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Research Update:

Gaming Company Intralot S.A. Downgraded To 'B-' On High Leverage And Tight Covenant Headroom; Outlook Negative

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Table Of Contents

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Overview

- We expect Greece-based gaming company Intralot S.A.'s leverage will increase to about 8.5x-9x in 2018 due to significantly lower EBITDA than previously forecasted.
- We now expect negative discretionary cash flows (DCF) both in 2018 and 2019, as a result of high capital expenditure needs for the Illinois project and other license acquisitions and renewals.
- We are therefore lowering to 'B-' from 'B' our long-term issuer credit rating on Intralot and the issue ratings on the senior unsecured notes.
- The negative outlook reflects our view that Intralot's operating performance could further deteriorate, limiting the company's ability to reduce leverage below 8.0x and generate positive DCF (free operating cash flows after nondiscretionary minority dividend payment).

Rating Action

On Sept. 14, 2018, S&P Global Rating lowered to 'B-' from 'B' its long-term issuer credit rating on Greece-based gaming company Intralot S.A. (Intralot). The outlook is negative.

At the same time, we lowered to 'B-' our issue ratings on Intralot's senior unsecured notes, issued by subsidiary Intralot Capital Luxembourg S.A. The recovery rating on these notes is unchanged, reflecting our expectation of average recovery (30%-50%; rounded estimate: 45%).

Rationale

The downgrade follows Intralot's weaker-than-anticipated operating results in the first half of 2018 and our expectation for a further and more meaningful weakening in the second half of 2018, which could continue into 2019. Specifically, we expect a further increase in proportionate adjusted debt to EBITDA to 8.5x-9.0x by year-end 2018, and we expect Intralot would only start reducing leverage in 2020. We expect discretionary cash flows (DCF; free operating cash flows after minority dividend payments) on a fully consolidated basis will be negative in the next couple of years, due to high capital expenditure (capex) requirements. This puts further pressure on the rating.

Under our revised forecasts, we expect lower revenues for 2018 on a consolidated basis compared to our previous forecast (about €1,050 million versus €1,104 million), mainly due to adverse foreign exchange (FX) changes in Turkey and Argentina in the third quarter of 2018. On a proportionate basis, we expect S&P Global Ratings adjusted EBITDA in 2018 will be about €90 million, below our previously forecasted €110 million. Our forecast for gross debt in 2018 is broadly unchanged at about €750 million-€755 million, while in 2019, we expect Intralot will draw on its revolving credit facility (RCF) in order to fund capex needs. We therefore estimate that debt should reach about €785 million, further increasing leverage.

In our view, the weaker performance that we expect for the next couple of years is a result of:

- The ongoing turmoil in the Turkish market, where the company generates about 20% of its fully consolidated EBITDA and about 15% on a proportionally consolidated basis. The Turkish lira has exhibited extreme volatility, followed by Turkey's prolonged economic overheating, external leveraging, and policy changes. Since the beginning of the year, the lira has dropped 38% against the euro. Our downgrade of Intralot incorporates our view of less favorable market conditions in 2018-2019, and our forecast of an economic recession in Turkey in 2019 with GDP growth of negative 0.5% due to exchange rate depreciation and volatility. It also takes into consideration a likely reduction in foreign financing inflows. We believe this will continue to increase volatility and put pressure on the performance of Inteltek and Bilyoner, the two subsidiaries in Turkey.
- The high volatility in the Argentine peso and the risk for further volatility in Argentina, where the company generates close to 10% of its fully consolidated EBITDA and about 8% on a proportionally consolidated basis. Since the beginning of the year, the Argentine peso has dropped 50% against the euro.
- Our previous expectation for EBITDA growth in several other countries is now less feasible due to increasing competition and lower-than-expected topline growth since the beginning of the year. For example, in Morocco, we expect an EBITDA gap of about €5 million-€10 million versus our previous forecast, as a result of weaker-than-expected performance.

In our view, Intralot's business remains constrained by its significant exposure to emerging markets (such as Turkey, Morocco, Argentina and Azerbaijan), potential significant FX fluctuations, the high regulatory and taxation risk in the global gaming industry, and the uncertainty regarding future license renewals (for example, the Turkish license–-Inteltek--which represents about 10% of the total EBITDA and was recently prolonged for an additional year until 2019). These business constraints are somewhat offset by Intralot's strong position among gaming technology leaders and largest sports betting companies and by its role as a vertically integrated company, providing technology as well as operating machines. Intralot is also well positioned in the U.S., which could benefit the company in the future in light of the recent changes in U.S. sport betting regulations.

For analysis of Intralot's business risk, see "Greek Gaming Company Intralot Outlook Revised To Negative On Increased Leverage; 'B' Ratings Affirmed," published April 25, 2018, on RatingsDirect.

The earnings from Intralot's partly owned subsidiaries (such as those in Turkey, Bulgaria, and Argentina) are fully consolidated, while debt is largely situated at the holdco. This distorts the company's credit metrics. We therefore assess Intralot's financial risk profile on a proportionate basis because not all of the group's cash flows are available to service debt, since they belong to partnerships and ultimately to minorities according to their relevant stakes.

On a fully consolidated basis, Intralot has weak DCF generation with a highly leveraged DCF-to-debt ratio. We consider this to be a true measure of free cash flow for Intralot, since we measure DCF after deducting significant nondiscretionary dividends paid to minority interests at the subsidiary level.

Our base case assumes:

- Macroeconomic prospects vary in Intralot's operating countries; we expect real GDP growth over 2018-2020 will be about 2%-3% in the U.S. and Turkey, 3%-4% in Bulgaria, and 1%-2% in Argentina. We believe this could have a positive impact on Intralot's revenue growth over the same period, but we maintain a restrained view due to uncertainty in some key markets.
- Revenue to decrease by about 4%-5% in 2018, mainly driven by the recent adverse FX fluctuations in Turkey and Argentina, underperformance in other markets such as Bulgaria and the Netherlands, and the amendment of the Greek Organisation of Football Prognostics (OPAP) contract in Greece. We expect Intralot will grow at about 1%-3% annually in 2019 and 2020.
- Intralot's adjusted EBITDA margin to decrease to about 13% in 2018, driven by the Illinois project implementation costs as well as lower margins in Greece (under the new OPAP contract) and in Turkey. In 2019, we expect the EBITDA margin will remain broadly stable, and we expect an increase in 2020 thanks to margin improvement, mainly in the U.S.
- Dividends to minority interest of €37 million-€38 million annually during 2018-2020. We view Intralot's dividends to minority interest as nondiscretionary in nature because noncontrolling partners of Intralot are entitled to their share of profits at the operating subsidiary level.
- Capex of about €120 million-€125 million in 2018, primarily related to the Illinois project implementation. We assume that Intralot will finance the capex needed to roll out the Illinois project with cash on the balance sheet. In 2019, we expect capex of €80 million-€85 million, assuming the renewal of the contracts in Turkey, Morocco, and the U.S., and investments in the Greek gambling market and U.S. sports betting market, among others. In 2020, we expect capex will normalize to about €50 million.

- Gross debt of about €750 million-€755 million at the end of 2018, followed by an increase of about €30 million in 2019 related to a planned drawing of an RCF to finance capex. We expect Intralot will fully repay this €30 million in 2020.

Based on these assumptions, we arrive at the following credit measures:

- On a proportionally consolidated basis, we expect an adjusted debt-to-EBITDA increase to about 8.5x-9.0x in 2018 and 2019. On a fully consolidated basis, we forecast adjusted leverage of 5.5x-6.0x in 2018 and 2019.
- On a proportionally consolidated basis, we expect EBITDA interest coverage of 1.5x in 2018 and 2019, climbing slightly to 1.7x by 2020. On a fully consolidated basis, we forecast 2x-2.5x EBITDA interest coverage for 2018 and 2019.
- We expect negative DCF in 2018 and 2019 due to weaker cash flow generation and high capex needs.

Liquidity

We have revised our assessment of the company's liquidity to less than adequate. This reflects our view that the ratio of liquidity sources to uses is about 1.2x in our base case for the next 12 months, and may decline below the minimum 1.2x threshold for our adequate liquidity assessment over this timeframe in case of further operating setbacks. It also reflects tight covenant headroom, which we currently estimate at less than 10% in 2019--below the 15% we require for adequate liquidity--which could pressure the company's ability to draw on its RCF if needed.

However, we do not view the company's liquidity as weak, because the company still maintains a large amount of cash and the majority of the short-term liquidity uses are related to capex, which is unlikely to result in liquidity stress. Furthermore, we note that although the company's notes are trading well below par, the capital structure is long-dated and the notes are not due before 2021 and 2024.

For the 12 months started July 1, 2018, we calculate the following principal liquidity sources:

- Cash and liquid investments immediately available at Intralot level of about €100 million;
- Our forecast funds from operations of about €50 million; and
- €85 million availability under the company's bilateral credit facilities.

For the same period, we calculate the following principal liquidity uses:

- Negligible nonseasonal working capital requirements for the next 12 months following €30 million outflows in the first half of 2018;
- Capex of approximately €120 million; and
- About €40 million of dividends related to minority interests.

Covenant analysis

Documentation governing Intralot's €500 million and €250 million senior unsecured notes do not include any maintenance financial covenants.

However, Intralot has a springing maintenance covenant on two bilateral credit facilities amounting to a total of €70 million. The €30 million bilateral facility has a covenant of 4.75x maximum net leverage, and the €40 million facility is currently under negotiations to increase the net leverage covenant to 4.75x from 3.75x. We assume the successful amendment of the second bilateral facility, and therefore a leverage covenant of 4.75x, which will be tested if the RCF is drawn. Under our base case, we expect covenant leverage of about 4.4x as of Dec. 31, 2018, remaining at this level in 2019. This is lower then 10% headroom, which could pressure the company's ability to draw high amounts on the RCF if needed.

Outlook

The negative outlook reflects our view that the volatile environment in some of Intralot's operating markets (mainly Turkey and Argentina) could put pressure on the company's operating performance in the next 12 months and consequently prevent any potential deleveraging. If Intralot maintained leverage at its current level for a prolonged period and DCF remained negative, we might reconsider our view of the capital structure's sustainability.

In addition, the tight covenant headroom of less than 10% in our 2018 and 2019 forecasts reduces the company's ability to absorb further unexpected operating setbacks, and could put pressure on the rating if the company needed to draw on the RCF but had limited ability to do so.

Downside scenario

We could lower the ratings if Intralot's DCF remained negative for a prolonged period and the company maintained leverage above 8.5x with no clear deleveraging trend. This could happen if Intralot raised further debt to finance capex needs or if EBITDA dropped lower than our base case. The latter could occur if the company's operating performance were weaker than expected, for example if Intralot disposed profitable operations or lost key licenses without replacing them with new profitable acquisitions, or if the market conditions further deteriorated.

Rating pressure could also arise if the headroom under Intralot's financial covenants further tightened, such that it posed a liquidity stress and rendered the company unable to fund capex needs and other expenses from the existing facilities.

Upside scenario

We could revise the outlook back to stable if operating performance stabilized such that we started seeing a gradual increase in EBITDA and decrease in leverage. We could also consider revising the outlook back to stable if the company substantially decreased debt by using proceeds from asset sales (such as Gamenet shares, for example) so that we no longer considered the capital structure at risk of becoming unsustainable.

We are unlikely to raise the rating over the next 12 months, given our expectations of sustained high leverage and no return to material positive DCF before 2020. However, we could foresee such a scenario if Intralot made a very swift recovery by posting 4%-6% revenue growth in 2019 as a result of securing new licenses or improving the performance of the existing ones. This could support the reduction in adjusted leverage to below 7x, as well as the generation of sustainably positive DCF. This would have to be combined with sufficient liquidity sources to cover capex and other expenses.

Ratings Score Snapshot

Issuer Credit Rating: B-/Negative/--

Business risk: Weak
- Country risk: Moderately high
- Industry risk: Intermediate
- Competitive position: Weak

Financial risk: Highly leveraged

Cash flow/leverage: Highly leveraged

Anchor: b-

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)
- Stand-alone credit profile: b-

Issue Ratings--Recovery Analysis

Key analytical factors

- The issue and recovery ratings on the €500 million senior unsecured notes due 2024 and the €250 million senior unsecured notes due 2021 are 'B-' and '4', respectively, indicating our expectations for meaningful recovery prospects (30%-50%; rounded estimate: 45%).
- The high amount of senior unsecured debt ranking pari passu and the relatively weak guarantor coverage constrain the recovery ratings.
- Our hypothetical default scenario assumes challenging economic conditions in Intralot's key markets leading to a significant decline in discretionary consumer spending, as well as unfavorable changes in regulation.
- We value the business as a going concern, given its leading position in gaming technology and sports betting industries globally.

Simulated default assumptions

- Year of default: 2020
- Jurisdiction: Greece

Simplified waterfall

- EBITDA at emergence: €73.5 million (capex at 1.5% of three-year average sales; cyclicality adjustment is 10%, in line with sector assumptions; we used no operational adjustment)
- Multiple: 5.5x
- Gross enterprise value at default: €404 million
- Net enterprise value after administrative costs (5%): €384 million
- Estimated senior unsecured debt: €839 million
- Recovery range: 30%-50% (rounded estimate 45%)
- Recovery rating: 4

Related Criteria

- 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

- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Greek Gaming Company Intralot Outlook Revised To Negative On Increased Leverage; 'B' Ratings Affirmed, April 25, 2018

Ratings List

Downgraded

	To	From
Intralot S.A.		
Issuer Credit Rating	B-/Negative/--	B/Negative/--
Intralot Capital Luxembourg S.A.		
Senior Unsecured	B-	B
Recovery Rating	4(45%)	4(45%)

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