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Research Update:

Avon's Stand-Alone Credit Profile Cut To 'b-' From 'b' And Natura's To 'bb-' From 'bb', Ratings Affirmed And Off Watch

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Research Update:

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Rating Action Overview

- Brazil-based cosmetics group Natura&Co Holding S.A. (Natura&Co) announced an at least R$1 billion capitalization to be received in June 2020, which will alleviate liquidity and leverage pressures.
- This, along with the ramp-up of digital transformation, business diversification, and measures to contain cash burn, will help mitigate the severe hit in sales and EBITDA at the operational subsidiaries, Natura Cosméticos S.A. (Natura) and Avon Products Inc.(Avon), amid the COVID-19 outbreak.
- On May 11, 2020, S&P Global Ratings revised downward the stand-alone credit profile (SACP) of Avon to 'b-' from 'b'. We also affirmed our global scale 'B+' issuer credit rating, reflecting our view of the company as a strategically important subsidiary of Natura&Co. We also affirmed the 'BB' senior secured and 'B+' senior unsecured issue-level ratings. The recovery ratings of '1' (95%) and of '3' (50%) on respective debts remain unchanged.
- We have also revised downward the SACP of Natura to 'bb-' from 'bb'. We affirmed the global scale issuer credit and issue-level ratings at 'BB-' on the company, the same as the group profile assessment, and the national scale issuer credit and issue-level ratings at 'brAA+'. The recovery rating remand at '3' (50%).
- At the same time, we removed all ratings from CreditWatch with negative implications.
- We assigned the negative outlook on the credit ratings. This reflects the risks of severe restrictions to contain COVID-19 in several countries remaining place in the third and fourth quarters, indicating that the consolidated leverage metric would remain above 4x at the group level beyond 2021, impairing its cash flows and liquidity.

Rating Action Rationale

COVID-19 will take a toll on metrics in 2020, but digital transformation and capital injection support ratings.
We currently expect a consolidated revenue decline of about 10% in Brazilian reals in 2020, reflecting an operating contraction of 20%-30% at each entity,

softened by the real's depreciation and its impact on international subsidiaries cash flows. Our base-case scenario assumes that consolidated leverage metric will reach 5.0x-5.5x by the year-end, with adjusted EBITDA margin of 8%-9% (5%-6% on a reported basis), due to Avon's subpar performance and a significant impact on leverage because of real's weakness.

However, we expect this metric to drop below 4x in 2021 thanks to the acceleration of digital transformation which will raise e-commerce sales and increasing use of digital tools by its consultants, and cash preservation measures such maintaining capital expenditures (capex) at maintenance level and cost cuts. In addition, the company announced that main shareholders will inject R$1 billion in capital, which could reach R$2 billion if minority shareholders do the same. This will strengthen Natura&Co's liquidity cushion and reduce covenant pressure at the subsidiary level.

We expect Avon's operations to suffer, leading to the lower SACP, but group support will allow the rating to remain at 'B+'.
Avon is likely to take the brunt because of COVID-19 and its structural overhaul, with performance still weaker than that of Natura. We expect Avon's gross debt to EBITDA will reach 10x and cash burn of $150 million - $200 million (about R$0.75 billion - R$1 billion) in 2020. These factors led us to revise its SACP to 'b-' from 'b'. Nonetheless, we still view Avon as a strategically important subsidiary of Natura&Co, resulting in a rating affirmation. Avon is integrating into Natura&Co, and it is being reported as an operational division of the group. Also, current promissory notes at the holding level contain cross-default clauses with subsidiaries.

No short-term liquidity concerns, but heavy maturities in 2021 and 2022 may pressure ratings.
Cash position of R$4.5 billion will benefit from the planned capitalization of at least R$1 billion and new short-term debt of R$750 million. But the group has significant maturities in 2021,2022, and 2023, mainly consisting of the R$1.8 billion debentures due September 2021, Avon's $900 million (or about R$4.3 billion) secured notes due August 2022, and the total of $1.2 bilion (or about R$4.9 billion, given hedged position) in Natura and Avon's unsecured notes due 2023. We expect to Natura to ramp up the refinancing of debt in the next 12 months and overhaul its capital structure to extend debt maturity profile and avoid liquidity pressures in the medium term.

Higher synergies, but execution risks are still high.
Management has increased the synergies guidance to $300 million -$400 million (more than R$1.4 billion) per year from $200 million - $300 million until 2024, after a deeper look into Avon's operations, which could bring leverage to below 2.0x in 2022 versus our base-case projections of 2.5x-3.0x. Execution risks are still high, because of difficulties in halting the deterioration of Avon's operations amid the virus outbreak.

Natura&Co's consolidated creditworthiness is the main driver of the ratings on Natura and Avon, but we analyze the SACPs of each entity separately.
Our assessment of the consolidated group's creditworthiness and the likelihood

of potential support (or intervention) from the group in each subsidiary influence the ratings on them. We currently view Natura as a core entity and Avon as a strategically important subsidiary.

Our Base Case For The Consolidated Operations

- A revenue decline in constant currency of 15%-20% in Natura's operations in Brazil and Latin America in 2020 due to lower volumes from representatives, but offset by higher usage of digital tools and the 150% increase in e-commerce operations during the next few quarters;
- A constant currency revenue drop of 30%-40% in The Body Shop's (TBS's) retail operations, offset by an about 200% growth in online sales over the next few quarters;
- Aesop to be more resilient, given a 500% rise in its e-commerce operations, but its revenue to decline 5%-10% in 2020;
- A constant currency revenue drop of 25%-30% at Avon in 2020, due to weak performance in some regions such as Asia-Pacific, and because of portfolio composition;
- We also consider the following macroeconomic assumptions:

	2019A	2020E	2021E	2022E
(%)				
Brazil's GDP growth	1.10	(4.60)	3.30	2.90
Brazil's average interest rate	6.00	3.50	3.60	4.30
FX (average R$ per $)	3.94	4.9	4.8	4.7
Brazil's average CPI	3.70	3.30	3.80	4.00
Argentina's GDP growth	(2.10)	(7.00)	2.60	2.50
FX (average ARP per $)	47.97	75	90	97.5
Mexico's GDP growth	(0.10)	(6.70)	2.90	2.30
FX (average MXN per $)	19.25	22	21.75	21.25
Eurozone's GDP growth	1.20	(7.30)	5.60	3.70
FX (end of period euro per $)	0.89	0.91	0.88	0.89

A--Actual. E--Estimate

Based on these assumptions, we forecast the following metrics:

	2019A	2020E	2021E	2022E
Natura&Co				
Revenue (bil. R$)		29-30	32-35	35-37
EBITDA (bil. R$)		2.4-2.6	3.6-3.9	4.4-4.6
Net debt to EBITDA (x)		5.0-5.5	3.0x-3.5	2.5-3.0
FFO to debt (%)		8-10	15-20	20-25

	2019A	2020E	2021E	2022E
FFO cash interest (x)		2	3	3.5-4.0
Natura				
Revenue (bil. R$)	14.5	13.0-13.5	15.0-15.5	15.5-16.0
EBITDA (bil. R$)	2.5	1.9-2.1	2.2-2.4	2.5-2.7
Net debt to EBITDA (x)	2.9	3.5-4.0	3	2.5-3.0
FFO to debt (%)	21.4	15-20	20-25	25-30
FFO cash interest (x)	3.4	3.0-3.5	4.0-4.5	4.0-4.5
Avon				
Revenue (bil. $)	4.7	3.3-3.5	3.9-4.1	4.2-4.4
EBITDA (mil. $)	287	170-190	330-350	400-450
Gross debt to EBITDA (x)	6.3	9.5-10.5	5.0-6.0	4.0-4.5
FFO to debt (%)	3.7	2.5-3.0	8-10	10
FFO cash interest (x)	1.4	1.0-1.5	2.0-2.5	2.0-2.5

A--Actual. E--Estimate.

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

- Health and safety and consumer related factors

Natura

Natura's lower SACP reflects the likely volatility in metrics amid the uncertainties of the duration and extent of the impact of COVID-19. Additionally, despite high cash position, covenant calculations for June and December 2020 are somewhat pressured. However, we believe Natura should be able to comply either by obtaining the waiver or with the support of the parent following cash capitalization. However, we expect metrics to be weaker than those of other 'BB' rated issuers in sectors less impacted from COVID-19. This is because of greater uncertainties over the direct sales business model's resilience amid the pandemic. The issuer credit and debt ratings remain at 'BB-' and 'brAA+', because they're already capped at the group credit profile. Also, recovery ratings remain at '3' (50%), in line with previous assessments. We currently expect Natura's debt to EBITDA in the 3.5x–4.0x range and funds from operations (FFO) to debt at 15%-20% in 2020, improving to 3.0x-3.5x in 2021 and 20%-25% in 2021.

Outlook

The negative outlook on Natura reflects that we can lower the ratings if the likelihood of restrictions remaining in place during the third and fourth quarters is high, which would impair cash flows and liquidity. Although some regions of the world are easing restrictions, a second wave of the spread and the new shift in consumers' demand are still uncertain. Also, a downgrade could occur if management fails to improve Avon's operations, further eroding consolidated margins and metrics.

Downside scenario

We could take a negative rating action in the next 6-12 months if recovery in 2021 is slow, leading to a consolidated debt to EBITDA above 4.0x, FFO to debt below 12%, and FFO cash interest below 2.0x consistently. Also, we could take a negative rating action if liquidity erodes due to weaker-than-expected margins or higher working capital needs.

Upside scenario

The outlook revision to stable in the next 12 months could stem from a gradual rebound in demand in the third quarter amid stronger-than-expected recovery in Avon's operations, resulting in Natura&Co's consolidated debt to EBITDA dropping below 4.0x and FFO cash interest rising close to 4.0x. Also, we would expect the company to maintain liquidity cushion and refinance its debt coming due in 2021. Although unlikely, we could revise upward Natura's SACP amid stronger operating performance and credit metrics. In this scenario, we would see its stand-alone debt to EBITDA consistently below 3.0x, FFO to debt at 30%-45%, and free operating cash flow (FOCF) to debt above 15%, while holding solid liquidity cushion and covenant headroom above 20%.

Liquidity

We view Natura's liquidity as adequate. We expect Natura&Co's sources over uses of cash of about 1.6x in the next 12 months. Despite Natura&Co's large cash position and solid relationship with banks, we currently view it has limited ability to absorb high-impact, low-probability events without refinancing. This is due to the likely significant debt refinancing at Avon and Natura starting in 2021. Liquidity cushion will strengthen thanks to the planned private capitalization, adding R$1 billion to its cash position. We expect portion of this capitalization will be used to support Natura's covenant compliance if needed, which requires net debt to EBITDA of 3.25x in June and 3.0x in December.

Main liquidity sources:

- Consolidated cash and short-term investments of about R$4.5 billion as of March 2020;
- Forecasted FFO of about R$850 million in the next 12 months; and
- Capital injection of at least R$1 billion.

Main liquidity uses:

- Consolidated short-term debt position of about R$1.9 billion as of March 2020;
- Working capital outflows of about R$540 million in the next 12 months and

seasonal working capital of about R$ 800 million; and

- Capex of R$750 million in the next 12 months.

Avon

Avon's lower SACP reflects our expectation that metrics will deteriorate in 2020, due to a 20%-25% drop in revenue, restructuring, and expenses related to the transaction with Natura. The weakening is more pronounced than our forecast for Natura because of Avon's higher exposure to Color and Fashion&Home products, and the weak operations in some countries in APAC. We expect Avon's gross debt to EBITDA of about 10x in 2020, but to recover to the 5x-6x range in 2021. Avon still has adequate liquidity, in our view, despite our expectations of weak cash flows in 2020. It held a cash position of about $300 million in March 2020. And the company has no significant debt maturities in the next 12 months.

Outlook

The negative outlook on Avon reflects a potential deterioration of the group's credit profile.

Downside scenario

We could revise downward our SACP on Avon if pressure on liquidity ratches up in the next 12 months, leading to an unsustainable capital structure. While less likely, we could lower the issuer credit rating on Avon on a reassessment of Avon's subsidiary status to a weaker category.

Upside scenario

We could revise the outlook to stable in the next 12 months amid improvement of the group's credit profile, resulting in Natura&Co's consolidated debt to EBITDA of less than 4.0x and FFO cash interest close to 4.0x. in the longer term, we could consider a higher SACP for Avon if its growth strategy supports consistent cash flow generation and improved credit ratios, such that leverage declines below 5.0x. However, a higher issuer credit rating on Avon is likely only if the company is fully integrated with Natura and managed as a division rather than a separate entity, including a demonstrated commitment of support from Natura&Co during credit stress and closer alignment of Avon's risk management with those of the parent.

Other Credit Considerations

Our issuer credit ratings on Natura and Avon incorporate Natura&Co's 100% ownership. We believe Natura is a core subsidiary of Natura&Co, due to its importance to the group--representing about 75% of total EBITDA-- integral role to the business strategy, and cash flow contribution. We believe Avon is important to the group's long-term strategies and is unlikely to be sold. While Avon will be held as an independent legal entity, we believe its operations will be jointly managed and that it will receive extraordinary support from the group in most foreseeable circumstances. However, there are some doubts about the extent of group support that preclude a higher support category.

Ratings Score Snapshot

Natura Cosméticos S.A.	
Issuer Credit Rating:	
Global scale	BB-/Negative/--
National scale	brAA+/ Negative /--
Business risk:	Fair
Country risk:	Moderately high
Industry risk:	Low
Competitive position:	Fair
Financial risk:	Significant
Cash flow/Leverage:	Significant
Anchor:	bb
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 Rating analysis:	Negative (-1 notch)
SACP: bb-	
Entity status within group:	Core
Avon Products Inc.	
Issuer Credit Rating:	
Global scale	B+/Negative/--
Business risk:	Weak
Country risk:	Intermediate
Industry risk:	Low
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)
Financial policy:	Neutral (no impact)

Liquidity:	Adequate (no impact)
Management and governance:	Fair (no impact)
Comparable Rating analysis:	Neutral (no impact)
SACP:	b-
Entity status within group:	Strategically important (+2 notch from SACP)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- 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 | 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
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

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Ratings Affirmed; CreditWatch/Outlook Action
                                        To                  From
Avon Products Inc.
 Issuer Credit Rating                   B+/Negative/--      B+/Watch Neg/--
  Senior Unsecured                          B+                  B+/Watch Neg
   Recovery Rating                      3(50%)              3(50%)


Avon International Operations Inc.
 Issuer Credit Rating                   B+/Negative/--      B+/Watch Neg/--
  Senior Secured                        BB                  BB/Watch Neg
   Recovery Rating                      1(95%)
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Avon International Capital p.l.c		
Senior Secured	BB	BB /Watch Neg
Recovery Rating	1(95%)	
Natura Cosmeticos S.A.		
Issuer Credit Rating	BB-/Negative/--	BB-/Watch Neg/--
Brazil National Scale	brAA+/Negative/--	brAA+/Watch Neg/--
Natura Cosmeticos S.A.		
Senior Unsecured	BB-	BB-/Watch Neg
Brazil National Scale	brAA+	brAA+/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. 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.

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