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## Research Update:

# Natura Cosméticos Outlook Revised To Stable From Negative On Lower Turnaround Risk; 'BB' And 'brAAA' Ratings Affirmed

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## Research Update:

# Natura Cosméticos Outlook Revised To Stable From Negative On Lower Turnaround Risk; 'BB' And 'brAAA' Ratings Affirmed

## Overview

- The performance of Brazil-based cosmetics company, Natura Cosméticos S.A., has been in line with our expectations. The Body Shop's (TBS) turnaround plan is on track, while its operations in other Latin American countries and the retail business Aesop have delivered strong growth over the past few quarters, offsetting the still sluggish margins improvement in the company's domestic operations.
- We're revising the outlook on the company to stable from negative. We're also affirming our global scale issuer credit and issue-level ratings on Natura at 'BB' and our national scale issuer and issue ratings at 'brAAA'.
- The stable outlook reflects our view that risks stemming from overhauling TBS following its acquisition have diminished, enabling Natura to capture operating improvements and gradually increase cash flows, while it gradually extends its debt maturity profile. Although operations in the company's largest market, Brazil, continue to suffer from fierce competition and the currency's slide, Natura's foreign operations and its commitment to reduce shareholders' remunerations have helped contain leverage. We expect the company to reach a debt to EBITDA close to 3x by the end of 2018.

## Rating Action

On Aug. 23, 2018, S&P Global Ratings revised its outlook on Natura Cosméticos S.A. (Natura) to stable from negative. We also affirmed our global scale issuer credit and issue-level ratings on the company at 'BB'. In addition, we affirmed our national scale issuer credit and issue-level ratings at 'brAAA'. We have also kept recovery rating at '3' on Natura's unsecured debt rated, reflecting our expectation of an average recovery of 50%, unchanged.

## Rationale

The outlook revision reflects our view of diminished risks associated with the turnaround of TBS's operations. We believe Natura's strategy for TBS has been assertive so far, consisting of price adjustments, optimization of brick-and-mortar stores, closure of 52 locations, and cost controls, with further potential benefits stemming from a global procurement of raw materials

and other back-office synergies. These factors increased TBS's reported EBITDA (excluding the overhaul expenses) to R\$82 million in the first half of 2018 from a loss in the same period of 2017. Reorganization is still ongoing, and should total about R\$125 million in additional expenses in 2018 and 2019.

In addition, Natura's operations in other Latin American countries and its Australian retail operation, Aesop, have posted strong revenue growth and maintained resilient margins, which we expect to persist over the next couple of years. The replication of Natura's direct-sales model in Latin America and the continued global expansion of Aesop's stores support our estimates of a revenue increase of around 7% in 2019.

In Brazil, which is Natura's largest market, the company was able to recapture market share through the restructuring of its direct-sales channel by increasing the focus on key consultants and improving productivity levels. It has also opened some retail stores in key locations to promote the brand. Nevertheless, the company has struggled to raise its margins due to depreciation of the currency that increased input costs and due to still fierce competition. The latter makes price adjustments to end products more difficult, while competition tends to foster promotional activities to support volumes and share. These factors will restrain Natura's margins below 20% this year, in our view, and they're likely to remain in that area for the next several quarters due to Brazil's sluggish economic growth. On a consolidated basis, we expect the company's adjusted EBITDA margins to be around 18.5% in 2018 and improving gradually afterwards.

Natura expects to reduce expenses by R\$420 million in the next three years through gains of scale on volumes purchased, logistics, third parties services, packaging and inputs. Our base-case forecast only considers a portion of these synergies, which should allow the company to improve adjusted EBITDA margins to around 20% as of 2020.

The company has maintained a more conservative approach to shareholders' remuneration, and we expect its payout ratio to remain at around 30%, down from 100%, of net income distribution in recent past, contributing to the deleveraging. We expect Natura to maintain this policy until the company returns to its historical leverage of below 2x. It has also issued a \$750 million bond to fund TBS's acquisition and additional issuances to extend the overall maturity profile. The bond is fully hedged into Brazilian reais, because the majority of Natura's cash flow still comes from its operation in Brazil, excluding exchange-rate risks.

Our base-case scenario for Natura assumes the following assumptions:

- Brazil's GDP growth of 1.6% in 2018 and 2.4% in 2019;
- Average CPI in Brazil at 3.7% and 4.1% in 2018 and 2019, respectively;
- End-of-period foreign-exchange rate at R\$3.70 per \$1 in 2018 and R\$3.75 per \$1 2019;
- Operations in Brazil at fairly stable volumes and higher productivity in

the direct-sales channel, slightly improving margins starting in 2019;

- The Latin America operation to increase its market share in direct sales, with volumes growing by 4.5%;
- Aesop's volumes rising through the opening of new stores, with growth of around 25% in 2018 and 10% in 2019;
- TBS's net revenue of about R\$3.8 billion in 2018 and R\$4.2 billion in 2019, with reported EBITDA margins in the 7.5%-9.5% range, reflecting partial effect of the turnaround plan that identified major gaps in profitability in each of the unit's regional operations;
- Capital expenditures of R\$560 million in 2018 and R\$650 million in 2019;
- A dividend payout at around 30% of previous-year net income in the next few years;
- We adjust the company's debt by operating leases, which add R\$1.8 billion to the debt and about R\$500 million to the EBITDA.

Given our assumptions above, we expect the following metrics:

- Consolidated net revenue of R\$12.5 billion – R\$13.0 billion in 2018 and R\$13.5 billion – R\$14.0 billion in 2019;
- Adjusted consolidated EBITDA margins around 18.5% in 2018 and in the 19-20% range for the next years afterwards;
- Debt to EBITDA close to 3.0x in 2018 and 2.5-3.0x in 2019; and
- EBITDA interest coverage of 2.5x-3.0x in 2018 and above 3.0x in 2019.

The rating on Natura is one notch above the 'BB-' rating on Brazil. Therefore, we continue to test the company's ability to withstand a sovereign default scenario. In such a scenario, we assume a GDP decline of 10%, inflation at 12.5% affecting domestic costs, doubling of floating rate interest rate, and a 50% currency depreciation. As result, Natura's EBITDA in Brazil would decline about 40% from our base-case assumptions, offset by the increase in cash flow contributions from the international operations. We also assume the company would reduce its annual capex to maintenance levels of around R\$300 million. In the default scenario, we also consider a 10% haircut on the company's cash and bank deposits and 70% on short-term investment position.

Natura would have enough liquidity sources to cover its short-term needs in the year of a simulated stress scenario, which allows the company to have a higher rating than on the sovereign. This is thanks to Natura's operations in international markets, relatively low exposure to short-term debt in foreign currency, and sound cash position and cash generation.

## **Liquidity**

We maintain our view the company's liquidity as adequate. We expect Natura's sources of cash to exceed uses by about 1.7x in the next 12 months and net sources to remain positive even in a scenario of a 15% drop in EBITDA. Thanks

to management's ongoing debt refinancing, Natura has maintained large cash position and manageable short-term debt maturities. Nevertheless, the company is still somewhat exposed to large maturities in the next 24 months, which prevents a stronger liquidity assessment. However, we expect the company to continue refinancing with comfortable time cushion.

We understand that Natura has a well-established relationship with banks and generally prudent risk management. Additionally, we expect the company to comply with all of its covenants with significant headroom of above 25%, which require a maximum leverage of 3.5x--measured by debt to EBITDA in 2018 and below 3.25x in 2019 excluding lease.

**Main liquidity sources:**

- Cash and short-term investments of R\$1.9 billion as of June 30, 2018;
- Forecasted funds from operations (FFO) of around R\$1.1 billion over the next 12 months; and
- Available revolving credit facility at TBS of £70 million, or around R\$360 million.

**Main liquidity uses:**

- Short-term debt of R\$1 billion as of June 30, 2018;
- Working capital outflows of about R\$195 million over the next 12 months;
- Capex of R\$610 million in the next 12 months; and
- Dividend distribution of 30% of net income.

## **Outlook**

The stable outlook reflects our expectation that Natura will gradually deleverage in the next 12 months. It also reflects our view of diminished risks stemming from restructuring TBS after its acquisition. We expect Natura's operations in Brazil to post modest growth with gains of productivity starting in 2019, a robust growth at Aesop and operations in other Latin American countries, and ongoing margin improvement at TBS. Our base-case forecast considers that Natura will reach a debt to EBITDA of about 3x in 2018 and between 2.5x and 3.0x in 2019, and EBITDA interest coverage of 2.5x-3.0x in 2018 and above 3.0x in 2019.

### **Downside scenario**

We could lower the ratings in the next 12-18 months if Natura faces operating problems at TBS while the Brazilian market further deteriorates--through falling demand, rising competition, increasing raw materials costs due to the currency's depreciation--deviating the company from its current deleverage path. In this scenario, we would see debt to EBITDA and EBITDA interest coverage consistently above 3.0x and below 3x, respectively.

Also, we could downgrade Natura if it doesn't maintain a conservative

financial policy with comfortable liquidity cushion in order to pass the hypothetical sovereign stress scenario.

### **Upside scenario**

We could raise the ratings in the next 24 months if Natura's turnaround and investments bear fruit. We would expect the company to demonstrate a tangible improvement in profitability with margins consistently above 23% and more robust revenue increase by defending its market share in Brazil even in a scenario of weak market conditions, while the company continues to grow abroad. In this scenario, we would see debt to EBITDA consistently below 3.0x, FFO to debt between 30% and 45%, and free operating cash flow to debt above 15%. Natura would also need to maintain comfortable liquidity cushion in order to maintain its global scale rating above that on the sovereign.

## **Ratings Score Snapshot**

Corporate Credit Rating:

Global scale	BB/Stable/--
National scale	brAAA/Stable/--

Business risk: Fair

- Country risk: Moderately high
- Industry risk: Low
- Competitive position: Fair

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable Rating analysis: Neutral (no impact)

## **Issue Ratings--Recovery Analysis**

### **Key analytical factors**

We rate Natura's senior unsecured debt at 'BB', reflecting the issuer credit rating on the company, given our expectation of meaningful recovery expectation around 50% on a hypothetical default scenario.

The company's debt is mainly composed of working capital lines, a bond, and local debentures. In addition, Natura has an available committed revolving

credit line of about R\$360 million, which we consider would be 85% drawn in a default scenario. Our hypothetical default scenario occurs in 2023 with a combination of prolonged period of lower volumes and recession affecting, eroding demand in Brazil while TBS's performance deteriorates, along with a tighter access to credit markets. Our simulated path to default for Natura would also impact working capital because inventories would take longer to be sold. Under such a scenario, Natura would be unable to generate enough cash to service its debt or refinance short-term maturities with banks or capital markets.

We consider that following a hypothetical bankruptcy process, the company would be restructured and continue to operate, generating higher value to creditors compared to a liquidation course. We value Natura using a 6.0x multiple applied to our projected emergence-level EBITDA of R\$768.9 million, arriving at a stressed enterprise value of R\$4.6 billion.

### **Simulated default assumptions**

- Simulated year of default: 2023
- EBITDA at emergence: R\$770 million
- EBITDA multiple: 6x
- Estimated gross enterprise value (EV): R\$4.6 billion
- Net EV, after 5% of administrative expenses: R\$4.3 billion

### **Simplified waterfall**

- Total claims at subsidiaries: R\$483 million
- Secured debt: R\$382 million
- Unsecured debt: R\$6.7 billion (bank loans, unsecured note and debentures)
- Recovery expectations on unsecured debt: 50%-70%

### **Related Criteria**

- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- 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 - Industrials: Key Credit Factors For The Retail And Restaurants 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: Ratings Above The Sovereign--Corporate And Government Ratings: 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Natura Cosméticos S.A.		
Issuer Credit Rating		
Global Scale	BB/Stable/--	BB/Negative/--
Brazil National Scale	brAAA/Stable/--	brAAA/Negative/--

Ratings Affirmed

Natura Cosméticos S.A.	
Senior Unsecured	
Global Scale	BB
National Scale	brAAA
Recovery Rating	3(50%)

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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.



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