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Research Update:

Localiza And Unidas Ratings Affirmed On Merger's Completion, Outlook Still Stable

July 14, 2022

Rating Action Overview

- Localiza Rent a Car S.A. (Localiza) and Companhia de Locacao das Americas S.A. (Unidas) recently received approval from the Brazilian antitrust authority to sell some assets, which was the requirement for their merger. The closing occurred on July 1, 2022.
- The business combination of the first- and second-largest players in the Brazilian car rental industry increases the scale that should bolster competitive advantages.
- Still, the merger's completion doesn't affect ratings on both companies, because we cap our 'BB+' global scale rating on Localiza at two notches above that on Brazil (BB-/Stable/B) and at the same level as our transfer and convertibility (T&C) assessment of the country. The 'brAAA' national scale issuer credit and issue-level ratings on both companies are at the highest point of our Brazilian national scale ratings.
- On July 14, 2022, S&P Global Ratings affirmed its 'BB+' issuer credit rating on Localiza and its 'brAAA' ratings on Localiza and Unidas. We also affirmed all the companies' issue-level ratings at 'brAAA' and kept recovery ratings for senior unsecured debentures unchanged at '3'.
- The stable outlook on both entities reflects the one on Brazil, given the cap of two notches above the sovereign rating.

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Rating Action Rationale

The merger will result in larger scale, further strengthening Localiza's leading position in Brazil. Localiza and Unidas are in the final stages to complete the merger of their operations, through which Unidas is now fully consolidated under Localiza. In our view, the merger will further strengthen Localiza's leading position in Brazil's car rental industry, with the larger asset base (about 450,000 cars, considering 49,000 cars to be sold soon) given that Unidas had the second-largest car fleet in Brazil. The merger will also allow for a more balanced mix of rental revenues: Localiza's rent-a-car (RaC) business represented about 75% of its fleet prior to the merger, and will now fall to 55%-60% because Unidas was the leading player in fleet management. This should elevate cash-flow predictability and lessen volatility. Also, the combined company should obtain synergies across various areas, such as in negotiations with original equipment manufacturers (OEMs), fleet allocation, maintenance costs, used-car sales. We still exclude these synergies from our combined base-case forecasts, given uncertainties over them including timing to materialize (likely starting in 2023).

Manageable leverage, although credit metrics are somewhat weaker than Localiza's historical levels. As the merger involved the exchange of shares, there's no substantial effect on the combined company's leverage. Localiza had lower leverage than Unidas, so the combined credit metrics are now somewhat weaker than Localiza's historical levels. Still, we expect Localiza to maintain a prudent approach to leverage, as seen in the past, and cash flows could rise on likely synergy gains. EBIT interest coverage is now weaker, given higher debt and a sharp increase in Brazil's base interest rates because most of group's debt has floating rates. We forecast EBIT interest coverage at 2.0x-2.4x and funds from operations (FFO) to debt of 15%-20% in 2023, but improving significantly in 2024 through expected lower interest rates and stronger cash generation.

We also expect the combined company to benefit from synergies in terms of debt costs (Localiza generally issues at a lower cost than Unidas). These would likely be achieved through debt refinancing over the years by issuing new debt at lower costs to prepay Unidas' more expensive debt.

We now view Unidas as a core subsidiary of Localiza, enabling ratings to be on the same level. Localiza now completely owns Unidas, representing close to 40% of consolidated fleet and EBITDA, and important to the overall group's strategy. Localiza will manage Unidas in an integrated manner, in terms of negotiation with suppliers, debt, and cash management. As a result, we expect support to Unidas from Localiza in all foreseeable scenarios, therefore, we now equalize the ratings on Unidas with those on Localiza.

Outlook

Given that we cap our rating on Localiza at two notches above the sovereign rating, the outlook on the company reflects the one on Brazil. We expect the combined company to benefit from its leading market position in Brazil, enabling robust fleet growth, average profitability, and controlled leverage. We expect Localiza to post EBIT interest coverage of 2.0-2.4x and FFO to debt of 15%-20% in 2023, while maintaining a strong liquidity position.

Downside scenario

A downgrade is very unlikely given the company's higher stand-alone credit profile (SACP) than the final rating. We would lower the ratings if we lower the sovereign rating. We could revise downward the company's SACP to 'bb+' if lower cash flows or higher leverage reduce EBIT interest coverage below 1.7x and FFO to debt below 20%. That could occur as a result of higher-than-expected debt-funded growth, a slump in demand, and plummeting used-car sales. Such a scenario could occur if customers' purchasing power falls amid Brazil's high unemployment, inflation, and base interest rates.

Upside scenario

A positive rating action on Localiza would follow the one on the sovereign, given the current rating cap. We could revise upward the company's SACP to 'bbb' if the merger synergies raise profitability and cash flows. The positive rating action could also occur if the company were to expand operations outside Brazil, widening revenue source diversification, which could further strengthen Localiza's competitive position. We would also expect stronger credit metrics such as EBIT interest coverage close to 3.0x and FFO to debt about or above 20%.

Company Description

Localiza is the leading Brazilian car rental company with total fleet of almost 290,000 vehicles at the end of 2021, operating in the RaC, fleet management, and used-car sales segments. Its net revenue reached R$10.9 billion in 2021. Unidas was the second-largest industry player in Brazil, leader in fleet management and third largest in the RaC segment, with total fleet of almost 200,000 vehicles at the end of 2021, and net revenue of R$6.5 billion in the same year. Localiza is now controlled by two shareholder blocks, consisting of the four founding shareholders of Localiza (16.21%) and the founding shareholders of Unidas (6.48%), totaling 22.6% of Localiza's capital. The remaining shares are traded at B3's Novo Mercado.

Our Base-Case Scenario

Our forecast currently incorporates basically pro forma combined figures starting in 2022, with the sum of our expectations for Localiza and Unidas on a stand-alone basis.

- GDP growth in Brazil of 1.2% in 2022, 1.4% in 2023, and 2.0% in 2024;
- Average inflation of 10.5% in 2022, 5% in 2023, and 3.7% in 2024, impacting the company's cost structure and tariff adjustments in the fleet leasing contracts;
- Average base interest rates of 12.4% in 2022, 11.4% in 2023, and 8.2% in 2024, affecting funding costs and contract rates for new fleet leases;
- The sale of Unidas' 49,000 vehicles and other assets for R$3.75 billion to be completed by the end of the third quarter of 2022;
- Fleet expansion in the end of the period of about 46,000 cars in 2022, 110,000 in 2023, and 96,000 in 2024;
- Purchases of about 265,000 new vehicles in 2022, 350,000 in 2023, and 368,000 in 2024;
- Used-vehicle sales of 219,000 units in 2022, 240,000 in 2023, and 272,000 in 2024;
- Average rented fleet of about 430,000 vehicles in 2022, 495,000 in 2023, and 580,000 in 2024;
- Net capital expenditures (capex) of about R$14.7 billion in 2022, and R$14 billion - R$15 billion in both 2023 and 2024;
- Shareholder remuneration of 25% of previous year's net income; and
- New debt issuances of R$6.2 billion 2022, R$8.4 billion in 2023, and R$11.5 billion in 2023 to fund capex.

Key metrics

	2020a	2021a	2022e	2023f	2024f
(Mil. R$)					
Revenue	10,308	10,901	24,000-25,000	32,000-35,000	39,000-42,000
EBITDA	2,468	3,698	9,000-9,300	10,000-10,500	12,100-12,600
EBIT	1,899	3,476	8,100-8,400	8,500-8,900	10,000-10,400
FFO	1,794	2,968	4,500-4,900	5,000-5,500	7,000-7,500
Capital expenditures	1,021	3,164	~14,750	14,000-15,000	14,000-15,000
Debt	7,194	8,216	22,000-24,000	30,000-33,000	37,000-40,000
EBIT interest coverage (x)	3.9	5.0	2.0-2.5	2.0-2.5	2.5-3.0
FFO to debt (%)	24.9	36.1	18-23	15-20	15-20

Note: Actual figures (2020 and 2021) relate to Localiza only. Expected and forecasted (2022-2024) are pro-forma for the combined entity.

Liquidity

We assess Localiza's liquidity as strong, with sources of cash exceeding uses by more than 1.5x in the next 12 months, and remaining above 1.0x in the following year even if EBITDA were to decline 30%. We expect the combined company to rely on its operating cash flows and ability to access long-term funding for its investment in fleet. The two companies have well established relationships with banks and a generally high standing in domestic credit markets.

Principal Liquidity Sources:

- Localiza's cash position of R$5.7 billion as of March 2022;
- Unidas' cash position of R$2.1 billion as of March 2022;
- FFO for the combined company of R$5.6 billion in the next 12 months after March 2022;
- Cash inflows of R$3.57 billion from the sale of the carve-out assets: vehicles, stores, and Unidas' brand;
- R$1.75 billion in debt raised by Localiza in the second quarter;
- R$1.7 billion in debt raised by Unidas in the second quarter;
- We consider as source of cash the ability to contract uncommitted secured financing of up to 70% of the purchase of new vehicles.

Principal Liquidity Uses:

- Localiza's short-term debt of R$1.7 billion as of March 2022;
- Unidas' short-term debt of R$901 million as of March 2022;
- Net capex of R$14.9 billion across both companies for fleet renewal and expansion;
- Dividend distribution of about R$785 million in the next 12 months; and
- Dividends to be paid in the next 90 days to Unidas' shareholders (related to the merger) of R$425 million.

Covenants

Localiza is subject to debt payment acceleration financial covenants under some of its debt, including all the debentures, which require the maintenance of net debt to EBITDA below 4.0x and EBITDA interest coverage above 1.5x. We expect Localiza to continue complying with these covenants with the headroom of at least 30% over the next few years. Unidas is also subject to these types of covenants, including the majority of its debentures. The most restrictive ones require the maintenance of:

- Net debt to EBITDA equal or below of 3.5x;
- EBITDA interest coverage equal or above 1.75x; and
- Net debt to book value equal or lower than 80%.

We expect Unidas to comply with theses covenants in 2022, but on a stand-alone calculation, it could breach the leverage covenant in 2023 depending mainly on capex levels. Still, we believe the company can prevent it by lowering expansion capex, cash injection from Localiza, or prepayment of two debentures (16th and 17th) that have the net debt to EBITDA covenant. These debentures' current amount is R$750 million, only 7% of Unidas' total debt. Unidas' all other debt has a 4.0x leverage limit.

Rating Above The Sovereign

We consider the auto sale and rental industries to be highly sensitive to a sovereign default: these business lines are closely correlated to economic activity, consumer purchasing power, inflation, and credit availability. In order to evaluate whether we can rate Localiza above Brazil, we apply a stress test to the company's cash flows and liquidity. In our stress scenario, we consider a GDP contraction of 10%, and doubling of inflation and interest rates. We also apply a 10% haircut on the company's cash and bank deposits and 70% on short-term investments. In the stress scenario, inflation would increase the company's operating costs, while it would have a limited ability to adjust service prices, thus leading to EBITDA decline of about 30% from our base-case scenario. We believe Localiza would reduce capex and maximize vehicle sales in order to maintain adequate liquidity. In this stress scenario, we expect Localiza's liquidity sources to remain above its uses, reflecting its ability to manage its fleet according to its cash flow needs.

Environmental, Social, And Governance

ESG credit indicators: E-2, S-2, G-2

ESG factors have an overall neutral influence on our credit rating analysis of Localiza. In 2020, the company was the first in Brazil's car rental industry to be included in the B3 Carbon Efficient Index, an arm of the Brazilian Stock Exchange, to encourage monitoring of GHG emissions. Recently, Localiza joined the ELLAS11 B3 index, which recognizes companies in which women occupy at least 50% of leadership positions. Both Localiza and Unidas have several environmental initiatives, including rainwater capture for reuse, solar power usage, dry cleaning vehicles, reverse logistics programs for vehicle spare parts to mitigate waste. Also, both companies already offer electric vehicle rentals.

Issue Ratings - Recovery Analysis

We affirmed all our 'brAAA' ratings on Localiza and Unidas' senior unsecured debt listed in the table below. We kept our '3' recovery ratings on these debts unchanged.

Issue Ratings

	Final maturity	Issue-level rating	Recovery rating
Localiza Rent a Car S.A.			
14th debentures issuance	Sep-26	brAAA	3(65%)
15th debentures issuance	Apr-26	brAAA	3(65%)
17th debentures issuance	Mar-31	brAAA	3(65%)
Companhia de Locação Das Américas S.A.			
18th debentures issuance	Sep-24	brAAA	3(65%)
19th debentures issuance	Jan-26	brAAA	3(65%)
20th debentures issuance	May-31	brAAA	3(65%)
21st debentures issuance	Sep-31	brAAA	3(65%)
22nd debentures issuance	Nov-26	brAAA	3(65%)
23rd debentures issuance	Apr-29	brAAA	3(65%)
24th debentures issuance	May-27	brAAA	3(65%)
1st commercial notes issuance	Feb-24	brAAA	3(65%)
Unidas S/A			
12nd debentures issuance	Sep-25	brAAA	3(65%)
13th debentures issuance	Apr-29	brAAA	3(65%)
16th debentures issuance	Dec-27	brAAA	3(65%)

Key analytical factors

- We value the company on a going concern basis because we believe that the company would be restructured in a default scenario given its size, geographic footprint, and brand recognition.
- The simulated default scenario encompasses a combination of high default rates in the company's contract portfolio and trade down movement of clients, pressuring prices and margins of new contracts, a slump in the used-car market, and a significant increase in interest rates amid stiff competition.

Simulated default assumptions

- Country of insolvency: Brazil (Jurisdiction B), resulting in a '3' jurisdictional cap for unsecured debt
- Year of default: 2027
- We apply a 15% haircut to fleet value, since the company would have to sell vehicles under

distress, providing discounts

- Dilution rate of 20% and then a haircut of 30% in receivables, simulating potential fall in clients' renewal rate
- We apply 100% haircut to the company's cash position with the assumption that it would be consumed up to default point
- The above assumptions lead to a general haircut of about 38% to Localiza's total asset base value, with estimated gross enterprise value (EV) at emergence of R$ 28.6 billion.

Simplified waterfall

- Net EV after 5% administrative expenses: R$27.2 billion, out of which R$12.7 billion attributed to Unidas and R$14.5 billion to Localiza
- Senior unsecured debt at Unidas: R$11.6 billion
- Value remaining to secured and unsecured claims at the holding level: R$1.1 billion
- Secured and priority debt at Localiza: R$350 million
- Senior unsecured claims at Localiza: R$13.9 billion
- Expected recovery of unsecured debt (Unidas and Localiza): 50%-70%

Note: All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Localiza

Issuer Credit Ratings

- Global scale BB+/Stable/--
- National scale brAAA/Stable

Business risk: Satisfactory

- Country risk: Moderately high
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/leverage: Intermediate

Anchor: bbb-

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)

- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb-

- Rating above the sovereign: -1 notch from SACP

Unidas

Issuer Credit Rating: brAAA/Stable/--

Group status: Core

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | Industrials: Key Credit Factors For The Operating Leasing Industry, Dec. 14, 2016
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed	
Companhia de Locacao das Americas S.A.	
Unidas S/A	
Issuer Credit Rating	
Brazil National Scale	brAAA/Stable/--
Companhia de Locacao das Americas S.A.	
Senior Unsecured	brAAA
Recovery Rating	3(65%)
Unidas S/A	
Senior Unsecured	brAAA
Recovery Rating	3(65%)
Ratings Affirmed	
Localiza Rent a Car S.A.	
Issuer Credit Rating	BB+/Stable/--
Brazil National Scale	brAAA/Stable/--
Senior Unsecured	brAAA
Recovery Rating	3(65%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.