11 Sep 2019 | Rating Changed Outlook to Stable

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

Fitch Ratings-Mexico City-11 September 2019: Fitch Ratings has affirmed Grupo Famsa, S.A.B. de C.V.'s ratings and revised the Rating Outlook to Stable from Positive. A full list of rating actions follows at the end of this release.

The revision of the Outlook to Stable from Positive reflects that Famsa's financial results are below Fitch's expectations and that potential profitability and operational improvements will take longer than the next 12 months to achieve given Mexico's current economic scenario. The Stable Outlook incorporates Fitch's expectation that FAMSA will be able to refinance its senior notes maturity for USD140 million before the end of 2019. Inability to refinance this maturity before year-end would pressure liquidity and result in negative rating actions.

The affirmation of the IDR is supported by Famsa's market position within the Mexican retail sector, the relatively stable operating cash flow generated by the Mexican retail operation and Fitch's confidence in Famsa's ability to improve its U.S operating results.

Fitch expects the company's FCF to remain neutral to positive for the short to medium term. Furthermore, Fitch forecasts a Debt to EBITDA (excluding banking deposits and operating leases related debt) ratio close to 6.0x at end-2019, which is high for the rating. Fitch expects Famsa to continue receiving, as scheduled, significant additional 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

Results Below Expectations: Famsa has taken actions to improve profitability and liquidity since 2017, such as improving origination standards, reducing expenses, executing maintenance-only capex and carrying out selective store closings. The company also refinanced an important portion of its short-term debt during 2017 and 2018.

These initiatives have not been enough to significantly improve consolidated profitability and therefore reduce leverage, as originally expected. An increasingly challenged competitive environment along with a still weak portfolio quality and weaker than expected results in U.S. operations have impeded Famsa's efforts to reduce leverage. At Dec. 31, 2018, the company's debt (excluding banking deposits and pre-IFRS16) to EBITDA ratio was 5.7x, higher than Fitch's expectations of less than 5.0x.

Sluggish Economic Environment in Mexico: During the past two years, Mexico was affected by a weak and volatile peso as well as high interest rates. Fitch believes the economic environment for 2019 will remain soft given lower investments and lower GDP growth expectations. Consumer spending has slowed but has not reached the levels of past economic slowdowns yet.

Fitch believes that in a case where a revenue slowdown takes place, Famsa would be more vulnerable than its peers due to its high leverage and limited financial flexibility. However, the company has the option of managing its working capital inflows by adjusting the pace of originations/collections in its credit business.

Fair Performance of Mexican Retail Sales: During the first half of 2019, Mexican retail sales performed well with an 11.2% increase compared to the same period of 2018. The company is making efforts to improve its commercial proposal by the use of digital tools for its door-to-door sales, promotions to boost the repeat purchase rate, and appointment of a new Director of Operations with experience in strategic approach. Famsa's main challenge is to retain market share and profitability amid the highly competitive environment in Mexico and expectations of a slowdown in national consumption.

Banco Famsa Supports Famsa's Business Model: The linkage between Famsa's retail business and the financial division, Banco Famsa (BAF), is strong as both depend on one another to complete service offerings to customers. BAF has good brand equity and a good competitive position in consumer finance, mainly in northeastern Mexico. BAF's financial performance is constrained by high funding costs and high loan impairment charges, which limit profitability and internal capital generation.

Given BAF's ambitious growth strategy, the institution has required consistent capital injections from Famsa. During 2016-2018, Famsa made average capital increases of more than MXN400 million annually 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 weak economic environments remains a limiting factor.

U.S. Operations Still Pressured: Same-store sales at Famsa's U.S. stores decreased the last three years beyond the company's expectations, but this trend seems to be stabilizing and for the first time since 2016 this operation presented positive EBITDA during the first half of 2019. For the LTM ended June 30, 2019, revenue from U.S. operations was MXN1.7 billion, down from MXN1.8 billion in 2017, mainly due to the closing of unprofitable stores and less traffic. During the past few years U.S. operations have been challenged by U.S. migration policy that negatively affects Famsa's target market of U.S. Hispanic customers. The company restructured these operations and is redirecting its commercial strategy by targeting second- and third-generation Hispanics and improving its social media presence.

DERIVATION SUMMARY

Grupo Famsa's business risk profile is closer to the upper level of the 'B' category when compared to peers. Grupo Famsa is less geographically diversified than Grupo Elektra S.A.B. de C.V. (BB+/Stable) and Grupo Unicomer Company Limited (BB-/Stable), but it is well positioned in its influence area of northern Mexico. The company also has smaller scale in number of stores than Grupo Elektra and Grupo Unicomer, with 401 stores compared to more than 1,000.

From a financial risk profile view, Grupo Famsa leans towards the low-level of the 'B' category when compared to peers. The company has slightly similar adjusted leverage than J.C. Penney (JCP, B-/Stable) and Rite Aid (B/Negative) with ratios of around 6.0x versus the U.S. peers adjusted leverage ratios in the low-7.0 range. The three companies present neutral to negative FCF, but JCP and Rite Aid have stronger liquidity position than Famsa's. 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 Latin American peers, the company maintains a weaker financial position than Elektra and Unicomer. Grupo Famsa's operating margins are lower than Unicomer's, while Elektra has the best operating margins of the three companies.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer
Consolidated revenues grow 5.2% on average annually during 2019-2022;
Average EBITDA margin of 8.4% during 2019-2022;
EBITDA from the U.S. division recovers to 3% in 2019 and around 7% in 2020-2022;
Average cash flow from operations of MXN0.5 billion per year for 2019-2022;
Consolidated debt (excluding bank deposits and operating leasings) of MXN9.3 billion in average for 2019-2020;
The company refinances the remaining balance of its senior notes due in 2020;

Average capex of MXN233 million during 2019-2022;
No dividend payments for 2018-2021;
Famsa receives MXN0.5 billion per year from Mr. Garza's guarantee during 2019-2021;
BAF issues MXN0.5 billion of subordinated bonds per year during 2019 and 2020 to support its growth strategy and comply with capital requirements.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
Developments that eventually may improve the company's credit quality are:
Improvements in debt maturity profile;
Sustained reduction in consolidated total gross debt to EBITDA (excluding deposits) to 5.0x or below;
Progress in the cash collection of Mr. Garza's pending guarantee;
A sustained recovery of U.S. operations;
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 refinance the Senior Notes outstanding balance as per the company's plan communicated to Fitch (before the end of 2019);
Additional or unexpected weaknesses in internal operating controls;
Deterioration in BAF's creditworthiness beyond Famsa's ability to lend support;
Failure to receive significant additional payments from Mr. Garza's guarantee;
Consolidated gross debt to EBITDA (excluding bank deposits) consistently above 6.5x;
Lower than expected EBITDA generation by Famsa USA;
Sustained deterioration in the quality of the consolidated loan portfolio.

LIQUIDITY

Tight Liquidity: Famsa's liquidity is challenged by the large debt maturity of USD140 million (app. MXN2.7 billion) due in May 2020, against a cash balance of MXN1.8 billion, mostly at BAF.

To refinance part of the Senior Notes, Famsa signed a credit agreement with Multiva for MXN0.5 billion. This new credit has a seven-year term, interest of TIIE + 3%, and maturities start in 2022. The company relies on its negotiations with banks and proceeds from Mr. Garza's collection rights to refinance the remaining portion of the notes.

Famsa's short-term debt mostly consists of its senior notes maturing in May 2020, short-term Cebures issuances, which the company has been able to roll over, and short-term bank loans.

Recovery Analysis

For issuers with Issuer Default Ratings (IDRs) of '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.

The recovery analysis assumes that Famsa would be considered a going-concern in bankruptcy and that the company would be reorganized rather than liquidated. We have assumed a 10% administrative claim.

Fitch's recovery analysis for Famsa places a going concern value under a distressed scenario of approximately
MXN5.6 billion; based on a going-concern EBITDA of MXN1.0 billion and a 5.5x multiple. The going concern value is higher than the liquidation value, which Fitch estimates at about MXN2.0 billion.

The going-concern EBITDA estimate reflects Fitch's view of a sustainable, post-reorganization EBITDA level upon which we base the valuation of the company. The MXN1.0 billion going-concern EBITDA assumption reflects a 30% discount from average annual EBITDA generation in the last six years. The discount reflects deterioration of 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 Recovery Rating of 'RR3' for the senior unsecured debt. However, according to Fitch's Country-Specific Treatment of Recovery Ratings Criteria, published in March 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 unsecured senior notes is 'RR4'.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3. ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

Grupo Famsa has an ESG Relevance Score of 5 for Management Strategy due to the number of operational restructures that have occurred due to challenges the company has faced in implementing its strategy, which has a negative impact on the credit profile and is highly relevant to the rating in conjunction with other factors.

Famsa has an ESG Relevance Score of 4 for Governance Structure due to board effectiveness and ownership concentration, which has an unfavorable impact on the credit profile and is relevant to the rating in conjunction with other factors.

Famsa has an ESG Relevance Score of 4 for Group Structure given that the company presents a below average transparency of related-party transactions. This has a negative impact on the credit profile and is relevant to the rating in conjunction with other factors.

Famsa has an ESG Relevance Score of 5 for Financial Transparency due to a track record of material differences from audited financial statements and the company's reported figures. This has a negative impact on the credit profile and is highly relevant to the rating in conjunction with other factors.

For more information on our ESG Relevance Scores visit www.fitchratings.com/esg.

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 Stable from Positive;
--Long-term National rating at 'BB(mex)', Outlook revised to Stable from Positive;
--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)'.

Contact:

Primary Analyst
Maria Pia Medrano
Director
+52 55 5955 1615
Fitch Mexico S.A. de C.V.
Blvd. Manuel Avila Camacho 88. Piso 10.
Lomas de Chapultepec, Ciudad de Mexico

Secondary Analyst
Jose Vertiz
Director
+1-212-908-0641

Committee Chairperson
Alberto Moreno
Senior Director
+52 81 8399 9133

Summary of Financial Statement Adjustments
Gains on fixed asset sales were deducted from the operating income.

Media Relations: Elizabeth Fogerty, New York, Tel: +1 212 908 0526, Email: elizabeth.fogerty@thefitchgroup.com

Additional information is available on www.fitchratings.com

Applicable Criteria

Corporate Rating Criteria (pub. 19 Feb 2019)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Country-Specific Treatment of Recovery Ratings Criteria (pub. 18 Jan 2019)
National Scale Ratings Criteria (pub. 18 Jul 2018)
Parent and Subsidiary Rating Linkage (pub. 16 Jul 2018)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy