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Research Update:

Gaming Company Novomatic Downgraded To 'BBB-/A-3' On Weaker Profitability And Credit Metrics; Outlook Stable

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Overview

- Austria-based gaming company Novomatic reported lower earnings and margins in first-half 2017, due to increased regulatory compliance and acquisition-related costs, and despite strong acquisition-driven sales growth.
- We have revised down our base-case metrics for Novomatic over 2017-2018 to reflect lower margins and temporarily higher capital expenditures.
- We are therefore lowering our ratings on Novomatic AG to 'BBB-/A-3' from 'BBB/A-2'.
- The stable outlook reflects our expectation that capex will decrease substantially from 2019, as well as increasing clarity on the impact of regulatory changes in Germany.

Rating Action

On Nov. 29, 2017, S&P Global Ratings lowered its long- and short-term corporate credit ratings on Austria-based gaming company Novomatic AG to 'BBB-/A-3' from 'BBB/A-2'. The outlook is stable.

At the same time, we lowered our rating on Novomatic's outstanding senior unsecured notes to 'BBB-' from 'BBB'.

Rationale

The downgrade reflects Novomatic's weaker earnings and profitability reported in first-half 2017, resulting in our forecast of an S&P Global Ratings-adjusted EBITDA margin of slightly below 25% in 2017 and 2018, compared with 25%-30% in our previous base case. This is the consequence of high integration costs from recently acquired businesses in Germany, Poland, Italy, and Spain; costs related to regulatory compliance in core markets such as Germany, where Novomatic generates about 29% of revenues; and the increasing gaming tax in Italy. In addition, the German Gaming Ordinance requires all gaming machines to be equipped with personalized player card logins by end-2018, affecting a significant number of gaming machines, mainly rented to operators in Germany. This will result in elevated capital expenditures (capex) to defend Novomatic's leading market position and technological leadership, which will burden cash flows in 2017 and 2018. As a consequence, we now expect S&P Global Ratings-weighted average adjusted free operating cash flow to debt to be only 8%-9%, compared with 15%-16% in our previous base case. However, we acknowledge the temporary nature of the high capex investments and we anticipate that cash flow metrics will be in line with our current financial risk assessment from 2019.

We also view the company's acquisition strategy as risky during this period of low cash flows and regulatory challenges. Additional pressure on profitability could arise in 2018, given possible integration costs resulting from the planned acquisition of the Australian gaming technology provider, Ainsworth.

On a positive note, we acknowledge more clarity and positive development on regulatory changes relating mainly to the application of the Interstate Treaty on Games of Chance, passed by the German Government in 2012 aimed to meaningfully reduce the overall number of gaming arcades in a distinct area and the number of machines per arcade starting in July 2017. In our view, municipalities permit numerous exceptions in application of the law, reducing the actual number of Novomatic's gaming machines rented to operators by only around 10%-15% over the period to end-2018, which is in line with our previous base case. We also expect this to be partly offset by an increase in utilization of the remaining gaming machines in the German market and by Novomatic's ability to relocate spare gaming machines from Germany to its operations in other jurisdictions.

Despite regulatory risks, we still see Novomatic's business risk profile as supported by its strong market position in European countries as a gaming technology provider with leading brands and products. In its respective market segment, Novomatic holds No. 1 positions in Austria and Germany and ranks among the top three in the U.K., Spain, and Italy. The acquisition of Ainsworth further diversifies the group, with operations in North America and Australia. Each of these regions could represent about 5% of total group revenues starting in 2018.

Our assessment of the company's financial risk profile reflects weakened credit metrics after several acquisitions, with adjusted debt to EBITDA increasing to about 2.5x in the near term. Our base case for Novomatic has been further affected by its high planned capex investments and lower EBITDA from existing business due to regulatory requirements and integration costs. We expect Novomatic's reported EBITDA from existing businesses to decrease to about €570 million in 2018, from about €590 million in 2017. However, after accounting for planned acquisitions and other adjustments (mainly operating leases and income from disposed businesses), we estimate S&P Global Ratings-adjusted EBITDA of about €660 million-€680 million and an S&P Global Ratings-adjusted EBITDA margin of 24%-25% over the next two years.

The high reported cash on the balance sheet of about €880 million on Dec. 31, 2016, following the €500 million bond issue in late 2016, is likely to decrease over 2017-2018, resulting in weaker credit metrics in line with our financial risk profile. S&P Global Ratings-adjusted three-year weighted average funds from operations (FFO)-to-debt ratio will weaken to about 31%-34% in 2017-2019. After accounting for higher capex than we previously anticipated, we see our adjusted weighted average of free operating cash flow (FOCF) to debt declining to about 8%-9% over 2017-2019, compared with our previous forecast of 15%-16%, and temporarily below what we see as in line with the rating.

In our base case, we assume:

- Real GDP in the eurozone growing by 2.2% in 2017 and 1.8% in 2018, with consumer price index inflation at around 1.5% per year.
- Growth of the gaming industry moderately above GDP, since markets are not fully saturated. However, regulatory changes, such as those made in Germany in 2017, will result in temporarily negative growth in some regions.
- Novomatic's revenues will increase materially above the industry average, by around 9% in 2017 and 2018, mainly thanks to acquisitions, which account for 5% of sales growth in 2017 and about 8%-9% in 2018.
- A decrease in the total number of Novomatic's rented-out gaming machines of about 10%-15% over 2017-2018, partly offset by price increases for the remaining machines in the German market.
- Revenues from operations in the remaining segments will grow in line with the industry average, at about 2%-3%.
- An S&P Global Ratings-adjusted EBITDA margin of 24.5% in 2017 and 2018, affected by regulatory compliance-related costs and integration costs from acquisitions.
- Acquisitions of €140 million-€180 million in 2017, around €380 million-€420 million in 2018, and €200 million annually thereafter.
- Capex of €400 million-€450 million per year in 2017-2018, driven by required investments to comply with new regulations and about €300 million per year thereafter.
- Dividends of €50 million-€60 million annually in 2017 and 2018, increasing to €80 million from 2019.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures for 2017-2019:

- Adjusted debt to EBITDA of just above 2.0x in 2017 and 2.4x-2.5x in 2018 and 2019 (1.8x in 2016).
- Adjusted FFO to debt of about 35%-37% in 2017 and just above 30% in 2018 and 2019 (44% in 2016).
- Adjusted FOCF to debt of 2%-8% in 2017 and 2018, and 14%-16% in 2019 (1.9% in 2016).

Liquidity

We view Novomatic's liquidity as strong. We estimate that the group's liquidity sources will likely cover liquidity needs by about 1.6x over the next 12 months. Although the existence of the group's significant on-balance-sheet cash, availability of credit lines, and its sound cash flow are supportive, our view is constrained by significant planned capex and the event risk of cash outflows related to additional mergers or acquisitions. We also see Novomatic as having well-established and solid relationships with banks, as well as a generally high standing in credit markets.

Principal liquidity sources for the 12 months started June 30, 2017, include:

- About €535 million in cash and equivalents, less cash trapped in gaming machines;
- Undrawn revolving credit facilities of around €1 billion; and
- FFO of about €480 million-€500 million.

Principal liquidity uses for the same period, include:

- Short-term debt and maturing long-term debt of about €220 million;
- Changes in working capital and intra-year working capital swings of €100 million;
- Capex of around €400 million-€450 million;
- Acquisitions of €380 million-€420 million; and
- Dividends of €50 million-€60 million.

Under our base case, we estimate headroom under the net-debt-to-EBITDA covenant and the equity-ratio covenant at around 50% for the next 12 months.

Outlook

Our stable outlook reflects increasing clarity on the impact from regulatory changes on Novomatic's business, but also weakened credit metrics and profitability after debt-financed acquisitions in 2017-2018. Although we expect depressed FOCF to debt of below 10% in 2017 and 2018, we think the ratio will approach 15% from 2019, because of lower investments relating to compliance with German regulatory requirements after 2018.

Downside scenario

We could lower the ratings if operating costs to comply with new regulations in different countries and further acquisition costs lower Novomatic's EBITDA more than we currently assume or if Novomatic makes elevated capex investments after 2018. Additional debt-financed acquisitions, leading to material weakening of credit metrics, could also weigh negatively on the rating. Specifically, we would consider a downgrade if S&P Global Ratings-adjusted FFO to debt falls materially below 30% in the next two years, or if FOCF to debt remains below 15% in 2019.

Upside scenario

We could raise the ratings if Novomatic adapts swiftly to the changing regulatory environment and smoothly integrates announced acquisitions, while EBITDA margins increase well above 25%, thus supporting a stronger assessment of the business. This could be the case, for example, if Novomatic is able to retain more gaming machines in Germany after the application of the new regulation, if capacity utilization in the remaining machines in Germany increases more than we anticipate, or if the group generates higher synergies from acquisitions. We could also raise the ratings if FFO to debt reaches 45% and FOCF to debt recovers to 25% over the next two years.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Stable/A-3

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

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: bbb-

Modifiers
- Diversification/Portfolio effect: Neutral/Undiversified (No impact)
- Capital structure: Neutral (No impact)
- Liquidity: Strong (No impact)
- Financial policy: Neutral (No impact)
- Management and governance: Satisfactory (No impact)
- Comparable rating analysis: Neutral (No impact)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- 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
- Criteria - Corporates - Industrials: Key Credit Factors For The Leisure And Sports Industry, March 5, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- 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: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Industry Top Trends 2018: Hotels, Gaming and Leisure, Nov. 14, 2017
- Online Demand Will Help European Gaming Companies Offset Increased Taxes

And Regulations, Sept. 6, 2017

Ratings List

Downgraded

	To	From
Novomatic AG		
Corporate Credit Rating	BBB-/Stable/A-3	BBB/Negative/A-2
Senior Unsecured	BBB-	BBB

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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 the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.