Research Update:

Bertelsmann Downgraded To 'BBB' On Expectation Of Weaker Earnings; Outlook Stable

October 14, 2020

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Rating Action Overview

- A weaker global economy and a customer shift toward digital media consumption are hampering Bertelsmann SE &Co. KGaA's (Bertelsmann's) earnings generation and visibility more than we anticipated, reducing the rating's tolerance for leverage.
- This comes on the back of Bertelsmann's already low ratings headroom given its material leverage due to prior investments and acquisitions to adapt the business to ongoing secular changes.
- We are therefore lowering our ratings on Bertelsmann and its senior unsecured debt to 'BBB' from 'BBB+'. At the same time, we are lowering the rating on the subordinated debt to 'BB+' from 'BBB-'.
- The stable outlook reflects our view of continuous recovery in European advertising demand from the severely stressed levels seen in first-half 2020, combined with earnings growth in Bertelsmann's more stable segments (music, publishing, education, and Arvato) and comfortable ratings headroom given our expectation of leverage of 2.0x-2.4x over the next 24 months.

Rating Action Rationale

Contracting economies in Europe and the U.S will likely weigh on Bertelsmann's earnings over the next two years. We expect advertising marketing spending over the next years will fall short of our previous expectations as a result of the pandemic-induced recession in Europe, heightening the risk that Bertelsmann will fail to generate earnings in line with our forecasts. We note that the Bertelsmann group still generated 20%-25% of revenue from advertising in 2019. However, we expect that, despite an about 9% decrease in group sales in first-half 2020 compared with the previous year, and a 22% drop in EBITDA as a result of the COVID-19-related lockdowns and the associated recession, earnings will stabilize. This is, to a large extent, thanks to an ongoing recovery in advertising spending from very distressed levels in spring 2020.

The expectation of lower earnings, combined with a secular change in media consumption toward digital mediums, further clouds our earnings visibility, reducing the rating's leverage tolerance. This comes on the back of Bertelsmann's already low headroom under the previous rating due to its meaningful leverage following acquisitions and investments in response to these ongoing changes. We note that customers are shifting away from traditional channels such as linear TV broadcasting, magazine, or linear radio, toward digital and on-demand offers. This led to an increased need for investments in new platforms, streaming services, and related content for traditional media businesses, further constraining such businesses' earnings generation. We believe these developments will affect Bertelsmann's TV broadcasting (RTL), magazine (Grunner + Jahr), and printing businesses, which represented about 55% of the group's 2019 EBITDA. Given our reduced earnings visibility, we are revising our base-case assumptions, and now forecast the company's adjusted EBITDA in 2021 at €2.4 billion-€2.5 billion, compared with our previous expectation of €2.7 billion-€2.8 billion, and its S&P Global Ratings-adjusted debt to EBIDTA at 2.0x-2.4x over the next two years. We believe a full recovery in earnings to pre-pandemic levels will likely not happen before 2022, consistent with our general macroeconomic assumptions.

We believe business diversification will help offset stronger earnings pressure in the coming years. While Bertelsmann's acquisition strategy over the past years has prevented the company from deleveraging, it has supported the group's diversification away from advertising-dependent revenue streams. The company ventured into business segments that we expect will be more resilient to macroeconomic changes and will likely show earnings growth over the next few years. In particular, we expect the music, education, outsourcing services, and publishing businesses (together generating about 45% of group revenue in 2019) will support earnings growth in the coming years, and likely avert further declines in the group's credit quality.

Bertelsmann's track record of successful business repositioning continues to solidify the group's leading position among peers. We acknowledge Bertelsmann's track-record in successfully adapting its media businesses in response to ongoing secular changes in the media industry. For instance, the group's music-recording business has shown considerable earnings growth in recent years, stemming from increased music sales through third-party streaming platforms that provide for stable income streams. The group's education business operates completely digitally, and turned profitable a few years ago. Even the RTL TV-broadcasting business, which we consider to lag behind the before-mentioned segments in adapting to industry changes, has set-up meaningful digital and platform services such as videoland and TV-now, which are dedicated to the German and Dutch markets. Digital and platform services combined contributed about 21% of RTL's group revenue in 2019, although we note its streaming services operate with lower profitability than the remaining TV-broadcasting segment due to meaningful ramp-up costs, and are not expected to break even before 2025.

Strong cost reduction, cash preserving measures, and available financial policy measures such as the recent dividend cut for 2020, support the rating. The group has demonstrated its ability to reduce costs and preserve cash during the pandemic-induced recession. Reduced costs offset roughly half of the sales decline at RTL, and the group managed even to improve its free operating cash flow after lease payments in first-half 2020 on a year-on-year basis. While this was partly driven by nonrecurring tax and working capital effects, we view the associated net debt reduction as sustainable, and it should help to keep leverage metrics in line with the previous year. This is further supported by management's recent decision to cancel the dividend for the current year, and our expectation of about €900 million proceeds from the very likely disposal of noncore assets over the course of 2020 and 2021. In our view, management could also materially reduce capital expenditure (capex) to further preserve liquidity if needed in a stress scenario. At the same time, we think a longer suspension of capex could undermine the company's long-term growth. This is because investments in new technology and services are important to sustain Bertelsmann's competitive advantage in light of structural changes and intensifying industry competition.

Outlook

The stable outlook reflects our expectation of a continuous recovery in European advertising demand over the reminder of 2020, following the severe deterioration during spring. It further reflects our view of the Bertelsmann group's proven ability to preserve cash and adhere to its leverage targets even in times of stress, and our anticipation of earnings growth in the group's publishing, music, and outsourcing-service divisions. It also reflects our expectation of solid credit metrics, with S&P Global Ratings-adjusted debt to EBITDA of 2.0x-2.4x, which is at the lower end of the 2.0x-3.0x expected for the current rating, and FOCF to debt of 16%-26% forecast over the next 24 months.

Upside scenario

We could upgrade Bertelsmann if sales and earnings recovered more quickly and strongly than we currently expect over the next 24 months. This would require ramp-up costs associated with the streaming businesses to have a lesser impact on Bertelsmann's earnings and cash flows than currently expected, and its S&P Global Ratings-adjusted EBITDA margins to materially improve from this year's level. To raise the ratings, the company's S&P Global Ratings-adjusted debt to EBITDA would have to fall sustainably below 2.0x, supported by a financial policy commitment, merger-and-acquisition activity, and shareholder remunerations consistent with these metrics.

Downside scenario

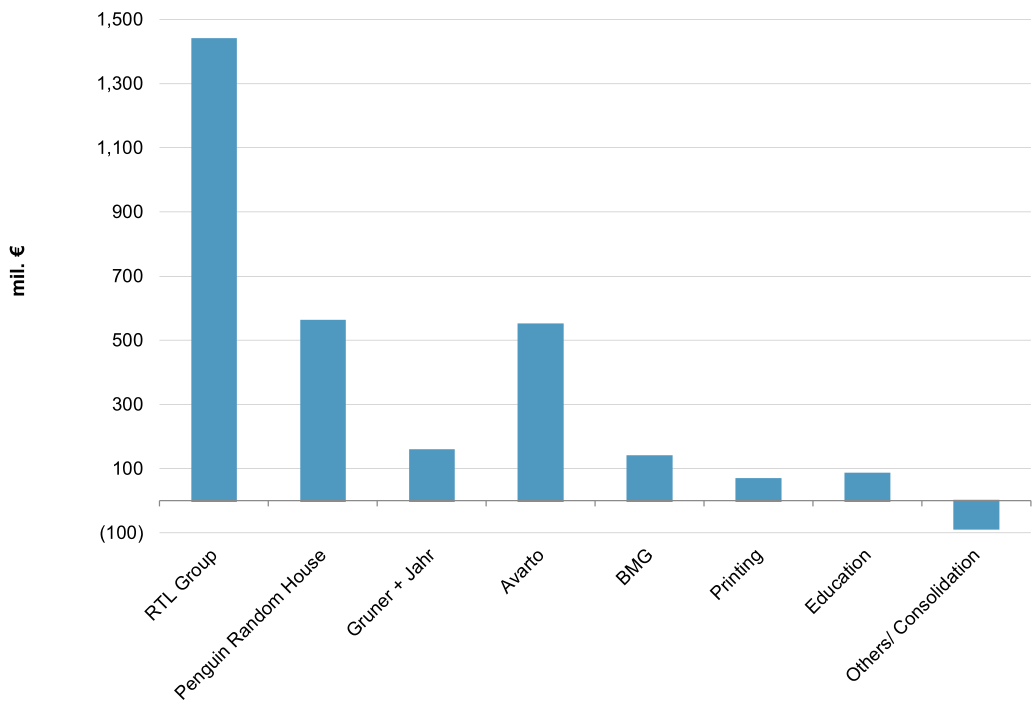
We could lower the rating over the next 24 months if recovery in the group's earnings from depressed levels seen in first-half 2020 faltered, for example if the recession worsened or operating pressures due to the secular digitalization accelerated, resulting in S&P Global Ratings-adjusted debt to EBITDA trending above 3.0x. We could also lower the rating in case of unforeseen large debt-funded acquisitions, large investments in the group's repositioning, or shareholder remunerations, also resulting in leverage over 3.0x.

Company Description

Germany-based Bertelsmann is a diversified global media group with €18.0 billion of revenue and €2.6 billion EBITDA generated in 2019. The group has a number of distinct business units, including broadcaster RTL, book publisher Penguin Random House (PRH), magazine publisher Gruner + Jahr, music publisher BMG, media-related and outsourcing services Arvato, Bertelsmann Printing Group, Bertelsmann Education Group, and Bertelsmann Investments.

Chart 1

Bertelsmann's Adjusted Operating EBITDA Per Segment In 2019



Source: S&P Global Ratings, Bertelsmann annual report 2019.

Our Base-Case Scenario

- Following an economic decline as a result of the COVID-19 pandemic, we forecast eurozone real GDP will fall by about 7.4% in 2020, rebounding by about 6.0% in 2021, and U.S. real GDP will decline by about 4.0% in 2020, rebounding by about 4.0% in 2021.
- Group revenue decline of 7.5%-8.5% in 2020, and growth of 3%-5% in 2021, compared with growth of 2% in 2019, which reflects this year's declining advertising revenue from TV broadcasting, printing, and magazine business, mainly given the weak macroeconomic environment and other effects of the COVID-19 pandemic.
- S&P Global-Ratings adjusted EBITDA margin of 14.0%-14.5% in 2020 and 2021, after 14.5% in 2019, with margins supported by cost savings amid the sales decline.
- S&P Global Ratings-adjusted EBITDA of €2.3 billion-€2.4 billion in 2020, down from about €2.6 billion in 2019.
- Annual working capital outflow of €50 million-€150 million from 2021, following an inflow of up to €100 million in 2020.
- Annual capex of €550 million-€650 million in 2020 and 2021, with flexibility to temporarily reduce further.

- No material dividend payments in 2020 for the year 2019 following the recent cancellation, and an about €400 million payment annually from 2021, with flexibility to reduce further.
- Asset disposals of €900 million over 2020 and 2021 comprising mainly real estate, such as the recently announced sale of an office building in Munich to Allianz and the sale of a majority stake in Arvato Financial Solution's risk management divisions.
- €650 million acquisitions in 2020 pertaining to the purchase of a 25% stake in PRH, and our assumption of annual bolt-on acquisitions of about €250 million.

Key metrics

Based on these assumptions, we arrive at the following adjusted credit measures for 2020 and 2021:

- S&P Global Ratings-adjusted EBITDA of €2.3 billion-€2.4 billion and €2.4 billion–€2.5 billion in 2021, down from €2.6 billion in 2019;
- Adjusted FOCF of €1.2 billion-€1.3 billion in 2020 and €0.95 billion-€1.05 billion, compared with €1.24 billion in 2019;
- Adjusted debt (including pensions, lease liabilities, and 50% of hybrid capital) of €5.0 billion-€5.3 billion in 2020 and €4.8 billion-€5.2 billion in 2021, down from €6.08 billion in 2019;
- S&P Global Ratings-adjusted debt to EBITDA of 2.2x-2.4x in 2020 and 2.0x-2.3x in 2021, after 2.3x in 2019;
- S&P Global Ratings -adjusted funds from operations to debt of 37%-40% in 2020 and 35%-39% in 2021, up from 32% in 2019; and
- FOCF to debt of 22%-26% in 2020 and 16%-20% in 2021, compared with 20% in 2019.

Liquidity

We view Bertelsmann's liquidity as strong because we expect sources of liquidity will exceed uses by about 2.2x over the next 12 months. The group benefits from sufficient committed credit facilities, a large cash balance, and our expectation of continued positive free cash flow generation. We also consider that Bertelsmann has a strong relationship with banks and high standing in the credit markets, as indicated by the recent benchmark notes issue amid currently stressed capital markets, and given the revolving credit facility (RCF) has no financial covenant.

Principal liquidity sources over the 12 months from June 30, 2020, are:

- Unrestricted cash on balance of €4.7 billion as of June 30, 2020;
- €1.2 billion RCF due in 2024, with an unutilized amount of €500 million as of June 30, 2020;
- Our forecast of cash FFO of €1.4 billion-€1.5 billion;
- €250 million of bond issuance completed in the second half of 2020; and
- €400 million-€450 million publicly confirmed asset disposals.

Principal liquidity uses over the same period are:

- Short-term debt maturities of about €2.2 billion;

- Seasonal and structural working capital outflow of up to €200 million peak intra-year outflow;
- Capex of €600 million-€650 million; and
- Dividends of about €400 million in 2021.

Issue Ratings - Subordination Risk Analysis

Capital structure

Almost all the debt of the group is located at the Bertelsmann SE & Co. KGaA level, is unsecured, and ranks pari passu. The only exception is the group's €1.3 billion hybrid capital, which is subordinated to the unsecured debt, but is also issued at parent level.

Analytical conclusions

There is no structural or contractual subordination and we therefore rate the unsecured debt at 'BBB', the same level as our issuer credit rating on Bertelsmann. The hybrid capital is rated 'BB+', two notches below our issuer credit rating, due to:

- Its subordination in the capital structure; and
- The payment flexibility, reflecting that the deferral of interest on the notes is optional.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/A-2

Business risk: Satisfactory

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

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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

Ratings List

Downgraded; Outlook Action

	To	From
Bertelsmann SE & Co. KGaA		
Issuer Credit Rating	BBB/Stable/A-2	BBB+/Negative/A-2
Senior Unsecured	BBB	BBB+
Junior Subordinated	BB+	BBB-