FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Royal FrieslandCampina's Debut Hybrid 'BBB-(EXP)'

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Fitch Ratings - Milan - 01 Sep 2020: Fitch Ratings has assigned Dutch dairy company Royal FrieslandCampina NV's (RFC) planned debut EUR300 million perpetual subordinated hybrid securities a 'BBB-(EXP)' rating. The proposed securities qualify for 50% equity credit. The assignment of the final rating is contingent on the receipt of final documents conforming materially to the preliminary documentation. Fitch has also affirmed RFC's Long-Term Issuer Default Rating (IDR) at 'BBB+'. The Outlook remains Negative.

RFC's 'BBB+' IDR is underpinned by its large scale in the global dairy market and balanced geographic footprint across developed and emerging markets. The rating also reflects management's initiatives to protect the balance sheet and our expectation that RFC will maintain a conservative financial policy, without material M&A transactions until it sees a sustained improvement in profit and cash flow generation.

The Negative Outlook reflects execution risks related to the sustainability of RFC's EBITDA margin recovery in 2019 due to challenges from stiff competition in key markets and disruptions from the coronavirus pandemic. It also considers that free cash flow (FCF) may remain negative until 2022.

KEY RATING DRIVERS

HYBRID NOTES

Rating Reflects Deep Subordination: The notes are rated two notches below RFC's IDR, given their deep subordination and consequently, lower recovery prospects in a liquidation or bankruptcy scenario relative to the senior obligations. In the capital structure, the notes only rank senior to the claims of equity shareholders and rank pari passu with RFC's member bonds and cooperative loan.

50% Equity Credit: The securities qualify for 50% equity credit as they meet Fitch's criteria with regard to deep subordination, perpetual nature, full discretion to defer coupons for at least five years, absence of covenants and limited events of default. These are key equity-like characteristics, affording RFC greater financial flexibility. Equity credit is limited to 50% given the notes' cumulative interest coupon, a feature considered more debt-like in nature.

Effective Maturity Date: While the notes are perpetual, Fitch deems the effective maturity to be in 25.25 years from the issuance or 20 years from the first coupon reset date, in accordance with the agency's hybrid criteria. From this date, the coupon step-up is within Fitch's aggregate threshold rate of 100bp, but the issuer will no longer be subject to replacement language expressing the company's intent to redeem the instrument at its call date with the proceeds of a similar instrument or with equity. According to Fitch's criteria, the equity credit of 50% would change to 0% five years before the effective maturity date.

Cumulative Coupon Limits Equity Treatment: Interest coupon deferrals are cumulative, which result in 50% equity treatment and 50% debt treatment of the hybrid notes by Fitch. Despite the 50% equity treatment, Fitch includes the full coupon payment in its interest or fixed charge coverage ratios. The company will be obliged to make a mandatory settlement of deferred interest payments under certain circumstances, including the declaration of a cash dividend or supplementary cash payments, which are dividend-alike in nature.

KEY RATING DRIVERS FOR RFC

Moderate Disruptions from Coronavirus: The coronavirus pandemic had a negative impact on RFC's EBITDA in 1H20, primarily due to higher logistics costs, lost sales in the foodservice channel and increased volatility of milk commodity prices, affecting its business in commoditised dairy products, such as cheese, butter and milk powder. This was combined with additional pressure from the closure of the Chinese border with Hong Kong, which is an entry point for some of the company's products to China and RFC's 1H20 Fitchcalculated EBITDA contracted by around 4%. The company has been able to partly protect profits with cost savings.

We assume these dynamics will continue challenging the company's performance in 2H20 and 1H21.

Turnaround Yet to be Achieved: RFC's EBITDA recovery in 2019 was an important achievement, confirming that the company's efforts to restore sales growth in branded products and reduce margin volatility and dependence on raw milk prices are starting to pay off. However, the competition in key markets of The Netherlands, Germany and China, where it sells value-added consumer dairy and special nutrition products, remains intense. In our view, disruptions from the pandemic may delay its turnaround in these markets and pose risks to the execution of its business plan for 2021-2022.

Innovation Key in China: Fitch believes that innovation and premiumisation of product portfolios, development of new sales channels and widening of distribution to lower-tier cities are key to protecting and growing RFC's share in China's infant nutrition market, which accounted for a substantial part of EBITDA in 2019. RFC's competitive position in China in 2020 should also be supported by the resolution of the lactoferrin shortage issue that affected its 2019 performance.

EBITDA Recovery Taking Time: RFC's EBITDA improved in 2019 after it fell sharply in 2017 and 2018 but EBITDA margin (2019: 7.7%) remains well below 2016's 11.2%. We are cautious in our profit recovery assumptions for 2021-2022, given the coronavirus-related challenges the company is facing in 2020, and competition in key markets. We therefore believe that rapid EBITDA margin recovery towards our positive rating sensitivity for 8% is unlikely in 2020-2021. This is reflected in the Negative Outlook.

Leverage to Benefit from Hybrids Issuance: RFC's funds from operations (FFO) net leverage fell to 1.9x in 2019 (2018: 2.4x). We expect a mild re-leveraging in 2020 due to a reduction in profits and increased discretionary payments to member farmers. However, we calculate that the debt refinancing with the proposed issuance of hybrid securities will help keep leverage from increasing by more than 0.3x. Better visibility on deleveraging prospects from 2021, coupled with steady profits and FCF recovery, could lead to a revision of the Outlook to Stable.

Conservative Financial Policy Assumed: We expect RFC to maintain a conservative financial policy in cash performance payments to members (treated as dividends), capex and M&A until it sees a sustained improvement in profit and cash flow generation. In 2019, despite weaker operating cash flow, RFC preserved its FCF by cutting capex and managed to reduce its debt with proceeds from non-core asset disposals.

We believe that RFC retains flexibility in managing its capex but expect an increase in its discretionary payments to member farmers in 2020, due to projected higher member take-out of cash performance premiums and partial redemption of member bonds.

Global Dairy Producer: RFC is the world's fifth-largest dairy producer, with well-known brands in The Netherlands and various developing markets. It benefits from a wide range of dairy-based products from commoditised cheese and butter to high-value-added specialised nutrition, including infant formula. RFC also has geographic diversification across emerging markets and especially Asia and Africa, where the supply of products of reliable quality is a competitive advantage and long-term growth fundamentals are strong. We view this as credit-positive, even though profits from these countries can be volatile.

Milk Payment Subordination: We view the mechanism of subordination of milk payments to senior creditors, which the cooperative introduced in its statute in July 2020, as a confirmation of members' commitment to protect the credit quality of the cooperative. At the current rating level of 'BBB+' it does not result in an uplift to the rating as the subordination mechanism is designed to come into effect only in the event of liquidation. Fitch would consider an uplift to the senior unsecured debt rating when the IDR moves down the rating scale, reflecting a close to default risk.

Cooperative Set-up Neutral to Rating: Fitch assesses RFC's ownership by a cooperative as neutral for the rating. We recognise the benefits of a reliable and stable supply of high-quality raw materials from cooperative members, but this is balanced by RFC's obligation to collect and purchase all the milk produced by member farmers. Milk supplies in excess of production capacity may lead to an inability to fully process milk into value-added products. However, RFC has been able to maintain a balance between its capacity and supplies from member farmers.

DERIVATION SUMMARY

The dairy market is inherently volatile as raw milk prices and selling prices for dairy products are largely outside producers' control. Market volatility leads to instability in dairy companies' profits and working capital. RFC's high share of value-added products in sales helps the company achieve greater control over selling prices and stronger profit margins than industry peers but does not fully isolate it from high sector risks. Fitch therefore expects RFC to adhere to a more conservative capital structure than similarly rated peers in the packaged food sector.

RFC is not fully comparable with other rated peers operating in the dairy market, such as Nestle SA (A+/Stable), Fonterra Co-operative Group Limited (A/Negative) and Dairy Farmers of America, Inc. (DFA, BBB/Negative). RFC's credit profile is characterised by higher volatility than Nestle due to the company's substantially higher exposure to commoditised products and more limited diversification across product categories and geographies. Furthermore, RFC's scale in the global food sector is substantially smaller than Nestle.

Similar to RFC, Fonterra's and DFA's operations are concentrated on dairy products produced under a cooperative set-up. The companies have similar business scales. However, Fonterra's and DFA's ratings benefit from a stronger mechanism of subordination of milk payments to the company's principal and interest obligations (and other costs), as specified in their by-laws. This allows them to operate under higher leverage than RFC. RFC's stronger profitability and geographic diversification than DFA's contributes to the higher rating.

No Country Ceiling, parent-subsidiary linkage or operating environment aspects affect RFC's rating.

KEY ASSUMPTIONS

Fitch's Key Assumptions within our Rating Case for the Issuer

- No recurrence of global lockdowns due to the coronavirus pandemic;

- Revenue growth in low single-digits, supported by growth in sales of value-added products;

- EBITDA reduction in 2020 due to greater losses in the Dairy Essentials segment; gradual improvement in EBITDA margin over 2021-2023;

- Stable profit distribution policy (55% added to equity, 10% distributed to farmers shareholders as fixed-member bonds and 35% distributed as performance premium - accounted as dividends by Fitch) with total member take-out of cash performance premium of less than EUR400 million over 2020-2023;

- Capex at EUR380 million in 2020 and below EUR450 million per year over 2021-2023;

- M&A spending not exceeding EUR250 million in total over 2020-2023.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action (revision of Outlook to Stable)/upgrade:

- Organic sales growth of value-added products and sustained improvement in EBITDA margin, confirming RFC's ability to withstand competitive pressures and to smooth profit volatility.

- Positive FCF margin.

- Visibility of FFO net leverage falling below 2.0x by end-2021 on a sustained basis.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Evidence that earning profile is subject to increased volatility on a sustained basis.

- Inability to recover EBITDA margin to 8%.

- Negative FCF in the low single-digits for more than two years, driven by weak operating performance, an aggressive financial policy or withdrawals of performance premiums from member accounts (treated as dividends) substantially exceeding accrued amounts.

- FFO net leverage persistently above 2.0x.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best-and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: At end-2019, RFC had around EUR1.2 billion of available liquidity, of which EUR196 million was Fitch-adjusted readily available cash and EUR990 million was an undrawn portion under a EUR1 billion credit facility maturing in October 2024. Liquidity was sufficient to cover short-term debt of EUR525 million (excluding lease liabilities) and expected negative FCF in 2020.

We believe RFC retains good access to external liquidity to fund any additional funding needs should the impact from the pandemic be more severe than we currently assume.

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch views as equity RFC's EUR1,641 million member bonds and EUR295 million perpetual shareholder loan outstanding at end-2019.

Fitch excludes from its EBITDA calculation the milk price paid to member dairy farmers in the form of performance premium and issuance of member bonds (2019: EUR138 million).

Fitch treats as common dividends the cash part of the performance premium paid out to the member dairy farmers (2019: EUR97 million).

Fitch treats interest paid to holders of member bonds and certificates as preferred dividends (2019: EUR48 million, of which EUR43 million was interest paid on member bonds). Fitch reclassifies interest paid on certificates to preferred dividends from working capital changes (EUR5 million).

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Royal FrieslandCampina NV	LT IDR	BBB+ Rating Outlook Negative	Affirmed	BBB+ Rating Outlook Negative
	ST IDR	F2	Affirmed	F2
• senior unsecured	LT	BBB+	Affirmed	BBB+
• subordinated	LT	BBB-(EXP)	Expected Rating	

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Corporate Hybrids Treatment and Notching Criteria (pub. 11 Nov 2019)

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Royal FrieslandCampina NV EU Issued

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