Research Update:

Natura Downgraded To 'BB-' From 'BB' On Higher Consolidated Leverage Following Avon's Acquisition; Outlook Stable

January 8, 2020

Rating Action Overview

- Brazil-based cosmetics company, Natura Cosméticos S.A. (Natura), completed the acquisition of Avon Products Inc. (Avon) on Jan. 3, 2020. Both entities are now controlled by a new parent company, Natura&Co Holding S.A. (Natura&Co), which is now the driver of Natura's credit quality.
- On Jan. 8, 2020, S&P Global Ratings lowered its global scale issuer credit and issue-level ratings to 'BB-' from 'BB', and its national scale issuer credit and issue-level ratings to 'brAA+' from 'brAAA' on Natura. The recovery rating on the unsecured debts remains at '3' (50%). At the same time, we removed all ratings from CreditWatch with negative implications, where we placed them on March 25, 2019.
- The downgrade reflects the higher leverage at the consolidated level, along with risks to improve Avon's currently weak operations.
- The stable outlook reflects our expectations that Natura&Co should be able to perform Avon's turnaround and reverse the declining EBITDA in the next 12-24 months, with leverage declining to 3.0x-3.5x by the end of 2020 and to 2.5x-3.0x in 2021, compared the forecasted pro forma of close to 4.0x in 2019.

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Rating Action Rationale

Natura is a core entity to Natura&Co.

Natura and Avon are legally independent entities, with no cross guaranteed debt between them, but Natura&Co fully owns both companies. The group's credit profile drives the rating on Natura due to its importance to the group--representing about 75% of total EBITDA--its integral role to the business strategy, and cash flow contribution. In addition, the former controlling shareholders of Natura will control Natura&Co, and the group will inherit the board and senior management of

Natura.

The downgrade reflects higher leverage and risks to improve margins at the group level.

We currently view Natura's 'bb' stand-alone credit profile (SACP) as stronger than Natura&Co's credit quality due to Avon's small EBITDA contribution and the weaker consolidated leverage metrics. Additional debt stemming from the merger will be limited, given that the acquisition was an all-share merger agreement, and the only additional debt will stem from the $91 million (or about R$365 million) accrued dividend payment to Cerberus Capital Management (Cerberus). According to our estimates, adjusted gross debt should fall, because Cerberus has opted to convert its preferred stock position at Avon into common shares of Natura&Co, and we previously treated the preferred stock as equivalent to debt at Avon.

We expect consolidated debt to EBITDA of close to 4.0x in 2019 and to drop to the 3.0x-3.5x range in 2020 and to 2.5x-3.0x in 2021, compared with our forecast of close to 3.0x in 2019 for Natura on a stand-alone basis, because of Avon's highly leveraged financial risk profile. We also believe risks associated with the turnaround of Avon's operations are still meaningful, mainly reflecting the difficulty in stanching the EBITDA decline of the past several years, despite the recent progress, such as headcount reduction and working capital optimization.

We believe Avon's overhaul is now more credible under the joint management with Natura. The latter company reversed the declining productivity and engagement of its representatives, and has been recovering its market share since 2017. We expect Avon to improve its margins and speed up digitalization of its platforms. However, significant amount of restructuring charges will still heavily weigh on Avon's EBITDA margins in the next two years, which we expect at 5%-7%. On a consolidated basis, we expect Natura&Co's EBITDA margin of close to 10% in 2019 and 2020, below the industry average, and well below those of leading peers such as L'Oreal and Estée Lauder, with margins in the 25% area.

But synergies could result in rating upside.

Our base-case forecast doesn't include significant synergies stemming from the merger, but they could reach $200 million - $300 million per year according to Natura's guidance. The company expects this would stem from sourcing optimization, distribution channels, and production facilities (unifying channels and production in Brazil, benefiting from Avon's strong position in Mexico etc.). As per management, synergies could materialize starting in 2021, allowing Natura&Co's debt to EBITDA to approach 2.0x, compared with our assumptions of 2.5x-3.0x for the same year.

Outlook

The stable outlook reflects our expectation that the group will focus on the integration of its business units, improving Avon's performance, maintaining the growth pace at The Body Shop (TBS), direct sales in Latin America, and Aesop, with fairly stable operations in Natura's Brazil operations. We expect the consolidated figures to gradually deleverage in the coming years, lowering consolidated debt to EBITDA to 3.0x-3.5x by the end of 2020 and in the 2.5x-3.0x range in 2021. We expect the group's funds from operations (FFO) cash interest coverage ratio in the 2.5x-3.0x range in 2020 and above 3.0x in 2021. We also expect each subsidiary to continue to refinance its debt. Natura's stand-alone debt to EBITDA metric should be about 3.0x in 2019 and in the 2.0x-3.0x range afterwards.

Downside scenario

We could take a negative rating action in the next 12 months if the new management fails to improve Avon's operations and it continues to lose market share, further eroding consolidated margins, which could lead to a consolidated FFO cash interest coverage ratio below 2.0x and debt to EBITDA above 4.0x.

We could lower Natura's SACP amid weaker stand-alone credit metrics, with its debt to EBITDA consistently above 3.0x and EBITDA interest coverage below 3.0x. This scenario would likely weaken the group's credit profile.

Upside scenario

A positive rating action in the next 12 months could stem from a faster recovery in Avon's operations, resulting in Natura&Co's consolidated debt to EBITDA below 3.0x and FFO cash interest close to 4.0x. In addition, any positive rating action would depend on the holding's ability to withstand a hypothetical sovereign default scenario, because the ratings are currently at the same level as those on Brazil (BB-/Positive/B).

We could raise Natura's SACP amid stronger operating performance and credit metrics. In this scenario, we would see its stand-alone debt to EBITDA consistently below 3.0x, FFO to debt between 30% and 45%, and free operating cash flow to debt above 15%.

Company Description

Natura&Co is the fourth-largest global cosmetics group, with annual revenues of about $10 billion. The group consists of Natura, Avon, Aesop, and TBS. The group is present in more than 100 countries across all continents, with a leading position in Brazil, and wide portfolio diversification, with offerings to different costumers' tiers and channel diversification. The group has a leading position in the direct sales models for cosmetics, with more than 6 million representatives, along with 3,200 stores.

Our Base-Case Scenario

- Real annual global GDP growth of 3.0%-3.5% over the next few years, including average growth of about 2.0% in Latin America in the next two years.
- Brazil's GDP growth of about 2.0% in 2020 and 2021.
- Average CPI in Brazil close to 4.0% in 2020 and 2021.
- Average foreign-exchange (FX) rate in the R$4.10-R$4.20 range in 2020.
- Avon's revenue to decline about 8% in 2019 and remain flat in the next couple of years, mainly due to weaker revenue at its Latin American and EMEA operations, with the lower number of representatives despite improving productivity and product mix. EBITDA margins to drop to mid-single digits in 2019 and 2020, due to significant expenses stemming from restructuring, recovering to close to 10% starting in 2021.
- High single-digit revenue growth at Natura's Brazilian operations in 2019 and the mid-single

digit pace in 2020 and 2021;

- A still robust growth of Aesop and Natura's operations in Latin America in 2020, with market share gains in direct sales and opening of new stores.
- TBS's net revenue of about R$4.0 billion – R$4.5 billion in 2019, R$4.6 billion in 2020, and close to R$5.0 billion in 2021, with reported EBITDA margins improving to the 8%-12% range.
- Capital expenditures (capex) of R$1.1 billion in 2019, and R$1.3 billion – R$1.4 billion in 2020 and 2021. The higher capex in 2020 is mainly due to Avon's turnaround plan.
- Dividend payout of 30% of the company's net income.
- Natura&Co's promissory note issuances totaling R$1.0 billion for working capital and to fund the payment of preferred dividend to Cerberus.

Based on these assumptions, we arrive at the following credit metrics for Natura&Co:

- Total revenue of about R$34.5 billion in 2019, R$36 billion in 2020, and R$37 billion in 2021;
- Consolidated EBITDA margin in the 10%-11% range in 2020 and 12%-13% in 2021;
- Consolidated Debt to EBITDA of about 4.0x in 2019, 3.0x-3.5x in 2020, and 2.5x-3.0x in 2021; and
- FFO cash interest coverage ratio in the 2.0x-3.0x range in 2019 and 2020, and above 3.0x in 2021.

We expect the following metrics for Natura, excluding Avon's figures:

- Adjusted EBITDA margin in the 18%-20% range in the next years;
- Debt to EBITDA close to 3.0x in 2019 and in the 2.0x-2.5x range in 2020 and 2021;
- FFO to debt of 25%-30% in 2019 and 2020, and about 35% in 2021; and
- EBITDA interest coverage of about 4.0x in 2019 and in the 4.5x-5.0x range in 2020 and 2021.

Liquidity

We view Natura liquidity as adequate. We expect Natura&Co to hold significant liquidity cushion in the following 12 months from September 2019, with cash sources over uses of about 2x. Despite Natura&Co's large cash position and solid relationship with banks, due to the likely significant debt refinancing at Avon and Natura starting in 2021, we currently view it has limited ability to absorb high-impact, low-probability events without refinancing. At the parent level, Natura&Co has a payment acceleration financial covenant on its promissory note that requires consolidated net debt to EBITDA to be below 4.0x, which we expect the group to comply with a cushion of above 15%. It's measured quarterly and excludes the impacts of IFRS 16. We also expect each subsidiary to comply with its debt covenants with a cushion of above 15%.

Main liquidity sources:

- Cash and short-term investments of about R$4 billion as of September 2019;
- Forecasted FFO of about R$1.8 billion in the next 12 months;
- TBS's available revolving credit facility of £70 million (or about R$370 million), and Natura's undrawn committed credit lines of R$150 million.

Main liquidity uses:

- Consolidated short-term debt position of about R$905 million as of Sept. 30, 2019;
- Working capital outflows of about R$68 million in the next 12 months;
- Capex of R$1.3 billion in the next 12 months;
- Dividend distribution of 30% of net income; and
- Cash disbursement of about $91 million (or about R$365 million) related to accrued dividends to Cerberus.

Covenants

The covenants for Natura's own debt exclude Avon's figures, and require Natura to maintain a maximum net debt to EBITDA of 3.25x in 2019 and 3.0x in 2020. We expect Natura to maintain headroom of at least 15% under its covenant for the next 12-24 months.

Issue Ratings - Recovery Analysis

Key analytical factors

Natura doesn't guarantee any of the debt of Avon or that of Natura&Co. If this structure changes, it could impact subordination structure and the issue-level rating of each subsidiary. We lowered our senior unsecured note ratings on Natura to 'BB-' and its unsecured debenture rating to 'brAA+' in line with the new issuer credit ratings on both scale. The recovery rating remains at '3' (50%).

Natura's debt mainly consists of working capital lines, a bond, and local debentures. In addition, Natura has an available committed revolving credit line of about R$480 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 eroding demand in Brazil, while TBS's performance deteriorates, along with a tighter access to credit markets. We consider that following a hypothetical bankruptcy process, the company would be restructured and continue to operate, generating higher value to creditors, compared with a scenario of the company's liquidation. We value Natura using a 6.0x multiple applied to our projected emergence-level EBITDA of R$790 million, arriving at a stressed enterprise value of R$4.8 billion.

Simulated default assumptions

- Simulated year of default: 2023
- EBITDA at emergence: R$790 million
- EBITDA multiple: 6x
- Estimated gross enterprise value (EV): R$4.8 billion
- Net EV, after 5% of administrative expenses: R$4.5 billion

Simplified waterfall

- Total claims at subsidiaries: R$540 million
- Senior secured debt and other priority claims: R$170 million
- Unsecured debt: R$6.9 billion (bank loans, unsecured note and debentures)
- Recovery expectations on unsecured debt: 50%-70%

Ratings Score Snapshot

Corporate Credit Rating:

- Global scale BB-/Stable/--
- National scale brAA+/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)

SACP: bb

Entity status within group: Core

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 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: Country Risk Assessment Methodology And Assumptions, 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Natura Cosmeticos S.A.		
Issuer Credit Rating	BB-/Stable/--	BB/Watch Neg/--
Brazil National Scale	brAA+/Stable/--	brAAA/Watch Neg/--
Natura Cosmeticos S.A.		
Senior Unsecured	BB-	BB/Watch Neg
Senior Unsecured	brAA+	brAAA/Watch Neg

; CreditWatch/Outlook Action

	To	From
Natura Cosmeticos S.A.		
Senior Unsecured		
US$750 mil 5.375% bnds due 02/01/2023	BB-	BB /Watch Neg
Recovery Rating	3(50%)	3(50%)
BRL1.577 bil fltg rate deb due 08/19/2024	brAA+	brAAA /Watch Neg
Recovery Rating	3(50%)	3(50%)
BRL1.827 mil fltg rate Segunda Serie deb due 09/25/2021	brAA+	brAAA /Watch Neg
Recovery Rating	3(50%)	3(50%)
BRL150 mil fltg rate deb ser Terceira due 03/16/2020	brAA+	brAAA /Watch Neg
Recovery Rating	3(50%)	3(50%)
BRL302.65 mil fltg rate deb ser TERCEIRA due 09/21/2022	brAA+	brAAA /Watch Neg
Recovery Rating	3(50%)	3(50%)
BRL308.31 mil fltg rate deb ser SEGUNDA due 09/21/2021	brAA+	brAAA /Watch Neg

Recovery Rating	3(50%)	3(50%)
BRL389.04 mil fltg rate deb ser PRIMEIRA due 09/21/2020	brAA+	brAAA /Watch Neg
Recovery Rating	3(50%)	3(50%)
BRL772.73 mil fltg rate Primeira Serie deb due 09/25/2020	brAA+	brAAA /Watch Neg
Recovery Rating	3(50%)	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 for further information. 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.

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