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Research Update:

Metro AG Affirmed At 'BBB-/A-3'; Outlook Remains Negative On Persisting Uncertainty For The Hospitality Sector

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Rating Action Overview

- Food wholesaler Metro AG's sales to the hospitality sector (about 45% of total) are still affected by restrictions to limit the spread of the coronavirus; recovery is taking longer than we anticipated in December 2020 and we now expect leverage to increase to 4.0x-4.5x in fiscal 2021 (year ending Sept. 30), from about 4.0x expected previously.
- However, we expect restrictions to restaurants in Western Europe to gradually ease over the coming weeks and travel and hotel accommodation to recover in the summer, supported by increasing vaccination and decreasing infections.
- We continue to anticipate deleveraging in fiscal 2022 to about 3.5x debt to EBITDA, also supported by the business' strength and diversification.
- We therefore affirmed our 'BBB-/A-3' ratings on Metro maintained the negative outlook.
- The negative outlook indicates persisting uncertainty for the hospitality sector and a possible downgrade within the next 12 months if disruptions from the pandemic sustainably weakens Metro's business model and long-term profitability; the group's credit metrics are hit stronger than we estimate for fiscal 2021; or the group is unlikely to restore its S&P Global Ratings-adjusted debt to EBITDA to less than 3.5x and free operating cash flow after leases to positive in fiscal 2022.

Rating Action Rationale

Dragging lockdowns in Europe could affect credit metrics more than we expected in fiscal 2021, meaning uncertainty persists. Most of Metro's customers in the European hospitality segment (mainly hotels, restaurants, and caterers) have reduced large parts of their operations given COVID-19 restrictions over the first four months of 2021. While most Western European countries announced an opening or partial opening of restaurants in May and June, disruptions took longer than we had expected in December 2020, and virus mutations pose additional risks. In addition, travel and hotel accommodations might take a hit well into the summer before restrictions fully end, and working from home may persist in the pandemic's aftermath for some employees. Therefore, we believe that the company's fiscal 2021 adjusted EBITDA could remain at €1.0 billion-€1.1 billion--5%-8% lower than our earlier estimate from December--increasing leverage further this year. Therefore, we expect Metro to land in the mid-range of its recently revised company adjusted EBITDA guidance and that its S&P Global Ratings-adjusted debt to EBITDA will increase to 4.0x-4.5x in fiscal 2021 compared with the 4.0x we expected as of December 2020, which was already out of line with the rating.

The affirmation reflects increasing vaccinations, announced openings of restaurants, implemented operating cash measures, and lower dividend payments from next year. We see vaccine production and vaccination gathering pace around the world. Metro's largest operating market, the EU, has also increased its speed in vaccinating the population. We therefore believe that most operating restrictions for restaurants and hotels (the majority of Metro's hospitality clients) should end in summer 2021, and fiscal 2022 will see largely a return to a more normal operating environment. With sales reaching prepandemic levels over autumn this year, increasing group adjusted EBITDA to about €1.3 billion in fiscal 2022, and our anticipation of lower dividends from fiscal 2022, we estimate leverage will decline to around 3.5x from fiscal 2022, which would be in line with the rating.

Our expectation that financial policy measures would offset any further operating underperformance supports the rating. While leverage metrics and free cash generation is currently out of line with the rating, we understood that management is committed to reducing leverage, to the necessary level in line with its intention to maintain an investment-grade rating. We believe management still has levers to pull for its credit metrics and expect it will use them over the next 12 months to prevent further deterioration in credit metrics. For instance, the company has about €3.0 billion in freehold real estate assets. It could also generate cash by selling its remaining 20% stake in the Chinese business to Wumei because it has a put option for an agreed selling price. In these cases, we expect the proceeds to preserve liquidity and support deleveraging, rather than for shareholder distribution. Also, we expect dividends from 2022 to be substantially lower than 2021, in line with our understanding of Metro's reiterated dividend policy of 45%-55% and low earnings per share in 2021.

While Metro gained market share during the pandemic, we also see risks of a structurally weaker hospitality market. The company's clients in the hospitality segment are mainly composed of small entrepreneurial businesses, at risk of structural weakening during the pandemic. In addition, we anticipate that a higher share of European workforces will continue working from home. This could result in durable shifts of food demand away from restaurants and cafes and toward home consumption, hampering Metro's sales recovery after the pandemic. Industry sales of food and beverage in the eurozone were still 20% below prepandemic levels in summer 2020 according to Eurostat data, at which time most lockdown restrictions in Europe had been lifted. Furthermore, we expect business travel will remain low. Therefore, we see the risk of durably lower demand, which could also require greater strategic changes such as cost reductions or reevaluation of growth segments that depend on the hospitality sector's health, affecting earnings and profitability beyond our expectations. At the same time, Metro gained market share from peers during the pandemic, because the company has a market-leading position in food wholesale in Europe, an attractive combination of stores and delivery services from clients and its creditor management department manages increasing credit stress of customers better than smaller competitors. This positions Metro well to participate in the increasing demand that we expect once lockdowns are durably lifted.

The partly debt-funded acquisition vehicle EP Global Commerce (EPGC) does not affect our ratings. EPGC, owned by the Czech investors Daniel Kretinsky and Patrick Tkac, recently bought another 10.6% of Metro's ordinary shares, bringing its share in the group's ordinary share base to just above 40% through a voluntary takeover offer. EPGC had access to term loans to fund the purchase of Metro shares. While we do not know EPGC's intentions, we do not factor a full takeover of Metro in our base-case scenario. With only two out of the 20 total board participants its shareholding is not sufficient to influence decisions on dividends at Metro's annual general meeting or determine the group's strategy. Therefore, we do not regard the current stake or funding raised at the EPGC level to be constraining factors.

Outlook

The negative outlook reflects uncertainty about the hospitality sector's future, the recovery path of restaurants and hotels, and how the pandemic will affect customer behavior, all of which raise questions about whether Metro will fully recover to prepandemic earnings in fiscal 2021. The outlook further indicates a possibility of a downgrade within the next 12 months if the pandemic sustainably weakens Metro's business model and long-term profitability; the group's credit metrics are hit stronger than we estimate for fiscal 2022; or the group is unlikely to restore its adjusted debt to EBITDA to less than 3.5x and its free operating cash flow after leases to positive over fiscal 2022. This could for instance happen if the pandemic's impact on the hospitality sector turns out to be deeper or longer, and financial policy measures from the company do not offset these. The outlook also reflects Metro's evolving shareholding structure and corporate governance, which adds uncertainty over the company's strategic direction and financial policy, particularly given the low headroom for the rating.

Downside scenario

We could lower the rating if:

- The pandemic's impact becomes more severe than we assume with S&P Global Ratings-adjusted debt to EBITDA exceeding 4.5x in fiscal 2021, or we assess that, for fiscal 2022, adjusted funds from operations (FFO) to debt could remain below 20%, debt to EBITDA above 3.5x, or free operating cash flow after all lease payments would remain negative.
- In case of any operating underperformance, the company does not take financial policy measures to mitigate the impact on credit metrics;
- The financial policy would otherwise turn more aggressive, for instance if EPGC were to gain control over Metro's strategy and prevent deleveraging; or

The pandemic led to a structurally weaker hospitality industry or were to hamper long-term growth targets, exemplified by Metro's group sales not recovering to pre-COVID-19 levels and adjusted EBITDA margins remaining below 5%. In this case, we could reevaluate our assessment of the company's business strength, regardless of the development in credit metrics.

Upside scenario

We could revise the outlook to stable if we gain more certainty regarding the pandemic's duration, severity, and permanent impact effect on the industry, consumer habits, and Metro's operating performance and cash flow; as well as further certainty on the shareholder structure. In particular, an outlook revision would depend on the group's ability to preserve cash, restore its sales and profitability to prepandemic levels, and improve its S&P Global Ratings-adjusted debt to EBITDA to below 3.5x and FFO to debt to sustainably above 20% after fiscal 2021, including a supportive financial policy and lower dividend payment.

Company Description

Germany-based Metro is Europe's largest food wholesale and food delivery operator. It has strong business-to-business operations in 34 countries, with clients in three main groups:

- Hotels, restaurants, and caterers with about 45% of 2020 sales;
- Independent retailers (traders), representing 22% of sales; and
- Service, companies, and offices, at about 30%.

The group also has active real estate operations through which it buys land and then develops and sells it after a few years, creating and realizing value in the process. For fiscal 2020, Metro reported revenue of €25.6 billion and S&P Global Ratings-adjusted EBITDA of €1.1 billion. The company's store network comprised 678 locations at fiscal year-end 2020.

EPGC is Metro's largest shareholder, at about 40% ownership, while family offices Meridian Foundation and Beisheim Holding pooled their interest and hold together about 23% while the rest is free-float.

Our Base-Case Scenario

Assumptions

- Real GDP growth of about 4.2% in Western Europe and 3.7% in Central and Eastern Europe in 2021, picking up pace in 2022 to 4.5% and 4.3% growth, respectively.
- Revenue to decline by 3%-5% in fiscal 2021 after a 5.4% drop in fiscal 2020, mainly due to the ongoing disruption in the hospitality sector. We expect revenue to recover to a large extent, by up to 10% in fiscal 2022, but still somewhat hampered by lower expected consumer sentiment and constrained operations.
- Adjusted EBITDA margins of 4.0%-4.5% in fiscal 2021 and 5.0%-5.5% in fiscal 2022 compared with 4.3% in fiscal 2020. We believe that margins in fiscal 2021 are supported by lower restructuring needs following major disposal completion in 2020 and higher earnings from recuring real estate development disposal gains.
- Capital expenditure (capex) of €340 million-€370 million in fiscal 2021, and €400 million-€450 million in fiscal 2022.
- Asset disposal proceeds of €50 million-€100 million in fiscal 2021 and €75 million-€150 million in fiscal 2022 from almost nil in fiscal 2020.
- Stable dividends of about €260 million in fiscal 2021 and very low dividends in 2022, in line with management's commitment and our interpretation of the dividend policy of a payout of 45%-55% of last's year earnings per share.

- Potential smaller opportunistic acquisitions of up to €100 million per year, mainly in the European foodservice segment.

S&P Global Ratings believes there remains high, albeit moderating, uncertainty about the evolution of the coronavirus pandemic and its economic effects. Vaccine production is ramping up and rollouts are gathering pace around the world. Widespread immunization, which will help pave the way for a return to more normal levels of social and economic activity, looks to be achievable by most developed economies by the end of the third quarter. However, some emerging markets may only be able to achieve widespread immunization by year-end or later. We use these assumptions about vaccine timing in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Key metrics

Metro AG--Key Metrics*

	--Fiscal year ended Sept. 30--				
(Mil. €)	2019a	2020a	2021f	2022f	2023f
Sales	27,082	25,632	24,000-25,000	26,000-27,000	26,800-27,800
EBITDA	1,767	1,110	1,000-1,100	1,300-1,400	1,350-1,450
FFO	1,206.8	711	700-800	950-1,050	1,000-1,100
Reported FOCF after lease payments	207	(355)	(80)-(180)	50-100	50-100
Debt§	5,471	4,177	4,550-4,700	4,60-4,800	4,600-4,800
Debt to EBITDA (x)	3.1	3.8	4.0-4.5	3.3-3.5	3.3-3.5
FFO to debt (%)	22.1	17	15.0-18.0	20.0-22.0	20.0-22.0
DCF/Debt (%)	3.2	(5.5)	(1.0)-(3.0)	3.0-8.0	3.0-8.0

*All figures adjusted by S&P Global Ratings. §2020 year-end debt consists of net financial debt of €2.29 billion. with key adjustments being €3.0 billion in leases, €310 million in pensions, and €1.5 billion surplus cash. FOCF--Free operating cash flow. FFO--Funds from operations. DCF--Discretionary cash flow. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess Metro's liquidity as adequate. We expect the company's liquidity sources will be around 1.5x its liquidity uses over the next 12 months. We do not expect sources of liquidity will drop below uses, even if EBITDA were to decline by 15% more than we foresee during this period. We think, however, that the group would not be able to withstand high-impact, low-probability events such a sovereign debt crisis without some refinancing needs. Although it has significant cash balances and no maturing long-term debt, these would not manage historically significant intrayear working requirements and related drawings on facilities in such a scenario. We also base our liquidity assessment on our expectation that the group will maintain good access to different financing sources and at least adequate headroom under its covenants.

We expect principal liquidity sources over the 12 months from March 31, 2021, will include:

- Cash on the balance sheet of about €1.0 billion;

- Committed and undrawn long-term credit facilities with at least 12 months remaining to maturity of €1.1 billion;
- Cash FFO after all leases payments of €200 million-€220 million; and
- Structural working capital inflows of up to €50 million.

We expect principal liquidity uses over the same period will include:

- Debt maturities of €1.0 billion, mainly outstanding-to-short-term commercial paper and drawing of short-term credit lines;
- Seasonal working capital swing of €100 million-€200 million;
- Capex of €340 million-€370 million; and
- Dividends of €100 million.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Negative/A-3

Business risk: Satisfactory

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

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Neutral (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017

- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

Metro AG	
Issuer Credit Rating	BBB-/Negative/A-3
Senior Unsecured	BBB-
Commercial Paper	A-3