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Research Update:

France-Based Sodexo Upgraded To 'A-' On Steady Strengthening Of Operations; 'A-2' S-T Rating Affirmed; Outlook Stable

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Overview

- Despite unsupportive trading conditions, France-based onsite and benefit services provider Sodexo has reported almost stable operating margin in 2013, excluding nonrecurring items.
- We are revising our comparative rating analysis for Sodexo to neutral for the ratings from negative, based on our view that Sodexo's efficiency program and its expanding service offering are positive for its business risk profile.
- We are therefore raising our long-term corporate credit and issue ratings on Sodexo to 'A-' from 'BBB+' and affirming our 'A-2' short-term rating.
- The stable outlook reflects our view that Sodexo will continue to deliver resilient operating performance and that acquisition spending and shareholder returns will remain moderate.

Rating Action

On Feb. 20, 2014, Standard & Poor's Ratings Services raised its long-term corporate credit rating on France-based onsite and benefit services provider Sodexo to 'A-' from 'BBB+'. The outlook is stable. At the same time, we affirmed our 'A-2' short-term corporate credit rating on the company.

We also raised our issue rating on Sodexo's €500 million senior unsecured bond due in March 2014 and its €880 million senior unsecured bond due in January 2015 to 'A-' from 'BBB+'.

Rationale

The rating action reflects Sodexo's resilient operating performance over the past fiscal year, despite unsupportive trading conditions. Foodservices volumes have decreased, notably in Europe, and clients seeking reductions in their own cost bases have put strong pressure on prices, making it more difficult for Sodexo to apply inflation clauses. The company reported a contraction in its 2013 operating margin (fiscal year ended Aug. 31) of just 7 basis points versus the 2012 level, adjusted for nonrecurring items (a €26 million positive pension adjustment in 2012, €139 million in costs related to its operational efficiency improvement program in 2013). Sodexo posted Standard & Poor's adjusted funds from operations (FFO) to debt of 37.6% on Aug. 31, 2013, 41.8% adjusted for oneoff expenses, a level we see as commensurate with an 'A-' rating.

We believe Sodexo will continue to deliver sound growth because of the rising contribution from emerging markets, despite weaknesses in its European markets. We view its scale, geographic footprint, and depth of services portfolio as a growing competitive advantage for the company, given the emergence of multiregion, multiservice contracts in the industry. In addition, the ramp-up of its efficiency program should lift the operating margin by at least 50 basis points by 2015 compared with the 2013 figure, positioning Sodexo's business risk profile even more firmly in our "strong" category.

In our base case, we assume:

- Organic revenue growth in the low single digits in both 2014 and 2015, with lower reported figures given potential negative foreign exchange swings--as seen in the first quarter of fiscal 2014--that are largely translational.
- EBITDA of approximately €1.3 billion, together with minimal change in working capital and stable capital outlays of about 2.0% of revenues.
- Returns to shareholders remaining broadly comparable year-on-year, growing in the mid-to-high single digits in 2015.

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

- Widening of operating margin toward Sodexo's target of 6.0% by fiscal 2015, given its efficiency plan, which is unprecedented in terms of its scale in the company's history.
- An FFO-to-debt ratio in excess of 40%.
- We believe that management's disciplined financial policy will remain largely unchanged. Consequently, although we view Sodexo as a natural industry consolidator we do not expect it to stretch its balance sheet excessively.

The ratings on Sodexo reflect our view of its "strong" business risk profile, underpinned by its leading position in the food catering and facilities management services, diversified customer base, and geographic coverage. The company has high earnings visibility because of its multiyear contracts and robust renewal rates. This, together with the voucher activity's elevated operating margins, translates into sustainable and strong cash flow generation.

These strengths are somewhat tempered by the limited price flexibility resulting from the combined impact of inflation on food prices and stiffening competition in a highly fragmented sector. While signs of economic recovery are noticeable globally, prospects remain uncertain in Europe, raising some concerns for Sodexo's corporate segment.

Liquidity

The 'A-2' short term rating reflects Sodexo's sizeable cash balances, strong free operating cash flow (FOCF) generation, and large availability under its committed credit lines. We view Sodexo's liquidity as "strong," as defined under our criteria. We anticipate that its sources of funding should cover its needs by at least 1.5x in the 12 months, following group 2013 fiscal results.

On Aug. 31, 2013, Sodexo's near-term liquidity sources included:
- Net cash and cash equivalents--not including €398 million restricted cash--of close to €2.5 billion, pro forma the announced issue of a multitranche, $1.1 billion U.S. private placement to be settled in the next few days;
- Unused credit committed lines of €954 million that will be available until July 2018, given the exercise of extension options; and
- FFO for the period in excess of €800 million, by our estimates.

These sources compare favorably with the company's potential liquidity uses of below €2.3 billion over the next 12 months to August 2014, comprising:
- Peak working capital and capital outlays of roughly €0.6 billion and €0.3 billion, respectively;
- Short-term debt totaling €752 million, including a €40 million overdraft. There is €903 million in debt coming due in the next 12 months, including the company's sizeable €880 million bond maturing on Jan. 30, 2015;
- Dividend payments of about €270 million; and
- Bolt-on acquisitions of approximately €300 million.

While there are no covenants attached to its syndicated facilities, Sodexo's U.S. private placements have standard maintenance covenant packages, including net assets and net leverage, which leave the company with substantial headroom.

Outlook

The stable outlook reflects our view that Sodexo will continue to deliver resilient operating performance in the next two years, despite the unsupportive trading conditions. We also factor into the outlook our anticipation that the company's adjusted FFO-to-debt will remain above about 40%, with acquisition spending and shareholder returns remaining moderate.

Upside scenario

We could consider a positive rating action if Sodexo durably strengthened its financial risk profile, posting FFO-to-debt of about 45% on a sustainable basis. This could happen if the company fully met its margin objective in 2015, coupled with targeted acquisitions and consistent shareholder returns. Given Sodexo's financial policy and internal leverage targets, we believe at this stage that a positive rating action is remote.

Downside scenario

We could consider a negative rating action if the company realized significant net debt-financed acquisitions in fiscal 2014, experienced deteriorating operating performance, or less likely, adopted a more aggressive shareholder policy.

Ratings Score Snapshot

Corporate Credit Rating: A-/Stable/A-2

Business risk: Strong
- Country risk: Low
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: a-

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

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors for Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Business And Consumer Services Industry, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

Ratings List

Upgraded; Ratings Affirmed

	To	From
Sodexo		
Sodexo Inc.		
Corporate Credit Rating	A-/Stable/A-2	BBB+/Positive/A-2
Sodexo		
Senior Unsecured*	A-	BBB+

*Guaranteed by Sodexo Inc.

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