

Rating Action: Moody's confirms Localiza's Ba2 rating following antitrust agency's approval of merger with Unidas with restrictions; stable outlook

20 Dec 2021

New York, December 20, 2021 -- Moody's Investors Service ("Moody's") has today confirmed Localiza Rent a Car S.A. ("Localiza")'s Ba2 global scale rating. The outlook was changed to stable from rating under review. This concludes the review for upgrade initiated on November 20, 2020.

The rating action follows Brazil's antitrust agency Conselho Administrativo de Defesa Econômica (CADE)'s decision on December 15, 2021 to approve the merger between Localiza and Unidas S.A. (Unidas) with restrictions, including the sale of a portion of its fleet, agencies and used car stores in the rent-a-car segment, the divestiture of the Unidas brand, limitations on further inorganic growth, among others.

The merger will be made through a share swap that will result in the incorporation of Unidas by Localiza and will improve Localiza's scale, bargaining strength and profitability due to cost synergies. Despite the improvements, the restrictions imposed by CADE will limit the upside potential in the company's profitability and market share, especially in the car rental segment. Accordingly, Localiza's credit metrics and cash generation will not immediately change after the incorporation and the company will incur integration and execution risks, implying a Moody's-adjusted leverage of around 3-4x through growth cycles. Additionally, Localiza will remain exposed to Brazil's economic environment and local debt market to finance future fleet growth, which limits the company's ability to be rated above Brazil's sovereign rating (Ba2 stable) at the closing of the transaction.

Confirmations:

..Issuer: Localiza Rent a Car S.A.

.... Corporate Family Rating, Confirmed at Ba2

Outlook Actions:

..Issuer: Localiza Rent a Car S.A.

....Outlook, Changed To Stable From Rating Under Review

RATINGS RATIONALE

Localiza's Ba2 rating is supported by the company's stable operating performance and cash flow, and resilient and flexible business model, which helps it weather economic and auto market slowdowns. Localiza's leading market shares in both car and fleet rental segments in Brazil, and its improved scale and market share after the merger with Unidas also support the rating. The company has historically maintained robust profitability as a result of low fleet maintenance requirements, high utilization rates, attractive discounts from automobile manufacturers and expertise in the used-car sale market. The rating also reflects the company's adequate corporate governance practices and strong liquidity.

Conversely, Localiza's rating is constrained by the capital-intensive nature of the car rental business, as well as its lack of a significant international footprint, with virtually 100% of revenues generated in Brazil. The company's rising gross Moody's-adjusted leverage stemming from its fast growth strategy and the integration and execution risks related to the merger further constrains its rating.

Moody's estimates that Localiza will generate annual revenue of about BRL15-17 billion and EBITDA margin between 25-30% after the merger and restrictions imposed by CADE and will have a total fleet of about 400-450 thousand cars, representing 40% to 45% of Brazil's total car rental and fleet management sector. The merger will increase the company's exposure to the fleet management segment, which has a less flexible business model than the car rental business, but that brings more stability to cash flows given the existence of long-term contracts with clients.

Localiza's operating performance improved sequentially along with the surge on Brazil's car rental demand since the bottom in April and May 2020, with consolidated EBITDA increasing to BRL3.6 billion in the twelve months ended September 2021, from BRL1.9 billion in 2020. Despite the demand drop in the car rental segment and the closure of used car sales stores in Q2 2020 due to the pandemic, the company's adjusted gross leverage declined with lower car purchases related initially to the temporary suspension of automotive production in Brazil during the pandemic and later to the chip shortage, ending the 12 months that ended September 2021 at 3.1x (down from 4.3x at the end of 2020). The company's cash position also remained strong at BRL3.5 billion as of September 2021 (compared to BRL4.0 billion as of year-end 2020) with the lower growth capex, supporting net leverage ratios and covenant compliance.

The company's gross leverage will increase slightly to around 3.5x after the incorporation of Unidas, but the entity's combined cash position will also increase with proceeds from the fleet disposal required to comply with CADE's restrictions, which will help to fund part of future organic growth. When the chip shortage in the automotive sector stabilizes, Moody's expects Localiza's leverage to increase again to close to 4x because of the sector's fast growth pace and Localiza's strategy to finance part of the fleet growth with debt. So far, the increase in Localiza's EBITDA has not been sufficient to offset the debt-financed expansion of its fleet, but with the synergy potential of the merger and rising yields and tariffs coming from higher interest rates, the company's leverage will decline over time and cash generation will increase.

LIQUIDITY

As of September 2021, Localiza reported BRL3.5 billion in cash and cash equivalents on its balance sheet and BRL1.6 billion in debt maturing until year-end 2022. In October 2021, Localiza issued BRL2.0 billion in new debentures for liability management which will improve liquidity further. Pro forma to the merger, Moody's estimates that Localiza will have a cash position of around BRL8.0 billion (including proceeds from asset disposals, Unidas' extraordinary dividend payment and short-term investments linked to Unidas' shareholders tax expenses on the capital gain on the share swap) and short-term debt of BRL3.0 billion. Additionally, the company will have a consolidated fleet of about 400-450 thousand vehicles (both in car and fleet rental divisions), mostly unencumbered and with an estimated market value of above BRL20 billion, which is an alternative source of liquidity, especially during economic downturns. The company's cash balance, alongside its unencumbered fleet value, will cover the totality of the combined total Moody's-adjusted debt of BRL19.6 billion. The company's current high cash position and proven ability to sell cars in a timely manner to raise cash mitigates the risks associated with high leverage and covenant breach, as the company can quickly adjust its cash position to offset the lower EBITDA stream during economic downturns.

RATING OUTLOOK

The stable outlook reflects Moody's expectations that Localiza will continue to grow while maintaining solid profitability and adequate leverage and cash generation.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATING

The rating could be downgraded if Localiza's liquidity deteriorates because of weakness in operations and inability to sell used cars, or if its car rental utilization rate decline to below 60% for an extended period of time. A sustained deterioration in credit metrics, measured by gross debt/EBITDA sustainably above 4.0x and EBITDA interest coverage falling below 3.0x without prospects of improvement could also lead to a downgrade. Finally, a downgrade of Brazil's sovereign rating could result in a downgrade of Localiza's rating.

Localiza's rating could be upgraded if the company is able to increase its market share, geographic diversification and revenue, while maintaining healthy credit metrics on a sustained basis. An upgrade of Brazil's sovereign rating would also be required for an upgrade of Localiza's rating.

COMPANY PROFILE

Founded in 1973 and headquartered in Belo Horizonte, Minas Gerais, Brazil, Localiza operates car rental and fleet rental businesses and has a used car sale business to deploy and renew its fleet in Brazil. The company also franchises rental car operations in Brazil and in five countries in South America. As of September 2021, the company had a total fleet of 273,233 cars in Brazil and five other countries. The company is the market leader in Brazil in terms of car rental, with the largest number of car rental locations and presence in all main Brazilian airports. In the 12 months ended September 2021, the company reported net revenue of BRL11.1 billion (\$2.1 billion) and EBITDA of BRL3.3 billion. Unidas is the second largest rent-a-car and the largest fleet management company in Brazil, with a total fleet of 165,370 cars at the end of September 2021. The company reported BRL6.4 billion in revenues and a 34% EBITDA margin in the twelve months ended September 2021.

The principal methodology used in this rating was Equipment and Transportation Rental Industry published in April 2017 and available at https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1061773. Alternatively, please see the Rating Methodologies page on www.moody.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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