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Research Update:

Gaming Co. Novomatic Outlook Revised To Negative On Regulatory Risks And Weaker Credit Metrics; Affirmed At 'BBB/A-2'

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Overview

- Austria-based gaming company Novomatic aims to strengthen its market position through several acquisitions, which have weakened its credit metrics, mainly by increasing our expected leverage to over 2x in 2017.
- Regulatory uncertainties surrounding new legislation in Germany that aims to lower the number of gaming machines in the market, alongside regulatory pressure in other markets, weigh on the rating as they decrease EBITDA margins.
- We are revising our outlook on Novomatic to negative from stable and affirming our 'BBB/A-2' ratings.
- The negative outlook reflects that we could downgrade Novomatic if integration of acquisitions and regulatory actions hinder earnings and profitability more than we currently anticipate.

Rating Action

On June 21, 2017, S&P Global Ratings revised its outlook on Austria-based gaming company Novomatic AG to negative from stable.

At the same time, we affirmed our 'BBB' long-term and 'A-2' short-term corporate credit ratings on Novomatic and the 'BBB' senior unsecured ratings on its outstanding notes.

Rationale

The outlook revision reflects our view of the uncertainties relating to a stronger impact from regulatory changes than we currently expect in Germany, Novomatic's largest core market, where it generates about 29% of its revenues. A stricter application of the new regulation by local municipalities than we currently expect could result in weaker revenues and a weaker EBITDA margin than we project in our base case. This could lead us to revise down our assessment of the group's business risk profile. In addition, the outlook also reflects the weakened credit metrics in our base case, mainly owing to Novomatic's announced acquisitions and the elevated planned investments in capital expenditures (capex) to adapt the business to the changing regulatory environment, to integrate new acquisitions, and to defend Novomatic's technological leadership position.

The regulatory changes relate mainly to the application of the Interstate Treaty on Games of Chance, passed by the German Government in 2012 aimed to meaningfully reduce the overall number of gaming arcades in a distinct area and the number of machines per arcade starting in July 2017. In our view, compliance with this treaty may force gaming operators to close up to 50% of the gaming machines in Germany over the next two years. We note, however, that the application of the law by local municipalities has been delayed, which should maintain a mostly stable operating environment for 2017.

Nevertheless, the strictness with which the municipalities interpret the law after June 30, 2017, could have an especially negative impact on Novomatic's revenues generated from machines rented to gaming operators. Discussions among municipalities and arcade operators are still ongoing, and the visibility regarding the exact timeframe and impact will likely remain limited for now.

In our view, the impact from the Interstate Treaty will be partly offset by an increase of machine utilization of the remaining gaming machines in the German market and by Novomatic's ability to relocate spare gaming machines from Germany to its operations in other jurisdictions. While disruptive in the short term, we also view the Interstate Treaty as a catalyst to market consolidation, leading finally to a protected local market situation among arcade operators in the long term.

Moreover, we see additional pressure on Novomatic's profitability arising from the increasing gaming tax in Italy, as well as from the German Gaming Ordinance, which aims to further strengthen protection for players in 2018.

Despite regulation risk, we still see Novomatic's business risk profile as satisfactory, supported by its strong market position in European countries as a gaming technology provider with leading brands and products, resulting in a high ability to pass-through increasing regulatory compliance-related costs to gaming operators. In its respective market segment, Novomatic holds No. 1 positions in Austria and Germany and ranks among the top three in the U.K., Spain, and Italy. The acquisition of Ainsworth Game Technology Ltd. further diversifies the group to North America and Australia. Each of these regions could represent about 5% of total group revenues starting 2018.

Our assessment of the company's financial risk profile reflects weakened credit metrics after several acquisitions, with leverage increasing to above 2x in the near to medium term. Our base case for Novomatic has been further weakened by its high planned capex investments and lower EBITDA from existing business due to regulatory changes. We expect Novomatic's reported EBITDA from existing businesses to decrease from about €600 million in 2017 to about €570 million in 2018. However, after accounting for planned acquisitions and other adjustments (mainly operating leases and income from disposed businesses), we estimate an S&P Global Rating-adjusted EBITDA margin of 25.5%-28.0% over the next two years and an S&P Global Ratings-adjusted EBITDA of about €660 million-€700 million.

The high reported cash on the balance sheet of about €880 million after the

€500 million bond issue in late 2016 is likely to decrease over 2017-2018, resulting in weaker credit metrics in line with our intermediate financial risk profile. S&P Global Rating's adjusted five-year weighted average funds from operations (FFO)-to-debt ratio has weakened to about 41% from 56% in our previous base case. After accounting for a higher capex investment than we previously anticipated, we see our adjusted weighted average of free operating cash flow (FOCF)-to-debt ratio declining to about 16% compared with 21% previously.

At the same time, we view our expected leverage metrics as now in line with the company's stated leverage target, because its acquisitions are now reflected in our base case. We therefore removed our negative financial policy modifier and see Novomatic's executed financial policy as in line with our assessment of its financial risk profile.

In our base case, we assume:

- Real GDP in the eurozone growing by 1.6% in 2017 and 1.5% in 2018, with consumer price index inflation at around 1.5% per year over the next 12 months.
- We expect the gaming industry to grow moderately above GDP, since markets are not fully saturated. However, regulatory changes, such as those made in Germany in 2017, will result in temporary negative regional growth.
- Novomatic will increase its revenues materially above the industry by around 8% in 2017 and 9% in 2018, mainly thanks to acquisitions, which will account for 7.5% of sales growth in 2017 and 8.0% in 2018.
- A decrease in the total number of Novomatic's rented-out gaming machines in the German market of about 30%-40% over the next 12 months, partly offset by price increases for the remaining machines in the German market.
- Revenues of operations in the remaining countries are expected to grow in line with the industry at about 3%.
- An S&P Global Ratings-adjusted EBITDA margin of nearly 27% in 2017 and 26% in 2018, affected by regulatory compliance-related costs and integration costs from the acquisitions.
- Acquisitions of €450 million to €550 million in 2017 and around €100 million per year thereafter.
- Capex of €300 million-€400 million in 2017-2018 with a peak in 2018, also driven by required investments to comply with new regulations.
- Dividends of €50 million annually.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures for 2017 and 2018:

- Debt to EBITDA of about 2.0x-2.3x (1.8x in 2016).
- FFO to debt of about 35% to 36% (44% in 2016).
- FOCF to debt of 6% to 12% (1.9% in 2016).

If the acquisitions are poorly executed and result in lower revenue growth of only 4% in 2017 and 5% in 2018, we would expect FFO to debt to decrease to about 33%-34% in 2017-2018. At the same time, we think that a potential stronger increase in the cost base, resulting in a lower expected EBITDA margin at around 23%-24% in 2017-2018, would decrease FFO to debt to 30%-31%.

Liquidity

We view Novomatic's liquidity as strong. We estimate that group's liquidity sources will likely cover liquidity needs by about 1.8x 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 capex and the event risk of cash outflows related to additional mergers or acquisitions. We also see Novomatic as having well-established and solid relationships with banks, as well as a generally high standing in credit markets.

Principal liquidity sources as of Dec. 31, 2016, include:

- About €720 million in cash and equivalents and short-term financial assets (excluding trapped cash in gaming machines and for player deposits);
- Undrawn revolving credit facilities of around €1 billion (signed in March 2017); and
- FFO of about €500 million-€520 million.

Principal liquidity uses as of the same date, include:

- Short-term debt and maturing long-term debt of about €210 million;
- Changes in working capital and intrayear working capital swings of €140 million;
- Capex of around €300 million;
- Acquisitions of €450 million-€550 million; and
- Dividends of €50 million.

Under our base case, we estimate headroom under the net debt to EBITDA and under the equity ratio financial covenants at around 50% for the next 12 months.

Outlook

Our negative outlook reflects worsening credit metrics and profitability after debt-financed acquisitions in 2016-2017, as well as the risk that regulatory uncertainties could affect Novomatic's earnings and EBITDA margin more than currently anticipated in our base case. Regulatory risks mainly relate to the application of the Interstate Treaty on Gaming in Germany, Novomatic's largest single market, starting in July 2017. We could lower our assessment of Novomatic's business risk profile if earnings or margins are lower than we expect in our base case.

Downside scenario

We could lower the rating if the new regulation is applied more strictly and impacts revenues more than we expect, or if operating costs to comply with new rules in different countries lower Novomatic's EBITDA more than we assume. We could also lower the rating if the integration of acquisitions leads to

further deterioration of profitability. Specifically, we would consider a downgrade if Novomatic fails to achieve an S&P Global Ratings-adjusted EBITDA margin of at least 25% in the next two years, if adjusted FFO to debt drops below 30%, or if FOCF to debt remains below 15% for an extended period.

Upside scenario

We could revise the outlook to stable if regulatory changes were applied less strictly than we currently anticipate, or if Novomatic adapts swiftly to the changing regulatory environment and smoothly integrates announced acquisitions. This could be the case, for example, if Novomatic is able to retain more gaming machines in Germany after the application of the new regulation, if capacity utilization in the remaining machines in Germany increases more than we anticipate, or if the group generates higher synergies from acquisitions. Specifically, we would consider revising the outlook to stable if EBITDA margins remain above 25%, FFO to debt remains well above 30%, and FOCF to debt recovers to 15% over the next two years. Likewise, we could also revise the outlook to stable if FFO to debt recovers to 45% and FOCF to debt approaches 25% even if the EBITDA margin is slightly below 25%. This could be the case, for example, if a potential capital increase leads to a substantial strengthening of the balance sheet.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Negative/A-2

Business risk: Satisfactory

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

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- 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
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, 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: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

Industry Top Trends 2017: Hotels, Gaming and Leisure, Feb. 14, 2017 (https://www.capitaliq.com/CIQDotNet/CreditResearch/viewPDF.aspx?pdfId=25098&from=Research)

Ratings List

Outlook Action; Ratings Affirmed

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

Additional Contact:
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