Research Update:

Novomatic AG Outlook Revised To Negative On COVID-19-Related Business Disruption; 'BB+' Ratings Affirmed

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Rating Action Overview

- Because Novomatic has closed the majority of its gaming arcades and is receiving only a share of normal revenue from leased gaming machines following the outbreak of COIVD-19, we expect the company's EBITDA will decline 30%-40% in 2020 compared with 2019.
- However, a sound liquidity buffer, adequate covenant headroom, well-established bank relationships, and cash preservation measures should enable the group to withstand disruption to its operations over the next few months, and manage upcoming 2020 maturities.
- We are revising our outlook on Novomatic AG to negative from stable, and affirming our 'BB+' ratings on the company.
- The negative outlook reflects our view that the impact of COVID-19 on the group's cash generation, credit metrics, and liquidity could be more pronounced than we currently anticipate given the uncertainty surrounding the duration and severity of the outbreak, and its impact on the wider economy.

Rating Action Rationale

As a result of the COVID-19 outbreak in Europe, we now expect Novomatic AG's sales will decline by up to 20% in 2020. This is based on the assumption that COVID-19 will be contained in Europe by the end of second-quarter 2020, and that consumer spending will recover moderately in the third quarter. Following restrictions introduced by European governments to contain the spread of COVID-19, Novomatic and customers for its leased-out machines have temporarily closed a large number of their gaming arcades. Therefore the group will only receive part of its normal revenue. Despite the lockdown, we believe the group will receive about one-fifth of its revenue stream, mainly reflecting flat fees for leased-out machines and the unaffected e-commerce business, which represented about 11% of 2019 group sales. Some countries such as Serbia and parts of Germany have already agreed on opening arcades early May, but we believe other areas that are more heavily affected by the pandemic will follow later this quarter.

We do not believe cost savings and cash preservation measures will prevent a decline in earnings and cash flow in 2020 compared with the last year. These measures include introducing state-funded part-time work for employees in most of its core regions, negotiating rents for closed arcades, reducing capital expenditure (capex) to only necessary projects, and benefitting from temporary government tax relief for gaming taxes, which represented about 12% of revenue alone in 2019. Despite these measures, we expect profitability will weaken due to the still substantial fixed cost share, and therefore expect S&P Global Ratings-adjusted debt to EBITDA of 4.4x–5.0x in 2020, as well as slightly negative free operating cash flow (FOCF) after all lease related payments. We believe these elevated metrics are temporary, but they are not in line with the current rating.

We believe the group has sufficient liquidity sources to weather the significant expected cash outflows over the next few weeks. Following the recent disposals, the company has about €360 million available cash and liquid investments and about €800 million available under its revolving credit facility (RCF) for liquidity management. The RCF documentation includes a net debt to EBITDA covenant with temporarily low headroom of only 15%-20% in 2020. While we do not expect a covenant breach in our current scenario and full availability over the next 12 months, we also believe Novomatic is well positioned to negotiate a waiver if necessary, thanks to the group's well-established bank relationships, material scale in Austrian financial markets, and the potential temporary nature of COVID-19 and its impact on earnings.

Uncertainties regarding the COVID-19 pandemic are clouding earnings visibility. We acknowledge a high degree of uncertainty about the rate of spread, peak of the coronavirus outbreak, and possible relief of government actions. Some government authorities estimate the pandemic will peak at about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: www.spglobal.com/ratings). As the situation evolves we will update our assumptions and estimates accordingly. We see a risk that governments could impose further restrictions, a new contagion wave might impose new governmental measure after a period of openness, or existing restrictions may continue for longer than we anticipate. This creates potential downside risks to our projections of Novomatic's future earnings and cash generation.

Ratings subject to further regulatory developments, despite some greater clarity for the German gaming market. While regulatory changes have affected Novomatic's earnings and cash generation over the past three years, and the sector remains prone to regulatory risks, we see limited near-term effects from recent regulatory changes. This is due to:

- The impact of German Gaming Ordinance measures regarding player safety on gross gaming revenue was negative in early 2019, but has meanwhile improved. In early 2019, the newly introduced V2 machines with card unlocking features were unpopular for players, and resulted in lower gross gaming revenue. However, these new V2 machines have become more accepted as players have become more used to the feature, and gross gaming revenue has thus materially improved.
- The new draft Interstate Treaty agreed by German states, which lays out a framework for regulation in the German market from July 2021. This allows states to accept the current level of exceptions granted for multi-concession arcades, therefore lowering risk to earnings expectations for Novomatic's German business.

- The impact of distance regulation on gaming arcades in Italy, which limits the number of arcades allowed in one area, as well as higher gaming taxes in the country, mostly in 2019, have been incorporated in our base case. We also expect less regulatory scrutiny in the sector given the significant impact of COVID-19 on businesses.

COVID-19-related government measures and the German online market's targeted regulation could accelerate a customer shift to online offers. While online gaming in Germany is prohibited, protecting Novomatic's large land-based business in this core market during the recovery period following the outbreak of COVID-19, the new Draft Interstate Treaty will allow this market to open in Germany in 2021. In our view, this creates a risk that Novomatic's competitors that already have a stronger online presence might increase competitive pressure over the next few years. This could cause a problem for Novomatic unless the company is able to successfully transfer its market leadership position into the online channel, and navigate any licensing or material investment costs associated with it.

Environmental, social, and governance (ESG) factors relevant to the rating action:

- Health and safety

Outlook

The negative outlook reflects our assumption of an about three-month disruption across the group's operations, but a moderate pickup in activity through third-quarter 2020, accelerating further toward the end of the year. Given that social distancing should not be a significant barrier to restarting operations, in our view, the group should be able to partly offset the slowdown in activity through a reduction in operating expenses and deferred capex. On this basis, we still expect S&P Global Ratings-adjusted debt to EBITDA will increase to 4.4x-5.0x in 2020, and that reported FOCF after lease payments will be slightly negative over the next twelve months. We will update our expectations and forecasts as we receive more information.

Downside scenario

We could lower the rating if:

- The impact of the COVID-19 pandemic was more severe that we currently assume, resulting in S&P Global Ratings-adjusted debt to EBITDA remaining materially above 3.5x, or FOCF after all lease payments remaining negative, or liquidity weakening to a degree not offset by any remedial action;
- The pandemic led to a structurally weaker gaming industry as a whole, exemplified by Novomatic's operating margins not recovering to pre-COVID-19 levels, or the company's positioning weakening compared with that of peers. The latter, for example, could occur if the online market opened up in Germany and Novomatic was not able to ramp-up their limited online presence, thereby losing market share to online competitors. In these two cases, we could reevaluate our assessment of Novomatic's business strength.

Upside scenario

We could revise the outlook to stable once we have more certainty regarding the duration and severity of the COVID-19 pandemic and its effects on the industry and on Novomatic's operating performance, liquidity, and cash flow. In particular, an outlook revision would depend on the group's ability to reduce costs, preserve cash, manage upcoming debt maturities, and defend its market position during the anticipated recovery from COVID-19, with its S&P Global Ratings-adjusted debt to EBITDA therefore reducing toward 3.5x after 2020.

Company Description

Novomatic operates in two segments: Gaming Technology (business-to-business segment) and Gaming Operations (business-to-consumer segment[B2C]). The Gaming Technology segment engages in the production, sale, and rental of gaming and entertainment machines and content, as well as 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 2019, Novomatic reported revenue and S&P Global Ratings-adjusted EBITDA of €2.6 billion and €663 million, respectively. Novomatic is a mostly European business with Germany, Austria, and Italy representing about 56% of its revenue.

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

Our Base-Case Scenario

- Real GDP growth in the eurozone of negative 7.3% in 2020 recovering by 5.6% in 2021, with consumer price index inflation of 0.5%-1.5% per year.
- Absent any regulatory changes, we anticipate land-based gaming operations in Europe will report modest growth, but remote gaming will expand significantly above GDP because markets are not fully saturated.
- Revenue decline of up to 20% in 2020 due to the impact of COVID-19, recovering to 10%-15% in 2021, somewhat hampered by various hardship exemption and active tolerance granted under the German Interstate Treaty expiring in June 2021.
- In light of the factors flagged above, and some level of fix costs included in operations, we forecast the company's S&P Global Ratings-adjusted EBITDA margin will dip below 20% in 2020 compared with 25.4% in 2019.
- Opportunistic bolt-on acquisitions of about €50 million in 2020 and 2021.
- Capex of €200 million-€240 million in 2020, which has been temporarily lowered due to COVID-19 impact. It would further accelerate toward €300 million-€350 million from 2021.
- Asset disposal net proceeds of about €100 million in 2020 to be utilized for debt repayment.
- Dividends of €30 million-€50 million in 2020 and 2021, compared with €33 million in 2019.

Key metrics

	2018a	2019a	2020e	2021f
Revenue (€ bil)	2.613	2.607	2.0-2.2	2.3-2.5

	2018a	2019a	2020e	2021f
EBITDA (€m)	611	663	380-450	550-620
EBITDA margin (%)	23.4	25.4	19.0-21.0	23.0-26.0
Debt to EBITDA (x)	2.8	2.9	4.4-5.0	3.0-3.5
FFO to debt (%)	25.3	29.5	15.0-20.0	22-30
FOCF to tebt(%)	(4.0)	12.8	2.0-5.0	8.0-12.0

All figures are S&P Global Ratings-adjusted. *2019 year-end debt comprises financial debt of €1.9 billion, for which key adjustments are €0.7 billion in leases and €0.4 billion in surplus cash available for debt repayment. e--Estimate. f--Forecast. FFO--Funds from operations. FOCF--Free operating cash flow. N/A--Not applicable.

Liquidity

We view Novomatic's liquidity as still strong, although expect cash outflows over the next twelve months will limit the headroom under this assessment. We estimate that the group's liquidity sources will likely cover liquidity needs by nearly 2.1x over the next 12 months. Although covenant headroom is temporarily only 15%-20% in 2020, we see Novomatic as having well-established and solid relationships with banks, enabling a favorable position on negotiating covenants if necessary. We also see the company as having a generally high standing in credit markets, helping to refinance upcoming maturities despite challenged capital markets in recent weeks.

Principal liquidity sources for the 12 months started April 1, 2020, include:

- About €360 million available in cash and equivalents, less cash required in gaming machines;
- Availability of about €810 million under its RCF of €1 billion due March 2024; and
- Funds from operations of about €245 million, net of all lease related payments.

Principal liquidity uses for the same period, include:

- Short-term debt and maturing long-term debt of about €250 million;
- Changes in working capital and intrayear working capital swings of €100 million-€150 million
- Capex of €200 million-€250 million; and
- Dividends of about €50 million.

Covenants

Compliance expectations

We estimate that headroom under the financial covenants will tighten to 15%-20% in 2020 and 30%-45% thereafter. Considering Novomatic's solid relationship with core banks, we believe that temporarily lower headroom under its covenants does not constrain our liquidity assessment.

Requirements

The subgroup of Novomatic is required to comply with semi-annually tested financial covenants in its €1.0 billion RCF. These include a maximum net debt to EBITDA covenant of up to 4.63x.

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 2025 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.
- Although the numerical recovery outcome exceeds 65%, our criteria caps the recovery rating of the notes at '3' due to their unsecured nature. This accounts for the risk that additional prior- or same-ranking debt could be raised on the path to default.

Simulated default assumptions

- Year of default: 2025
- Jurisdiction: Austria

Simplified waterfall

- Emergence EBITDA: €320 million (capex represents 6% of sales. Cyclicality adjustment is 10%, in line with the specific industry subsegment. Operational adjustment is -5% to reflect the regulatory pressure in gaming technology segment).
- EBITDA multiple: 6.5x
- Gross recovery value: €2.08 billion
- Net recovery value after administrative expenses (5%): €1.2 billion
- Estimated priority debt: €53 million
- Estimated unsecured claims[1]: €2.14 billion
- The value available to unsecured claims: €1.92 billion

- Recovery expectations: 50%-70% (rounded estimate: 65%)

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

Includes €1.0 billion RCF assumed to be drawn at 85%

Ratings Score Snapshot

Issuer Credit Rating: BB+/Negative/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

- General Criteria: Group Rating Methodology, July 1, 2019
- 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
- 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- COVID-19: Coronavirus- And Oil Price-Related Public Rating Actions On Corporations, Sovereigns, And Project Finance To Date, May 11, 2020, 2020
- Credit Conditions In Europe Darken As Costs Of Lockdowns Add Up, April 27, 2020
- Credit FAQ: Assessing The Coronavirus-Related Damage To The Global Economy And Credit Quality, March 24, 2020

Ratings List

Ratings Affirmed; Outlook Action

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