

Natura Cosmetics S.A. (/gws/en/esp/issr/90714090)



Fitch Assigns 'BB' IDR to Natura Cosmetics; Outlook Stable

Fitch Ratings-Chicago-19 January 2018: Fitch Ratings has assigned 'BB' Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) and a National Scale rating of 'AA(bra)' to Natura Cosmetics S.A. Fitch has also assigned a 'BB(EXP)' rating to Natura's proposed senior unsecured notes, in the amount of up to USD1.15 billion, due to 2023 or 2025. Proceeds of the issuance will be used to repay the promissory notes issued to finance the acquisition of The Body Shop (TBS).

The Rating Outlook is Stable.

Natura's ratings reflect its solid business position in the Cosmetics, Fragrances and Toilette (CF&T) sector in Brazil and Latin America which is due to its strong brand value and recognition, large operating scale, elaborate direct sales structure and track record of maintaining a solid capital structure. Natura's current ratings are pressured by high leverage due to its recent debt-financed acquisition of TBS for EUR1 billion. This acquisition is accompanied by high execution risks, as TBS has a business model that unlike Natura is focused mainly on retail operations and is primarily based outside of Brazil. It is part of an attempt by Natura to move from a direct sales single-model to an omni-channel strategy. The fierce competition scenario of the CF&T industry, with its well-capitalized players and threat from online retailers, is also incorporated into the analysis.

Fitch expects Natura to remain committed to a sound credit profile in the medium term while proceeding with its business reorganization/integration. Fitch expects Natura's net leverage, measured by the ratio of net adjusted debt/ EBITDAR, to remain high during 2017 and 2018 at around 4.0x, with a modest decline during 2019 as the integration process moves forward.

KEY RATING DRIVERS

New Industry Dynamics: The CF&T industry is attractive due to its resilience throughout economic cycles. Nevertheless, there is a new business dynamic in the market, which is bringing more volatility to results and altering traditional business models. With the channel shifting toward e-commerce and specialty stores, direct sales and traditional consumer companies are facing intense competition from multi-national beauty giants that have implemented omni-channel strategies, as well as smaller, nimbler, fast-growing companies. In Brazil, the sharp economic downturn during 2015 and 2016 put further pressure on the industry, with consumers shifting to lower-ticket products.

Challenge to Reformulate Business Model: The structural change in the competitive environment is leading Natura to alter its business strategy. Near term, Natura is seeking to strengthen its innovation pipeline to compete in new categories in the market while developing its multi-channel, multi-category and multi-product platforms. Since 2016, Natura has opened 18 stores, mostly in Sao Paulo and Rio de Janeiro. In the medium to long term, Fitch expects to have its sales channel divided between direct sales (40%), online (30%) and stores (30%). Fitch believes that the company should be able to capture benefits from these changes; however, stronger marketing initiatives, higher R&D expenses and, a lower product mix should drive margins down. Fitch's base case considers EBITDA margins of around 15%, including TBS, which represents a significant drop from historical margins in the range of 23%-25%.

Execution Risks on TBS Integration: Over the long term, we see the acquisition of TBS as positive, as it enhances Natura's product portfolio, sales channel and geographic diversification. Both companies share the same commitment to organic/natural products. The acquisition helps Natura with its strategy to expand its retail operations, moving it away from a single direct-sales structure. Nowadays, only 3% of The Body Shop's sales are through direct sales, and Latin America, Natura's key market, represents only 2% of its sales. Nevertheless, TBS's large business scale in regions/markets where Natura does not operate and its massive retail operations have elevated execution risk. TBS has been losing operating margins under the management of L'Oreal over the last few years and Natura will be challenged to turnaround its results.

Increasing Geographic Diversification: Once the integration is complete, Natura should benefit from increased business and geographic diversification. Brazil currently represents the bulk of Natura's operations, accounting for 65% of its revenues and 72% of its EBITDA generation. Per Fitch's calculations, including TBS, the revenue split should be 46% Brazil, 32% TBS, 18% Latin America (excluding Brazil) and 5% Aesop. For EBITDA, the split would be 60% Brazil, 15% Latin America (excluding Brazil), 18% TBS and 7% Aesop.

High Leverage: Fitch expects Natura's net leverage, measured by net adjusted debt/ EBITDAR, to remain high during 2017 and 2018 at around 4.0x, with a modest decline during 2019 as the integration process moves forward. Fitch's leverage calculation

includes adjustments related to operating lease rentals.

Higher Capex Should Pressure FCF: Natura's operating cash flow generation has shown some volatility over the last two years as a result of the challenging industry scenario and ongoing changes in business strategy that have impacted profitability. However, operational performance has started to show some recovery during 2017. During 2015, 2016 and LTM Sept. 30 2017, Natura generated BRL1.5 billion, BRL775 million and BRL1 billion of CFFO, respectively. Lower capex and dividends distribution helped to boost FCF during 2016 and 2017; FCF was BRL471 million in 2015, BRL346 million in 2016 and BRL595 million LTM Sept. 30, 2017. In the next two to three years, Fitch expects FCF to be in the range of BRL50 million-BRL150 million, as capex should grow to BRL550-BRL650 million to support Natura's new strategy to change its business model and TBS's turnaround.

Natura has a track record of shareholder-friendly policy, with average net income payout of around 90% during 2012-2015. Fitch expects dividends to fall to the minimum required by Natura's bylaws (30%) as the company seeks to lower its leverage.

DERIVATION SUMMARY

Natura's 'BB/AA(bra)' ratings reflect its good business position in the CF&T industry, underpinned by strong brand recognition, with a focus on sustainability, large scale enabling a competitive cost structure and a large direct-sales structure. Natura's brand and product portfolio, with its higher-ticket products is well positioned against its main competitor in the direct sales segment, Avon Products, Inc. (IDR B+/Negative Outlook). The company also has a track record of less volatile operating cash flow and more conservative credit metrics. Even at this time, when Natura's leverage has deteriorated following the debt-financed acquisition, it shows lower leverage compared to Avon. Natura has the challenge to continue to conduct its activities on a profitable basis while preserving its strong market position in Brazil, within the context of increasing competition. Natura's market share in the Brazilian market declined to 10.4% in 2016 from almost 14.1% in 2012, according to EuroMonitor. Natura also faces strong competition from a local player, O Boticario (not rated), which presents a stronger financial profile and solid business profile, supported mainly by its bricks-and-mortar franchise chain.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- Low-single-digit decline in volumes;
- Consolidated EBITDA margins around 15%, following acquisition of TBS;
- Increase in Capex levels to around BRL550 million;
- Dividend payouts at 30%;
- Debt refinancing as planned.

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action

--Given the challenges Natura faces to recover its profitability and manage the TBS's acquisition, Fitch does not foresee an upgrade in the short to medium term.

--The company's ability to return TBS's EBITDA margin to above 9.5% while managing capex and SG&A, and moving net leverage ratios closer to 2.5x could lead to a positive rating action.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action

- EBITDA margins declining to below 14% on a recurrent basis;
- Net adjusted leverage above 4.0x by the end of 2019 and/or diminished prospects of falling to 3.5x by 2020;
- Competitive pressures leading to severe loss in market-share; or a significant deterioration in its brand reputation.

LIQUIDITY

Natura has a track record of maintaining strong liquidity. As of Sept. 30, 2017, Natura had BRL3.7 billion in cash and marketable securities against BRL2.1 billion of short-term debt, leading to cash/short-term debt ratio of 1.8x, this compares to average ratio of 1.7x from 2013 to 2016. On Sept. 30, 2017, the company had total debt of BRL9.7 billion. Natura faces some debt concentration in the medium term with an additional BRL4.5 billion coming due by the end of 2019, including BRL3.7 billion of the bridge loan used to fund the acquisition. The company's main strategy is to refinance it with a cross-border bond issuance or, in the case of capital market volatility it should be refinanced with local banks.

FULL LIST OF RATING ACTIONS

Fitch has assigned the following ratings:

Natura Cosméticos S.A.

--Long-Term Foreign and Local Currency IDRs of 'BB';

--National scale Long-Term rating of 'AA(bra)';

-- USD1.15 billion senior unsecured notes due to 2023 or 2025 of 'BB(EXP)'.

The Rating Outlook is Stable.

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Summary of Financial Statement Adjustments

--Total debt includes net derivatives;

--Operating lease expenses pertaining to the real estate of the stores, majority TBS, are capitalized using a multiple of 8x.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria

Corporate Rating Criteria (pub. 07 Aug 2017) (<https://www.fitchratings.com/site/re/901296>)

National Scale Ratings Criteria (pub. 07 Mar 2017) (<https://www.fitchratings.com/site/re/895106>)

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Natura Cosmetics S.A.	-	Local Currency Long Term Issuer Default Rating	Unsolicited
Natura Cosmetics S.A.	-	National Long Term Rating	Unsolicited
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