FitchRatings

04 Jun 2020 | Downgrade

# Fitch Downgrades Natura's IDR to 'BB-' & Affirms Avon's IDR at 'B+'

Fitch Ratings-Chicago-04 June 2020:

Fitch Ratings has downgraded Natura Cosmeticos S.A.'s Long-Term (LT) Foreign Currency (FC) Issuer Default Rating (IDR) and Local Currency (LC) IDR to 'BB-' from 'BB', as well as its unsecured USD750 million notes due 2023 to 'BB-'from 'BB'. The National Scale Rating was downgraded to 'AA-(bra)' from 'AA(bra)'. The Rating Outlook remains Negative.

In conjunction with these rating actions, Fitch has affirmed Avon Products, Inc.'s LT IDR at 'B'+, and its unsecured notes at 'B'/'RR5'. In a related move, Fitch has also affirmed the 'B+' LT IDR of Avon International Operations, Inc., and its 'BB+' secured bond due in 2022, in addition to Avon International Capital PLC's 'BB+' secured bond due in 2022. The Rating Outlook has been revised to Stable from Positive.

The downgrade of Natura Cosmeticos' ratings and the revision in Avon's Outlook to Stable from Positive reflects challenges faced by these two sister companies that are both wholly owned by Natura&Co Holding S.A. These challenges include: elevated medium term refinancing risk, integration risk involved with achieving synergies while growing top-line revenues, fast-changing industry dynamics, and headwinds presented by negative growth rates in Brazil, Europe and the U.S. due to the coronavirus pandemic.

The rating of Avon, one notch below Natura Cosmeticos, reflects Avon's higher leverage, weaker business position, and higher refinancing risk. Avon's debt is not guaranteed by either Natura Cosmeticos or Natura&Co. Avon's rating of 'B+' with a Stable Outlook reflects Fitch's expectation that during the next 12 to 24 months debt at Avon will likely be replaced by debt with guarantees from the holding Natura&Co and that the consolidated credit quality of the group of companies would not be below 'B+'.

The Negative Outlook for Natura Cosmeticos reflects risk that the credit profile of both companies will merge during the next 12 to 24 months through refinancing activities that will tighten the credit linkage between the two companies and that cash flow pressure remains high due to unfavorable macroeconomic and industry conditions.

Fitch projects that the consolidated revenues of Natura&Co will decline by about 14% in 2020 and that the group's consolidated net leverage will be around 4.8x. Natura&Co has around USD2.1 billion of cross-border debt issuances in addition to local issuances coming due during 2022 and 2023. The company recently announced its intent to issue up to BRL2 billion (around USD390 million) of equity, that together with a new issuance of local promissory notes of BRL750 million completed during May will alleviate near-term liquidity and financial covenants pressure.

## Key Rating Drivers

Ratings Migration: Natura and Avon are separate legal entities that are both wholly owned by Natura&Co. The bonds of both companies have been issued by different legal entities that are domiciled in different countries. In the medium term, Fitch expects the debt of both entities to be replaced by debt that would include intra-group and/or cross-guarantee structures. The ratings of both issuers would likely migrate to the same level if this occurs. Strategic ties are strong between Avon and Natura's operations in Latin America and the company is attempting to generate material operating synergies from the ownership of these two companies by Natura&Co.

Large Business Scale: Avon's acquisition significantly increases Natura&Co's business scale, enhances its consultant base to 4.15 million reps, expands its product portfolio and strengthens its Latin American market presence. The combined entity will benefit from up-sell opportunities in terms of channels and value proposition. Natura&Co has announced an increase in the expected synergies to USD300 million to USD400 million from a previous level of USD200 million to 300 million; these synergies are expected be captured mainly in Brazil and Latin America through the leveraging of its manufacturing and distribution capabilities. In Fitch's view, most of the savings will need to be reinvested to improve the companies' competitive positions within the highly competitive global beauty sector. Natura and Avon both have high exposure to the decline in direct sales and are attempting to gravitate to an omni-channel strategy.

Challenging Industry Dynamics: The CF&T industry is attractive due to its resilience throughout economic cycles. Nevertheless, pressure business dynamics are changing and sales volumes and margins are under pressure due to a shift in the channel toward e-commerce and specialty stores; traditional consumer companies are facing intense competition from multi-national beauty giants that have implemented omni-channel strategies, as well as smaller, nimbler, fast-growing companies.

High Execution Risks: To compete against this challenging backdrop, Natura&Co will have to maintain a strong pipeline of innovation to compete in the fast changing beauty trends and digitalize to engage more directly with end consumers. These challenges will be compounded by the challenges of integrating Avon's global operations outside of Latin America (47% of Avon's revenues), which have been pressured by declining active representatives and sales volumes in complex emerging markets such as Russia. This transaction follows Natura's acquisition of TBS late in 2017 for EUR1 billion. Unlike Avon and Natura, TBS primarily operates through retail stores.

Margin Under Pressure: The challenging industry dynamics have pressured the margins of Avon and TBS. Avon's EBITDA margin declined to 6.6% in 2018/2019 from an average of around 8.7% between 2015 and 2017. TBS' margins have shown improvement during 2019 to 9.7% from 7.9% in 2018. In comparison, Natura Cosmeticos had a 14.2% margin in 2018 and a 12.8% during 2019, which compares to an average EBITDA margin of 16.9% between 2015 and 2017. Natura's high margins reflect its strong brand value and recognition, large operating scale, extensive direct-sales structure and in-house manufacturing capabilities. For 2020, Fitch expects the company's consolidated EBITDA margin to move around 9%.

Expanded Geographic Presence: The purchase of Avon slightly improved the Natura&Co groups geographic diversification. Brazil represents the bulk of Natura's current operations and accounts for 43% of revenues and 56% of EBITDA generation. As of 2019, Brazil and Argentina represent 42% of Avon's operating profit, while Europe, the Middle East and Africa account for 36%, North Latin America accounts for 11% and Asia/Pacific for approximately 8%.

Medium Term Refinancing Risks: The combined entity, Natura&Co, will have to seek long-term funding to avoid higher refinancing risks by 2021–2023 as it has about USD2.1 billion of cross-border bonds coming due, as well local debentures issuance. Natura has announced a capital increase of up to BRL2 billion to be completed by June 2020, which aims to reinforce liquidity and net leverage ratios.

## Derivation Summary

Natura's 'BB-'/'AA-(bra)'/Negative Outlook reflects the combined credit quality of Avon and Natura, challenges to execute the turnaround in Avon's operations and medium-term refinancing risks. Natura's 5.0x consolidated net leverage ratio, is high for the rating category, however, it incorporates a deleverage trend by 2021 to around 4.0x. Natura has a solid business position in the CF&T industry within Brazil, underpinned by strong brand recognition, large scale, competitive cost structure and a large direct-sales structure. Natura has the challenge of adapting its business model to an omni-channel strategy and boosting its digital platform while integrating TBS and becoming more integrated with its sister company, Avon.

Avon's 'B+'/Positive Outlook reflects Fitch's expectation that the ratings of Natura and Avon will gravitate over time to the same level as the parent company for both entities, Natura&Co, moves debt from these entities to the holding company.

Key Assumptions

Fitch's Key Assumptions Within Our Rating Case for the Issuer

--Fitch expects Natura&Co's revenue to decline around 14% in 2020, reflecting weaker volumes during 2Q20 and ongoing consumer discretionary spending concerns throughout the year.

--Consolidated EBITDAR margins around 12% in 2020 and recovering to around 14% in 2021.

--Reduced capex of around BRL600 million in 2020, with a recovery to around BRL1 billion in 2021.

--No dividends payments in 2020.

--Natura to maintain its proactive approach on refinancing its short-term debt avoiding refinancing risks.

For issuers with IDRs at 'B+' and below, Fitch performs a recovery analysis for each class of the issuer's obligations. The issue ratings are derived from the IDR and the relevant Recovery Rating (RR) and notching, based on Fitch's recovery analysis that places an enterprise value under a distressed scenario.

Fitch's recovery analysis assumes that Avon would be reorganized as a going concern (GC) in bankruptcy rather than liquidated. Fitch has assumed a 10% administrative claim. Fitch's GC EBITDA estimate reflects Fitch's view of a sustainable, post-reorganization EBITDA level upon which Fitch bases the enterprise valuation. This enterprise value is based on an EBITDA of USD330 million in a distressed scenario at a 4.0x EV/EBITDA multiple, which is at the low end of recent consumer products transactions but considers Avon's operating challenges.

Fitch applies a waterfall analysis to the post-default EV based on the relative claims of the debt in the capital structure. The agency's debt waterfall assumptions take into account the company's total debt at March 31, 2020. These assumptions result in a below average recovery rate for the unsecured bonds consistent with the 'RR5' range.

RATING SENSITIVITIES

Natura Cosmeticos:

Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Consolidated EBITDAR margins above 14% on consistent basis for Natura as well as Natura&Co;

--Consolidated net adjusted debt/EBITDAR ratio around 3.5x on a consistent basis for Natura as well as Natura&Co;

--Successful refinancing strategy with no major debt maturities within two to three years for Natura and Natura&Co.

Factors That Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Failure to receive at least BRL1 billion on capital injection;

--Inability to refinance the USD900 million of secured bonds at Avon by mid-2021;

--Consolidated EBITDAR margins declining to below 12% on a recurrent basis;

--Consolidated net adjusted leverage above 4.5x by 2021;

--Competitive pressures leading to severe loss in market-share for either Natura and Avon; or a significant deterioration in its brands reputation.

Avon Products, Inc.:

Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Increased legal linkage between the debt obligations of Avon and Natura&Co.

Factors That Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Failure to receive at least BRL1 billion on capital injection;

--Inability to refinance the USD900 million of secured bonds at Avon by mid-2021;

--Consolidated EBITDAR margins declining to below 12% on a recurrent basis;

--Consolidated net adjusted leverage above 4.50x by 2021;

--Competitive pressures leading to severe loss in market-share for either Natura and Avon; or a significant deterioration in its brands reputation.

Best/Worst Case Rating Scenario

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

## Liquidity and Debt Structure

Adequate Liquidity; Medium Term Refinancing Risks: Natura has a track record of maintaining adequate liquidity and solid access to the local credit market, but the company has an important challenge to refinance its medium- and long-term debt (2021-2023). As of March 31, 2020, the company had BRL4.6 billion in cash and marketable securities which compares with BRL2.2 billion million of short-term debt, including BRL209 million of forfait operation, leading to a cash/short-term debt ratio of 2.1x. This compares with an average ratio of 1.5x from 2015 to 2019. Natura has announced a capital increase of up to BRL2 billion to be completed by June 2020, which aims to reinforce liquidity and net leverage ratios.

Fitch expects Natura will remain disciplined with its liquidity position and will maintain a proactive approach in liability management to avoid major exposure to refinancing risks in the short term. During May 2020, the holding company and Natura Cosmeticos issued BRL500 million and BRL250 million, respectively, in promissory notes. Natura's ability to start to access cross-border market by mid-2021 is essential to its current ratings. Natura faces long-term debt amortization of BRL3.1 billion in 2021, BRL5.3 billion in 2022, BRL4.5 billion in 2023 and BRL2.8 million from 2024 onwards.

On March 31, 2020, Natura had total debt of around BRL17.8 billion, excluding on balance leasing obligations (BRL3.9 billion). Natura's debt is mainly composed of BRL1.1 billion at the holding level, BRL7.5 billion at Natura Cosmeticos (net of derivatives plus forfeit obligation) and BRL9.1 billion at Avon. Cross-border bonds (62%), local debentures (23%) and promissory notes (6%) are the company's main debt.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING
The principal sources of information used in the analysis are described in the Applicable Criteria.

## ESG Considerations
The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or

to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Avon International Capital P.L.C.
----senior secured; Long Term Rating; Affirmed; BB+
Natura Cosmeticos S.A.; Long Term Issuer Default Rating; Downgrade; BB-; RO:Neg
; Local Currency Long Term Issuer Default Rating; Downgrade; BB-; RO:Neg
; National Long Term Rating; Downgrade; AA-(bra); RO:Neg
----senior unsecured; Long Term Rating; Downgrade; BB-
Avon Products, Inc.; Long Term Issuer Default Rating; Affirmed; B+; RO:Sta
----senior unsecured; Long Term Rating; Affirmed; B
Avon International Operations, Inc.; Long Term Issuer Default Rating; Affirmed; B+; RO:Sta
----senior secured; Long Term Rating; Affirmed; BB+

Contacts:

Primary Rating Analyst
Debora Jalles,
Director
+1 312 606 2338
Fitch Ratings, Inc.
One North Wacker Drive
Chicago 60606

Secondary Rating Analyst
Renato Donatti,
Director
+55 11 4504 2215

Committee Chairperson
Joe Bormann, CFA
Managing Director
+1 312 368 3349

Media Relations: Elizabeth Fogerty, New York, Tel: +1 212 908 0526, Email: elizabeth.fogerty@thefitchgroup.com

Additional information is available on www.fitchratings.com

**Applicable Criteria**

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)
Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)
National Scale Ratings Criteria (pub. 18 Jul 2018)
Parent and Subsidiary Rating Linkage (pub. 27 Sep 2019)

**Applicable Model**

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).
Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

**Additional Disclosures**

Dodd-Frank Rating Information Disclosure Form
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