

Research Update:

Elior Group 'B+' Rating Affirmed On Expected Gradual Profitability Improvement And Announced Acquisition; Outlook Stable

February 8, 2023

Rating Action Overview

- Despite continued pressure on Elior Group S.A.'s EBITDA margins due to the challenging pass-through of high cost inflation and exceptional charges associated with its turnaround plan, S&P Global Ratings believes the group's operating performance will gradually improve, supported by solid organic revenue growth and contract negotiations.
- The announced acquisition of Derichebourg S.A.'s multi-services (DMS) business, which in our view is likely to materialize, will have a positive impact on the group's credit metrics, although it also poses some integration and execution risks.
- We affirmed our 'B+' long-term issuer credit rating on Elior and our 'B+' issue rating on the group's €550 million senior notes due 2026.
- The stable outlook factors in a gradual improvement in Elior's operating performance and successful integration of DMS, translating into leverage of 5.6x-5.8x and funds from operations (FFO) to debt of 12%-13% in fiscal 2023 (including the pro forma effect of DMS), despite free operating cash flow after lease payments remaining moderately negative.

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Rating Action Rationale

The affirmation reflects that the acquisition of DMS, which we believe will proceed, will increase Elior's EBITDA base and support deleveraging. In December 2022, shareholder Derichebourg S.A. agreed to move its DMS division to Elior in exchange for new Elior Group shares. Following this transaction, Derichebourg's ownership will increase to about 48.4% from about 24.36% currently. We view the proposed acquisition as positive because it increases the group's EBITDA by about €50 million on a pro forma 12-month basis, excluding synergies of an estimated €30 million, and it will complement Elior's facility management's activities, extending its customer base and geographic footprint. We view positively the increased diversification of the group's services away from catering services, with multi-services activities representing about 30% of

Elior's pro forma combined revenue base compared with less than 15% currently. Nevertheless, there are potential execution risks associated with integrating DMS operations and with the changes in management and governance announced as part of this transaction. This could create higher-than-expected costs and cash outflows, and could delay the group's operational efficiency improvement plans. The transaction is subject to customary conditions, including obtaining an exemption from French financial markets regulator AMF from making a compulsory public tender offer, approval from anti-trust authorities, and Elior shareholder approval at an extraordinary general meeting. It is expected to close in April-May 2023.

In our view, Elior's progress in renegotiating its contracts to pass through cost inflation, and the benefits from margin improvement initiatives, will support a gradual recovery in EBITDA margins despite persistent inflation. The group made significant progress in renegotiating contracts with its customers in the past 12 months, to mitigate inflation's effects, and it reported achieving an approximately €234 million price increases on a 12-month rolling basis, based on 73% of contracts renegotiated as of Dec. 31, 2022, compared with 90% the group had targeted for then. We understand that implementing price increases is more difficult with certain groups of customers, in particular public customers in France. We also include costs associated with restructuring and reorganization measures, which continue to weigh on EBITDA margin improvement and cash flow. But our base-case scenario still forecasts a significant improvement in the group's operating margins in fiscal years 2023 and 2024, benefiting from continued positive organic growth and ongoing recovery from COVID-19, the already-achieved contract negotiations, and the exit of the loss-making Preferred Meals business.

Despite Derichebourg's expected increased ownership of Elior's share capital, we do not factor in any extraordinary shareholder support in our assessment of the group's creditworthiness If the proposed transaction proceeds, Derichebourg will reinforce its long-term investment in Elior. Daniel Derichebourg, current CEO of Derichebourg, is to become Elior's CEO and chairman while remaining chairman of Derichebourg. We factor in Derichebourg's increased influence as shareholder and commitment to help turnaround Elior's operations and create value and synergies by combining DMS with the group's facility management's segment. However, we understand that both groups will be managed and funded independently and maintain arm's length relationships. Therefore, we continue to assess Elior's creditworthiness stand-alone. Any change in our perception of the relationship between the companies, notably our view of Derichebourg's willingness to support Elior's capital structure or liquidity, may warrant a reassessment of the latter's status within the group.

Following the new covenant waiver obtained in December 2022, we expect Elior will maintain adequate liquidity and covenant headroom in the next 12 months. With the waiver, the covenant test based on Sept. 30, 2023, results will have a target leverage of 6.0x (versus 4.5x previously). The covenant then decreases to 4.5x in March 2024. This provides additional time for Elior to restore its profitability and credit metrics. However, this is the second time the past 12 months that the company had to adjust its covenant levels, reflecting difficulties anticipating and mitigating operational risks that have significantly affected its profitability and cash flows in the past two years.

Outlook

The stable outlook factors in a gradual improvement in Elior's operating performance and successful integration of DMS, translating into leverage of 5.6x-5.8x and FFO to debt of 12%-13% in fiscal 2023 (including DMS' pro forma effect), despite free operating cash flow after lease payments remaining moderately negative.

Downside scenario

We could lower the rating in the coming 12 months if we no longer expected Elior to deleverage toward 5.5x and its FFO to debt to increase above 10%, pro forma the DMS contribution, or if the group faced heightened liquidity and covenant pressure despite the recent covenant waiver. This could happen if:

- The DMS acquisition failed to materialize, implying weaker credit metrics for Elior given the EBITDA contribution from the multi-services activities.
- We anticipated no significant improvement in the group's EBITDA margins toward pre-pandemic levels due to persistently high inflation or higher-than-expected restructuring and integration costs.
- We expected the group's adjusted FOCF to remain negative.

Upside scenario

We could upgrade Elior if sustained positive organic growth combined with EBITDA margin improvement beyond our expectations, on fruitful contract negotiations and restructuring measures, as well as the successful integration of DMS, resulted in S&P Global Ratings-adjusted debt to EBITDA improving to and staying below 4.5x and FFO to debt to above 16%.

Company Description

Founded in 1991, France-based Elior is a global leading operator in contract catering and support services, offering services targeted at three key client markets: corporate entities and government agencies (business and industry), education establishments, and health care and leisure facilities. The group has leading positions in five key countries and employs about 97,000 people, feeding over 3 million people in 20,250 restaurants every day, and offering support services at 2,400 sites in France. The group generated €4.45 billion in revenue in fiscal 2021-2022. It is listed on Euronext Paris.

Our Base-Case Scenario

Assumptions

- Muted GDP growth in the group's markets in 2023, with 0.2% in France and 0.9% in Spain; and a GDP decline of 1% in the U.K., 0.1% in Italy, and 0.1% in the U.S.
- CPI growth of 4.4% in France, 5.1% in Spain, 7% in the U.K., 6.1% in Italy, and 4.3% in the U.S.

- Revenue growth of 14%-15% in fiscal 2023 supported by Elior's revenue growth of about 5% (including the negative impact from exiting the Preferred Meals business) on continued gradual post-COVID-19 recovery, price increases from contract negotiations, and steady retention rates above 90%. We also include a five-month contribution from DMS in our base-case scenario, or €410 million-€420 million.
- Steady organic revenue growth of 4%-5% in fiscal 2024 and the full-year contribution of DMS, bringing total revenue growth to 15%-17%.
- Adjusted EBITDA margins of 4.3%-4.5% in fiscal 2023 from 1.3% in fiscal 2022. We continue to forecast pressure from input cost inflation, which we expect the group won't be able to fully pass through despite contract renegotiations, and restructuring costs associated with reorganizing operations and integrating DMS.
- EBITDA margins improving to above 6% in fiscal 2024, as Elior reaps the benefits from contract renegotiations, decreasing inflation stress, termination of loss-making contracts, and reduced exceptional costs.
- Capex remaining at about 1.5% of revenue in fiscal 2023 (about €75 million) in fiscal 2021, and 1.5%-2.0% afterward.
- Working capital outflows of €10 million-€20 million each year.
- No material acquisition in the next two years.
- No dividend payments until fiscal 2025.

Key metrics

Based on these assumptions, we derive the following credit metrics:

- S&P Global Ratings-adjusted debt to EBITDA of 6.4x-6.6x in fiscal 2023 (5.6x-5.8x including the pro forma full-year DMS contribution) and improving toward 4.0x in fiscal 2024.
- Adjusted FFO to debt of 10.0%-10.5% in fiscal 2023 (12.0%-12.5% including the pro forma DMS contribution), increasing to 17%-19% in fiscal 2024.
- Adjusted FOCF to debt of 2.5%-3.0% in fiscal 2023 (about 5% including the pro forma DMS contribution), increasing to 8%-10% in fiscal 2024.
- FFO cash interest coverage of 3.0x-3.5x in fiscal 2023, improving to 4.5x-5.0x in 2024.

Liquidity

We assess Elior's liquidity position as adequate, with sources of liquidity exceeding uses by greater than 1.2x over the next 12 months.

We estimate that Elior's liquidity sources over the 12 months from Jan. 1, 2023, including the acquisition of DMS, will be:

- Balance-sheet cash of about €59 million.
- Unadjusted cash FFO--after lease payments--of about €110 million.
- €189 million available under the committed €350 million RCF that matures in June 2026.

We estimate that Elior's liquidity uses over the same period will include:

- Capex of €85 million-€90 million.
- Working capital outflows of €60 million-€70 million, including intra-year fluctuations.
- €28 million for the first amortization of the PGE loan in October 2023.

Covenants

Under the group's senior facilities agreement, and following the new waiver agreement in December 2022, Elior will have to comply with a net leverage covenant of 7.5x in March 2023, falling to 6.0x in the following test period on Sept. 30, 2023, and 4.5x from March 2024 and beyond. We expect Elior will maintain at least 15% covenant headroom.

Environmental, Social, And Governance

To E-2, S-3, G-3; from E-2, S-4, G-2

Governance factors are now a moderately negative consideration in our credit rating analysis of Elior, reflecting our view that management failed anticipating and mitigating operational risks that have significantly affected the group's profitability and cash flows in the past two years. This includes the inability to rapidly adjust the cost base to reduced volumes following more people working from home post-COVID-19, and delayed actions taken to mitigate high input cost inflation that have resulted in deteriorated EBITDA margins (1.3% in 2022 compared with 2.3% in 2021).

We now consider social factors only as a moderately negative consideration in our credit rating analysis of Elior. The group's revenue has strongly recovered to about 95% of pre-pandemic levels because the effects of pandemic-related restrictions are fading away and demand for catering services at business and corporate clients has returned. Nevertheless, our moderately negative assessment reflects our view that the sector remains sensitive to health and safety issues, and that any virus variant resulting in renewed social distancing measures or increased absenteeism at corporate restaurants or school canteens could have a significant impact on the group's operating performance and credit metrics.

Issue Ratings - Recovery Analysis

Key analytical factors

- The issue rating on Elior's €550 million senior unsecured notes is 'B+', with a recovery rating of '3', reflecting our expectation of meaningful recovery (50%-70%; rounded estimate: 55%) in the event of a default.
- Recovery prospects are supported by our valuation of the company as a going concern but constrained by the group's significant amount of prior-ranking liabilities.
- We do not include in our recovery analysis any improvement in the group's enterprise value from the DMS acquisition, since the acquisition has not yet closed. We anticipate no change in the recovery rating once the transaction completes, but recovery prospects could increase to higher than 55% based on the increased group value including DMS.
- Besides the senior unsecured notes, the group has unrated debt facilities, including a €100

million senior unsecured term loan and €350 million revolving credit facility, which rank pari passu with the notes. In addition, Elior raised a €225 million state-guaranteed loan in March 2021, which amortizes 25% annually from October 2023 to March 2027. The group further has about €360 million of securitization facilities, and drawings under its bank overdraft facility. We assume 60% of the securitization facilities would be drawn at the time of default and consider the claims priority liabilities.

- In our hypothetical default scenario, we assume a default in 2027, following a prolonged deterioration in economic conditions, including high inflation, which would reduce demand for Elior's products as its clients continue to cut costs and consumers continue to reduce their discretionary spending.
- We value the group as a going concern, given its strong market position, resilient business model, good geographic diversification, and asset-light structure.

Simulated default assumptions

- Year of default: 2027
- Jurisdiction: France

Simplified waterfall

- Emergence EBITDA: €149 million
- Multiple: 5.5x
- Gross enterprise value at emergence: €820 million
- Net enterprise value after administrative expenses (5%): €779 million
- Priority liabilities: €217 million (constituting mainly the assumed drawing under the securitization facilities and bank overdraft facilities)
- Collateral value available to senior secured debt: €562 million
- Estimated senior unsecured debt claims: €969 million
- --Recovery expectation: 50%-70% (rounded estimate: 55%)

Unsecured de claims include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating	B+/Stable/--
Business risk:	Fair
Country risk	Low
Industry risk	Intermediate
Competitive position	Fair
Financial risk:	Highly leveraged
Cash flow/leverage	Highly leveraged

Issuer Credit Rating	B+/Stable/--
Anchor	b
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Positive (+1 notch)
Stand-alone credit profile:	b+
Group credit profile	bb+
Entity status within group	Nonstrategic

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- General Criteria: Methodology: Industry Risk, 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: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- French Food Service Provider Elior Group Downgraded To 'B+' On Slower-Than-Expected Recovery; Outlook Stable, May 25, 2022

Ratings List

Ratings Affirmed	
Elior Group S.A.	
Issuer Credit Rating	B+/Stable/--
Elior Group S.A.	
Elior Participations S.C.A	
Senior Unsecured	B+
Recovery Rating	3(55%)

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