Research Update:

German Food Wholesaler Metro AG 'BBB-/A-3' Ratings Put On CreditWatch Negative On Possible Takeover And Higher Debt

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Rating Action Overview

- EP Global Commerce (EPGC) has offered to buy all of Metro AG's outstanding shares for a cash payment that values Metro's equity at about €5.8 billion.
- Given the uncertainties around the funding structure behind the offer and the scale of the transaction, we believe that Metro's debt could increase under its new owners, if the bid is successful, amid low existing rating headroom.
- We are therefore placing our 'BBB-/A-3' issuer credit ratings on Metro as well as our issue ratings on its debt on CreditWatch with negative implications.
- We intend to resolve the CreditWatch upon completion of the takeover, after having assessed the group's new capital structure and business plan.

Rating Action Rationale

The CreditWatch placement follows EPGC's conditional offer to buy Metro's outstanding shares and reflects the increasing uncertainty regarding Metro's future capital structure. Held by Czech investor Daniel Kretinsky and his Slovakian partner Patrik Tkac, EPGC has offered to acquire Metro's entire issued ordinary shares for €16 per share and preference shares for €13.80 per share, which values Metro's equity at about €5.8 billion. Although we have no information on Metro's post-acquisition capital structure, we think, given the size of the offer, it is possible that the transaction could be funded with a meaningful amount of additional debt. This could result in a higher adjusted debt-to-EBITDA ratio relative to our current forecast for Metro of 3.2x-3.5x in the fiscal year ending Sept. 30, 2019 (fiscal 2019), excluding any cash proceeds from the planned, but not yet contracted, sale of the hypermarket business Real as well as potential benefits from a considered strategic partnership in China. Given our view of financial leverage with other investments of EPGC's controlling owner, Mr. Kretinsky, we believe that EPGC's financial policy is less aggressive than that of a conventional financial sponsor or private equity firm.

We highlight that Metro's bond documentation does not include a change of control clause, which would protect bond investors from any deterioration in credit metrics following a debt-funded acquisition. At the same time, a sizeable amount of Metro's liquidity facilities have a change of control clause that would become active if EPGC takes control of Metro and, as a result of the shareholder change with additional debt burden, we lowered our rating on Metro. However, the acquirer could replace these facilities at a higher group level in case of a successful takeover.

We believe that EPGC is seeking full control of the group. The offer is voluntary and conditional on EPGC acquiring a share sufficient to establish a domination and profit-and-loss transfer agreement, which would require 75% of the votes cast in a general meeting. Metro's management views the offer as significantly undervaluing the company. However, we understand that EPGC currently owns about 17.5% of Metro, and that the current shareholder Franz Haniel & Cie. GmbH has irrevocably committed to sell their remaining 15.2% stake to EPGC during the voluntary public takeover offer process.

In its current form and excluding the implications of the possible acquisition, our view of Metro's financial risk profile and overall creditworthiness is primarily based on our expectation that the company will maintain S&P Global Ratings-adjusted funds from operations (FFO) to debt just above 20%. Accordingly, in our view, Metro has very limited rating headroom under the existing rating. Our expectation is supported by robust EBITDA generation and notwithstanding ongoing operating pressure in Russia and planned investments in e-commerce capabilities. Our projections are also based on completion of expected real estate disposals, robust sales generation in local currency, and execution on the sale of Real as planned. However, it excludes any potential benefits from the considered strategic partnership in China.

CreditWatch

We aim to resolve the CreditWatch placement after completion of the proposed acquisition, or once we are certain about the transaction details and that it will take place, which we expect could take a few months.

We would likely lower our ratings on Metro after the potential acquisition depending on the company's new capital structure following any new debt added through the transaction, the new owners' financial policy, and our resulting projections of the company's credit metrics and cash flow generation. We could also lower the rating on Metro if the company's business, scope, or strategy were to weaken because of a change in ownership.

We could affirm the ratings if Metro's debt does not increase due to the transaction, if EPGC funds the transaction with equity, or if the transaction is unsuccessful. Any affirmation, however, would also hinge on operating performance and projected credit metrics in line with our base case (adjusted FFO to debt of 20%-22% and debt-to-EBITDA of 3.2x-3.5x) that also includes the successful execution of real estate disposals and the Real sale, with Real being an already discontinued business. Given the current low headroom for the rating category under the FFO and cash flow ratios, our current rating is predicated on sustainable improvement in operating margins and meaningful FOCF generation.

Company Description

Germany-based Metro AG is Europe's largest wholesale and food service operator and the second largest in the world. It has strong business-to-business operations under its wholesale business in 36 countries, targeting hotels, restaurants, catering companies, and trading companies. The group also has active real estate operations through which it buys land parcels, and then develops and sells them after a few years, thus realizing value appreciation in the process.

For fiscal 2018, Metro group reported revenue of €29.5 billion and EBITDA of €1.4 billion. Metro's store network comprises 769 locations. The company registered €128 million of gains from the sale of real estate during the year.

Metro put its hypermarket business, Real, up for sale and as such considers it a discontinued operation in its financial reporting from fiscal 2018.

Our Base-Case Scenario

Excluding any implications of the possible acquisition from EPGC, we assume the following in our base case:

- Real GDP growth of 0.5% in Germany, 1.4% in France, and 1.1% in eurozone in 2019, and about 1.3%-1.6% in these regions in 2020. We expect inflation of 1.3%-1.8% in 2019 and 2020 in these countries, which will have a moderately negative impact on consumer spending.
- Revenue declining by 0%-0.5% in fiscal 2019 and increasing by about 0%-0.5% in fiscal 2020, due to weak Russian operations coupled with the negative impact of currency fluctuations, offset by organic growth.
- Margins remaining under pressure due to unfavorable foreign exchange impacts, mainly relating to movements Russian ruble and Turkish lira to the reporting currency euro and increasing competition, but supported by lower restructuring costs and about €200 million of real estate gains.
- Annual capital expenditure of €600 million, in line with management's guidance.
- Stable dividends of about €260 million in fiscals 2019 and 2020, in line with the historical payout ratios.
- No major acquisitions.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures for fiscals 2019 and 2020:

- An EBITDA margin of about 6.0%-6.4% in fiscal 2019 and 5.8%-6.2% in fiscal 2020 (6.0% in fiscal 2018).
- Debt to EBITDA of about 3.2x-3.5x (3.3x in fiscal 2018).
- FFO to debt of about 20%-22% (20.8% in fiscal 2018).
- Discretionary cash flow to debt no greater than 5% (5% in fiscal 2018).

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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 | Industrials: Key Credit Factors For The Retail And Restaurants Industry, Nov. 19, 2013
- 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- German Food Wholesaler Metro's Rating Headroom Remains Tight Amid Soft Trading And Progress On Real Disposal, May 10, 2019
- Metro Shareholders Would Receive A Mandatory Offer If EPGC Shareholding Exceeds 30%, March 1, 2019
- Metro AG, Jan. 18, 2019

Ratings List

CreditWatch Action

	To	From
Metro AG		
Issuer Credit Rating	BBB-/Watch Neg/A-3	BBB-/Stable/A-3
Senior Unsecured	BBB-/Watch Neg	BBB-
Commercial Paper	A-3/Watch Neg	A-3