Research Update:

Austrian Gaming Group Novomatic AG Downgraded To 'BB' On Extended Business Disruption

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PRIMARY CREDIT ANALYST

Natalia Arrizabalaga
Paris
+ 33 1 4420 6662
Natalia.Arrizabalaga@spglobal.com

SECONDARY CONTACTS

Patrick Janssen
Frankfurt
+ 49 693 399 9175
patrick.janssen@spglobal.com

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

Rating Action Overview

- European countries are again locking down to defend against the recent second wave of COVID-19 cases in Europe, and so Novomatic AG has again closed most of its gaming arcades in Europe.
- In light of our estimate that a vaccine will not be widely available before midyear 2021, we expect that some level of disruption will continue until then and Novomatic's EBITDA in 2021 could remain 30%-35% below the level seen in 2019, resulting in debt to EBITDA remaining at 3.9x-4.4x in 2021.
- We are therefore lowering our ratings on Novomatic and its senior unsecured notes to 'BB' from 'BB+'. The recovery rating on the debt is '3', reflecting our expectation of about 65% recovery
- The negative outlook reflects the risk that Novomatic could underperform our base case in the next 12 months, such that our adjusted leverage remains above 4x for an extended period, or if there is any impact from ongoing Austrian legal proceedings.

Rating Action Rationale

The second lockdown in Europe is postponing Novomatic's expected deleveraging. Following restrictions introduced by European governments to contain the spread of COVID-19 in the fourth quarter of 2020, Novomatic and customers of its leased-out machines have again closed many of their gaming arcades. We currently assume that restrictions will continue into the first half of 2021, but be less severe and less frequent. This is because we anticipate that a vaccine or effective treatment will likely not become widely available before the middle of 2021 and the non-essential nature of gaming operations will continue to expose land-based gaming operators to anti-coronavirus measures until then. Therefore, we now forecast that Novomatic will witness a stronger impact on earnings, with adjusted EBITDA deteriorating by 50%-55% in 2020 compared with €663 million in 2019, and 30%-35% lower in 2021. We believe it will take the company longer to recover from the leverage spike in 2020, which we forecast will peak at S&P Global Ratings-adjusted 5.3x-5.7x. We forecast that leverage could also remain above our 4x trigger for a downgrade until the end of 2021.

Novomatic's business lacks stronger online presence or greater product diversity outside of the B2B and B2C machines that have supported peers' earnings during the pandemic. Novomatic operates in two segments: Gaming Technology (business-to-business [B2B]) and Gaming Operations (business-to-consumer [B2C]). We note that Novomatic generated 40% of revenue from Austria and Germany in 2019 and has exhibited higher earnings volatility during the pandemic than similarly rated peers in gaming. First, this is because Novomatic generates only about 5% of revenue in the more resilient online gaming versus 46% in the case of Australian-based Aristocrat Leisure (BB+/Negative/--) and about 90% in case of Ireland-based Flutter Entertainment (BB+/Stable/--). Second, despite B2B and B2C diversification, Novomatic lacks additional meaningful product diversification outside of machines, which has cushioned some peers' earnings from high exposure to land-based operations during the pandemic, such as in lottery-like Scientific Games (B/Negative/--). We expect Scientific Games's lottery sales to decline by only 5%-10% in 2020 because the company's lottery sales rely largely on food retail outlets, which have generally remained open during the pandemic. Therefore, we believe that Novomatic's business is more prone to the disruption of COVID-19 than these peers' and we have revised down our assessment of its business risk to fair from satisfactory. Additionally, we see a risk that Novomatic's B2B customer group, who are themselves being affected by the pandemic, may be forced to lower their capacity or presence to accommodate the economic impact from the crisis.

COVID-19-related government measures and the German online market's targeted regulation could accelerate a customer shift to online. Although online gaming in Germany has been prohibited, the new Draft Interstate Treaty, if implemented, will allow this market to open in Germany from July 2021. In addition, German lawmakers agreed on a transition period whereby existing online gaming companies operations will be tolerated from now on, as long as they adhere to the conditions compatible with the new proposed regulations taking effect in 2021, albeit this is not confirmed by the courts yet. We see more operators launching online activities already, such as Loewenplay, Germany's third-largest gaming arcade operator. Although we view Novomatic's decision to enter the online market in Germany in the second half of 2021 as prudent, we also see the risk that the competitors that had already built an online presence might now gain a competitive advantage over the next few years. This risk is further accentuated, given that more players in Europe have at least temporarily shifted to online offerings during the pandemic. Their return to land-based gaming remains uncertain, especially the longer the lockdown persists, even though we saw substantial demand in the middle of 2020 when lockdowns where temporarily lifted. We understand that Novomatic has already built online and sports betting capabilities for B2B and B2C in the past. However, we see the risk that a broader role for Germany next year could require additional capital expenditure (capex), which, at about 10% of sales, is quite high in normal years versus industry peers and which constrains free cash generation.

We believe Novomatic has sufficient liquidity sources to absorb the expected large cash outflows over the next several months. Following recent disposals, such as Casinos Austria AG, the group has about €900 million available cash and liquid investments and about €560 million available under its revolving credit facility (RCF) for liquidity management. Although liquidity sources remain large and sufficient to cover expected outflows and scheduled redemption of €450 million over the next 12 months, we have revised down our liquidity assessment to adequate from strong. We note there remains a potential for a breach under the financial maintenance covenant for the next reporting date in May 2021, given very limited headroom. However, we see Novomatic as well positioned to negotiate a waiver if necessary, in light of the group's well-established bank relationships and large scale in Austria. As such, we envisage full availability of the RCF over the next 12 months. The scheduled significant maturity and tight covenant headroom and credit spreads on Novomatic's 2023 bonds, all of which we consider to be higher than similarly rated peers, contribute to our adequate liquidity assessment.

Cost management and cash-preserving measures will prevent a large increase in adjusted debt. Most governmental support measures to support businesses during the pandemic were extended for the second lockdown, as well. These include state-funded part-time work for employees in most of Novomatic's core regions, negotiating rents for closed arcades, reducing capex to only necessary projects, and benefitting from temporary government tax relief for gaming taxes, which represented about 12% of revenue alone in 2019. In our view, this will help Novomatic's free operating cash flow (FOCF) generation after leases, which was roughly neutral during the first half of 2020. As a consequence, we believe that absolute debt levels will not increase significantly.

Technological capabilities, scale, and diversification in different jurisdictions support the rating. Despite the challenges from the pandemic, we see Novomatic as one of the leading land-based gaming operators and producer of gaming machines in the European gaming sector, with well-known brands, such as Admiral, and S&P Global Ratings-adjusted EBITDA of about €663 million in 2019. It benefits from being vertically integrated, having operations in multiple European geographies and to a small extent also in North America and Australia, and a significant scale that supports investments in research and development to enable the development of new products with high technological standards.

The ratings are subject to further regulatory developments, despite greater clarity for the German land-based gaming market. Regulatory changes have put a dent in Novomatic's earnings and cash generation over the past three years, and the sector remains prone to regulatory risks. However, near-term effects from recent regulatory changes for Novomatic's large land-based operations should be limited. This is due to:

- The impact of German Gaming Ordinance measures regarding player safety on gross gaming revenue was negative in early 2019, but has improved since then. In early 2019, the newly introduced V2 machines with card unlocking features were unpopular with players, and resulted in lower gross gaming revenue. However, as players have become more used to the feature, the new machines have become more accepted, and gross gaming revenue has thus improved.
- The new draft Interstate Treaty agreed by German states, laying out a framework for regulation in the German market from July 2021. This allows states to accept the current level of exceptions granted for multi-concession arcades, therefore lowering risk to earnings expectations for Novomatic's German business.
- We have incorporated in our base case the impact of regulation on gaming arcades in Italy that limits the number of arcades allowed in one area, as well as higher gaming taxes in the country, mostly in 2019. We also expect less regulatory scrutiny in the sector, given the significant impact of COVID-19 on businesses.

Legal proceedings pose reputational risks and could constrain Novomatic's ability to do business if current investigations lead to prosecution or other legal actions. 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 include attempting to illegally influence gaming legislation and licensing in Austria. The investigations are connected to broader allegations surrounding a political scandal in Austria, which began in 2019, and are likely to continue for some time. Although we understand Novomatic and named parties deny any wrongdoing and are cooperating fully with authorities, and we believe the current impact of the investigations on Novomatic's business is minimal, the longer they continue, the investigations could nevertheless threaten the group's reputation. This would particularly be the case if they resulted in legal proceedings against the company or connected parties. Gaming operators rely on their good standing and reputation, and that of their key personnel, among regulators to maintain gaming licenses. This has always been the case with Novomatic, but things could become more challenging if the investigations and potential proceedings are protracted.

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

- Health and safety

Outlook

The negative outlook reflects the existing uncertainty and the risk that Novomatic could underperform our base case over the next 12 months, such that leverage remains above S&P Global Ratings-adjusted 4x for an extended period. Financial underperformance could occur if, for example, the extent and duration of lockdowns are worse than anticipated, or any recovery is more muted than forecast. On this basis, we forecast S&P Global Ratings-adjusted debt to EBITDA could remain high, at 3.9x-4.4x, in 2021, but we think that would be temporary.

The outlook also reflects our view of the downside risk to Novomatic should the ongoing investigations by Austrian authorities progress to prosecution or other legal action, 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 were more severe than we assume, resulting in S&P Global Ratings-adjusted debt to EBITDA remaining above 4x, or FOCF after all lease payments remaining negative on a prolonged basis.
- If the trend toward online gaming grew stronger than we assume.
- The liquidity of the group weakened to a degree not offset by any remedial action, for instance by not obtaining a covenant waiver in case of a potential breach.
- 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 impacts on Novomatic's reputation or standing in operating or financial markets.

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 on Novomatic's operating performance, liquidity, and cash flow. In particular, an outlook revision would depend on the group's ability to manage costs, cash, and upcoming debt maturities, with its S&P Global Ratings-adjusted debt to EBITDA therefore falling below 4x after 2021. A stable outlook would also hinge on a resolution of the ongoing investigations.

Company Description

Novomatic operates in two segments:

- Gaming Technology (business-to-business segment [B2B]) and
- Gaming Operations (business-to-consumer segment[B2C]).

The Gaming Technology segment engages in the production, sale, and rental of gaming and entertainment machines and content, as well as the operation of online content for business customers.

The Gaming Operations segment is involved in the operation of casinos and electronic gaming machines, as well as the online B2C business, and the provision of sports and horse racing betting services.

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

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

Our Base-Case Scenario

- S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. Reports that at least one experimental vaccine is highly effective and might gain initial approval by the end of the year are promising, but this is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by the middle of next year. We use 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.
- Real GDP growth in the eurozone of negative 7.2% in 2020 recovering by 4.8% in 2021, with consumer price index inflation of 0.0%-1.0% per year.
- Absent any regulatory changes, we anticipate land-based gaming operations in Europe will report modest growth, but remote, online gaming will expand significantly above GDP because markets are not fully saturated.
- Revenue decline of 30%-35% in 2020 due to the impact of COVID-19, recovering only partly by 8%-15% in 2021 and 18%-25% in 2022 because of ongoing governmental restrictions in the first half of next year.
- In light of the factors flagged above, and some level of fixed costs included in operations, we forecast the group's S&P Global Ratings-adjusted EBITDA margin will dip to around 17%-20% in 2020 compared with 25.4% in 2019.
- Opportunistic but discretionary bolt-on acquisitions of about €50 million annually.

- Capex of €180 million-€210 million in 2020 and €200 million-€220 million in 2021, which Novomatic has temporarily lowered due to COVID-19 impact. It would further accelerate toward €300 million-€350 million from 2022.
- Asset disposal net proceeds of about €120 million to €150 million in 2020 to be used for debt repayment.
- Dividends of up to €50 million-€60 million in 2020 and 2021, compared with €33 million in 2019.

Key metrics

Novomatic AG Key Metrics

	2018a	2019a	2020e	2021f	2022f
Revenue (bil. €)	2.613	2.607	1.7-1.8	1.9-2.0	2.3-2.5
EBITDA (mil. €)	611	663	310-340	420-460	560-600
EBITDA margin (%)	23.4	25.4	18.0-19.0	22.0-23.0	24.0-26.0
Debt to EBITDA (x)	2.8	2.9	5.3-5.7	3.9x-4.4x	3.0x-3.3x
FFO to debt (%)	25.3	29.5	14.6-15.5	18-23	25-28
FOCF after lease payments	115	12.8	About zero	50-80	50-80

All figures are S&P Global Ratings-adjusted. *2019 year-end debt comprises financial debt of €1.9 billion, for which key adjustments are €0.7 billion in leases and €0.4 billion in surplus cash available for debt repayment. e--Estimate. f--Forecast. FFO--Funds from operations. FOCF--Free operating cash flow. N/A--Not applicable.

Liquidity

We view Novomatic's liquidity as adequate (versus strong previously), although we estimate that the group's liquidity sources will likely cover liquidity needs by nearly 2.1x over the next 12 months. This is because we see only very limited covenant headroom over the next 12 months, which may require the group to secure a covenant waiver. Having said that, we believe that Novomatic, with its well-established and solid relationships with banks, would likely be able to secure a waiver if required. In addition, the persistently high spreads in the company's bonds over the last few months in our view means that its standing in debt capital market is only satisfactory in the sense of adequate liquidity.

- Principal liquidity sources for the 12 months started Oct. 1, 2020, include:
- About €900 million available in cash and equivalents, minus the cash required in gaming machines;
- Availability of about €560 million under €1 billion RCF due March 2024; and
- Funds from operations of about €235 million-€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 €190 million-€220 million; and

- Dividends of about €50 million.

Covenants

Compliance expectations

We estimate that headroom under the financial covenants should be very limited for the next testing in May 2021 for the full year figures in 2020. Although we expect headroom to increase toward 20%-30% over 2021, we see a risk of a breach. Given Novomatic's solid relationships with core banks and the likely only temporary covenant issues, we believe that the management would likely be able to secure a waiver if needed.

Requirements

Novomatic AG is required to comply with semi-annually tested financial covenants in its €1 billion RCF. These include a maximum net debt to EBITDA covenant of 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%) in a payment 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.
- Our simulated default scenario contemplates a payment default occurring in 2024 due to regulatory changes that would shrink Novomatic's addressable market, combined with a prolonged economic downturn that would reduce consumer spending on gaming, extend the gaming equipment replacement cycle, and meaningfully reduce arcade operators' spending on new equipment.
- We assume Novomatic would reorganize under a distressed scenario and we 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 RCF would be 85% drawn at the time of 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 -5% to reflect the regulatory pressure in gaming technology segment).
- EBITDA multiple: 6.5x
- Gross recovery value: €2.08 billion
- Net recovery value after administrative expenses (5%): €1.98 billion
- Estimated priority debt: €53 million
- Estimated unsecured claims[1]: €2.14 billion
- The value available to unsecured claims: €1.92 billion
- Recovery expectations: 50%-70% (rounded estimate: 65%)

[1] All debt amounts include six months of prepetition interest. Includes €1.0 billion RCF assumed to be drawn at 85%

Ratings Score Snapshot

Issuer Credit Rating: BB/Negative/B

Business risk: Fair

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

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: Adequate(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
- 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: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Scientific Games Rating Affirmed On Less Volatile Lottery Business, Expected 2021 Leverage Improvement; Outlook Negative, June 17, 2020
- Aristocrat Leisure Ltd. 'BB+' Rating Affirmed On Earlier Reopening Of Casinos, Strong Digital Gaming; Outlook Negative, Sept 8, 2020
- Flutter Entertainment Rating Affirmed At 'BB+' On Equity Raising; Outlook Stable, June, 11, 2020

Ratings List

Downgraded

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