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Research Update:

Austria-Based Gaming Group Novomatic AG Assigned 'BBB/A-2' Ratings; Outlook Stable

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Overview

- Austria-based gaming group Novomatic AG has a satisfactory business risk profile and minimal financial risk profile, and we expect a substantial rise in its leverage resulting from future acquisitions.
- We are assigning our 'BBB/A-2' corporate credit ratings to Novomatic.
- The stable outlook reflects our view of a continued solid rise in Novomatic's revenues and its broadly stable EBITDA margins, which should translate into reported free operating cash flow of €200 million-€300 million per year, excluding acquisitions.

Rating Action

On Oct. 2, 2015, Standard & Poor's Ratings Services assigned its 'BBB/A-2' long- and short-term corporate credit ratings to Austria-based gaming group Novomatic AG. The outlook is stable.

At the same time, we assigned our 'BBB' long-term issue rating to the company's €600 million senior unsecured notes, maturing in 2017, 2019, and 2021. We also assigned our 'BBB' rating to the €440 million backup credit facilities, maturing in 2018 and 2020.

Rationale

The ratings on Novomatic reflect our assessment of its "satisfactory" business risk and its "minimal" financial risk profiles. They also incorporate our expectation of a substantial rise in leverage resulting from future major acquisitions over the next 24 months. We have not factored in such acquisitions, such as the targeted acquisition of a stake in Casinos Austria, into our base-case assumptions and leverage ratios at this stage.

We base our view of Novomatic's "satisfactory" business risk on the group's position as either market leader or ranking among the leading companies in each of its core markets. The group is primarily active in two complementary fields of operation: the development and manufacturing of gaming equipment ("gaming technology") and the operation of electronic casinos, gaming facilities, and betting outlets ("gaming operations").

In gaming technology, Novomatic holds a clear No. 1 position in both Austria and Germany, where it has more than 50% share of the market. It is also strong in Europe's other larger gaming markets. While it ranks among the three largest players in the U.K. and Spain, it is one of the five largest players in Italy. In Italy, it has a leading position, with a more than 50% share in video lottery terminals. Generally modest market shares in gaming operations outside of Austria somewhat constrain the business risk profile, however.

The strong degree of integration between the group's two segments should help it generate synergies and keep a high degree of flexibility, for example by quickly adapting products relative to market trends and direct customer feedback. It also serves as a source of diversification because adverse changes in regulation frequently have an only indirect impact on technology providers. The in-house technology expertise, in our view, puts Novomatic in a favorable position to benefit from an anticipated strong rise in e-gaming revenues.

Novomatic is among the most diversified gaming groups in Europe, geographically. This enables it to offset the effects of legislative changes or volatility caused by economic swings in certain countries thanks to stronger earnings in other countries, keeping cash flow volatility under control. Because ofinternational expansion over the past several decades, the group's home market Austria contributes only 20%-25% to total revenues. Novomatic's largest exposure is to Germany, where it generates about 30% of revenues, followed by Italy with a 10%-15% revenue share. It derives the remainder in several other European countries, including the U.K., The Netherlands, and Latvia. Continued expansion, for example in Spain, will likely further diversify the revenue stream.

Because rental contracts typically run for multiple years and management has good visibility as to the number of machines it operates, Novomatic's revenues have a high degree of predictability. We estimate that 30%-35% of the group's revenues from machine rentals are almost fully predictable for the current and the subsequent year, and another 50%-55% from the operation of machines should be fairly predictable. This greatly reduces the potential for unpleasant surprises regarding earnings from the underlying operations.

However, one of the main constraints to our business risk assessment arises from the risk of unexpected adverse changes in regulation and the loss of profitable concessions. For instance, this occurred at the end of 2014, when Novomatic had to decommission all gaming terminals in Vienna. In addition, legislative changes in Germany effective from 2017 will likely lead to a material reduction in the number of rented gaming machines in the country. Although the group is likely to largely offset the negative consequences of these events because of its high degree of diversification, in our view there is an imminent risk of adverse regulatory changes.

Another risk factor is the uncertain development of the e-gambling sector. Although this segment represents a business opportunity, we believe it is fairly uncertain at what pace it will evolve, to what extent it may overtake traditional casinos and gaming facilities, and whether or not Novomatic is able to defend its market position against unknown new entrants. The possible need to develop new software, pressure on revenues, and the drying-up of currently profitable revenue streams may squeeze the group's margins. In addition, earnings pressure could arise from a steep increase in gambling taxes or personnel expenses, which have both been on the rise in recent years as a percentage of revenues.

So far, however, we expect profitability will remain at above-average levels for the sector, as reflected in our Standard & Poor's adjusted EBITDA margin of more than 30%. This should translate into sound underlying reported free operating cash flow (FOCF) for the group of €200 million-€300 million per year, which it can fully use to fund bolt-on acquisitions and dividends without having to raise additional debt. It also enables management to have a high level of research and development activity and to maintain the group's products and facilities at modern standards.

Novomatic's strong free cash flow generation profile, combined with moderate dividend payments and a tempered capital expenditure and acquisition budget, result in "minimal" financial risk as our criteria define this term. On a weighted-average basis for 2013-2017, we estimate Novomatic's Standard & Poor's-adjusted funds from operations (FFO) to debt at 70%-80%. Our adjusted debt to EBITDA should be at just around 1.0x over the same period and our adjusted FOCF to debt is likely to be at 40%-45%. All three ratios point toward "minimal" financial risk.

Management has expressed its strategy to further expand the business both organically and through acquisitions. The recent attempt to purchase a majority stake in Casinos Austria is one example. We have not included this transaction in our base-case forecast, given the fairly uncertain likelihood of closing, as indicated by the pre-emptive rights of some shareholders, questionable approval from the cartel authorities, and uncertain political reactions. Although we do not expect the group to exceed our leverage threshold in case of a successful acquisition, the transaction shows that management is willing to accept higher leverage. We therefore factor this possible rise in leverage into our current long-term rating on the group by adjusting down our 'a-' anchor by two notches on financial policy considerations.

In our base case, we assume:

- Real GDP in the EU growing by around 2% per year in 2015 and 2016, with real private consumption growing approximately by the same amount.
- Novomatic will increase its revenues only slightly, by 1%-2% in the current fiscal year ending Dec. 31, 2015, due to the loss of the Vienna operations. However, revenue growth will pick up to 5%-6% in 2016, in our view, because of strong anticipated expansion in the number of operated, rented, and sold gaming machines.
- A reported EBITDA margin of about 28% per year compared with 32.7% in 2014, owing to the absence of one-off gains and the loss of the Vienna operations. This translates into a Standard & Poor's adjusted EBITDA margin of 30%-31%.
- Reported FOCF of €200 million-€220 million in 2015 and €240 million-€260 million in 2016.

- Acquisitions of approximately €230 million, including the group's increase in its stake in the Austrian Lottery operator in 2015 and €150 million budgeted in 2016.
- An extraordinary dividend of €150 million in 2015 and a recurring payout of €50 million from 2016.

Based on these assumptions, we arrive at the following credit measures for Novomatic:

- Adjusted debt to EBITDA of 1.1x-1.3x in 2015 and around 1.0x in 2016.
- Adjusted FFO to debt of 60%-70% in 2015 and 70%-80% in 2016.
- Adjusted FOCF to debt of about 35% in 2015 and 40%-45% in 2016.

Liquidity

We view Novomatic's liquidity as "strong" under our criteria. We estimate that group's liquidity sources will likely meet liquidity needs by 3.0x over the next 12 months. Although the existence of the group's significant on-balance-sheet cash, availability of credit lines, and its sound cash flow are supportive, our view is constrained by significant planned capital expenditures and the risk of cash outflows related to mergers or acquisitions. Under our base case, we estimate headroom under financial covenants at more than 80%.

After closing of the €275 million private placement (Schuldschein) and a minor bank loan, we estimate principal sources of liquidity to reach more than €1.3 billion, including:

- About €460 million-€470 million in cash and equivalents and short-term financial assets;
- Undrawn credit facilities of around €400 million out of total lines of €440 million; and
- FFO of slightly above €450 million.

Uses of liquidity should amount to about €400 million, including:

- No significant changes in working capital or intra-year working capital swings;
- Capital expenditures of around €200 million;
- Acquisitions of about €150 million; and
- Dividends of €50 million.

Outlook

Our stable outlook reflects our view that Novomatic will likely increase its revenues while keeping its Standard & Poor's-adjusted EBITDA margin at or slightly above 30% over the next two years. This should translate into sufficient FOCF to fund smaller acquisitions and dividend payments on a recurring basis. Our outlook also incorporates management's intention to raise the group's leverage through larger acquisitions. If this occurs, we expect that the group's leverage ratios will not exceed the thresholds that are commensurate with our "modest" financial risk category.

Downside scenario

We could lower our ratings on Novomatic if management decides to pursue large debt-funded acquisitions, which would push our leverage ratios for the group into our "intermediate" category or higher. Specifically, this would be the case if our ratio of adjusted debt to EBITDA exceeded 2.0x or if our adjusted FOCF-to-debt ratio declined to below 25%.

We could also lower our ratings if large debt-financed purchases, or any legislative changes, among other factors, resulted in a material reduction in the group's profitability, liquidity coverage, or covenant headroom. In particular, we would consider lowering the ratings if the group was unable to generate meaningfully positive FOCF that exceeded both the group's acquisition budget and planned dividend payments.

Upside scenario

We could raise our ratings on Novomatic by one notch if management pursues a financial policy that prevented a deterioration of the group's leverage ratios to below our "minimal" category. This would imply maximum adjusted debt to EBITDA of 1.5x and adjusted FOCF to debt remaining above 40%.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Stable/A-2

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

Financial risk: Minimal
- Cash flow/Leverage: Minimal

Anchor: a-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Negative (-2 notches)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Neutral (no impact)

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Leisure And Sports Industry, March 5, 2014

- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

New Rating

Novomatic AG	
Corporate Credit Rating	BBB/Stable/A-2
Senior Unsecured	BBB

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@standardandpoors.com

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