Research Update:

Austrian Gaming Operator Novomatic Downgraded To 'BB+/B' On Declining Profitability; Outlook Stable

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Rating Action Overview

- German Gaming Ordinance-enforced AWP changes have affected Novomatic's operations, causing us to revise our previous forecast. We no longer expect the group's EBITDA margin to improve in 2019.
- Consequently, we forecast the lower EBITDA margins to translate into lower free operating cash flow (FOCF) rendering Novomatic unable to maintain its credit metrics at a level we consider commensurate with a 'BBB-' rating.
- We are therefore downgrading Novomatic to 'BB+/B' from 'BBB-/A-3' and lowering our issue ratings on its outstanding senior unsecured notes to 'BB+' from 'BBB-'.
- Despite the challenging environment in some of its key markets, the stable outlook reflects our view that management intended use of excess cash flows to repay debt will enable it to maintain S&P Global Ratings-adjusted debt to EBITDA below 4.0x and funds from operations (FFO) to debt above 20% over the next two years.

Rating Action Rationale

The downgrade reflects our view that the effects of the German Gaming Ordinance, along with a tough competitive environment in markets such as Italy and Australia, could cause Novomatic's EBITDA margin to further decline in 2019. Our previous expectation for improved ratios in 2019 seems less feasible now, and we do not think the group's cash flow measures could improve to a level that we consider commensurate with a 'BBB-' rating.

Novomatic continues to face material challenges in Germany, its main end-market. The termination of online B2B relationships with German customers and the introduction of new gaming laws effective November 2018 changed the landscape significantly. While Novomatic felt the effects of the former in 2018, it will notice the fall-out from the latter in both of its trading segments this year.

The German Gaming Ordinance required the introduction of a new generation of amusements-with-prizes (AWPs) from November 2018. Unlike its peers, Novomatic made a strategic decision to focus on manufacturing V2 machines only and not V1 machines (which will be valid only till February 2021). However, users were slow to accept the card unlocking feature in the V2 machines, which led Novomatic to lose some of its market share in the leased machines segment in Germany (previously it had a 50% share). Gross gaming revenue from its German operations declined by about 30%-40% in the initial weeks after the ordinance was introduced. For further details about V1 and V2 machines, please refer to our report "German Arcade Operators Face A Challenging 2019 As Gaming Ordinance Effects Are Worse Than Anticipated," Jan. 25, 2019.

Players' acceptance of Novomatic's V2 machines has since improved but we nonetheless forecast an organic decline in gross gaming revenue from its German gaming operations of about 10%-20% in 2019. There is minimal scope to reduce costs because of the fixed costs of manufacturing and the need to keep staff in stores to help players get used to the new machines.

To reduce its exposure to regulatory risks in Germany, Novomatic has tried to diversify its geographical presence. However, not all acquisitions have achieved the intended consequences. In January 2018, Novomatic completed the acquisition of about 52% shares in Ainsworth Game Technology Ltd. (Ainsworth) for €320 million. However, by end-2018 the value of the business was written down by €264 million after re-evaluating the long-term earnings prospects in light of a particularly weak performance in Australia. We previously anticipated Ainsworth would improve the group's margins, but we now forecast it will weigh on them.

We also forecast the revenue portion of the group's higher margin gaming technology segment will gradually decline as the AWP market in Germany continues to shrink. This change in the mix will affect the group's overall margins.

We therefore see the group's overall margins for 2019 declining to 21.5%-22.0% compared to our previous expectation of them improving to 24%-25% this year.

We had anticipated financial-year 2018 to be a time of transition. The Ainsworth stake, accelerated capital expenditure (capex) for V2 machines, and one-off costs associated with AWP replacements in Germany resulted in S&P Global Ratings-adjusted FFO to debt of 25% and negative free operating cash flows (FOCF) to debt. We thought these ratios would improve to above 30% and 15%, respectively, in 2019, but we now forecast 26%-28% and 6%-9%. This means the group's credit metrics will not be commensurate with a 'BBB-' rating for about the next two years.

Despite margin strain and inherent regulatory challenges, we recognize Novomatic as one of the leading operators in the European gaming sector with S&P Global Ratings-adjusted EBITDA of about €610 million. It benefits from being vertically integrated, having operations in multiple European geographies, and a significant scale that supports investments in R&D to enable the development of new products.

Outlook

The stable outlook reflects our view that management's intended use of excess cash flows to repay its debt will enable it to maintain S&P Global Ratings-adjusted debt to EBITDA below 4.0x and FFO to debt above 20% over the next two years, despite some challenging end-markets.

Downside scenario

We could lower the ratings if S&P Global Ratings-adjusted FFO to debt falls materially below 20% or debt to EBITDA climbs above 4.0x in the next two years, or Novomatic is unable to generate material FOCF. This could stem from revenues or margins declining more than we currently anticipate because of regulatory changes in other key markets, a material hike in its gaming tax, a material debt-financed acquisition, or shareholder returns. Longer term risk could arise when the current exemption from, or active tolerance of, the German Interstate Treaty expires toward 2021.

Upside scenario

We consider the potential for rating upside to be remote. The regulation-induced revenue decline in the gaming technology segment, limited contribution from online segments, and weak operating performance of the stand-alone Ainsworth business present material operating challenges in the next 12-24 months. However, we could raise the ratings if Novomatic were able to address these risks while improving EBITDA margins to around 25%-28%, thereby supporting a stronger assessment of the business. Alternatively, we could also raise the ratings if FFO to debt reaches 30% and FOCF to debt recovers to 15% over the next two years if Novomatic is able to materially reduce its debt through asset disposals or new equity infusion.

Company Description

Novomatic operates in two segments: Gaming Technology (business-to-business segment) and Gaming Operations (business-to-consumer segment). The Gaming Technology segment engages in the production, sale, and rental of gaming and entertainment machines; and the operation of online content for business customers. The Gaming Operations segment is involved in the operation of casinos and electronic gaming machines, as well as the online B2C business; and the provision of sports and horse racing betting services.

In 2018, Novomatic reported revenue and S&P Global Ratings-adjusted EBITDA of €2.6 billion and €611 million, respectively. Novomatic is a mostly European business with Germany, Austria, and Italy representing about 57% of its revenues.

The group is effectively controlled by Prof. Johann F. Graf (founder of the group) through an investment holding company, Novo Invest Gmbh.

Our Base-Case Scenario

- Real GDP growth in the eurozone of 1.1% in 2019 and 1.4% in 2020, with consumer price index inflation around 1.3% per year.
- Absent any further regulatory changes, we anticipate land-based gaming operations in Europe to report modest growth whereas remote gaming will grow significantly above GDP because markets are not fully saturated.
- For 2019, we forecast an organic revenue decline of about 2%-5% in Novomatic's gaming technology segment (37% of the group's revenue), after a 4% decline in 2018. We expect the decline to stem from there now being fewer leased gaming machines in Germany although partly offset by a higher monthly rental for the new machines.
- Revenues from the gaming operations segment (63% of the group's revenue) will grow above the industry average, at about 4% in 2019 compared with 8% in 2018. This is supported by strong growth in all regions except Germany. Germany's performance will be affected by reduced player activities on the V2 machines.
- Overall, we forecast total revenue growth of 1% in 2019, and about 2%-5% in 2020.
- 2021 could be another difficult year as the various hardship exemptions and active tolerance granted under the German Interstate Treaty could expire by June 2021.

- In light of the above, we forecast S&P Global Ratings-adjusted EBITDA margin to dip below 22% in 2019 compared to 23.4% in 2018 (pre-IFRS 16).
- Bolt-on acquisitions of around €50 million in 2019 and 2020 per year.
- Asset disposal proceeds of about €100 million-€200 million in 2019 to be used for debt repayment.
- Capex of about €325 million in 2019, a return to normal maintenance levels after two years of accelerated capex.
- Dividends of €30 million-€40 million in 2019 and 2020, compared to €32 million in 2018.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures for 2019-2020:

- Adjusted debt to EBITDA of about 2.7x-2.8x.
- Adjusted FFO to debt of about 26%-28%.
- Adjusted FOCF to debt of about 6%-9%.

These forecasted credit metrics do not include the effects of IFRS 16 lease accounting. Novomatic has already flagged that the adoption of IFRS 16 will result in higher lease liabilities. This increase arises from the accounting standard's requirement to use the license term as the key parameter to estimate the term of a lease. It is a departure from the previous disclosures where management reported its lease liabilities commitments only for its non-cancellable period. Overall, we anticipate our significant financial risk profile assessment will accommodate the impact of the increased lease liabilities under IFRS 16.

Liquidity

We view Novomatic's liquidity as strong. We estimate that the group's liquidity sources will likely cover liquidity needs by above 2.0x over the next 12 months. Although the quantitative assessment indicates a better liquidity assessment, our strong assessment incorporates covenant headroom of 30% (rather than 50%) and factors in our concerns about the group's ability to absorb, high-impact, low probability events without refinancing. We also see Novomatic as having well-established and solid relationships with banks, as well as a generally high standing in the credit markets.

Principal liquidity sources for the 12 months started Jan. 1, 2019, include:

- About €378 million in cash and equivalents, less cash trapped in gaming machines;
- Availability of €550 million under its revolving credit facilities of €1 billion due March 2024; (pro forma €250 million bonds repaid in January 2019);
- Committed proceeds from asset disposal of €40 million; and
- FFO of about €400 million.

Principal liquidity uses for the same period, include:

- Short-term debt and maturing long-term debt of about €39 million (pro forma €250 million bonds repaid in Jan 2019);
- Changes in working capital and intra-year working capital swings of €130 million;

- Capex of around €325 million;
- Acquisitions of €50 million; and
- Dividends of €30 million-€40 million.

Covenants

Novomatic has the same two maintenance covenants under its various debt facilities, namely an equity ratio of at least 20% and net debt to EBITDA of less than 3.75x.

From Jan. 1, 2019, Novomatic has agreed with almost all of its lenders to amend the covenant levels to accommodate the effects arising from IFRS 16 (lease reporting). The new covenant levels are an equity ratio of at least 15.0% and net debt to EBITDA of a maximum of 4.625x. Under our base case, we estimate headroom under the net-debt-to-EBITDA covenant and the equity-ratio covenant at around 30% for the next 12 months.

Environmental, Social, And Governance

Social risks are significant for gaming companies like Novomatic. Concerns from the public and regulators include money laundering, gambling addiction, harm to underage players, and displays of anti-social behavior around gambling halls. Consequently, various countries have enacted laws, often significantly affecting gaming companies and their financial performance. Examples of such regulations include the prohibition of gaming machines in Vienna; the German Interstate Treaty that enforces minimum distance conditions and bans multi concessionaires; and the Italian government's decision in 2017 to reduce total AWPs by 35%.

We consider Novomatic's governance to be at a similar level to other peers we rate in the region. The group's compliance risk framework is robust; it has not had to pay any material fines or penalties. Additionally, unlike some of its peers, the group operates in regions where there is regulatory certainty and has a strict and conservative approach to compliance.

Following the German federal court's ruling in October 2017 regarding the legality of online casinos, Novomatic terminated its B2B contract with its customers. This decision reduced its reported EBITDA of its overall online segment by €75 million in 2018. While, on the one hand, this development reflects the impact of social risks that Novomatic faces, it also reflects its conservative approach relative to peers such as GVC, who continue to provide online casinos in Germany based on the interpretation that such gaming is allowed under European law.

Conversely, in our view, the impairment of Ainsworth could indicate the need to tighten controls. Acquisitions are relatively challenging in the gaming sector due to the risk of constant regulatory changes. Therefore, a typical acquisition in this industry tends to incorporate a sizable deferred consideration. While Novomatic did have such a deferred consideration clause in its other business purchases, it did not have such a provision in its Ainsworth transaction.

Issue Ratings - Recovery Analysis

Key analytical factors

- The issue rating on the unsecured notes (€200 million due 2021 and €500 million due 2023) is 'BB+' with a recovery rating of '3', reflecting our expectation of meaningful recovery (50%-70%, rounded estimate 65%) under a default scenario.

- Our simulated default scenario contemplates a payment default occurring in 2024 due to regulatory changes which will shrink Novomatic's addressable market combined with a prolonged economic downturn that reduces consumer spending on gaming, extends the gaming equipment replacement cycle, and meaningfully reduces arcade operators spending on new equipment.
- We assume Novomatic will reorganize under a distressed scenario and use a 6.5x multiple to value the company, which is in line with the average multiple we use for the leisure industry.
- We assume the revolver would be 85% drawn at the time of default.
- Due to the unsecured nature of the bonds, we cap the recovery rate to 65%, despite the numerical calculation will indicate a higher recovery of about 85%.

Simulated default assumptions

- Year of default: 2024
- Jurisdiction: Austria

Simplified waterfall

- Emergence EBITDA: €314 million (capex represents 6% of sales. Cyclicality adjustment is 10%, in line with the specific industry subsegment. Operational adjustment is 30% to reflect the higher capital expenditure relating to gaming technology segment).
- EBITDA multiple: 6.5x
- Gross recovery value: €2.04 billion
- Net recovery value after administrative expenses (5%): €1.94 billion
- Estimated priority debt: €53 million
- Estimated unsecured claims[1]: €2.1 billion
- The value available to unsecured claims: €1.89 billion
- --Recovery expectations: 50%-70% (rounded estimate: 65%)

[1] All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating: BB+/Stable/B

Business risk: Satisfactory

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

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers:

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

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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 - Industrials: Key Credit Factors For The Leisure And Sports Industry, March 5, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, 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 2019: Hotels, Gaming, And Leisure, Nov. 13, 2018
- Consolidation Helps European Gaming Companies Ride Out Regulatory Changes, Sept. 12, 2018.

Ratings List

Downgraded

	To	From
Novomatic AG		
Issuer Credit Rating	BB+/Stable/B	BBB-/Stable/A-3
Senior Unsecured	BB+	BBB-
Recovery Rating	3(65%)	