S&P Global
Ratings

RatingsDirect®

Research Update:

Novomatic AG Ratings Affirmed At 'BB+' With Operations Exiting Lockdown And Amid Legal Investigations; Outlook Negative

July 28, 2020

PRIMARY CREDIT ANALYST

Patrick Janssen
Frankfurt
(49) 69-33-999-175
patrick.janssen@spglobal.com

SECONDARY CONTACT

Patrick E Flynn
London
+ 44 20 7176 0053
patrick.flynn@spglobal.com

ADDITIONAL CONTACT

Industrial Ratings Europe
Corporate_Admin_London@spglobal.com

Rating Action Overview

- Novomatic AG has reopened the majority of its gaming arcades in Europe and operations have returned to pre-pandemic levels in most regions, which in our view has lessened downside risk relative to our earlier revised financial base-case scenario, including S&P Global Ratings' forecast of EBITDA declining 30%-40% in 2020 compared with 2019, before rebounding in 2021.
- Ongoing investigations from Austrian economic and corruption authorities into the company and some of its personnel exposes the group to potential legal, regulatory, reputational, and licensing risks, in our view, with limited impact so far.
- While it is not certain that the current investigations will lead to any legal proceedings or prosecutions, we see risks that they may affect Novomatic's standing among the regulators who govern the awarding and renewing of its regional gaming licenses or potentially damage the group's reputation if investigations were to continue for a long period.
- We are affirming our 'BB+' ratings on the company and its debt.
- The negative outlook reflects our view that uncertainties around the impact of the recessionary environment clouds our visibility on consumer spending over the next 12 months. It also factors in the ongoing investigations in Austria, which--in case the group or key personnel were subject to legal proceedings or found to have breached ethical obligations--could hurt the group's reputation in the gaming sector, in financial markets, or its standing among regulators.

Rating Action Rationale

The majority of gaming arcades in Europe have reopened following the COVID-19 outbreak, and core markets show solid recovery, so we see receding earnings risk. While some of Novomatic's core gaming markets such as Germany, Austria, and Eastern Europe opened arcades in May, other regions like Spain, Italy, and the U.K. opened later in June and July, which is overall in line with our expectation of the lockdown's duration. In addition, we expect consumer spending will recover only moderately given the recession. Early trading results for gaming machine operators have shown that in Germany, Austria, and Italy, there might be an element of pent-up demand following the lockdown, supported by fewer leisure alternatives. Overall, we view the downside risks to our previous revised base-case as lessening. Our forecast base-case scenario is for a decline in sales of up to 20% sales and 30%-40% EBITDA in 2020. We therefore believe that S&P Global Ratings-adjusted debt to EBITDA will reach 4.4x–5.0x in 2020, which will be out of line with the rating temporarily. Therefore, a rebound to normalized performance in FY21, where we forecast leverage to fall sustainably below 3.5x, remains an underpinning factor supporting the current rating level.

Legal proceedings pose reputational risks and could constrain the ability to do business if current investigations were to lead to prosecution or other legal actions, in our view. Investigations by Austrian economic and corruption authorities against Novomatic, its former CEO, the majority shareholder, and some former and current employees are ongoing. The allegations under investigation include attempting to illegally influence gaming legislation and licensing in Austria. These investigations are connected to broader allegations surrounding a political scandal in Austria, which began in 2019 and are likely to continue for some time. While we understand Novomatic and named parties deny any wrongdoing and are cooperating fully with authorities, and while we believe the current impact of the investigations on Novomatic's business is minimal, it remains that the investigations could threaten the group's reputation the longer they continue. This is particularly the case if they are seen to progress toward legal proceedings against the company or connected parties, or if they are found to have breached some ethical obligation. Gaming operators rely on their good standing and reputation, and that of their key personnel, among regulators to maintain gaming licenses, which has always been the case with Novomatic so far, but could become more challenging if investigations and proceedings are protracted.

We believe the group has sufficient liquidity sources to pay down the maturity of long-term debt over the next 12 months as planned, despite the lockdowns. Following the confirmed disposal of Casino Austria, the company has nearly €1.2 billion in cash, other liquid investments, and availability under its revolving credit facility (RCF) for liquidity management, which is more than twice maturing long-term debt over the next 12 months. The RCF documentation includes a net debt-to-EBITDA covenant with temporarily low headroom of only 10%-20% in 2020. While we do not expect a covenant breach in our base-case scenario and full availability over the next 12 months, we believe Novomatic is well positioned to negotiate a waiver following the end of the lockdown in Europe and the business' ramp-up.

Uncertainties regarding the pandemic and the recession's impact still cloud our earnings visibility. S&P Global Ratings acknowledges a high degree of uncertainty about the evolution of the coronavirus pandemic. The consensus among health experts is that the pandemic may now be at, or near, its peak in some regions but will remain a threat until a vaccine or effective treatment is widely available, which may not occur until the second half of 2021. We are using this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Environmental, social, and governance (ESG) factors relevant to the rating action:

- Health and safety

- Other governance factors

Outlook

The negative outlook reflects our assumption of a contained COVID-19 outbreak in Europe for the remainder of the year and our view that the risk of a second wave and the recession limits our visibility on further development of consumer spending and the group's earnings in 2020. On this basis, we still expect S&P Global Ratings-adjusted debt to EBITDA will temporarily increase to 4.4x-5.0x in 2020 and moderating to 3.0x-3.5x in 2021.

The outlook also reflects our view of the downside risk to Novomatic should the ongoing investigations from Austrian authorities progress to prosecution or other legal action, or result in findings of unethical behavior, against the company or connected parties, and the impact this could have on the group's reputation and standing.

Downside scenario

We could lower the rating if:

- The impact of the pandemic and related recession was more severe that we assume, resulting in S&P Global Ratings-adjusted debt to EBITDA remaining materially above 3.5x, free operating cash flow (FOCF) after all lease payments remaining negative, or liquidity weakening to a degree not offset by any remedial action.
- The pandemic led to a structurally weaker gaming industry as a whole, exemplified by Novomatic's operating margins not recovering to pre-COVID-19 levels, or the company's positioning weakening compared with that of peers. The latter, for example, could occur if the group loses market share to online competitors. In these two cases, we could reevaluate our assessment of Novomatic's business strength. and
- The investigations progressed, for example, to prosecution or other legal action, or led to findings of unethical behavior. While it is not our base-case scenario, we could also consider lowering the rating if investigations were protracted and we saw evidence of impacts on reputation or standing in operating or financial markets. Lastly, we might take a negative rating action if there were further allegations and proceedings beyond the current scope that would lead us to reassess the group's governance and control functions.

Upside scenario

We could revise the outlook to stable once we have more certainty regarding the COVID-19 pandemic and the related recession's effect on consumer spending in the European gaming market and Novomatic's operating performance, liquidity, and cash flow. In particular, an outlook revision would depend on the group's ability to reduce costs, preserve cash, manage upcoming debt maturities, and defend its market position in recovering from COVID-19, with its S&P Global Ratings-adjusted debt to EBITDA therefore falling toward 3.5x after 2020. A stable outlook would also hinge on a termination of the investigations.

Company Description

Novomatic operates in two segments: Gaming technology (business-to-business segment) and gaming operations (business-to-consumer [B2C] segment). The gaming technology segment produces, sells, and rents gaming and entertainment machines and content, as well as the operation of online content for business customers. The gaming operations segment operates casinos and electronic gaming machines, the online B2C business, and sports and horse racing betting services.

In 2019, Novomatic reported revenue and S&P Global Ratings-adjusted EBITDA of €2.6 billion and €663 million, respectively. Novomatic is a mostly European business with Germany, Austria, and Italy representing about 56% of its revenue.

The group is effectively controlled by Johann F. Graf (founder of the group) through investment holding company Novo Invest GmbH.

Environmental, Social, And Governance

Social risks are significant for gaming companies like Novomatic. Concerns from the public and regulators include money laundering, gambling addiction, harm to underage players, and displays of anti-social behavior around gambling halls. Consequently, various countries have enacted laws, often significantly affecting gaming companies and their financial performance. Examples of these regulations include the prohibition of gaming machines in Vienna.

We consider Novomatic's governance at a similar level to other peers we rate in the region and that are not publicly listed. It has not had to pay any material fines or penalties. In addition, unlike some of its peers, the group operates in regions where there is regulatory certainty and has a strict and conservative approach to compliance with gaming regulations.

Following the German court's ruling in October 2017 regarding the legality of online casinos, Novomatic terminated its B2B contract with its online customers. This reduced its earnings in 2018. While this development reflects the impact of social risks that Novomatic faces, it also reflects its conservative approach relative to peers such as GVC, who continue to provide online casinos in Germany based on the interpretation that this gaming is allowed under European law.

Conversely, in our view, the impairment of Ainsworth in 2018 could indicate the need to tighten controls. Acquisitions are relatively challenging in the gaming sector due to the risk of constant regulatory changes. Therefore, a typical acquisition in this industry tends to incorporate a sizable deferred consideration. Novomatic had a deferred consideration clause in its other business purchases, but did not have this provision in its Ainsworth transaction.

Similarly, the holding and renewing of gaming licenses depends on the operator's good standing among the decision making regulatory authorities. Any conviction or finding of unethical behavior could harm a company's standing among regulators. Because no wrongdoing of the group has been established from Austrian authorities, we see no impact on our management and governance (M&G) assessment at this time. However, in case legal proceedings became likely, for instance through criminal prosecution, we could see pressure on our M&G assessment emerging.

Our Base-Case Scenario

Assumptions

- Real GDP contraction in the eurozone of 7.8% in 2020 recovering by 5.5% growth in 2021, with consumer price index inflation of 0.5%-1.5% per year.
- Absent any regulatory changes, modest growth in land-based gaming operations in Europe, but remote gaming will expand significantly above GDP because markets are not fully saturated.
- Revenue decline of up to 20% in 2020 due to the impact of COVID-19, recovering to 10%-15% in 2021, somewhat hampered by various hardship exemption and active tolerance granted under the German Interstate Treaty expiring in June 2021.
- S&P Global Ratings-adjusted EBITDA margin dipping below 20% in 2020 compared with 25.4% in 2019 in light of the above factors, and some level of fix costs included in operations.
- Opportunistic bolt-on acquisitions of about €50 million in 2020 and 2021.
- Capital expenditure (capex) of €200 million-€240 million in 2020, which has been temporarily lowered due to COVID-19's impact. It would further accelerate toward €300 million-€350 million from 2021.
- Asset disposal net proceeds of about €100 million in 2020 to be used for debt repayment.
- Dividends of €30 million-€50 million in 2020 and 2021, compared with €33 million in 2019.

Key metrics

	2018a	2019a*	2020e	2021f
Revenue (bil. €)	2.613	2.607	2.0-2.2	2.3-2.5
EBITDA (mil. €)	611	663	380-450	550-620
EBITDA margin (%)	23.4	25.4	19.0-21.0	23.0-26.0
Debt/EBITDA (x)	2.8	2.9	4.4-5.0	3.0-3.5
FFO/debt (%)	25.3	29.5	15.0-20.0	22-30
FOCF/debt(%)	(4.0)	12.8	2.0-5.0	8.0-12.0

Note: All figures are S&P Global Ratings-adjusted. *Year-end debt for 2019 comprises financial debt of €1.9 billion, for which key adjustments are €700 million in leases and €400 million in surplus cash available for debt repayment. a--Actual. e--Estimate. f--Forecast. FFO--Funds from operations. FOCF--Free operating cash flow.

Liquidity

We view Novomatic's liquidity as strong, although expect planned debt repayment over the next 12 months will limit the headroom under this assessment. We estimate that the group's liquidity sources will likely cover liquidity needs by nearly 1.6x over the next 12 months. Although covenant headroom is temporarily only 15%-20% in 2020, we see Novomatic as having well-established and solid relationships with banks, enabling a favorable position on negotiating covenants if necessary. We also see the company as having a generally satisfactory standing in credit markets, helping to refinance upcoming maturities if needed.

Principal liquidity sources for the 12 months started July 1, 2020, include:

- About €1.2 billion available in cash and equivalents, less cash required in gaming machines and availability under the RCF maturing in March 2024
- Funds from operations of about €250 million, net of all lease-related payments

Principal liquidity uses for the same period, include:

- Short-term debt and maturing long-term debt of about €450 million
- Changes in working capital and intrayear working capital swings of €100 million-€150 million
- Capex of €200 million-€250 million
- Dividends of about €50 million

Covenants

Compliance expectations

We estimate that headroom under the financial covenants will tighten to 10%-20% in 2020 and 30%-45% thereafter. Considering Novomatic's solid relationship with core banks, we believe that temporarily lower headroom under covenants does not constrain our liquidity assessment.

Requirements

The subgroup of Novomatic is required to comply with semiannually tested financial covenants in its €1.0 billion RCF. These include a maximum net debt-to-EBITDA covenant of up to 4.63x.

Issue Ratings - Recovery Analysis

Key analytical factors

- The issue rating on the unsecured notes (€200 million due 2021 and €500 million due 2023) is 'BB+' with a recovery rating of '3', reflecting our expectation of meaningful recovery (50%-70%; rounded estimate 65%) under a default scenario.
- Our simulated default scenario contemplates a default in 2025 due to regulatory changes that shrink Novomatic's addressable market, combined with a prolonged economic downturn that reduces consumer spending on gaming, extends the gaming equipment replacement cycle, and meaningfully reduces arcade operators spending on new equipment.
- We assume Novomatic will reorganize under a distressed scenario and use a 6.5x multiple to value the company, which is in line with the average multiple we use for the leisure industry.
- We assume the revolver will be 85% drawn at the time of default.
- Although the numerical recovery outcome exceeds 65%, our criteria caps the recovery rating of the notes at '3' due to their unsecured nature. This accounts for the risk that additional prior- or

same-ranking debt could be raised on the path to default.

Simulated default assumptions

- Year of default: 2025
- Jurisdiction: Austria

Simplified waterfall

- Emergence EBITDA: €320 million (capex represents 6% of sales. Cyclicality adjustment is 10%, in line with the specific industry subsegment. Operational adjustment is negative 5% to reflect the regulatory pressure in the gaming technology segment.)
- EBITDA multiple: 6.5x
- Gross recovery value: €2.08 billion
- Net recovery value after administrative expenses (5%): €1.97 billion
- Estimated priority debt: €53 million
- Estimated unsecured claims: €2.14 billion
- Value available to unsecured claims: €1.92 billion
- Recovery expectations: 50%-70% (rounded estimate: 65%)

All debt amounts include six months of prepetition interest.

Unsecured claims include €1.0 billion RCF assumed to be drawn at 85%.

Ratings Score Snapshot

Issuer Credit Rating: BB+/Negative/B

Business risk: Satisfactory

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

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)

- Liquidity: Strong (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Leisure And Sports Industry, March 5, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Global Credit Conditions: The Shape Of Recovery: Uneven, Unequal, Uncharted, July 1, 2020
- Novomatic AG Outlook Revised To Negative On COVID-19-Related Business Disruption; 'BB+' Ratings Affirmed, May 12, 2020

Ratings List

Ratings Affirmed	
Novomatic AG	
Issuer Credit Rating	BB+/Negative/B
Senior Unsecured	BB+
Recovery Rating	3(65%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such