Fitch Affirms Famsa's IDRs at 'B-', Revises Outlook to Positive

Fitch Ratings-Mexico City-18 September 2018: Fitch Ratings has affirmed Grupo Famsa S.A.B. de C.V.'s (Famsa) Long-Term, Local- and Foreign-Currency Issuer Default Ratings (IDRs) at 'B-', National Long-Term Rating at 'BB(mex)' and National Short-Term Rating at 'B(mex)'. The Rating Outlook has been revised to Positive from Stable.

The ratings reflect Grupo Famsa, S.A.B de C.V.'s market position within the Mexican retail sector, geographic and product diversification, stable operating cash flow generation by the Mexican retail operation and the expectation of a gradual improvement in leverage.

Famsa's Positive Outlook reflects its improving financial position followed the deleveraging plan and short-term debt refinancing the company has executed since 2017. The Outlook considers the increased confidence in Famsa's ability to keep improving consolidated profitability and to turn over its U.S operation results.

Fitch Ratings expects Famsa to continue receiving, as scheduled, additional significant payments from the collection rights to its main shareholder, Humberto Garza Gonzalez. These proceeds are expected to be directed toward repaying debt.

KEY RATING DRIVERS

Good Mexican Retail Sales Performance: During the LTM ended June 30, 2018, Mexican retail sales performed in line with peers and showed a 9.7% increase over the year-earlier period. Famsa's current main challenge is to retain market share and profitability amid the high competitive environment in Mexico, where larger retail chains, such as Coppel and Elektra, also target the low-income segment of the population.

Profitability and Liquidity Initiatives On the Rise: Famsa has taken effective actions to improve profitability and liquidity since 2017, such as redesigning its personnel structure, reducing expenses, executing maintenance-only capex and carrying out selective store closings. The company also refinanced a portion of its short-term debt, which as of June 2018 totalled MXN2.4 billion, up from MXN4.0 billion at the end of 2016.

Since the last quarter of 2017, Famsa turned to a more conservative origination policy. Salary compensation for certain positions was linked to portfolio quality, promoting new credits with higher quality standards. These initiatives have positively affected 2018 results relative to Fitch's expectations. Famsa expects to maintain consolidated NPLs of around 12% given its target market characteristics. As of June 2018, the consolidated NPL level was 12.7%.

Operational Consolidation at Banco Famsa: Famsa's financial division, Banco Famsa (BAF), has good brand equity and a good competitive position in consumer finance, mainly in Northeastern Mexico. BAF's profitability is improving but its financial performance is constrained by its high funding costs and still-high loan-impairment charges, which limit profitability and internal capital generation. However, during the last year BAF has improved its credit origination policy, and the company expects improvements in its portfolio's credit quality, which would improve BAF's profitability. Given BAF's ambitious growth strategy, the institution has required consistent capital injections from Famsa. During 2015-2017, Famsa made average annual capital increases of MXN400 million to BAF.

One of BAF's main strengths is its diversified and relatively stable and resilient base of customer deposits. BAF also shows organic growth in its loan portfolio, although its customers' sensitivity to a weak economic environment continues to be a limiting factor.

U.S. Operations Under Pressure: U.S. stores' same-store sales decreased 10%-25% during the last two years, beyond the company's expectations, however, it seems to be stabilizing during 2018. For the LTM ended June 30, 2018, revenues from U.S. operations were MXN1.7 billion, down from MXN2.3 billion in 2016 mainly due to the closing of unprofitable stores. Fitch believes 2018 will remain a challenging year for Famsa's U.S. operations, given the migration policy that negatively affects Famsa's target market of U.S. Hispanic customers. The company is redirecting its commercial strategy for the U.S. by targeting second and third generation Hispanics and improving its social media presence.

Leverage to Recover: Weaker than expected results in the U.S. operations along with a weaker portfolio quality and a competitive environment in Mexico have led Famsa to higher leverage in recent years. At June 30, 2018, the company's lease adjusted debt (excluding banking deposits) to EBITDAR ratio was 6.4x, similar to a year earlier.

Fitch expects total adjusted debt to EBITDAR to decrease to around 5.0x-5.5x and total debt to EBITDA to be below 5.0x by YE 2018, supported by improved profitability and debt reduction. As of June 30, 2018, Famsa's total debt was MXN9.3 billion - of which approximately MXN0.5 billion was directed to refinance short-term debt in July 2018. The company expects debt to decrease to around MXN8.5 billion by the end of 2018 after the reception of the collection rights to Mr. Garza of around MXN0.4 billion during the second half of the year.

DERIVATION SUMMARY

Grupo Famsa's business risk profile is closer to the upper level of the 'B' category when compared with peers. Grupo Famsa is less geographically diversified than Grupo Elektra (BB/Positive) and Grupo Unicomer (BB-/Stable), but it is well positioned in its influence area of Northern Mexico. The company has smaller scale in number of stores than Elektra and Unicomer.

From a financial risk profile view, Grupo Famsa leans toward the mid-level of the 'B' category when compared with peers. The company has similar adjusted leverage to J.C. Penney (JCP; B/Stable) with ratios between 5.0x and 6.0x, but it is stronger than Rite Aid (B/Negative) which has an adjusted leverage ratio in the mid-7.0x range. The three companies present neutral to negative FCF, but JCP and Rite Aid have stronger liquidity positions than Famsa. On the other hand, Famsa has higher profitability margins than JCP and Rite Aid and the prospects for the retail industry in Mexico are stronger than in the U.S.

Compared with regional peers, the company maintains a weaker financial position in terms of profitability, flexibility and financial structure than Elektra and Unicomer. Grupo Famsa's operating margins are lower but close to Unicomer's, while Elektra has the best operating margins of the three companies.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within the Rating Case for the Issuer

--Consolidated revenues grow 5.9% on average annually during 2018-2021;
--Average EBITDA margin of 9.8% during 2018-2021;
--EBITDA from the U.S. division is slightly negative in 2018-2019 and neutral to positive in 2020-2021;
--Average CFO of MXN1.4 billion per year for 2018-2021;
--Consolidated debt (excluding bank deposits) of around MXN8.3 billion in 2018-2019;
--The company refinance the remaining balance of its Senior Notes due on 2020;
--Average capex of MXN215 million during 2018-2021;
--No dividend payments for 2018-2021;
--Famsa receives MXN0.8 billion per year from Mr. Garza's guarantee during 2018-2021;
--BAF requires capital increases of MXN450 million per year from Famsa during 2018-2021 to support its growth strategy.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
--Sustained reduction in consolidated total gross debt to EBITDA (excluding deposits) of 5.0x or below;
--Progress in the cash collection of Mr. Garza's pending MXN3.6 billion guarantee;
--A recovery of U.S. operations;
--Refinancing of the remaining balance of the USD Senior Notes due in 2020;
--Lower currency mismatch between debt and cash flows;
--Decreasing capital injections from Famsa to BAF;
--Continued strengthening of the consolidated credit portfolio's quality.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
--Failure to receive significant additional payments from Mr. Garza's guarantee;
--Additional or unexpected weaknesses in internal operating controls;
--Deterioration in BAF's creditworthiness beyond Famsa's ability to lend support;
--Consolidated gross debt to EBITDA (excluding bank deposits) consistently above 6.5x;
--Lower than expected EBITDA generation by Famsa USA;
--Deterioration in the quality of the consolidated loan portfolio.

LIQUIDITY

Adequate Liquidity: As of June 30, 2018, Famsa's short-term debt (excluding banking deposits) was MXN2.4 billion, and it had cash holdings of about MXN1.4 billion (most of it at BAF). Famsa's short-term debt is mostly made up of short-term Cebures issuances, which the company has been able to roll over, and bank loans with several institutions.

Famsa's main creditor is Bancomext with a total debt of MXN3.6 billion divided in two credit facilities with terms of 10 and 7 years. Proceeds from these loans were used to prepay part (USD110 million) of the senior notes, a portion of the company's short-term debt and working capital requirements.

Famsa has MXN2.7 billion of debt related to the USD140 million senior notes issuance (originally USD250 million). These notes have an annual interest rate of 7.25% and are due in 2020. The company currently does not have hedges to reduce its currency mismatch between U.S. dollar-denominated debt and its modest U.S. dollar cash flow generation from its U.S. operations. However, Famsa has covered the senior notes' 2018 coupons.

Recovery Analysis

For issuers with IDRs at 'B+' and below, Fitch performs a recovery analysis for each class of obligations of the issuer. The issue rating is derived from the IDR and the relevant Recovery Rating (RR) and notching, based on the going concern enterprise value of a distressed scenario or the company's liquidation value.

Fitch's recovery analysis for Famsa places a going concern value under a distressed scenario of approximately
MXN5.2 billion; based on a going-concern EBITDA of MXN921 million and a 5.5x multiple. The going

concern value is higher than the liquidation value, which Fitch estimates at about MXN2.0 billion.

The MXN921 million going-concern EBITDA assumption reflects a 40% discount from the average annual EBITDA generation during the last four years. The discount reflects deterioration of the U.S. operations and, at the same time, a significant consumer contraction in Mexico. The 5.5x multiple is the median multiple for retail going-concern reorganizations.

The liquidation value considers no value for cash due to the assumption that cash dissipates during or before the bankruptcy. Fitch applied a 100% discount on the credit portfolio given that most of it is allocated within BAF, which is a regulated entity and has another liquidation process. Fitch has also applied a 50% discount on inventory and PPE as a proxy for the liquidation value of those assets.

With these calculations, Famsa's waterfall results in a 52% recovery corresponding to a Recovery Rating of 'RR3' for the senior unsecured debt. However, according to Fitch's 'Country-Specific Treatment of Recovery Ratings Criteria', published in April 2018, the Recovery Rating for Mexican corporate issuers is capped at 'RR4', constraining the upward notching of issue ratings in countries with a less reliable legal environment. Therefore, the Recovery Rating for Famsa's senior notes is 'RR4'.

FULL LIST OF RATING ACTIONS

Fitch has affirmed the following ratings:
Grupo Famsa S.A.B. de C.V.
--Long-Term, Foreign- and Local-Currency IDRs at 'B-', Outlook revised to Positive from Stable;
--Long-term National rating at 'BB(mex)', Outlook revised to Positive from Stable;
--Short-term National rating at 'B(mex);
--USD140 million senior unsecured notes due in 2020 at 'B-'/'RR4';
--MXN0.5 billion short-term Certificados Bursatiles program at 'B(mex)';
--MXN1.0 billion short-term Certificados Bursatiles program at 'B(mex)'.

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Summary of Financial Statement Adjustments -
--The gain of MXN0.2 billion related to sales of fixed assets was deducted from the operating income.

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Additional information is available on www.fitchratings.com
Applicable Criteria
Corporate Rating Criteria (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10023785)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10024585)
Country-Specific Treatment of Recovery Ratings Criteria (pub. 16 Apr 2018) (https://www.fitchratings.com/site/re/10026835)
National Scale Ratings Criteria (pub. 18 Jul 2018) (https://www.fitchratings.com/site/re/10038626)
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