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## Research Update:

# Spain-Based Cirsa Gaming Corp. Outlook Revised To Stable On Liquidity Improvement; 'B+' Rating Affirmed

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## Research Update:

# Spain-Based Cirsa Gaming Corp. Outlook Revised To Stable On Liquidity Improvement; 'B+' Rating Affirmed

## Overview

- On Jan. 8, 2014, Spanish gaming company Cirsa Gaming Corp. completed a €120 million tap issue on its existing €780 million senior unsecured notes.
- We believe that this issue enhances Cirsa's liquidity by removing some bank refinancing risk, replenishing the drawn revolving credit facility, and maintaining a sizable cash balance.
- We are therefore revising our outlook on Cirsa to stable from negative and affirming our 'B+' rating on the group. We are also assigning our 'B+' issue rating and '4' recovery rating to the bond tap.
- The stable outlook reflects our view of Cirsa's liquidity as "adequate," based on our projection that the group will maintain sufficient liquidity during the next 12 months and that its EBITDA will comfortably cover interest expense over the same period.

## Rating Action

On Jan. 13, 2014, Standard & Poor's Rating Services revised its outlook on Spain-based gaming company Cirsa Gaming Corp. S.A. to stable from negative. We also affirmed the 'B+' long-term corporate rating on Cirsa.

At the same time, we assigned a 'B+' issue rating to Cirsa's €120 million bond tap. The recovery rating on these notes is '4', indicating our expectation of average (30%-50%) recovery for noteholders in the event of a payment default.

We also affirmed our 'B+' issue rating on the existing €780 million senior unsecured notes. The recovery rating on these notes remains unchanged at '4', reflecting our expectation of average (30%-50%) recovery for noteholders in the event of a payment default.

## Rationale

The outlook revision incorporates our view that the €120 million tap issue improves Cirsa's liquidity. It removes some bank refinancing risk, resets the revolving credit facility (RCF) to its €50 million availability, and allows Cirsa to maintain a sizable cash balance.

We understand that Cirsa will use part of the cash raised for selective

acquisitions. However, we also take into account the group's ongoing resilient operating performance--which further supports our outlook revision--despite some notable weakness in Argentina, Spain, and Italy. We expect Cirsa's Standard & Poor's-adjusted EBITDA for 2013 to increase by about 5% to €395 million compared with 2012. This rise is principally due to improved adjusted margins by about 50 basis points to roughly 25%, and it is driven by operating efficiencies, the installation of additional slot machines in better performing halls, and the expansion of existing halls in Panama and Colombia.

Cirsa is a privately owned gaming company that operates slot machines, casinos, and bingo halls in Latin America, Spain, and Italy. The rating on Cirsa reflects our view of its "weak" business risk profile. This stems from the regulatory framework in which the group operates and our view of political risks in Latin America. This is particularly the case in Argentina, where the group generates about 25% of its EBITDA, given the substantial macroeconomic risks we continue to see. In addition, Cirsa's earnings in Spain and Italy are increasingly constrained by the currently weak economic conditions in both countries. In Italy, we have seen recent gaming tax increases, which further limit earnings capacity generation. Nevertheless, our assessment is supported by the group's leading positions in the low-stake, high-repeat, cash-generative profitable businesses and its geographically diverse portfolio. In addition, Cirsa benefits from regulatory barriers to entry, given the licensing and exclusivity agreements requirements with site owners in Spain and Italy.

We view Cirsa's financial risk profile as "aggressive." This reflects the group's unhedged open foreign exchange positions--which imply currency translation risks--its fairly modest free operating cash flow (FOCF) after capital expenditures (capex), and its financial policy, which we regard as aggressive. These weaknesses are somewhat mitigated by the group's cash-generative characteristics and manageable maintenance capex requirements. Moreover, we believe that Cirsa's management is capable of maintaining a financial risk structure commensurate with the current ratings.

We apply our criteria for rating above the sovereign because we assess the group as having material (roughly 25%) exposure to the lower-rated sovereign of Argentina. According to our criteria, we assess the group's exposure to Argentina's country risk as "moderate." The group has passed our stress test on its operations (including a drop in GDP, depreciation of the local currency, and higher inflation). Additionally, in our view, Cirsa has enough financial flexibility to withstand a period of sovereign stress in Argentina.

Our base case assumes:

- In 2014, uncertainty in Argentina will keep growth low, and overall flat to low-single-digit percentage revenue growth across the group's markets;
- A fairly consistent adjusted EBITDA margin, leading to stable profits in 2014; and
- Sizable capex and plans for several acquisitions in 2014, which will translate into neutral to slightly positive FOCF.

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

- An adjusted ratio of debt to EBITDA of approximately 3.5x in 2014 and 2015;
- Adjusted EBITDA interest coverage of about 3.0x over the next two years; and
- Adjusted FOCF to debt of nearly 5%, which reflects the group's financial policy of reinvesting most of its generated cash flows into its operations.

## **Liquidity**

We view Cirsa's liquidity as "adequate" under our criteria. We expect liquidity sources to exceed uses by 1.2x or more over the upcoming 12 months. We believe that the sources of liquidity would continue to exceed uses even if our EBITDA estimate were to decrease by 15%. Furthermore, we view the group's bank relationships as sound and its credit market standing as satisfactory.

We calculate the following principal liquidity sources:

- About €155 million of cash balances pro forma the tap issue, as of Sept. 30, 2013;
- €50 million available under the RCF maturing in 2018; and
- Approximately €155 million of expected funds from operations in 2014.

Against these sources, we calculate that Cirsa has the following liquidity uses:

- About €180 million of total annual capex (including mergers and acquisitions) in 2014;
- Roughly €70 million of contractual debt maturities for 2014; and
- Approximately €12 million for the recent 20-year license extension on the 26 electronic casinos in Panama to 2037 (due by March 31, 2014), as well as transaction costs from the tap issue.

We note that if restrictions on cash flow repatriation from Argentina intensify more than we anticipate, and economic conditions continue to worsen in Cirsa's main markets, the group's liquidity will likely hinge on its ability and willingness to cut capex.

## **Outlook**

The stable outlook reflects our view of Cirsa's "adequate" liquidity, based on our projection that the group will maintain sufficient liquidity during the next 12 months and that the group's EBITDA will comfortably cover interest expense over the same period.

## **Upside scenario**

We believe that rating upside is limited over the next 12 months. However, we could consider a positive rating action if Cirsa's ongoing solid operating performance resulted in notable positive FOCF on a consistent basis, and it moved toward a financial policy consistent with a higher rating.

## Downside scenario

The ratings could come under pressure if liquidity weakened sharply. This could stem from weaker-than-anticipated trading conditions if further restrictions on repatriating cash flows from Argentina materialized, or if Cirsa were unable to control capex. We could also take a negative rating action if the Standard & Poor's-adjusted EBITDA interest coverage figure fell toward 2x. Moreover, rating pressure could arise if FOCF unexpectedly turned negative.

## Ratings Score Snapshot

Corporate Credit Rating: B+/Stable/--

Business risk: Weak

- Country risk: High
- Industry risk: Intermediate
- Competitive position: Weak

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: b+

Modifiers

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

## Recovery Analysis

### Key analytical factors

- The 'B+' issue ratings on Cirsa's senior unsecured €780 million notes due 2018 and the €120 million tap issuance are in line with the corporate credit rating on Cirsa. The recovery rating on both is '4', indicating our expectation of average (30%-50%) recovery prospects for noteholders in the event of a payment default. The notes are unsecured and guaranteed by the parent company and certain subsidiaries.
- Our issue ratings are supported by the group's strong market positions and its stable earnings and cash flow generation. The ratings are constrained, however, by the unsecured nature of the notes, high capex requirements, significant priority liabilities, and the Spanish jurisdiction, which we view as unfavorable to creditors in an event of default. The ratings are further constrained by the group's exposure to multiple jurisdictions, which would lengthen the recovery process and

thereby lead to value erosion.

- We assume that a default scenario would most likely stem from increasing restrictions on cash flow repatriation from Argentina, potential regulatory actions, and worsening economic conditions in Latin America and Europe, among other factors.
- We value the business as a going concern at the simulated point of default, given our view of the group's ability to renew its gaming licenses.
- For the purpose of our recovery analysis, we consider that the €50 million secured RCF and €102 million secured bank loans rank ahead of the unsecured debt. We also consider the €29.4 million promissory notes and other loans, a €22.4 million capital lease obligation, €19.6 million of unsecured revolving facilities, €13.4 million of gaming tax deferrals, and €5.8 million in receivable financings as prior ranking, due to either a structural or legal priority.

### Simulated default assumptions

- Year of default: 2017
- EBITDA at emergence: €157 million
- Implied enterprise value multiple: 5.0x
- Jurisdiction: Spain

### Simplified waterfall

- Gross enterprise value at default: €786 million
- Administrative costs: €94 million
- Net value available to creditors: €692 million
- Priority claims: €252 million\*
- Unsecured debt claims: €939 million\*
- --Recovery expectations: 30%-50%

\*All debt amounts include six months of prepetition interest.

## Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Ratings Above The Sovereign-Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt, Aug. 10, 2009

## Ratings List

Ratings Affirmed; Outlook Action

To

From

Cirsa Gaming Corp. S.A. Corporate Credit Rating	B+/Stable/--	B+/Negative/--
Cirsa Funding Luxembourg S.A. Senior Unsecured Recovery Rating	B+ 4	B+ 4

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