should remain close to €250 million, which is commensurate with our 'BBB' rating. As topline and margins recover over 2022 and mainly in 2023, we expect FOCF will to rebound to €300 million in 2022 and to more than €425 million in 2023.

RFC is committed to keeping its investment-grade ratings and implemented several measures in past years to ensure stability and stronger control of cash flow to face inherent volatility of commodity prices that is likely to continue in the coming years. In 2018, the company began taking measures to tackle milk price volatility leading to shrinking profitability and a spike in leverage. Its first step was to implement a change in its milk money regulation to better balance the milk supply of its farmers with market demand and reduce its exposure to commodity price volatility. In 2019, the company redesigned its milk money regulation and introduced a guaranteed price system to bring more flexibly of its cost structure and offset part of volatility prices that created margins pressure. To retain its investment-grade status, the company also optimized its capital structure with notably the issuance of a €300 million hybrid security in September 2020, which we view as having intermediate equity content. Also, the company formalized an explicit milk payment subordination contract with its member farmers resulting in milk payment being contractually subordinated to debtholder in case of bankruptcy, creating further support for the 'BBB' rating.

Outlook

The stable outlook reflects that the implementation of new instruments at the parent level will allow RFC to redeem a large part of its member bonds that we currently treat as debt and improve its financial flexibility in the next 12-18 months. We now expect RFC will post debt to EBITDA of 3.5x-4.5x in the next 12-24 month, which clearly supports the current 'BBB' rating, even in the event of future further operating setbacks.

Downside scenario

We could lower the ratings if RFC were to face other operational headwinds, mainly due to high raw material prices, or inability to return leverage metrics in line with current ratings. In addition, if the group were to undertake a material debt-funded acquisition this would put pressure on credit metrics. Despite the upcoming capital contribution coming from its parent, if financial headroom were to be fully absorbed by one of the above mentioned factors we could lower our ratings.

Upside scenario

We could raise our ratings if we saw improvement in RFC's debt-to-EBITDA ratio to less than 3.5x on a sustainable basis leading to a stronger assessment of our financial risk profile. Moreover, a rating in the 'BBB+' category would be subject to significant improvements in the group's EBITDA margin; this could imply a successful turnaround of Chinese operations that have suffered in recent years from tightening regulation and local competition while the other divisions perform in line with our expectations.

Company Description

Netherlands-based, RFC is an agricultural cooperative group, with revenue of €11.1 billion and reported S&P Global Ratings-adjusted EBITDA of €806 million in 2020. RFC is among the fifth-largest global dairy groups globally.

The group produces and sells consumer milk, milk powder, dairy-based beverages, infant nutrition, cheese, butter, and desserts. RFC operates through five business divisions: consumer dairy, specialized nutrition, ingredients, trading, and professional.

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 and margin pressure remains tough. Additionally, margins were negatively impacted by COVID-19 headwinds, which directly affected food service and out-of-home channels.

RFC's vertically integrated business model enables it to control and manage volume inflow of raw materials, but also push farmers toward more sustainably produced milk to best fit consumers' increasing preference toward healthier lifestyle.

Currently, the group is working on turning around its commodity businesses (trading, professional, and consumer diary divisions), which tend to be exposed directly to volatile milk prices, but remain key to process sizeable volumes of milk collected from cooperative members' farms. Moreover, the group's ambition in increase traceability and premiumization of its ingredients and infant formula products should 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.

RFC is fully owned by the cooperative Zuivelcoöperatie FrieslandCampina, with 11,100-member dairy farms (supplying approximately 10.064 billion kilograms of milk in 2020), in the Netherlands, Germany, and Belgium, with a total of close to 17,000 individual members (farmers).

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

Our Base-Case Scenario

- Flat revenue in 2021, primarily driven by our anticipation of a decline in its dairy essentials division of 18% off-set by positive growth trends in the other divisions (3%-5%), due to regain in volumes. Increased marketing spending in 2021 should support market share gains throughout the year, notably in the dairy essential division.
- Revenue should increase by 6.5% in 2022, thanks to higher growth prospect for the diary essentials division after a challenging 2021 and large marketing spending; we expect other divisions to post growth of 4%-6% in 2022.
- An adjusted EBITDA margin of 7.3% in 2021, which similar to 2020 levels, mainly owing to a higher cost of goods sold reflecting relatively high milk prices anticipated in 2021. We do not anticipate a significant rebound in profitability due to ongoing challenges in the infant formula division, mainly in Hong Kong and China were competitive pressure remains fierce.

- In 2022, EBITDA margins should gradually recover to 7.6%, reflecting stable milk prices but a higher level of SG&A after two years of abnormal spending linked to the pandemic. However, we consider that the company will see profitability recover above 9% in 2023 on the back of successful distribution channels for infant formula in its key regions of Hong Kong and China, with targeted cost improvements fully achieved by then.
- Capex remaining at about €400 million in 2021, but increasing closer to historical levels of €500 million-€550 million annually in 2022 and 2023.
- FOCF of close to €250 million in 2021, which is slightly lower than in 2020 due to greater working capital volatility linked to inventory build-up; we expect FOCF will gradually recover to €300 million in 2022 and more than €400 million in 2023.

Key metrics

- Adjusted debt to EBITDA of about 4.3x in 2021, and about 2.8x in 2022.
- FOCF to debt of about 7% in 2021 and about 12% in 2022.
- EBITDA interest coverage of about 9x-10x 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 15%. RFC has significant headroom under the financial covenants on its senior debt.

We estimate that principal liquidity sources for the 12 months from March 31, 2021, include:

- Cash and cash equivalents of €35 million;
- 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 €684 million for the next 12 months.

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

- Short-term debt maturities of about €890 million, comprising €735 million of commercial paper drawn at March 31, 2021;
- Maximum seasonal working capital requirements of about €350 million captured in current commercial paper drawings and anticipated annual outflow of €25 million; and
- Capex of about €400 million-€500 million for 2021.

Environmental, Social, And Governance

In terms of environmental factors, we consider RFC performs in line with peers in the dairy industry that has acknowledged its negative impacts on the environment and is proactively working on implementing effective mitigants. The company's "From grass to glass" strategy where it controls the entire value chain enables it to better control carbon emission and soil contamination across its value chain that stem from dairy farming, which also include methane and nitrous oxide (laughing gas).

The company engages with various FMCG (fast-moving consumer good) companies, such as Danone and Barry Callebaut, to accelerate the transition toward sustainable dairy farming and specific food additives that potentially reduce emission of greenhouse gases and to help its farmers transitions toward sustainable practices.

The group also aims to reduce its scope 3 emissions by having all its packaging made of recyclable/reusable material by 2025 and by reusing 99% of its waste materials. In 2020, 87.3% of its total packaging portfolio was already recyclable. The company also aims to sustainably procure 100% of its agricultural raw materials by 2025, and targets having 95% of its raw materials be traceable back to their source (currently 91% of the company's palm oil, soy, pulp and paper, and cocoa are traceable to the source).

On the social front, we view RFC as an active player in its communities through its initiative to prohibit child labor and forced or compulsory labor, and to promote union rights and freedom of association.

In terms of governance, the group is aligned with the Dutch Corporate Governance, which includes high standards for competition law and antitrust, bribery and corruption, conflict of interests, money laundering, and trade control.

Issue Ratings - Subordination Risk Analysis

Capital structure

We do not see any structural subordination problem with bulk of the debt being unsecured and issued at parent level, secured debt and debt in operating subsidiaries clearly accounting for less than 50% of total debt. We rate only rate the €300 million perpetual bonds for which we granted intermediate equity.

Koninklijke FrieslandCampina holds most of its debt at the holding level. Most of the group's debt is unsecured and subordinated hybrids, including €1,6 billion of member bonds fully treated as debt (no equity content), a €295 million of cooperative loan also with receiving no equity content and a €300 million perpetual bonds for which we granted intermediate equity content.

Analytical conclusions

We only rate the €300 million subordinated perpetual bonds 'BB+' and continue to assess it as having intermediate equity content (50% debt, 50% equity).

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/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)
- 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: BBB

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, 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 | 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: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings List

Ratings Affirmed; Outlook Action

Koninklijke FrieslandCampina N.V.		
	To	From
Issuer Credit Rating	BBB/Stable/A-2	BBB/Negative/A-2
Senior Secured	bbb	bbb
Junior Subordinated	BB+	BB+
Commercial Paper	A-2	A-2