Fitch Ratings

Fitch Affirms Royal FrieslandCampina at 'BBB+'; Stable Outlook

Fitch Ratings - Moscow - 21 September 2018: Fitch Ratings has affirmed Dutch dairy producer Royal FrieslandCampina NV's (RFC) Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB+'. The Outlook on IDR is Stable. Fitch has also affirmed RFC's Short-Term IDR at 'F2'.

The rating affirmation and Stable Outlook reflect our expectation that RFC's leverage will fall over 2019-2021 after exceeding levels compatible with 'BBB+' rating so far in 2018. This is based on our assumption that RFC will be able to grow sales organically and restore EBITDA margin despite intense competition in key markets of operations. The ratings also take into account our expectation that the company will maintain a conservative financial policy and refrain from material M&A transactions until there is a sustained improvement in its existing business.

RATING ACTIONS

ENTITY	RATING		PRIOR
Royal FrieslandCampina NV	ST IDR F2 Affirmed		F2
senior unsecured	LT BBB+ Affirmed		BBB+
Notes	LT BBB+ Affirmed		BBB+

KEY RATING DRIVERS

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

Unfavourable Milk Price Developments: In 2H17 and 1H18 RFC's profits were hit by a failure to fully pass on the increased price of raw milk to selling prices. This applied not only to commoditised products of the Dairy Essentials division, which is a price-taker on sales and procurement, but also to more value-added dairy products as it takes time to renegotiate prices in the retail channel. We believe that divergence between prices for basic dairy products (cheese, butter and milk powder) and raw milk is not sustainable in the long run and should normalise in 2H18-2019, driving smaller losses in the Dairy Essentials division (1H18: loss of EUR132 million).

RFC has developed a number of measures to reduce margin volatility of basic products but we are cautious to assume any improvements until we see evidence of greater margin stability through commodity price cycles.

Competitive Pressures: RFC has recently been facing heightened competition in China in addition to Benelux and Germany, where the market has been tough in the past two years. Furthermore, sales in Pakistan, which the company entered in December 2016, declined due to local protests against packaged milk. Fitch believes that RFC's ability to withstand challenges in these markets is critical as they account for around 50% of the company's sales. Protection of its market position in China (9% of sales in 2017) is strategically important as the market provides strong growth opportunities and is one of the most profitable for RFC.

EBITDA to Recover: We project a gradual EBITDA recovery from 2H18 after it fell 23% and 31% yoy in 2017 and 1H18 respectively, with EBITDA margin dropping to 7.7% and 6.9% during the same period (FY16: 11.0%; 1H17: 9.3%). In 2H18 EBITDA growth will be supported by smaller losses in basic dairy, while over the longer term we expect the major drivers of profit recovery to be renewed organic growth, in particular in China, development of sales through foodservice channels and a turnaround in Germany and Pakistan. We expect targeted EUR150 million cost savings will largely be reinvested into product innovation and marketing to support the competitiveness of RFC's branded products.

Global Dairy Producer: RFC's rating is supported by the company's market position as the sixth-largest dairy producer globally with well-recognised brands in the Netherlands and various developing markets. RFC benefits from a wide range of dairy-based products from commoditised cheese and butter to high value-added specialised nutrition, including infant formula. We also positively view RFC's geographic diversification and footprint across emerging markets and especially Asia, where long-term growth fundamentals are strong.

Diminished Rating Headroom: Rating headroom for RFC has diminished significantly due to operating under-performance in 2017-2018. We project that in 2018 funds flow from operations (FFO) adjusted net leverage will exceed 2.5x, which we consider as the highest level compatible with a 'BBB+' rating in the dairy sector. Nevertheless, today's rating affirmation and Stable Outlook reflect our expectation of that RFC will deleverage towards 2.3x by 2021. No evidence of improved operating performance or more aggressive financial policies, eroding the deleveraging path, may lead to a negative rating action.

Cushion from Lower Performance Payments: We expect RFC to pay lower performance premiums in 2018-2020 than over the past four years to cushion a reduction in profits. Performance premium represents a small part of milk price RFC pays to farmers, which is linked to the company's performance and is treated by Fitch as a dividend. RFC measures its attractiveness to member farmers by the ability to offer higher price for agricultural supplies than other cooperatives and we believe that dependence of performance premiums on net profit aligns the interests of the member farmers with those of RFC's creditors.

Conservative Financial Policy Assumed: The rating incorporates our expectation that RFC will maintain a conservative financial policy in terms of cash performance payments, capex and M&A. We expect RFC to continue to adhere to its historically conservative capital structure, although its internal leverage target allows the company to incur more debt.

Cooperative Set-up Neutral to Ratings: Fitch assesses RFC's ownership by a cooperative as neutral for the ratings. 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. So far, RFC has been able to keep the balance between its capacity and supplies from member farmers.

DERIVATION SUMMARY

RFC is not fully comparable to other rated peers operating in the dairy market, such as Nestle SA (AA-/ Negative), Fonterra Co-operative Group Limited (A/ Stable) and Land o Lakes Inc. (BBB-/ Stable). Nestle's credit profile is characterised by lower volatility than RFC's due to the company's substantially smaller exposure to commoditised products and well-diversified operations across various packaged food categories and geographies. Furthermore, Nestle's rating reflects the group's strong market position as the largest food company globally and high profit margins. Similarly to RFC's, Fonterra's operations are also concentrated on dairy products. Both companies have similar scale and profitability. However, Fonterra's rating benefits from effective subordination of milk payments to the company's principal and interest obligations (and other costs), as specified in Fonterra constitution. In contrast to RFC, Land O'Lakes operates in the animal nutrition and crop inputs segments. RFC is rated higher than Land O'Lakes due to its higher profitability and operational scale and lower leverage.

KEY ASSUMPTIONS

Fitch's Key Assumptions within our Rating Case for the Issuer
- Restored organic sales growth in value-added products from 2019
- Gradual improvement in EBITDA margin to above 9% in 2021
- Stable profit distribution policy (55% added to equity, 10% distributed to farmers shareholders as fixed-member bonds and 35% distributed as performance premium in cash - accounted as dividends by Fitch)
- Capex at around 4.5% of revenue
- No material M&A in 2018-2019 as Fitch expects RFC to focus on improving organic growth and the cost structure of its existing business
- EUR300 million M&A spending over 2020-2021

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
- A further increase of scale in profitable and stable businesses, enhancing product and geographic diversification and reducing the proportion of sales from the more volatile Dairy Essentials division
- Further improvement in product or geographic diversification and/ or leaner cost structure driving EBITDA margin sustainably above 12% (2017: 7.7%) and FCF margin consistently above 2% (2017: -2.1%)
- FFO adjusted net leverage below 1.5x (2017: 2.3x)

Developments That May, Individually or Collectively, Lead to Negative Rating Action
- Evidence that the group's earning profile is subject to increased volatility on a sustained basis
- Inability to recover EBITDA margin to 9%
- Negative FCF, in the low single digits of sales, for more than two years driven by weak operating performance or aggressive financial policies
- FFO adjusted net leverage persistently above 2.5x

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: At end-June 2018 RFC had over EUR1.2 billion of available liquidity, of which EUR348 million related to Fitch-adjusted readily available cash and a EUR980 million undrawn portion under the group's EUR1 billion revolving credit facility maturing in 2022. Liquidity was sufficient to cover short-term debt of EUR726 million.

SUMMARY OF FINANCIAL STATEMENT ADJUSTMENTS

Fitch adjusted end-2017 debt by applying a multiple of 8x the yearly operating lease expense (2017: EUR66 million).

Fitch excluded from readily available cash the cash held in non-investment-grade countries and applied a discount of 30% to the cash held in countries that are experiencing high currency volatility. Total cash excluded amounted to EUR126 million at end-2017.

Fitch adjusted end-2017 debt by deducting EUR25 million to reflect value of debt after the impact of hedging instruments.

Fitch assigned 100% equity credit to RFC's EUR1,596 million member bonds and EUR295 million perpetual shareholder loan outstanding at end-2017.

Fitch excluded from its EBITDA calculation the milk price paid to member dairy farmers in the form of performance premium and issuance of member bonds (2017: EUR142 million). Fitch also excluded net non-operating non-recurring income and expenses from EBITDA (2017: EUR24 million).

Fitch treated as common dividends the cash part of the performance premium paid out to the member dairy farmers (2017: EUR185 million).

Fitch treated interest paid to holders of member bonds and certificates as preferred dividends (2017: EUR44 million, of which EUR37million was interest paid on member bonds). Fitch reclassified interest paid on certificates from changes in working capital (EUR7 million).

Fitch treated dividends received and dividends paid to minorities as part of operating cash flow (2017: EUR81 million).

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Applicable Criteria

Corporate Rating Criteria (pub. 23 Mar 2018) (/site/re/10023785)
Sector Navigators (pub. 23 Mar 2018) (/site/re/10023790)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form (/site/dodd-frank-disclosure/10045388)
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