

# **FITCH UPGRADES CARLSBERG BREWERIES TO 'BBB+'; OUTLOOK STABLE**

Fitch Ratings-Moscow/Milan/London-29 June 2018: Fitch Ratings has upgraded Carlsberg Breweries A/S's Long-Term Issuer Default Rating (IDR) and senior unsecured rating to 'BBB+' from 'BBB', and Short-Term IDR to 'F2' from 'F3'. The Outlook is Stable.

The upgrade reflects Fitch's expectation that the company will be able to maintain the improved credit metrics it achieved over 2016-2017, thanks to stronger cash generation capability and a conservative financial policy. Strong credit metrics are aligned in our projections for 2018-2020 with the 'A' category; however, lower leverage than peers supports the 'BBB+' rating, reflecting Carlsberg's weaker global market position as the fourth-largest international beer company. Our projections incorporate some headroom for bolt-on M&A in the largely consolidated international beer industry. We assume modest organic revenue and profit growth but flexibility to react to industry challenges such as currency movements, input costs and competition in the group's markets of operation.

## **KEY RATING DRIVERS**

**Stronger Profit Margins:** Since launching the "Funding the Journey" efficiency programme in 2015, Carlsberg has over-delivered on cost savings, already achieving around DKK1.7 billion in benefits compared to an initial target of DKK1.5 billion-DKK2 billion. It has since raised its target to DKK2.3 billion by end-2018 (representing around 17% of our forecast EBITDA). Although the company has been reinvesting around half of these benefits in marketing and innovation initiatives, the group's EBITDA margin improved to 21.5% in 2017 (2015: 19.6%), closer to the margins of its closest rival, Heineken (NR; 2017: 22.6%). We project EBITDA margins above 22% in 2018-2019, thanks in part to the positive impact of premiumisation initiatives.

**Conservative Capital Structure:** Thanks to our expectation that Carlsberg should defend the stronger levels of profit and cash flow generation achieved over 2016-2017 and despite assuming stable to growing dividend distributions and some bolt-on M&A activity, we project that debt should remain close to the levels achieved in 2017. This means maintaining funds from operations (FFO) adjusted net leverage at 2017's 2.1x or lower, supporting the Stable Outlook for the new ratings. Carlsberg's targeted capital structure with a net debt/EBITDA ratio of below 2x is commensurate with a higher rating category. This level corresponds to nearly 2.5x in terms of Fitch's FFO adjusted net leverage and is comfortably below the maximum 3.0x level consistent with the upgraded 'BBB+' rating.

**Subdued Top-Line Growth:** We expect low-single-digit organic sales growth for Carlsberg in 2018-2021. This is marginally below the levels we expect for its major peers. Carlsberg's volume growth in Western Europe (59% of total revenue) remains constrained by the maturity of demand for beer and the high competition in its core countries of operation. This should be offset by premiumisation initiatives and expansion in the growing craft, speciality and non-alcohol beer categories. The Russian beer market remains sluggish, constraining growth opportunities for a large portion of Carlsberg's operations. The Asian business is Carlsberg's main growth engine.

**Larger Rival in Russia:** Following the merger of Anheuser-Busch InBev NV/SA's (ABI; BBB/Stable) and Anadolu Efes's operations in Russia and Ukraine, Carlsberg will - from 2018 - compete with a stronger rival in Eastern Europe. With a 25% market share, this entity should become a strong number-two to Carlsberg's 32% share in Russia, gaining greater bargaining power with retailers. While a less fragmented market might benefit from greater price discipline, we cannot rule out a more aggressive pricing and/or marketing strategy from ABI-Efes. These risks are

reflected in our assumption of only modest organic sales growth for Eastern Europe, driven by limited price/mix growth and continuing volume declines.

**Growing Asian Markets:** We expect Carlsberg's organic expansion to remain strong in Asia. Carlsberg has been demonstrating mid-single-digit organic sales growth here over the last four years. We expect this to continue in 2018-2021 due to favourable market fundamentals. The group continues its expansion in China, its largest single country by revenue from 2017. Also, the company remains interested in growing through acquisitions in Asia, and we believe most of its bolt-on M&A activity will take place in this region. Our rating case assumes the acquisition of a stake in Vietnamese brewer Habeco, which we would view as strengthening Carlsberg's position in the region.

**Moderate M&A Activity:** We expect mainly bolt-on acquisitions and the completion of the Habeco deal in Vietnam in the medium term, which are likely to be covered by annual free cash flow (FCF) generation. With a stronger balance sheet, Carlsberg may also consider a bigger M&A deal, but there are not many potential large targets for sale in Western Europe and Asia, its main regions of operation, in our view. We calculate that an acquisition of above USD3.5 billion would most likely drive leverage above our negative sensitivity for two to three years, but at the same time it would likely improve Carlsberg's business profile, particularly in terms of diversification.

**Potential for Increased Shareholder Distributions:** In the absence of large M&A spending, we expect shareholder distributions to remain high over 2018-2021. In 2017, Carlsberg announced a 60% increase in dividends, which corresponds to a 50% payout ratio, in line with other peers in the sector. Given anticipated healthy cash flow generation, we project shareholder distributions (in the form of dividends or share buybacks) to remain at above 50% of net profit over 2018-2021. At the same time, we acknowledge the group's flexibility to reduce these distributions in case of an acquisition or upward pressure on leverage endangering management's target of net debt/EBITDA below 2.0x.

## DERIVATION SUMMARY

Carlsberg is smaller and less geographically diversified than ABI, the world's largest beer company, which enjoys a comparatively stronger business profile. However, ABI's ratings are currently pressured by heightened leverage, more representative of a 'B' category rated issuer, after the acquisition of SABMiller plc. At the same time, Carlsberg's business profile is commensurate with the upper 'BBB' rating category. This stems from its leading market positions in most of its countries of operation, its strong brand portfolio, and its improving diversification with decreasing reliance on a single country.

In addition, Carlsberg exhibits a more conservative financial policy and capital structure than its closest peers, including ABI and US-based Molson Coors Brewing Company (BBB-/Stable), but also global spirits leading players Diageo plc (A-/Stable) and Pernod Ricard S.A. (BBB/Positive).

## KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- average USD/EUR rate of 0.82 in 2018-2021 and average RUB/USD rate of 58.9 in 2018;
  - low-single-digit annual organic revenue growth, supported mostly by price-mix effect;
  - EBITDA margin broadly stable at around 22%;
  - capex at DKK4.5 billion in 2018 and at 7% of revenue over 2019-2021;
  - dividend payout of DKK2.4 billion in 2018, increasing by 15%-20% annually over 2019-2021;
- and
- no large M&A (we factor DKK1 billion per year into the current rating), aside from the acquisition of a 34% stake in Habeco in 2019, which we assume at around DKK3.2 billion.

## RATING SENSITIVITIES

### Developments That May, Individually or Collectively, Lead to Positive Rating Action

Although we do not envisage any further positive rating actions in the foreseeable future, below are the parameters we would consider for an upgrade:

- Improved business profile with greater diversification and maintaining leading positions on its main markets;
- Group EBITDAR margin above 25% (2017: 22%) and FCF margin sustainably above 5% (2017: 9.6%);
- FFO-adjusted net leverage sustainably below 2.0x (2017: 2.1x).

### Developments That May, Individually or Collectively, Lead to Negative Rating Action

- A severe decline in operating performance from key markets or much stronger remuneration of shareholders, coupled with an increased M&A appetite, causing FFO adjusted net leverage to increase sustainably above 3.0x;
- An erosion of the FCF margin below 3.0%;
- A shift in financial policy towards higher levels of net debt/EBITDA from the current target of below 2x.

### LIQUIDITY

Strong Liquidity: Liquidity was strong at end-2017 as DKK0.9 billion of short-term debt was well covered by undrawn committed credit lines of DKK18 billion, Fitch-adjusted unrestricted cash of DKK3.4 billion and estimated FCF in 2018 of around DKK2.2 billion.

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### Summary of Financial Statement Adjustments

- Dividends to minorities/from associates: Under our methodology, we included in the calculation of FFO dividends received net of dividends paid to minorities (2017: a net DKK530 million outflow).
- Debt: We adjusted total debt by adding guarantees for bank loans provided to third parties (2017: DKK475 million).
- Debt: A multiple of 8 times annual operating leases was used for calculation of lease-adjusted debt.

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Additional information is available on [www.fitchratings.com](http://www.fitchratings.com). For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

## Applicable Criteria

Corporate Rating Criteria (pub. 23 Mar 2018)

<https://www.fitchratings.com/site/re/10023785>

Sector Navigators (pub. 23 Mar 2018)

<https://www.fitchratings.com/site/re/10023790>

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