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Research Update:

Travel Retailer Dufry Downgraded To 'B+' On Longer Than Expected Global Travel Disruption; Still On CreditWatch Negative

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Rating Action Overview

- Amid COVID-19-related travel disruption, we see longer than previously anticipated stress to Switzerland-based travel retailer Dufry AG's earnings, cash generation, and credit metrics; full-year revenues are forecast to fall short of the 2019 level by about 60% in 2020 and only restore the top line by 2024.
- Although Dufry benefits from a more flexible cost base than traditional retailers, and has shored up its liquidity since the beginning of the pandemic, a prolonged decline in earnings could compromise the group's plans to refinance its 2022 maturities.
- We are therefore downgrading Dufry and its senior unsecured debt to 'B+' from 'BB-' and keeping all ratings on CreditWatch with negative implications.
- The CreditWatch placement indicates that the effects of the COVID-19 pandemic on the group's cash generation, credit metrics, and liquidity could be more pronounced than we currently anticipate, given the uncertainty surrounding the duration and economic effect of the outbreak and the related travel disruption.

Rating Action Rationale

As a result of the protracted travel disruption on the back of the COVID-19 outbreak, we now expect Dufry to only restore its revenues to the 2019 level by 2024. We consider that the group faces longer than we had previously anticipated stress to its earnings and cash generation, and that the travel retail sector will remain depressed over the next 24 months. The outlook for passenger traffic, particularly long-haul international flights, has deteriorated over the past few months, and we think Dufry will face headwinds for the rest of 2020 and into 2022. We expect global air passenger traffic to drop by 60%-70% in 2020 compared with 2019, a steeper decline than we previously estimated. We also project a more gradual recovery to pre-COVID-19 traffic levels by 2024. Similarly, we forecast Dufry's revenues will fall short of the 2019 level by about

25%-30% in 2021 and about 15% in 2022. This sharply contrasts with our pre-pandemic expectations of 4.0%-4.5% growth per year.

International travel restrictions will continue to hinder air passenger traffic and travel retail recovery. Our 2020 forecasts now include actual results for the calendar year, during which global air passenger traffic was largely grounded for almost three months prompting the closure of the bulk of travel retail operations globally. Domestic travel has proved more resilient, and we expect it to recover faster than international travel, as countries have initially started to ease travel restrictions within their home markets, and due to pent-up demand for visiting friends and relatives. We expect some near-term recovery in international travel but acknowledge the uncertainty surrounding it, with some governments reinstating restrictions on certain countries with rising infection rates, including quarantine rules or testing for the virus. Intercontinental traffic is likely to take some time to reopen given more severe border restrictions.

The weakening global macroeconomic outlook will also hit both consumer and business spending power on all but essential travel. Furthermore, some countries are reportedly set to cut the number of short-haul flights available for environmental reasons (for example, where there is a reasonable alternative rail service), particularly where generous government support packages have been awarded to legacy carriers.

We believe cost savings and cash preservation measures will not be sufficient to prevent a decline in Dufry's earnings and cash flows, and forecast negative free operating cash flow (FOCF) after full concession payments in 2020 and 2021. The group has introduced a series of initiatives to support earnings and cash flows, and agreed a number of measures with its suppliers and concession partners. The initiatives Dufry has implemented in 2020 to date include savings on personnel and other operating expenses, reduction of capital expenditure (capex) to only necessary projects, and canceled dividends. In the first half of 2020, fixed costs savings totaled about Swiss franc (CHF) 470 million, while lease payments covering the fixed concession fees (minimum annual guarantees [MAG]) were CHF284 million--less than half of those a year ago. Despite these measures, we estimate that the FOCF after full lease payments will be about CHF1.0 billion negative in 2020 and up to CHF200 million-CHF300 million negative in 2021 with investment in working capital accounting for about a third of these outflows.

Conservative capitalization and liquidity management will support Dufry's creditworthiness over the next 12-24 months. Since March 2020, when travel restrictions took hold globally, Dufry has undertaken a number of measures to shore up its liquidity and strengthen its balance sheet. The group's committed multi-currency €1.3 billion (CHF1.4 billion equivalent) revolving credit facility (RCF) is available until Nov. 3, 2024. In addition, Dufry has raised a CHF390 million liquidity/term loan (TL) facility due 2021 with the option to extend to May 2022 and about CHF142 million in various government-backed COVID-19-related loans maturing in 2022-2025.

Moreover, Dufry issued a CHF350 million convertible bond due 2023 and raised about CHF150 million equity. At the same time, the closest bullet maturity is Nov. 3, 2022, when the $700 million and €500 million term loans are due, together comprising CHF1.2 billion equivalent as of June 30, 2020.

As of June 30, 2020, cash totaled CHF737 million and we estimate that about CHF550 million-CHF575 million was undrawn under the committed lines. These liquidity sources should allow the group to comfortably meet the requirement of at least a CHF300 million liquidity cushion, agreed as part of the covenant holiday in respect of the leverage and interest cover ratios, which will not be tested until Sept. 30, 2021. The group also intends to issue approximately

CHF500 million equity before the end of 2020, largely to finance its announced CHF300 million buyout of the minority holders in its North American subsidiary Hudson Group.

Dufry's credit metrics will begin to gradually improve from 2021 but the pace of recovery could fail to mitigate covenant pressure and challenge refinancing prospects. We assume a rebound in air traffic in second-half 2021, underpinned by our current view that a vaccine or effective treatment for COVID-19 will become widely available and restore passenger confidence in flying. That said, we still expect 2021 air passenger traffic to be 30%-40% below the 2019 level, while we foresee a recovery to pre-COVID-19 levels only by 2024. We anticipate that Dufry's earnings will rebound considerably in 2021, albeit at a slower pace than we previously projected, because of our revised air traffic assumptions. We now forecast S&P Global Ratings-adjusted EBITDA of about CHF1.25 billion-CHF1.30 billion, which will support adjusted funds from operations (FFO) to debt recovering to about 10% in 2021, although it will stay far below the 2019 level of 23%. That said, S&P Global Ratings acknowledges a high degree of uncertainty about the evolution of the pandemic, and how the resulting recessionary trends and impact on passenger volumes and travel retail demand will affect our forecasts.

Although not tested until September, 2021, Dufry's bank facilities contain two maintenance financial covenants: leverage at maximum 5x net debt to adjusted operating cash flow (AOCF) and interest coverage at minimum 3x AOCF to interest expense. Our base case estimates the AOCF will still fall short of the covenant threshold level in second-half 2021. While we do not expect banks to accelerate the group's capital structure repayment, this could put pressure on Dufry to address the refinancing of its 2022 maturities or result in higher finance costs.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Social; and
- Health and safety.

Credit Watch

In resolving the CreditWatch, we will evaluate new information regarding the spread of COVID-19 and the effect it is having on Dufry's operating performance, liquidity, and cash flows. In particular, we will review our base case once we have more information regarding the pace of recovery of passenger traffic and travel retail demand in the rest of 2020 and in 2021.

We could affirm the 'B+' ratings if the group successfully places its CHF500 million equity issue and improves its cash generation such that it is likely to achieve adjusted FFO to debt of at least 10% and its FOCF is close to fully covering the concession MAGs in 2021, while maintaining adequate liquidity.

We could downgrade Dufry to 'B' or lower if the COVID-19 pandemic, and resulting severe travel disruption and economic weakness, looked likely to extend through 2021 and beyond, testing our view on the resilience of the travel retail business. This would further pressure the group's ability to restore its credit metrics and sustain comfortable headroom under its maintenance covenants, as well as refinance its 2022 maturities in good time. In particular, we could downgrade Dufry if it failed to place the equity issue as planned, if its FOCF after MAG payments remained persistently negative, or if the prospects of raising adjusted FFO to debt toward 10% seemed unlikely in the next 12 months. We could also lower the rating if liquidity weakened, including the ability to comply with the covenants.

Company Description

Switzerland-based Dufry is a leader in travel retail with a global airport retail market share of around 20%. As of Dec. 31, 2019, it had a footprint of more than 2,300 shops in 65 countries throughout the U.S., Europe, the Middle East, Asia, South America, Africa, and Australia. Dufry operates in both the duty-free and duty-paid segments of travel retail through channels such as airports; border downtown and hotel shops; railway stations; and cruise liners and seaports. Consumer products such as perfumes and cosmetics, wines and spirits, luxury goods, tobacco products, and electronics and confectionery are sold through these outlets. In 2019, Dufry reported total turnover of CHF8.6 billion and EBITDA of CHF2.1 billion.

Dufry is listed on the Swiss Stock Exchange in Zurich. As of Sept. 30, 2020 its market capitalization was CHF1.6 billion.

Our Base-Case Scenario

- Global air passenger numbers to fall by up to 70% in 2020, versus 2019; in 2021, air passenger traffic will remain 30%-40% lower than the 2019 base; and a very gradual recovery to pre-pandemic levels by 2024.
- We expect domestic and short-haul air travel to recover more quickly than intercontinental traffic, given the severe border restrictions hindering the latter.
- Given Dufry's material presence in the recovering domestic travel duty-paid segment (40% of first-half 2020 revenues), we expect the group's revenue to decline by up to 60% in 2020, marginally less than the estimated global average passenger traffic. The group's revenue will somewhat recover in 2021, trailing the evolution of passenger traffic, but will remain 25%-30% below the 2019 base.
- Revenue of about CHF3.7 billion in 2020 and up to CHF6.4 billion in 2021 assuming no new wave of large-scale store closures, and continued recovery in both passenger traffic and travel retail.
- Benign erosion of the gross margin of about 70 basis points on the back of supporting measures from suppliers.
- S&P Global Ratings-adjusted EBITDA margin decline to 16% in 2020 followed by 20% in 2021, from 25% in 2019, as the group expands its top-line and implements its cost saving measures.
- Working capital outflow of up to CHF345 million in 2020 and up to CHF75 million in 2021, moderated by suppliers' willingness to accommodate more relaxed payments terms and stock management across mainly fashion and luxury goods categories.
- Capex of about CHF100 million in 2020 rising to CHF160 million in 2021, down from CHF253 million in 2019, focused on projects that cannot be delayed without long-term detrimental effects on earnings.
- No dividends over the forecast horizon.
- No acquisitions beyond the announced CHF300 million buyout of Hudson Group's minorities before the end of 2020, which is expected to be fully financed by the forthcoming equity issue.
- Operating leases: MAG concession payments of about CHF860 million in 2020 and about

CHF1.04 billion in 2021; and liability of about CHF5.1 billion from CHF4.46 billion in 2019.

Based on the assumptions, we forecast the following metrics in 2020 and 2021:

- Adjusted operating cash flow as per the company's definition of up to negative CHF285 million in 2020 reversing to about CHF250 million in 2021 (CHF960 million in 2019).
- S&P Global Ratings-adjusted debt to EBITDA of over 10x in 2020 and up to 7x in 2021 (3.4x in 2019).
- S&P Global Ratings-adjusted FFO to debt of about 2.5% in 2020 and about 10% in 2021 (22.9% in 2019).

Liquidity

Our adequate assessment reflects our estimate that Dufry will keep the required CHF300 million liquidity cushion for monthly tests until September 2021. However, we consider that the group could breach at least one of its maintenance covenants applicable from September 2021 unless its cash generation substantially improves. We forecast that, over the coming 12 months, Dufry's liquidity sources should exceed uses by about 1.7x. Our assessment is supported by Dufry's solid standing in the credit markets and generally sound relationships with banks. We think that the group's well-established relationship with the bank syndicate will allow it to agree a temporary covenant relief in good time, or otherwise renegotiate the covenant schedule.

We anticipate the following principal liquidity sources over the 12 months to June 30, 2021:

- Cash on balance sheet of about CHF670 million net of estimated CHF67 million held by subsidiaries operating in countries with exchange controls or other legal restrictions on money transfer;
- About CHF550 million-CHF575 million availability under the committed CHF1.4 billion RCF and CHF390 million RCF/TL; and
- About CHF415 million equity issue as publicly confirmed by the group being arranged with Advent International.

We anticipate the following principal liquidity uses over the same period:

- Forecast cash FFO after MAG payments of about negative CHF200 million-CHF230 million;
- Working capital requirements of up to CHF330 million, of which up to CHF120 million seasonal;
- Capex of up to CHF130 million, of which about CHF80 million relates to maintenance capex and the rest earmarked for capex that we expect management to incur even in a downturn; and
- Hudson Group minorities buyout of about CHF300 million.

Issue Ratings - Recovery Analysis

Key analytical factors

- We rate the senior unsecured notes issued by Dufry One BV, the fully-owned financial subsidiary of Dufry AG, at 'B+'. The rating is on CreditWatch with negative implications, as is the

'B+' issuer credit rating on Dufry.

- The notes comprise the €800 million 2.5% issue due in October 2024 and a €750 million 2.0% issue due in February 2027, and are guaranteed by the parent, Dufry AG. The recovery rating on both instruments is '3' indicating our expectation of meaningful recovery (50%-70%; rounded estimate: 50%) in a hypothetical default.
- The recovery rating is supported by the limited prior ranking liabilities but constrained by the significant amount of unsecured debt. Our recovery expectation for the unsecured debt is around 50%.
- In our hypothetical default scenario, we assume negative regulatory changes and reduced airport travel following a natural disaster or terrorist event, combined with an economic recession in Europe.
- We value the business as a going concern given Dufry's leading market position in the duty-free travel retail market and its global footprint.

Simulated default assumptions

- Year of default: 2024
- Jurisdiction: Switzerland

Simplified waterfall

- EBITDA at emergence: CHF490 million (10% operational adjustment reflecting significant geographic and portfolio diversity and cost flexibility)
- Implied enterprise value multiple: 6.0x
- Gross enterprise value at default: CHF2.9 billion
- Net enterprise value after administrative costs (5%): CHF2.8 billion
- Estimated priority claims: CHF222 million [1]
- Estimated senior unsecured claim: CHF5.05 billion[2]
- Value available for senior secured claims: CHF2.6 billion
- Recovery rating: '3' (50%-70%; rounded estimate: 50%)

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

Includes borrowings at local operating subsidiaries level including government-backed facilities.

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

Includes €1.3 billion RCF assumed to be drawn at 100% and the CHF390 million TL assumed to be refinanced and drawn at 85%.

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019

- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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

- COVID-19- And Oil Price-Related Public Rating Actions On Corporations, Sovereigns, And Project Finance To Date, Sept. 29, 2020
- From Bad To Worse: Global Air Traffic To Drop 60%-70% In 2020, Aug. 12, 2020.
- Industry Top Trends Update: EMEA Retail And Restaurants, July 16, 2020
- COVID-19 Will Shape The Future Of Retail, May 27, 2020

Ratings List

Downgraded

	To	From
Dufry AG		
Issuer Credit Rating	B+/Watch Neg/--	BB-/Watch Neg/--
Dufry One B.V.		
Senior Unsecured	B+/Watch Neg	BB-/Watch Neg
Recovery Rating	3(50%)	3(50%)

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; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.