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Research Update:

Swiss Cocoa And Chocolate Supplier Barry Callebaut Downgraded To 'BB+' On Weaker Financial Profile; Outlook Negative

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Overview

- We view Switzerland-based chocolate products supplier Barry Callebaut's financial policy as aggressive because of its ongoing acquisition of Singaporean Petra Foods Ltd.'s cocoa ingredients division and because its credit metrics were already tight for the ratings.
- We now view the group's financial risk profile as "significant" and our assessment of the business risk profile remains as "satisfactory".
- We are therefore lowering our long-term corporate credit and issue ratings on Barry Callebaut to 'BB+' from 'BBB-'.
- The outlook is negative, reflecting our view that there is a one-in-three chance that Barry Callebaut's credit metrics will stay at the very low end of the "significant" category in the coming 18 months.

Rating Action

On March 28, 2013, Standard & Poor's Ratings Services lowered its long-term corporate rating on Switzerland-based chocolate products supplier Barry Callebaut AG to 'BB+' from 'BBB-' and removed it from CreditWatch with negative implications, where it had been placed on Dec. 14, 2012. The outlook is now negative.

At the same time, we also lowered the issue ratings on the senior unsecured notes issued by Barry Callebaut Services N.V. to 'BB+' from 'BBB-' and removed them from CreditWatch negative. We assigned a recovery rating of '4' to these unsecured notes, indicating our expectation of average (30-50%) recovery for unsecured debtholders in the event of a payment default.

Rationale

The downgrade reflects our view that the ongoing acquisition of Singapore-based Petra Foods Ltd.'s cocoa ingredients division, achieved at a high 14.3x 2011 EBITDA, indicates a more aggressive financial policy than we had anticipated. We acknowledge that, in the longer term, the acquisition should bring Barry Callebaut sizable additional volumes in emerging markets, especially in Asia and Latin America, and diversify the company's cocoa sourcing outside Africa. However, it comes just after Barry Callebaut at the end of fiscal 2012 reported credit metrics that were already tight for investment-grade ratings and were weakening, with adjusted FFO to debt of

25.5% and debt to EBITDA of 2.9x.

We already stated in our explanation of our upgrade of Barry Callebaut in December 2011 that a sizable, largely debt-financing acquisition resulting in adjusted debt to EBITDA of more than 3.0x would not be compatible with a financial risk profile of "intermediate". Given that one-third of the transaction would be financed through equity issuance, we forecast adjusted FFO to debt of slightly below 20% and debt to EBITDA ratio of close to 4.0x after the acquisition, which is a stretch even for a "significant" financial risk profile.

We acknowledge that Barry Callebaut's deterioration in credit profile paves the way for eventual future growth. But the company's investments to support growth have proved greater than we had anticipated. Barry Callebaut had to invest massively to support sales volume growth of 5% and 8.7% over the past two years. Profitability thus proved lower than expected. Moreover, the announced acquisition would be margin dilutive.

Capital expenditures were also higher, at Swiss franc (CHF) 217.8 million in fiscal 2012 while we had anticipated CHF150 million annually. Furthermore, we understand that, excluding the acquisition, the company nevertheless intends to continue to invest massively, notably in fast-growing markets, so that capital expenditures would remain at around CHF200 million. We have noted that, despite significant investments, adjusted EBITDA has just been stable over the last five years. Free cash flow was negative over the past two years, which signals a limited potential for deleveraging.

Liquidity

Barry Callebaut is financing the acquisition with a bridge facility, which it has already secured and which is currently undrawn. We moreover understand the transaction led to the obtaining of a waiver on group's main covenants.

Recovery analysis

The rating on the senior unsecured debt issued by Barry Callebaut Services N.V. and guaranteed by Barry Callebaut AG is rated 'BB+' in line with the corporate credit rating. The recovery rating on this debt is '4', indicating our expectation of average (30%-50%) recovery for unsecured debtholders in the event of a payment default.

Our recovery and issue ratings reflect the unsecured character of Barry Callebaut's existing capital structure, although we see the notes as being subordinated to a €275 million factoring facility and some facilities provided directly to subsidiaries. We understand that the notes are unsecured and benefit from the similar guarantee package to the unsecured revolving credit facility. On this basis we assume that the notes rank pari passu with the revolving credit facility. We understand that the documentation for the notes included a negative pledge covenant restricting permitted security over assets of 35% of total tangible net assets.

Our hypothetical default scenario contemplates a default driven by weaker operating performance driven by a potential combination of a more competitive operating environment resulting in lower revenues. We believe that this would most likely coincide with significant capital expenditures to invest in newly signed long-term contracts with multinationals. We assume a default in 2017 triggered by the maturity of the €350 million unsecured notes.

We value Barry Callebaut as a going concern, given its market position, well-known customer base, and long-term contracts with established players in the chocolate industry. Our stressed valuation does not include any potential value of the proposed acquisition from Petra Foods.

At our hypothetical point of default, we envisage a stressed enterprise value of around CHF1.23 billion, equivalent to a 6.0x stressed valuation multiple. From this we deduct priority liabilities of around CHF560 million (including around CHF110 million of enforcement costs, CHF275 million factoring facility and uncommitted facilities currently drawn at the operating subsidiary level). This leaves around CHF670 million for unsecured lenders at Barry Callebaut AG and Barry Callebaut Services N.V. We envisage around CHF1.7 billion of unsecured debt at these entities outstanding at default (including 100% drawing on the revolving credit facility, six months' prepetition interest, and assumed rolled-over current drawings under uncommitted facilities.

Outlook

The negative outlook reflects our view that there is a one-in-three chance that Barry Callebaut's adjusted FFO to debt would not get close to 25% in the coming 18 months because working capital needs and capital expenditures are poised to continue weighing on cash flow generation and constraining deleveraging.

We could further downgrade Barry Callebaut if we do not see a clear path to deleveraging.

We could revise the outlook to stable if we were to see enhanced cash conversion and if FFO to debt improved to close to 25% and debt to EBITDA ratios comfortably improved to about 3.0x-3.5x.

We could revise the outlook to stable if the ongoing acquisition does not take place.

Related Criteria And Research

- Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Key Credit Factors: Criteria For Rating The Global Branded Nondurable

Consumer Products Industry, April 28, 2011
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- 2008 Corporate Ratings Criteria: Ratios And Adjustments, April 15, 2008

Ratings List

Downgraded

	To	From
Barry Callebaut AG		
Barry Callebaut Services N.V.		
Corporate Credit Rating	BB+/Negative/--	BBB-/Watch Neg/--
Barry Callebaut Services N.V.		
Senior Unsecured*	BB+	BBB-/Watch Neg

Recovery Rating Assigned

	To	From
Barry Callebaut Services N.V.		
Senior Unsecured*		
Recovery Rating	4	NR

*Guaranteed by Barry Callebaut AG

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