

Research Update:

# Natura & Co Assigned 'BB' And 'brAAA' Issuer Credit Ratings; Natura Cosméticos Proposed Notes Rated 'BB'; Outlook Stable

April 21, 2021

## Rating Action Overview

- The boost in digital sales, increased channel and geographic diversification, and strong brand recognition has helped the Brazilian cosmetic company, Natura & Co. Holdings S.A. (Natura&Co), sustain resilient volume sales despite the pandemic. However, notable risks remain from subsidiary Avon Products Inc.'s (Avon; BB-/Stable/--) operational overhaul amid the pandemic still affecting several of its markets.
- Natura&Co has a robust balance sheet, large liquidity cushion, and strong commitment to keeping leverage controlled, all of which support its credit profile.
- On April 21, 2021, S&P Global Ratings assigned its 'BB' global scale and 'brAAA' national scale issuer credit ratings to Natura&Co.
- We also assigned our 'BB' global scale issue-level rating to the new proposed senior unsecured notes of Natura Cosméticos S.A., which will be fully and unconditionally guaranteed by the parent company, Natura & Co Holding S.A..
- At the same time, we affirmed our 'BB-' issue-level rating on Avon's unsecured notes and our 'BB' and 'brAAA' issue-level ratings on Natura Cosmetics S.A.'s unsecured notes and debentures.
- The recovery ratings of all unsecured debt of the group is now 3(65%), slightly higher than our previous assessment following the prepayment of Avon's 2022 secured notes with the cash proceeds of the equity follow-on concluded in the fourth quarter of 2020.
- The stable outlook reflects our expectation that Natura&Co will maintain current strong credit metrics and healthy liquidity to cushion potential volatility from the pandemic and to fully integrate and gradually revamp Avon. We forecast that Natura&Co will post debt to EBITDA close to 2.0x in 2021 and close to 1.5x afterward, and funds from operations (FFO) to debt above 35%.

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## Rating Action Rationale

### **Resilient business model and fast digital expansion has sustained growth and margins.**

Natura&Co has broad geographic diversification with revenue distribution of 30%-35% in Brazil, 35%-40% in APAC and EMEA, 25% in Latin America excluding Brazil, and 0%-5% in other regions. It also has a diversified sales channel with strong positions in direct selling, e-commerce, and retail. This diversification helped to keep its business resilient during the pandemic, along with agile execution to foster the use of digital tools by its representatives, to increase the At-Home channel at The Body Shop (TBS), and to promote e-commerce in all its divisions. Those factors have offset most of the revenue contraction in its retail stores. The subsidiary Aesop had online sales growth of 190% and TBS of 72% in the fourth quarter of 2020, which combined with currency depreciation resulted in revenue growth in 2020 of 50% and 20%, respectively.

Despite the uncertain conditions from the restrictions caused by COVID-19 globally, we believe that Natura&Co's strategies will support revenue expansion over the next several years. The group is working on its entrance into the Chinese market with local stores Aesop and TBS, and is intensifying the At-Home and digital channels of TBS and growing in the U.S. and Japan markets. We expect Aesop's growth momentum to continue in the next couple of years based on geographic expansion, higher digital sales, and expanding fragrance product portfolio. The group will also explore synergy opportunities to boost cross-selling revenues among Natura and Avon that could add \$90 million-\$120 million of revenue per year.

### **Avon's operational overhaul is still a significant risk, but signs of recovery are coming into focus.**

Avon's adjusted EBITDA margins were only 2.5% in 2020 versus 6.0% in 2019 due to significant restructuring charges and one-off expenses related to the integration with Natura&Co and the pandemic's hit to its direct sales. 2021 should still be a challenging year for Avon's international operations because of continuing pandemic-related restrictions, but we forecast margins to return to 5%-7% in 2021 and 10%-12% in 2022. As Avon's margins improve, the group's consolidated EBITDA margins should rise above 13% in 2022 from the current 10%-11%.

Avon's operations in Brazil and Latin America have posted improving results since the second half of 2020, with revenue growth at constant currency of about 4.9% in Brazil and 3.0% in Latin America (excluding Brazil) in the fourth quarter. This growth has come mainly from aligning commercial practices, communication strategies, and expanding digital tools offered to the clients and representatives.

The group achieved \$73 million of synergies in 2020 from the integration of Avon with Natura, mainly from administrative and procurement gains, and total synergies could reach \$350 million to \$450 million per year. On top of administrative and sourcing, the recurring synergies would also stem from revenue synergies, and the integration of logistic distribution and product manufacturing. For example, Avon's Poland plant will produce some TBS products, replacing outsourced suppliers.

The full achievement of synergies will likely boost consolidated EBITDA margins 150-250 basis points (bps) above our base case and lead to an additional R\$500 million-R\$1.0 billion of free operating cash flow per year.

### **Robust balance sheet, large liquidity cushion, and commitment to contain leverage support the ratings.**

Natura&Co has a strong balance sheet to withstand current volatile conditions and fund its growth strategy. It ended 2020 with a cash position of R\$8.3 billion and an adjusted net debt to EBITDA of 1.9x. Also, the group illustrated its commitment to a conservative capital structure

through the capitalization of R\$2 billion in the second quarter of 2020 and the R\$5.6 billion equity follow-on in fourth quarter of 2020, along with the prepayment of \$900 million (or about R\$5.0 billion) of Avon's secured debt. The company will further strengthen its capital structure with the new proposed notes and plans to use the proceeds to prepay the outstanding 2023 notes of Natura Cosméticos and fund the amortization of its debentures due September 2021. With that, it will extend its debt maturity profile and increase financial flexibility because the new notes don't have financial covenants.

## **Outlook**

The stable outlook reflects our expectation that Natura&Co will sustain its current strong credit metrics and healthy liquidity to cushion volatility related to the pandemic and improve Avon's margins. Still high capex in 2021 will prevent a larger deleverage this year, but we expect stronger results in 2022. We expect Natura&Co to keep debt to EBITDA close to 2.0x in 2021 and close to 1.5x afterward, and FFO to debt consistently above 35%.

## **Upside scenario**

A positive rating action would stem from a much stronger-than-expected improvement in Avon's operations, boosting consolidated margins and EBITDA by unlocking synergies despite competition and currency swings. In this scenario, we would expect Natura&Co to maintain its debt to EBITDA below 2.0x, FFO to debt above 45%, and to improve FOCF (free operating cash flow) to debt consistently above 15%. Also, we would expect the company to sustain its healthy liquidity cushion and low margin volatility, and to maintain its ability to withstand a hypothetical default scenario of Brazil.

## **Downside scenario**

We could take a negative rating action in the next 12-24 months if we see increasing cases of COVID-19 worldwide leading to operational disruptions for the company, weaker-than-expected demand, and/or higher working capital needs that could pressure its credit metrics. In addition, if Natura&Co keeps a more aggressive approach toward acquisitions or shareholders remuneration, or if the group's credit quality worsens because Avon continues to drag down cash, it could lead to a downgrade. In those scenarios, we would see debt to EBITDA close to 4.0x and FFO to debt below 20% consistently. This scenario would also squeeze the company's liquidity position and result in tight covenant headroom, which would also limit the company's ability to be rated above the sovereign.

## **Company Description**

Natura&Co is the fourth largest global cosmetics group, with annual revenue of about \$7 billion (or R\$37 billion). The group controls Natura Cosméticos S.A. (BB/Stable/--) and Avon Products Inc, and owns the brands Natura, Avon, Aesop, and The Body Shop. The group operates in more than 100 countries across all continents, with a leading position in Brazil, and has wide portfolio diversification, with offerings to various customer tiers and channel diversification. The group has strong brands with clear value propositions and a leading position in the direct sales models for cosmetics, with more than 6 million representatives and more than 3,000 stores.

## Our Base-Case Scenario

- Consolidated revenue growth in Brazilian reais of about 10% in 2021 and 6% in 2022, mainly driven by TBS and Aesop that should post growth over 20% in the in 2021 and above 10% in 2022, but also reflecting currency fluctuation;
- Growth of Natura&Co's operations in Latin America (including Brazil) of above 5% in 2021 and 2022;
- Avon's international revenues to grow about 6% in 2021 and 4% in 2022.
- We expect Natura&Co to post modest consolidated EBITDA margin expansion in 2021, but stronger performance in 2022 and 2023 as the company captures synergies and reduces restructuring expenses, pushing consolidated margins above 13%;
- We expect 4%-6% EBITDA margins at Avon in 2021, hampered by expenses in its restructuring process and integration with Natura, and then gradually recovering to double digits in 2022;
- Capex of R\$1.4 billion in 2021 and R\$1.2 billion-R\$1.3 billion in the years afterward. The higher capex in 2021 will be mainly to expand its digital capabilities, expand in Asia and the U.S., integrate Avon, execute postponed capex from 2020 due to the pandemic, and to push forward its 2030 sustainability action plan;
- Dividend payout of 30% of the company's net income; and
- We consider the following macroeconomic assumptions:

	2020A	2021F	2022F	2023F
(%)				
Brazil's GDP growth	(4.4)	3.4	2.5	2.4
Brazil's average interest rate	3.3	4.5	5.0	5.5
FX (average R\$ per \$)	5.2	5.5	5.5	5.5
Brazil's average CPI	3.3	4.5	5.0	5.5
Argentina's GDP growth	(9.9)	6.1	2.5	2.0
FX (average ARP per \$)	70.6	105.0	147.5	185.0
Mexico's GDP growth	(8.5)	4.9	2.7	2.2
FX (average MXN per \$)	21.5	21.8	21.0	21.3
Eurozone's GDP growth	(6.8)	4.2	4.4	2.1
FX (end of period euro per \$)	0.8	0.8	0.8	0.8
APAC GDP growth	(1.4)	6.7	4.7	4.9
Latam GDP growth	(6.7)	4.7	2.9	2.6

A--Actual. F--Forecast

- Based on these assumptions, we forecast the following metrics:

	2019A	2020A	2021F	2022F	2020F
Revenues	33	37	40-42	43-45	44-47

	2019A	2020A	2021F	2022F	2020F
EBITDA	3.6	4.0	4.2-4.5	5.5-6.0	5.7-6.2
EBITDA margin (%)	11.0	10.8	10-11	13-14	13.5-14.5
Funds from operations (FFO)	1.8	2.4	3.0-3.5	4.0-4.5	4.5-5.0
Capital expenditures	0.81	0.67	1.4	1.2-1.4	1.2-1.4
Free operating cash flow	1.0	0.6	0.6-0.8	1.5-2.0	2.5-3.0
Debt/EBITDA (x)	3.2	1.9	1.5-2.0	1.5	1.0-1.5
FFO to debt (%)	15.5	32.2	35-40	45-50	55-60
FFO cash interest coverage ratio (x)	2.4	2.9	3.5-4.0	5.0-5.5	5.5-6.0
Free operating cash flow/debt (%)	8.3	8.2	9.0-10.0	20-25	35-40

A--Actual. F--Forecast

## Liquidity

We consider Natura&Co's liquidity as adequate. We expect Natura&Co's sources over uses of cash over the next 12 months to be about 1.5x and net sources to remain positive even if EBITDA dropped 15%. Natura has strengthened its cash position after the equity follow-on concluded in October 2020, mostly used to prepay Avon's 2022 senior secured notes.

The company's planned new senior unsecured notes issuance should extend its debt maturity profile, primarily by funding the early redemption of the \$750 million senior notes due 2023 issued by Natura Cosméticos S.A. and the amortization of the debentures due September 2021. We also consider that Natura&Co has a well-established relationship with banks and high standing in credit markets, indicated by its ability to access equity and debt capital markets.

Primary liquidity sources:

- Cash position of R\$8.3 billion as of Dec. 31, 2020.
- FFO of R\$2.1 billion over the next 12 months.

Primary liquidity uses:

- Short-term debt of R\$3.8 billion as of Dec. 31, 2020.
- Working capital outflows of R\$760 million.
- Seasonal working capital of R\$700 million.
- Capex of R\$1.4 billion.
- Dividend payment of R\$260 million.

## Covenants

Natura&Co and Avon don't have financial covenants on their own debts. The debentures held by Natura Cosméticos have a 3.0x net debt to EBITDA covenant that could trigger debt acceleration, but we expect this to have a more than 50% cushion. Natura Cosméticos' current 2023 notes also have a 3.5x net debt to EBITDA covenant. The covenant calculation excluded the impact of

International Financial Reporting Standards (IFRS) 16.

## **Ratings Above the Sovereign**

We tested Natura&Co's ability to withstand a sovereign default scenario in order for us to rate it above our 'BB-' foreign currency rating on Brazil. We tested a default of Brazil because the group is headquartered in the country and generates about 30% of its revenues there.

In the stress test, we assumed the following:

- GDP decline of 10% in Brazil in 2021, hurting volumes;
- Inflation at about 12% in that year, increasing costs and selling, general, and administrative expenses;
- Limited ability to adjust prices;
- A 10% haircut on cash and bank deposits and a 70% haircut on short-term investments held in Brazil;
- Currency depreciation of 50%, affecting costs indexed to the dollar and the debt and cash position held in foreign currency;
- Capex at maintenance level; and
- Doubling of interest rates for floating debt.

The sizable cash and cash flows from outside Brazil, and a low debt maturity schedule for 2021 enable Natura&Co to pass the test.

## **Issue Ratings - Recovery Analysis**

### **Key analytical factors**

The recovery rating of the unsecured debt issued by Natura Cosmetics and Avon is 3(65%), slightly stronger than our previous view due to prepayment of the secured debt position at Avon in the fourth quarter of 2020.

The group capital structure in December, 2020 mainly included:

- \$500 million, 5% unsecured notes due 2023 (\$461 million outstanding) issued by Avon Products Inc.
- \$250 million, 6.95% unsecured notes due 2043 (\$216 million outstanding) issued by Avon Products Inc.
- \$750 million, 5.375% unsecured notes due 2023 issued by Natura Cosméticos SA.
- Aggregated amount of R\$ 4 billion in local unsecured debentures, issued by Natura Cosméticos SA maturing in 2021, 2023 and 2024
- R\$ 500 million of promissory notes issued by Natura & Co Holding S.A.
- R\$ 250 million of promissory notes issued by Natura Cosméticos S.A.
- We are considering in our recovery model the new proposed senior unsecured notes issued by Natura Cosméticos S.A. The new notes are guaranteed by the parent company, therefore, the

recovery prospect for this note will benefit from the residual value of Avon Products that would upstream to Natura&Co.

We consider that following a hypothetical bankruptcy process, the company would be restructured and continue to operate, generating higher value to creditors, compared with a scenario of the company's liquidation. We value Natura Cosméticos using a 6.0x multiple applied to our projected emergence-level EBITDA of R\$1.0 billion, arriving at a stressed enterprise value of R\$6.3 billion. We value Avon Products using a 5.5x multiple applied to our projected emergence-level EBITDA of U\$165 million, arriving at a stressed enterprise value of \$910 million. Avon's multiple is lower than Natura because the company is still amid a difficult operational turnaround.

## Simulated default assumptions

- Year of default: 2026 for Natura Cosméticos and 2025 for Avon Products.
- EBITDA at emergence: \$165 million (about R\$ 860 million) for Avon and R\$ 1.0 billion for Natura Cosméticos.

## Simplified waterfall

- Net recovery value: R\$10.5 billion (R\$ 4.6 bi of Avon and R\$ 6.2 bi of Natura Cosméticos);
- Unsecured debt at Avon: \$728 million (about R\$ 3.9 bi)
- Avon's residual value upstream to parent company: R\$ 760 million
- Unsecured debt recovery expectation at Avon: 50%-70% (rounded estimate: 65%)
- Secured debt at Natura Cosméticos and debt at Natura Cosméticos' subsidiaries: R\$ 620 million
- Unsecured claims at Natura Cosméticos (debentures, working capital lines and unsecured note) R\$ 7.8 bi
- Unsecured debt recovery expectation at Natura Cosméticos: 50%-70% (rounded estimate: 65%)

\*All debt amounts at default include six months accrued prepetition interest

## Financial Summary

### Natura & Co Holding S.A -- Financial Summary

Industry Sector: Personal Care And Household Products

	--Fiscal year ended Dec. 31--			
	2020	2019*	2018*	2017*
<b>(Mil. R\$)</b>				
Revenue	36,922.0	32,942.2	34,965.7	28,789.5
EBITDA	4,001.2	3,627.9	3,876.0	3,629.2
Funds from operations (FFO)	2,412.1	1,814.7	1,948.2	2,220.6

## Natura & Co Holding S.A -- Financial Summary (cont.)

Industry Sector: Personal Care And Household Products

	--Fiscal year ended Dec. 31--			
	2020	2019*	2018*	2017*
Interest expense	1,351.8	1,203.5	1,401.0	1,095.3
Cash interest paid	1,257.7	1,274.8	1,319.4	882.4
Cash flow from operations	1,285.6	1,794.1	1,729.6	2,548.2
Capital expenditure	674.2	813.6	852.4	684.9
Free operating cash flow (FOCF)	611.4	980.5	877.2	1,863.3
Dividends paid	133.9	152.9	201.7	109.4
Discretionary cash flow (DCF)	528.6	787.7	664.2	1,734.7
Cash and short-term investments	8,342.3	8,161.4	4,492.7	6,591.0
Gross available cash	8,342.3	8,161.4	4,492.7	6,591.0
Debt	7,481.2	11,744.7	13,705.8	13,015.0
Equity	27,387.1	1,728.9	(897.7)	(733.2)

### Adjusted ratios

Annual revenue growth (%)	12.1	(5.8)	21.5	N.M.
EBITDA margin (%)	10.8	11.0	11.1	12.6
EBIT margin (%)	3.6	6.2	6.7	7.5
Return on capital (%)	5.4	15.6	18.6	17.6
EBITDA interest coverage (x)	3.0	3.0	2.8	3.3
FFO cash interest coverage (x)	2.9	2.4	2.5	3.5
Debt/EBITDA (x)	1.9	3.2	3.5	3.6
FFO/debt (%)	32.2	15.5	14.2	17.1
Cash flow from operations/debt (%)	17.2	15.3	12.6	19.6
FOCF/debt (%)	8.2	8.3	6.4	14.3
DCF/debt (%)	7.1	6.7	4.8	13.3

\*Pro forma figures. N.M.--not meaningful.

## Reconciliation

### Natura & Co Holding S.A--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts

	--Fiscal year ended Dec. 31, 2020--				
	Debt	Shareholders' equity	EBITDA	Operating income	S&P Global Ratings' adjusted EBITDA
(Mil. R\$)	13,822.9	27,364.3	3,508.5	789.6	4,001.2



## Natura & Co Holding S.A--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (cont.)

### S&P Global Ratings' adjustments

Cash taxes paid	--	--	--	--	(331.5)
Cash interest paid	--	--	--	--	(1,257.7)
Reported lease liabilities	3,858.5	--	--	--	--
Postretirement benefit obligations/deferred compensation	--	--	25.2	25.2	--
Accessible cash and liquid investments	(8,342.3)	--	--	--	--
Share-based compensation expense	--	--	232.0	--	--
Nonoperating income (expense)	--	--	--	264.3	--
Noncontrolling interest/minority interest	--	22.8	--	--	--
Debt: Foreign currency hedges	(1,857.9)	--	--	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	--	(11.9)	(11.9)	--
EBITDA: Other	--	--	247.4	247.4	--
Total adjustments	(6,341.7)	22.8	492.7	525.0	(1,589.1)
S&P Global Ratings' adjusted amounts	<b>Debt</b>	<b>Equity</b>	<b>EBITDA</b>	<b>EBIT</b>	<b>Funds from operations</b>
	7,481.2	27,387.1	4,001.2	1,314.6	2,412.1

## Ratings Score Snapshot

Natura&Co Issuer credit rating:

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

Business risk: Fair

- Country risk: Moderately high
- Industry risk: Low
- Competitive position: Fair

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)

- Capital structure: Neutral (no impact)
- Liquidity: Adequate
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis Neutral (no impact)

Stand-alone credit profile: bb

## Related Criteria

- 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 | 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
- 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: Ratings Above The Sovereign--Corporate And Government Ratings: 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

### New Rating; CreditWatch/Outlook Action

#### Natura & Co Holding S.A

Issuer Credit Rating	BB/Stable/--
Brazil National Scale	brAAA/Stable/--

### Ratings Affirmed

#### Natura Cosméticos S.A.

	To	From
Senior Unsecured	BB	BB
Senior Unsecured	brAAA	brAAA
Recovery Rating	3(65%)	3(50%)

**Avon Products Inc.**

	To	From
Senior Unsecured	BB-	BB-
Recovery Rating	3(65%)	3(50%)

**New Rating**

**Natura Cosméticos S.A.**

Senior Unsecured	BB
Recovery Rating	3(65%)

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