Research Update:

Travel Retailer Dufry Outlook Revised To Stable; 'B+' Rating Affirmed

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Rating Action Overview

- Switzerland-based travel retailer Dufry AG has reported robust trading results for 2021 and has been successful in proactively managing its liquidity and debt maturity profile.
- We consider that Dufry's capital structure, ability to manage costs, and cash generation are sufficiently flexible to accommodate the still-uncertain trajectory of passenger traffic and topline growth over the next 12-24 months.
- We therefore revised our outlook on Dufry to stable from negative. We affirmed our 'B+' long-term issuer credit rating on Dufry and its senior unsecured debt.
- The stable outlook indicates our anticipation of a recovery in travel retail. Despite our forecast of steep cost inflation in 2022, this recovery should support improvement in the group's credit metrics over the next 18-24 months, namely S&P Global Ratings-adjusted funds from operations (FFO) to debt of 10%-15% and positive free operating cash flow (FOCF) after full concession fee payments.

Rating Action Rationale

Dufry's robust performance in 2021 exceeded our expectations and its more flexible cost structure will underpin medium-term deleveraging prospects. Dufry's recently reported results for 2021 outperformed our base case and supported a drastic improvement in its credit metrics. Although at Swiss franc (CHF) 3.9 billion annual revenues fell short of our previous forecast by about CHF500 million, the company's efforts in saving costs and preserving cash resulted in S&P Global Ratings-adjusted ratios notably exceeding our expectations. For example, adjusted FFO to debt was 14.9% and FOCF after full concession payments was CHF229 million compared with our previous expectation of the outflow of up to negative CHF300 million-CHF400 million. In 2021, Dufry achieved CHF1.9 billion in cost savings comprising about CHF1.1 billion from the reduction in its minimum annual payments (MAGs) included in the concession contracts, CHF607.9 million in personnel costs and the remaining CHF234 million in other costs. As a result of the undertaken restructuring and efficiency measures, we think the company's cost base will stay more flexible than before the pandemic. This should allow the group to stay agile as there remains considerable uncertainty around the pace of recovery of global economy and travel retail. We therefore forecast that Dufry's revenue will reach 2019 level by 2024, while its annual cash generation will be positive and sufficient to cover the concession fees in full until then.

Air passenger traffic is on the upswing but the road to full recovery remains uneven and varied by region. Dufry's performance relies on air travel recovery, and the company's global footprint positions it well to benefit from the stronger momentum in domestic and short haul holiday destinations, particularly in the Americas and Europe, the Middle East, and Africa (EMEA). We think that the disruption to air passenger traffic caused by the COVID-19 omicron variant will be short-lived, and that positive traffic momentum will resume in the second quarter of 2022, picking up pace in the summer season. Nevertheless, the recovery in air passenger traffic depends heavily on general health conditions. Moreover, rising fuel and personnel costs will make travel more expensive, stalling the prospects of passenger traffic reaching its 2019 level sooner than 2023-2024 globally. In Europe, we have recently revised our forecast of airline traffic owing to the rapid spread of omicron cases depressing passenger volumes in the first quarter of 2022 (see "Omicron Has Only Slowed European Airlines' Climb To Clearer Skies" published on Feb. 17, 2022). We now anticipate European airline traffic in 2022 will reach 50%-65% of the 2019 level rather than 60%-75% as of November 2021.

We forecast a temporary dip in Dufry's credit metrics in 2022 as the group bears the cost of keeping stores open while top line catches up to pre-pandemic level. In our base case, we forecast the group's top line to recover to about two-thirds of the 2019 level by end-2022. At the same time, we note the pressure on margins and, particularly, cash flows from rapidly rising energy and personnel costs and phasing out of the reliefs on concession fee payments granted during the height of the pandemic disruption. As passenger traffic gains momentum across all regions and revenue generation evens out across the locations, we consider that Dufry will be able to gradually raise its gross margins to the pre-pandemic level and better absorb operating costs' inflation. We estimate that by end-2024, Dufry will reach annual revenues of about CHF9.0 billion and gross margins of about 60% from CHF3.9 billion and 56.5%, respectively, in 2021.

Dufry's conservative and proactive management of its capital structure and its ample liquidity underpin the group's path to full recovery. On the back of significant disruption to its operations during the COVID-19 pandemic, Dufry has proactively managed its liquidity and capital structure, which allowed the group the breathing room to reshape operations at a time of drastic decline in its earnings and cash flows. The latest of the transactions was announced in February 2022, when the group confirmed that it has prolonged the testing-free period of its maintenance covenants until and inclusive of the second quarter of 2023. Under our base case, by that time Dufry should comfortably comply with its leverage covenant of 5x net financial debt to adjusted operating cash flow (AOCF) and continue deleveraging in compliance with the covenant threshold step down to 4.5x from the first quarter 2024.In our estimate, compliance with the leverage covenant will ensure even higher headroom under the AOCF to interest cover test at 3x. Overall, during 2020 and 2021 the group raised close to CHF900 million in net proceeds from share issues, placed two convertible bonds (CHF350 million, which was converted to equity in April 2021, and CHF500 million), issued a CHF69.5 million mandatory convertible note, and refinanced its CHF1.1 billion equivalent term loans extending debt maturities to 2024 from November 2022. As of March 8, 2022, Dufry's maturity profile was relatively well-spread with just CHF88 million due in 2023 before €800 million notes and $550 million term loan come due in October and November 2024, respectively.

The concession fee structure and accounting will affect the historical comparability of some of Dufry's credit metrics. We estimate that in 2022-2024 total concession fees will account for about 30%-32% of Dufry's revenues, while the variable component will take a higher share versus MAG payments compared to the pre-pandemic split. While variable payments are included in operating expenses, MAG payments are treated as akin to leases in the audited accounts and under our methodology. Higher share of variable fees will constrain operating profitability margins over our forecast period of 2022-2024, making Dufry unlikely to return to its 2019 level of 25% adjusted EBITDA margin. In our base case, we forecast an adjusted EBITDA margin of 15%-17% in 2022 rising to 18%-20% in 2024. At the same time, Dufry's credit metrics will also reflect the likely lower level of lease liabilities on its balance sheet representing capitalized MAGs. In our forecast, we have estimated relatively stable adjusted debt of around CHF7 billion over the 2022-2024 horizon. However, depending on the timing of the contract wins, losses and renewals, and the terms of the concession contracts prevailing at a time, Dufry's lease liability position can change significantly from one year to the next.

The air passenger traffic and travel retail path to recovery depends on the pandemic's evolution, geopolitical developments, and their economic effects. S&P Global Ratings acknowledges a high degree of uncertainty about the extent, outcome, and consequences of the military conflict between Russia and Ukraine. Irrespective of the duration of military hostilities, sanctions and related political risks are likely to remain in place for some time. Potential effects could include dislocated commodities markets -- notably for oil and gas -- supply chain disruptions, inflationary pressures, weaker growth, and capital market volatility. As the situation evolves, we will update our assumptions and estimates accordingly.

Outlook

The stable outlook indicates that the recovery we anticipate in travel retail should support the sustainable improvement in the group's credit metrics over the next 12-24 months, notwithstanding the temporary spike in leverage in 2022 on the back of the increase in costs exceeding our forecast of topline recovery. We forecast S&P Global-adjusted FFO to debt of about 10% in 2022 rising to 12%-15% in 2023, with sustainably positive reported FOCF after leases.

Downside scenario

We could downgrade Dufry if:

- The adjusted FFO to debt fell to less than 10%;
- FOCF after minimum annual guarantees (MAG) payments turned negative;
- The group's liquidity or covenant headroom were to weaken; or
- Passenger spending at airports failed to recover swiftly alongside the air traffic, thereby bringing into question the long-term resilience of the travel retail business.

This could occur if the economic weakness related to the pandemic or geopolitical tensions led to travel disruption extending longer than we anticipate, cost inflation rises way ahead of revenues, or Dufry loses a substantial number of contracts without profitable replacement, which, combined with consumers changing their shopping habits, would weaken the group's competitive position.

Upside scenario

We could upgrade Dufry over the next 12-24 months if air passenger traffic and travel retail recovers to the 2019 level faster than we anticipate, while cost control and focus on cash generation allow Dufry to build on its recent improvement in earnings and credit metrics such that:

- Adjusted FFO to debt trends to 20% by end of 2023;
- Reported FOCF after full concession payments (including MAGs) is consistently positive and sufficient to cover any shareholder remuneration payments once resumed; and
- Dufry is on track to restore its profitability, cash generation, and credit metrics to historical levels over the medium term.

Any positive rating action will be predicated on Dufry maintaining a consistent financial policy supportive of the stronger performance and credit ratios. Once the new CEO is in place in June 2022, we will follow the group's communications regarding strategy and financial objectives.

Company Description

Switzerland-based Dufry is a leader in travel retail with a global airport retail market share of around 20% (pre-pandemic). It has a footprint of more than 2,300 shops in 66 countries throughout the U.S., EMEA, 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 2021, Dufry reported total turnover of CHF3.9 billion and adjusted EBITDA of CHF1.2 billion (CHF8.8 billion and CHF2.2 billion, respectively, in 2019).

Dufry is listed on the Swiss Stock Exchange in Zurich. As of March 29, 2022, its market capitalization was CHF3.5 billion.

Our Base-Case Scenario

- In 2022, we expect airline traffic will reach 80%-90% of 2019 level in North America and only 50%-65% in Europe, because virtually all of it is international and subject to government policies and restrictions. International flying to, from, and within Asia remains very depressed.
- We expect domestic and short-haul air travel to recover more quickly than intercontinental traffic, and the overall return to 2019 levels to differ by region.
- We expect the group's revenue to recover broadly in line with passenger traffic and reach 65%-70% of the 2019 level in 2022, and remain about 10% below the 2019 base in 2023.
- Revenue of about CHF5.6 billion-CHF6.1 billion in 2022 and up to CHF8.0 billion in 2023, assuming no large scale disruption to the industry in the wake of the military conflict between Russia and Ukraine.
- S&P Global Ratings-adjusted EBITDA margin of 15%-17% in 2022 and 16%-18% in 2023, as the group expands its top line and benefits from increased flexibility of its cost base.

- Capex of about CHF180 million or close to 3% of revenue in 2022 as the group normalizes spending after lean 2020 and 2021, and around CHF200 million-CHF220 million in 2023.
- No dividends over the forecast horizon.

Based on the assumptions, we forecast the following key metrics:

Table 1

Dufry AG--Key Metrics*

	--Fiscal year ended Dec. 31--					
	2019a	2020a	2021a	2022f	2023f	2024f
(Mil. CHF)						
Revenue	8,849	2,561	3,915	5,800-6,200	7,500-8,000	8,700-9,000
Revenue versus 2019 (%)		~29	~44	~65-70	~85-90	~100
EBITDA	2,234	334	1,253	1,000-1,200	1,250-1,400	1,500-1,750
EBITDA margin (%)	25	13	32	15-17	16-18	17-20
AOCF	960	-406	147	350-400	700-900	700-900
FOCF after full concession payments	388	-994	229	50-120	250-450	300-500
Debt	7,704	8,889	6,974	7,000-7,100	7,000-7,100	7,000-7,100
Debt to EBITDA (x)	3.4	26.6	5.6	5.0-7.0	5.0-6.0	4.0-4.5
FFO to debt (%)	22.9	1.4	14.9	10.0-15.0	12.0-18.0	15.0-20.0

Note: All figures adjusted by S&P Global Ratings except AOCF. Debt includes CHF3.6 billion IFRS16 liabilities. AOCF--Adjusted operating cash flow as per Dufry's definition. CHF--Swiss franc. a--Actual. e--Estimate. f--Forecast.

Liquidity

Our adequate assessment reflects our estimate that Dufry will keep the required CHF300 million liquidity cushion for monthly tests until September 2023. We forecast that, over the coming 12 months, Dufry's liquidity sources should exceed uses by over 6x. Our assessment is supported by Dufry's solid standing in the credit markets and generally sound relationships with banks. Considerable uncertainty of the group's path to full recovery, maintenance covenants becoming effective in the second half of 2023, and substantial debt maturities coming due in 2024 constrain our liquidity assessment.

We anticipate the following principal liquidity sources over the 12 months to Dec. 31, 2022:

- Cash on balance sheet of about CHF736 million net of estimated CHF58 million, held by subsidiaries operating in countries with exchange controls or other legal restrictions on money transfer;
- Full CHF1.4 billion availability under the committed €1.3 billion revolving credit facility (RCF) due Nov. 3, 2024; and
- Cash FFO after MAG payments of about CHF150 million–CHF250 million.

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

- Working capital requirements of up to CHF150 million, largely seasonal;

- Capex of about CHF170 million-CHF180 million; and
- Payments to minorities and bank debt repayments of up to CHF30 million–CHF50 million.

Environmental, Social, And Governance

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

Social factors are now a moderately negative consideration in our credit rating analysis of Dufry. Because of strict travel and mobility restrictions during the pandemic, the group had extensive store closures that led to a 71% contraction of the group revenue and 85% contraction in EBITDA in 2020, while the FOCF turned severely negative. As of March 8, 2022, Dufry has reopened about 80% of its stores and is on its way to restore its earnings and cash flow to the pre-pandemic level within 24 months. At the same time, although the extreme disruption due to the pandemic is a likely one-off, we note that the group's higher reliance on air passenger traffic compared with the general retail sector increases its exposure to global or regional disease outbreaks, terrorist attacks, and other health and safety risks.

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, at 'B+', in line with the issuer credit rating on Dufry.
- The notes are guaranteed by the parent, Dufry AG and its selected subsidiaries, and comprise:
- --€800 million 2.5% due Oct.15, 2024;
- --CHF300 million 3.625% due April 15, 2026;
- --€750 million 2.0% due Feb. 15, 2027; and
- --€725 million 3.375% due April 15, 2028.
- The recovery rating on all 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.
- 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 and North America.
- We value the business as a going concern given Dufry's leading market position in the duty-free travel retail market and its diverse global footprint.

Simulated default assumptions

- Year of default: 2026

- Jurisdiction: Switzerland

Simplified waterfall

- EBITDA at emergence: CHF492 million (we apply operational adjustment reflecting significant geographic and portfolio diversity and cost flexibility)
- Implied enterprise value multiple: 6.0x
- Gross enterprise value at default: CHF2.95 billion
- Net enterprise value after administrative costs (5%): CHF2.8 billion
- Estimated priority claims: CHF240 million
- Estimated senior unsecured claim: CHF4.9 billion *
- Value available for senior secured claims: CHF2.6 billion
- Recovery rating: '3' (50%-70%; rounded estimate: 50%)

*All debt amounts include six months of prepetition interest.

Includes €1.3 billion RCF assumed to be drawn at 85% and 2024 maturities assumed refinanced on similar terms.

Ratings Score Snapshot

Issuer Credit Rating: B+/Stable/--

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Highly Leveraged

- Cash flow/Leverage: Highly Leveraged

Anchor: b+

Modifiers

- Diversification - Portfolio Effect: Neutral (No impact)
- Capital Structure: Neutral (No impact)
- Financial Policy: Neutral (No impact)
- Liquidity: Adequate (No impact)
- Management and Governance: Fair (No impact)
- Comparable Ratings Analysis: Neutral (No impact)

Environmental, social, and governance (ESG) credit factors for this change in credit rating/outlook and/or CreditWatch status:

- Health and safety

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- 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
- 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

- Omicron Has Only Slowed European Airlines' Climb To Clearer Skies, Feb. 17, 2022
- Credit FAQ: How The Russia-Ukraine Conflict Is Affecting Ratings And The Global Economy, March 23, 2022

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Dufry AG		
Issuer Credit Rating	B+/Stable/--	B+/Negative/--
Ratings Affirmed		
Dufry One B.V.		
Senior Unsecured	B+	

Recovery Rating	3(50%)