Research Update:

Gaming Group Novomatic AG Upgraded To 'BB+' On Sound Operating Performance And Reducing Leverage; Outlook Stable

June 16, 2023

Rating Action Overview

- Austrian gaming group Novomatic AG reported sound operating performance in 2022, when revenue reached €2.86 billion and EBITDA rose to €746 million; it achieved a full recovery thanks to the lifting of pandemic restrictions in all its markets.
- Credit metrics improved beyond our base-case expectation, with leverage reducing to 2.2x in 2022, from 3.0x in 2021 and free operating cash flow (FOCF) to debt improving to 20% from 8% over the same period.
- We therefore raised our long-term rating on Novomatic AG to 'BB+' from 'BB'.
- Our stable outlook is based on our expectation that Novomatic's operating performance will remain sound as it integrates its latest bolt-on acquisitions and invests in its core businesses (including the online segment), such that leverage reduce further, toward 2.0x, while FOCF to debt remains at least 20%.

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Rating Action Rationale

Novomatic demonstrated sound operating performance in 2022, exceeding pre-pandemic levels, and its credit metrics have significantly improved. Revenue, at €2.86 billion, increased by 55% compared with 2021 and 10% compared with 2019. Meanwhile, EBITDA increased to €746 million, 30% up on last year and 12% higher than in 2019. This was driven by a full recovery in both the gaming technology (up 33% versus 2021) and gaming operations (up 72% versus 2021) segments, as the restrictions in all Novomatic's markets were lifted last year. The group also made several small acquisitions that contributed to earnings growth and formed part of its international expansion strategy. These included the acquisition of a majority share in the Italian HBG Group. In addition, the group reduced its gross financial debt by about €120 million by partly repaying its outstanding bond before its 2023 maturity date. Adjusted leverage improved to 2.2x, from 3.0x in 2021. Free operating cash flow (FOCF) after leases also recovered to €205 million in

2022 from €11 million in 2021, while FOCF to debt reached 20% from 8% over the same period.

S&P Global Ratings anticipates further earnings growth, despite rising regulatory pressure in Europe and the group's limited online presence. We expect the group will continue to roll out its expansion strategy by making small bolt-on acquisitions and investments in its core markets and businesses, notably in the online segment, which is growing fast and highly profitable, but contributed only about 9% of revenue in 2022. This is well below the 45%-90% that peers such as Aristocrat Leisure Ltd., Entain PLC, or Flutter Entertainment PLC generate through their online channels. Regulatory pressure is rising throughout Europe, especially in Germany, but we anticipate that Novomatic will harness its scale and leading position to help it absorb the impact. Therefore, we forecast that revenue will rise to €3.2 billion in 2023, although EBITDA margins could contract to about 24% in 2023, from 26.1% in 2022. Increased marketing expenses and rising energy and personnel costs could affect margins via the effect on adjusted EBITDA (estimated at €765 million for 2023).

We expect adjusted leverage to decrease toward 2.0x in 2023 and cash flow to remain at least stable. This is commensurate with management's target for reported leverage of below 2x (based on company-reported net leverage); this measure stood at 1.7x at the end of 2022. We expect FOCF after leases to stay relatively stable at about €200 million in 2023, as higher taxes offset higher earnings. Although cash generation has significantly improved in 2022, it is still weaker than that of peers, largely because of the product mix and lower exposure to the online segment. FOCF to debt is likely to remain at about 20%.

Legal proceedings pose reputational risks and could constrain Novomatic's ability to do business if current investigations lead to prosecution or other legal 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 that 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. To maintain their gaming licenses, gaming operators rely on their good standing with regulators, as well as their reputation and that of their key personnel. To date, Novomatic has retained its good standing and reputation, but an escalation of the current legal issues would complicate matters.

Outlook

The stable outlook indicates that we expect Novomatic's operating performance to remain sound in 2023 and that it will successfully integrate its latest bolt-on acquisition and invest in its core businesses, enabling our adjusted leverage metric to drop toward 2.0x and FOCF to debt to remain about 20%.

Downside scenario

We could downgrade the company if:

- Changes in regulatory, competitive, or economic conditions in Novomatic's key markets hampered profitability, such that adjusted debt to EBITDA deteriorates toward 3x;
- Cash flow generation underperforms our base case, such that adjusted FOCF to debt falls below 15%;
- The company pursued material debt-financed acquisitions or shareholder returns, such that the leverage ratios exceed our target ratio over a prolonged period, and the group appears to deviate from its financial policy target; or
- The investigations reveal unethical behavior, lead to prosecution or other legal actions, or trigger significant financial penalties. Although it is not our base-case scenario, we could consider lowering the rating if the investigations are prolonged enough to taint Novomatic's reputation or standing in operating or financial markets.

Upside scenario

We view an upgrade as unlikely while the investigations remain open. Over the longer term, we could raise the rating on Novomatic, if:

- The investigation is terminated with no detrimental outcome for the group;
- The group continues to expand its earnings base, gaining operational scale, diversifying its product offering, and extending its geographic reach, such that it consolidates a significant FOCF after lease generation; and
- The company increases its S&P Global Ratings-adjusted FOCF to debt sustainably above 25% while maintaining adjusted leverage well below 2x, and commits to a company-reported net leverage ratio comfortably below this level.

Company Description

Novomatic operates in two segments:

- Gaming technology, a business-to-business segments that 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; and
- Gaming operations, a business-to-consumer (B2C) segment 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 2022, Novomatic reported revenue of €2.86 billion and S&P Global Ratings-adjusted EBITDA of €746 million. Novomatic is a mostly European business: Germany, Austria, Italy, the U.K., and Spain represent about 54% of its revenue.

The group is effectively controlled by its founder, Professor Johann F. Graf, through investment holding company Novo Invest GmbH.

Our Base-Case Scenario

Assumptions

- Real GDP growth in the eurozone of about 0.3% in 2023 and 1.0% in 2023.
- Revenue to increase by about 12% in 2023 and 4% in 2024 on investments in its core businesses as well as contributions from recent acquisitions.
- Adjusted EBIDTA margin to contract slightly to about 24% in 2023 from 26.1% in 2022, based on higher personnel and energy costs; higher marketing expenses, especially in the online segment; and integration costs related to the latest acquisitions.
- Capital expenditure (capex) of about €290 million in 2023 and €330 million in 2024, about half of which represents replacement capex and half is for expansion.
- Small bolt-on acquisitions of about €70 million annually. No large acquisitions over the two-year forecast period.
- Annual dividends of about €50 million.

Key Metrics

Novomatic AG--Key Metrics

	2020a	2021a	2022a	2023e	2024f
Revenue (bil. €)	1.744	1.842	2.859	3.2-3.3	3.3-3.60
EBITDA (mil. €)	297	573	746	765-800	820-880
EBITDA margin (%)	17.1	31.1	26.1	23.5-24.5	24.5-25.5
Debt to EBITDA (x)	5.7	3.0	2.2	1.9-2.1	1.8-1.6
FFO to debt (%)	13.7	26.6	36.6	35-40	38-43
FOCF to debt (%)	7.1	7.8	19.9	19-22	19-24

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 based on our expectation that sources of liquidity will cover uses by at least 1.2x. Although we consider that Novomatic has well-established and solid relationships with banks, we see limited likelihood that it would be able to withstand high-impact, low-probability events without refinancing.

Principal liquidity sources for the 12 months from April 1, 2023, include:

- About €471 million available in cash and equivalents;
- €230 million of availability under its €800 million revolving credit facility (RCF);
- Funds from operations of about €460 million; and

- €50 million new credit facility agreement obtained in May 2023.

Principal liquidity uses for the same period, include:

- Short-term debt and maturing long-term debt of €305 million, including the amount still outstanding on the bond that matures in September 2023 (€237.6 million);
- Dividend payment of about €50 million;
- Maximum changes in working capital and intrayear working capital swings of about €100 million; and
- Capex of close to 300 million.

Covenants

Novomatic AG is required to comply with semiannually tested financial covenants in its €800 million RCF. These include a maximum net debt to EBITDA covenant of 4.25x. Under our base-case scenario, we estimate that is will have sufficient headroom under the covenant over the next 12 months.

Environmental, Social, And Governance

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

Social factors are a moderately negative consideration in our credit rating analysis of Novomatic. 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' that reflects our expectation of meaningful recovery (50%-70%; rounded estimate 65%) in a default.
- Nevertheless, we cap the recovery rating on 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 2028 that follows

significant regulatory change, a rapid competitive shift, or prolonged economic downturn.

- We assume Novomatic would reorganize as a going concern under a distressed scenario, given its strong brands, market position, technology, and intellectual property rights. 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: 2028

Simplified waterfall

- Emergence EBITDA: €306 million.
- EBITDA multiple: 6.5x
- Gross recovery value: €1.99 billion
- Net recovery value after administrative expenses (5%): €1.89 billion
- Estimated unsecured claims*: €1.44 billion
- The value available to unsecured claims: €1.89 billion
- Recovery expectations: 50%-70% (rounded estimate: 65%)

*All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating	BB+/Stable
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
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Fair

Issuer Credit Rating	BB+/Stable
Comparable rating analysis	Neutral
Stand-alone credit profile:	bb+

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

Upgraded; Outlook Action

	To	From
Novomatic AG		
Issuer Credit Rating	BB+/Stable/B	BB/Positive/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