

Research Update:

Novomatic Outlook Revised To Positive On Improving Operating Performance And Decreasing Leverage; 'BB' Ratings Affirmed

June 29, 2022

Rating Action Overview

- Novomatic AG's 2022 revenue and EBITDA will likely surpass pre-pandemic levels, on a ramp-up in activity of the group's gaming technology segment and a swift recovery of its operations segment thanks to lifted restrictions.
- We expect Novomatic to report a reduction in S&P Global Ratings-adjusted leverage to 2.3x-2.5x in 2022 from 3.0x in 2021, and that its free operating cash flow (FOCF) after leases will strengthen markedly to about €150 million in 2022 from €10 million the year before. The group's gross debt repayments have supported these improvements.
- Consequently, we revised our outlook on Novomatic to positive from negative and affirmed our 'BB' ratings on the group and its debt.
- The positive outlook reflects the possibility of an upgrade over the next 12 months if the company deleverages further, such that S&P Global Ratings-adjusted debt to EBITDA drops to, or below, 2x or below and S&P Global Ratings-adjusted FOCF to debt improves sustainably above 20%.

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Rating Action Rationale

Novomatic's operating performance is recovering faster than our prior expectation, thanks to an increasing demand in the B2B technology segment. Following the lifting of pandemic-related restrictions, many arcades resumed their plans to upgrade their land-based equipment, prompting a surge in Novomatic's technology segment order book. As a result, the technology segment's revenue increased 20.4% in 2021 to €806 million from €670 million a year earlier. This contributed to total revenue growth of about 5.7% in 2021, marking a pronounced improvement over the 33.1% reduction experienced year-on-year in 2020. That said, the segment's revenue in 2021 recovered to only 85% of levels before the pandemic. Some countries, such as Austria and Germany, lifted their full COVID-19-related restrictions only recently, and land-based arcades

started to renew their equipment only in the first half of 2022. Consequently, we believe that the segment will continue to rebound over the remainder of the year. We forecast segment revenue growth of about 30% in 2022 to about €1.1 billion, thereby surpassing the 2019 revenue (€946 million) by about 11%.

Although the business-to-consumer segment (B2C) operations segment's revenue still lags that of the other segments, it should reach pre-pandemic levels by year-end. Revenue from the B2C gaming operations segment in 2021, at about 60% of its 2019 level, remained subdued, since they were affected by the pandemic-related restrictions imposed in almost all Novomatic's markets. Even though the group's online subsidiary Greentube performed well in 2021, overall, the share of revenue that the company generates from online and digital sources stands near 20%. This is significantly lower than that of peers such as Aristocrat Leisure (BB+/Positive/--), Entain (BB/Stable/--), or Flutter Entertainment (BB+/Positive/--), which generate 45%-90% of their gaming revenue online. Nevertheless, now that restrictions have been lifted in almost all geographies in which Novomatic operates, we anticipate a swift recovery of its land-based operations, particularly in Germany and Austria. Moreover, the company is expanding its geographical footprint of operations in this segment, both online and offline. In our base case, we expect Novomatic's B2C operations revenue to increase 55% this year to about €1.6 billion from €1.0 billion in 2021, almost bouncing back entirely to pre-pandemic levels.

Novomatic's 2021 profitability hit a record high thanks to cost efficiency and optimization measures, but we expect the EBITDA margin to normalize this year. In 2021, Novomatic's reported EBITDA dropped about 15% to €588 million from €685 million in 2019. Despite the absolute level remaining subdued during 2021, the EBITDA margin expanded to 31.1% in 2021 from 17.5% in 2020. This came thanks to operational efficiency and optimization measures, such as the unwinding of some gold reserves, subsidies received from governments, tax redemptions, and much smaller foreign exchange losses compared with 2020, boosting EBITDA. We expect absolute EBITDA to recover to its pre-pandemic level in this fiscal year. That said, profitability will decrease due to higher marketing expenses, as the company enters new markets and the impact from inflationary pressure in the majority of Novomatic's geographies, namely Central and Western Europe. We anticipate an adjusted EBITDA margin of 25%-26% in 2022.

Novomatic's management is proactively reducing debt and targets a conservative financial policy of below 2.0x, based on company-reported net leverage. In February 2022, the company launched a cash tender offer to purchase more than half of its existing traded bonds, financed via partial drawdowns of their revolving credit facility (RCF), short-term financing, and cash on balance sheet. As a result, over the past six months, Novomatic's financial indebtedness outstanding has declined to €1.2 billion from €1.4 billion at Dec. 31, 2021. We now forecast S&P Global Ratings-adjusted debt to EBITDA of 2.3x-2.5x in 2022, down from 3.0x in 2021. Novomatic is targeting a financial policy of company-reported net debt to EBITDA of below 2.0x.

On top of the potential reputational risks, legal proceedings could constrain Novomatic's ability to do business if current investigations lead to prosecution or other actions. The Austrian economic and corruption authorities' investigations into Novomatic, including current and former employees, executives, and its shareholders, continues. The allegations include attempting to illegally influence gaming legislation and licensing in Austria and seeking beneficial support from the government in return for favors. 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. We understand Novomatic and named parties deny any wrongdoing and

are defending themselves against all allegations, and we believe the investigations have so far had a minimal impact on Novomatic's business. However, the longer the investigations continue, the more likely they are to harm the group's reputation. We particularly note the potential reputational damage that could stem from legal proceedings against the company or connected parties. Gaming operators rely on their good standing and reputation, and that of their key personnel, with regulators to maintain gaming licenses. This has always been the case with Novomatic, unless an escalation of the current legal issues complicates matters.

Outlook

The positive outlook reflects our forecast that, in the next 12 months, Novomatic could exceed pre-pandemic levels of revenue and EBITDA and deleverage such that S&P Global Ratings-adjusted debt to EBITDA decreases to 2.3x-2.5x and FOCF to debt improves to about 15%-18%. In our view, material FOCF is key to sustaining Novomatic's creditworthiness in the higher end of our 'BB' rating category since it demonstrates rising headroom and financial flexibility to meet the group's operating, financing, and strategic commitment and goals.

Upside scenario

We could raise the rating on Novomatic in the next 12 months if:

- The group decreases its leverage to 2x or below and remains committed to a company reported net leverage ratio of comfortably below this level;
- Organic revenue and EBITDA continue to increase;
- Adjusted FOCF to debt improves sustainably to 20% or above; and
- The ongoing investigations do not result in a detrimental outcome for the group.

Downside scenario

We could downgrade the company if:

- Changes in regulatory, competitive, or economic conditions in Novomatic's key markets hampered the group's recovery and constrain EBITDA, such that adjusted debt to EBITDA surpasses 3x;
- The company pursued material debt-financed acquisitions or shareholder return such that the leverage ratios exceed the target ratio over a prolonged period, and the group appeared to deviate from its financial policy target;
- FOCF underperformed our base case, such that adjusted FOCF to debt fell below 15%;
- The investigations led to, for example, prosecution or other legal action, or revealed unethical behavior. Although it is not our base-case scenario, we could consider lowering the rating if investigations carried on much longer than expected and therefore tainted Novomatic's reputation or standing in operating or financial markets.

Company Description

Novomatic operates in two segments: Gaming Technology (business-to-business segment) and Gaming Operations (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 2021, Novomatic reported revenue of €1.8 billion and S&P Global Ratings-adjusted EBITDA of €573 million. Novomatic is a mostly European business: Germany, Austria, Italy and Spain represent about 54% 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

Assumptions

- Real GDP growth in the eurozone of about 2.7% in 2022 and 2.2% in 2023.
- Revenue to increase about 45% in 2022, recovering to pre-pandemic level of €2.5 billion-€2.6 billion. We expect revenue growth to continue in 2023 by 9%-10%, supported by geographical expansion in the operations segment and a strong contribution from the technology segment, as arcades renew their leased machine after reopening.
- Adjusted EBITDA margin to normalize to pre-pandemic levels at 25%-26%, compared with the exceptional 31.1% in 2021.
- Capital expenditure (capex) of €300 million-€325 million in both 2022 and 2023 as the company resumes its normal maintenance capex levels after two years of low spending due to the pandemic.
- No dividend or significant acquisitions over the forecast period.

Key metrics

Novomatic AG--Key Metrics

	2019a	2020a	2021a	2022e	2023f
Revenue (bil. €)	2.607	1.744	1.842	2.5-2.8	2.8-3.1
EBITDA (mil. €)	663	297	573	650-680	720-750
EBITDA margin (%)	25.4	17.1	31.1	25.0-26.0	25.0-26.0
Debt to EBITDA (x)	2.9	5.7	3	2.3-2.5	1.8-2.3

Novomatic AG--Key Metrics (cont.)

	2019a	2020a	2021a	2022e	2023f
FFO to debt (%)	29.5	13.7	26.6	27.0-34.0	34.0-43.0
FOCF to debt (%)	12.8	7.1	7.8	15.0-18.0	18.0-21.0

All figures are S&P Global Ratings-adjusted. a—Actual. e--Estimate. f--Forecast. FFO--Funds from operations. FOCF--Free operating cash flow.

Liquidity

We view Novomatic's liquidity as adequate, although we estimate that the group's liquidity sources will likely cover liquidity needs by greater than 2.0x over the next 12 months. Although we believe that Novomatic has well-established and solid relationships with banks, the likelihood that the company will be able to withstand high-impact low-probability events without refinancing is limited.

Principal liquidity sources for the 12 months started March 31, 2022, include:

- About €451 million available in cash and equivalents;
- Availability of about €340 million under its RCF of €1 billion due March 2024;
- Funds from operations of about €420 million; and
- Working capital inflow of €50 million-€55 million.

Principal liquidity uses for the same period, include:

- Short-term debt and maturing long-term debt of €200 million-€205 million;
- Maximum changes in working capital and intra-year working capital swings of €90 million-€100 million; and
- Capex of €290 million-€310 million.

Covenants

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. Under our base-case scenario, we estimate compliance headroom of about 60% for the next 12 months.

Environmental, Social, And Governance

ESG credit indicators: To E-2, S-3, G-4 from E-2, S-4, G-3

Social factors are now a moderately negative consideration in our credit rating analysis of Novomatic, because we believe the negative impact from the COVID-19 pandemic has softened. The company now operates at 100% capacity, since pandemic-related restrictions due to the pandemic are lifted in almost all countries in which Novomatic operates. Like most gaming companies, Novomatic is exposed to regulatory and social risks and the associated costs related

to increasing player health and safety measures, prevention of money laundering, and changes to gaming taxes and laws. Governance factors remain a negative consideration. We note the ongoing investigation into allegations of potential corruption and bribery involving the company and certain employees. Novomatic denies involvement, is defending its position, and is cooperating with authorities. We also note that as a privately held company, the control and majority ownership of the group is held predominately by its founding owner, and we believe that the company is likely to prioritize the interests of its controlling shareholder.

Issue Ratings - Recovery Analysis

Key analytical factors

- The issue rating on the outstanding unsecured notes of €237.6 million due 2023 is 'BB' with a recovery rating of '3', reflecting our expectation of meaningful recovery (50%-70%, rounded estimate 65%) in a default.
- Although the numerical recovery outcome exceeds 65%, according to our methodology, we cap the recovery rating of the notes at '3' due to their unsecured nature and lack of structural protections. 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 2027 that could come about via significant regulatory change, rapid competitive shift or prolonged economic downturn for example.
- We assume Novomatic would reorganize under a distressed scenario as a going concern given its material brands, market positions, technology, and IP; 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

- Jurisdiction: Austria
- Simulated year of default: 2027

Simplified waterfall

- Emergence EBITDA: €297 million.
- EBITDA multiple: 6.5x
- Gross recovery value: €1.93 billion
- Net recovery value after administrative expenses (5%): €1.83 billion
- Estimated unsecured claims [1]: €1.49 billion
- The value available to unsecured claims: €1.83 billion
- Recovery expectations: 50%-70% (rounded estimate: 65%)

[1] All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating	BB/Positive/B
Business risk:	Fair
Country risk	Intermediate
Industry risk	Intermediate
Competitive position	Fair
Financial risk:	Intermediate
Cash flow/leverage	Intermediate
Anchor	bb+
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Adequate (no impact)
Liquidity	Neutral (no impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Negative (-1 notch)

Environmental, social, and governance (ESG) credit factors for this change in credit rating/outlook and/or CreditWatch status:

- Health and safety

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: Methodology: Industry Risk, 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: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Novomatic AG		
Issuer Credit Rating	BB/Positive/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 criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914

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