Georgian Beer Company JSC
Georgia, Consumer Goods

SCOPE **BB-** STABLE

The Georgian Beer Company (GBC) was founded in 2011 by Czesar Chocheli who built a Western-style brewery equipped with state-of-the-art brewhouse and filling line technology (KHS, Krones) from scratch. Chocheli controls GBC via building technology company Mixori (ready mixed concrete) which has a 63.5% ownership in GBC. Other shareholders GIG (active, supervisory board representation) and PSP (passive) are independent owners. Today, GBC produces mainly beer (60% of sales) as well as non-alcoholic soft drinks (lemonades, Cola, juices) which are expected to grow strongly from 2018.

Key metrics

			Scope estimates	
Scope credit ratios	**2016**	**2017**	**2018F**	**2019F**
EBITDA/interest cover (x)	7.1x	9.1x	5.3x	4.5x
SaD/EBITDA	3.6x	2.0x	2.5x	2.3x
Scope-adjusted FFO/SaD	24%	42%	30%	31%
FOCF/SaD	-14%	15%	-16%	14%

Rating rationale

Scope Ratings assigns an issuer rating of BB- to Georgia-based Georgian Beer Company JSC. The rating Outlook is Stable and the prospective GEL 20m domestic bond is rated BB.

The issuer rating mainly reflects our perception of GBC's relatively strong balance sheet and resulting level of key credit metrics, its significant market shares in Georgia as one of the leading national beer and lemonade/ juice producers, as well as its comparatively high level of profitability. The rating also reflects our view on the company operating in an evolving macro-economic and industrial environment, reflecting the risks and opportunities presented by expected industry consolidation as well as the likely prospect of significant change in the retail segment in future.

With regard to GBC's **business risk profile** (rated BB-), we believe the underlying branded consumer goods industry to have relatively favourable credit characteristics such as little macro-economic cyclical exposure and medium market entry barriers. In combination with our view of low substitution risk, this translates into an industry risk rating in the A category for the branded consumer goods industry. With respect to GBC's competitive position, we particularly view its market shares, as well as its comparatively high operating margins, as providing the strongest support for the ratings. In 2017, the company's Georgian market shares were about 30% in beer and 17% in carbonated soft drinks/lemonades, while GBC plans to significantly improve its market shares in juices to about 20% in 2018, following the installation of a new aseptic filling line last year. Scope considers these results, just five years after the company started production, to be a major achievement, reflecting GBC's focus on premium brands and quality vis-à-vis the competition.

Ratings & Outlook

Corporate ratings	BB-/Stable
Senior unsecured rating	BB

Analysts

Olaf Tölke
+49 69 6677389 11
o.toelke@scoperatings.com

Sebastian Zank, CFA
+49 30 27891 225
s.zank@scoperatings.com

Related methodology

Corporate Ratings, January 2018

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Tel. + 49 69 6677389 0

Headquarters

Lennéstraße 5
10785 Berlin

Tel. +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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The fact that GBC is the first domestic beer brewer to operate licenses from international brewers like Dutch Bavaria underscores this ambition, in our view. The EBITDA margin of about 25% compares well to peers, even on a global scale. GBC achieved EBITDA margins in excess of 25% in three of the last five years. Margins only dropped to about 22% in 2015, when revenues fell by 15% due to the introduction of an excise tax on beer.

As a relatively small player on an absolute scale, GBC does not compare favourably with larger multinational consumer goods companies with regard to diversification as it is, by and large, focused on one country and one industry (beverages). This might improve in future following the management's plan to significantly increase its export share of sales which currently stands at about 5%. We believe that the company's product and customer diversification is significantly more robust than its regional and industrial diversification as GBC's product range encompasses a relatively large number of individual beverages in different end-user markets. In addition, as a nationwide distributor, GBC has wide customer diversification, in our view, with about 15,000 points of sale ranging from small bazaar-style shops to large supermarkets.

Scope believes that GBC's **financial risk profile** (rated BB) is stronger than its business risk profile from a ratings perspective. We consider GBC's operating profitability to be significant, and so far fairly stable, enabling satisfactory free cash generation. Historically, this has led to the build-up of a very comfortable equity ratio exceeding 50% of total assets. As no dividend payments or acquisitions have been made in the past, the company's credit metrics remain at a healthy level, as demonstrated by the funds-from-operations (FFO) to Scope-adjusted-debt (SaD) ratio of more than 40% in 2017 and SaD coverage by EBITDA of about 2x (these are estimates as the final 2017 annual report is not yet available). These are at comparatively high levels with regard to the rating. Additionally, free cash flow generation recovered greatly from 2016, with about GEL 7m in cash likely to have been generated, compared to a negative GEL 9m in 2016. While the previous year's performance was entirely due to high capital expenditure of almost GEL 20m, mainly for the aseptic filling line supporting the company's growth ambitions in this product field, capital expenditure in 2017 was almost down to maintenance levels of about GEL 7m.

Scope believes GBC's liquidity profile to be adequate. This is based on relatively low short-term debt maturities of about GEL 5m per year and the availability of more than GEL 5m in multi-year committed credit lines in addition to about GEL 5m in balance sheet cash. In addition, the company generates positive free operating cash flows in years not characterised by expansion investments.

Scope's interpretation of projected financial metrics is conservative, reflecting the evolving dynamics of both the Georgian country and the consumer goods industry. It is necessary to account for potential downside in fast-moving economies and industries, such as the consumer goods industry in Georgia, as the food retail segment appears to be undergoing strong consolidation at present, potentially changing competitive dynamics profoundly in the near future.

Among the **supplementary ratings drivers** Scope does not expect financial policy to become an issue for the ratings as GBC is seen as a traditional family vehicle which is not in danger of implementing an aggressive shareholder remuneration policy or entering into expensive M&A transactions. TBC Bank loan covenants prescribing maximum leverage of 3x also provide a safeguard here. We also understand – and the rating assumes – that corporate governance topics with regard to debt-holder protection vis-à-vis shareholders are addressed adequately within the company as stipulated and monitored by the Georgian capital markets regulation via the National Bank of Georgia.

Scope's recovery assessment looks at recovery values for bond holders in a hypothetical case of default. While this possibility may appear remote from today's perspective, we have assumed a significant fall in revenues in 2019 as a consequence of new market entrants and significant price erosion for the companies' products. Scope calculated a recovery rate of about 70% for the GEL 20m senior unsecured bond (existing bank loans and vendor loans are secured), all available credit lines were deemed fully drawn at default. This equates to Scope's 'above average' (50-70%) recovery category, resulting in a one-notch uplift for the bond compared to the issuer rating (in our hypothetical default case, based on distressed EBITDA of about GEL 15m and an exit multiple of 4) and after deduction of 10% administrative claims.

Outlook

The Outlook is Stable and reflects Scope's expectation that GBC's credit metrics will be able to remain above 30% with regard to the FFO-to-SaD ratio without significantly exceeding a level of 3x with regard to the SaD-to-EBITDA ratio. A positive rating action could be warranted by the FFO-to-SaD ratio exceeding 35% on a sustainable basis and the SaD-to-EBITDA ratio sustainably trending below 3x. A negative rating action could result from a deterioration in credit metrics as indicated by the FFO-to-SaD ratio falling below 30% and the SaD-to-EBITDA ratio increasing above 3.5x on a sustained basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• One of the leading Georgian beer brewers • Comparatively high operating profitability • Modern production facilities • High margins enable free cash generation	• Small absolute company size • Evolving country and industry environment • Potential margin pressure due to retail consolidation • Execution risk of management’s new growth strategy

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Adding scale and diversification • FFO/ SaD >35% • SaD/ EBITDA <3x	• Debt-funded acquisition • FFO/ SaD <30% • SaD/ EBITDA >3.5x

Financial overview

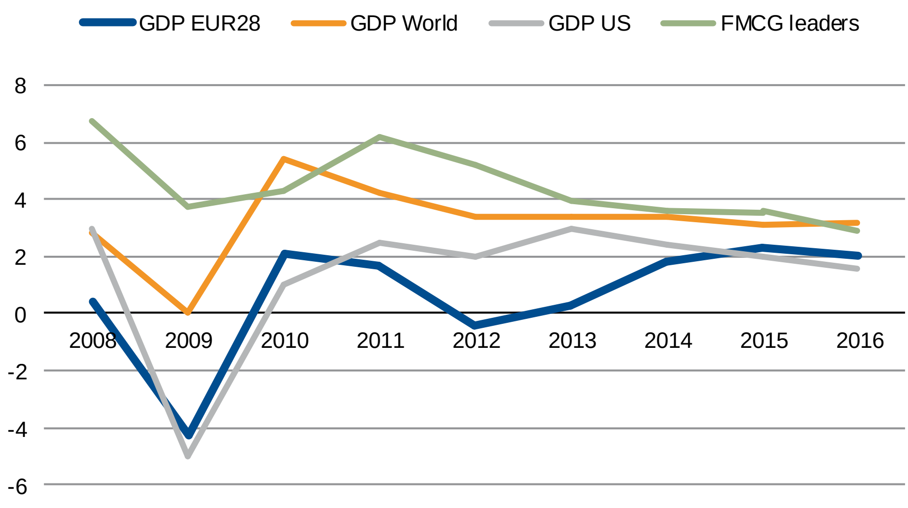
			Scope estimates	
Scope credit ratios	**2016**	**2017**	**2018F**	**2019F**
EBITDA/interest cover (x)	7.1x	9.1x	5.3x	4.5x
SaD/EBITDA	3.6x	2.0x	2.5x	2.3x
Scope-adjusted FFO/SaD	24%	42%	30%	31%
FOCF/SaD	-14%	15%	-16%	14%
Scope-adjusted EBITDA in GEL m	**2016**	**2017**	**2018F**	**2019F**
EBITDA	17.0	20.0	20.5	22.3
Operating lease payment in respective year	0	0	0	0
Other	0	0	0	0
Scope-adjusted EBITDA	17,0	20.0	20.5	22.3
Scope funds from operations in GEL m	**2016**	**2017**	**2018F**	**2019F**
EBITDA	17.0	20.0	20.5	22.3
less: (net) cash interest as per cash flow statement	-2.4	-2.2	-3.9	-5.0
less: cash tax paid as per cash flow statement	0.0	-1.4	-1.0	-1.1
add: depreciation component operating leases	0	0	0	0
Scope FFO	14.6	16.4	15.6	16.2
Scope-adjusted debt in GEL m	**2016**	**2017**	**2018F**	**2019F**
Reported gross financial debt	37.5	39.0	52.0	52.0
Contingent liabilities	23.1	0	0	0
SaD	60.6	39.0	52.0	52.0

Business risk profile

Stable industry

We believe the underlying branded consumer goods industry to have relatively favourable credit characteristics such as little macro-economic cyclical exposure and medium market entry barriers. In combination with our view of low substitution risk this translates into an industry risk rating in the A category for the branded consumer goods industry.

Figure 1: Consumer goods more stable than GDP (in%)



Source: Eurostat

Competitive position – overview

With regard to GBC's competitive position, we particularly view its market shares as well as its comparatively high operating margins as providing the strongest support for the ratings. Scope believes that diversification ranks lower than these two factors reflecting the company's focus on Georgia and no other industry exposure than to the beverages sector.

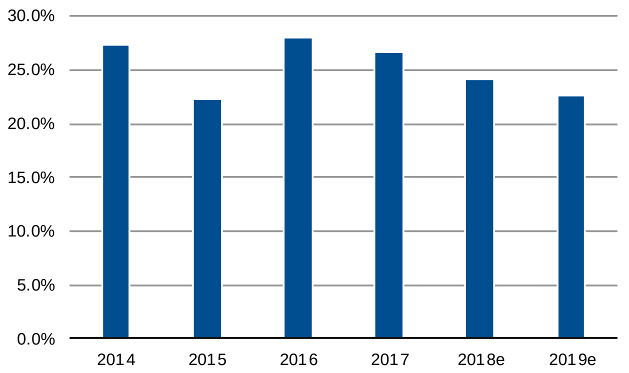
High market shares

Over recent years, GBC has been able to build up its domestic market shares consistently and significantly. According to Euromonitor, GBC started with a share of about 5% of the Georgian beer market in 2012, shortly after the company's foundation. In 2017, GBC's domestic market shares were about 30% in beer and 20% in carbonated soft drinks/lemonades, with management plans to significantly improve its market shares in juices to about 20% by the end of 2018, following the installation of a new aseptic filling line last year. Scope views these results, just five years after the company started production, as a major achievement, reflecting GBC's focus on premium brands and quality vis-à-vis the competition. The fact that GBC is the first domestic beer brewer to operate licenses from international brewers like Bavaria underscores this ambition, in our view. Due to Georgia's small absolute market sizes, there is a notable absence of large international beer and beverage producers in the country. Apart from Turkish EFES (unrated) in beer and lemonades, no other international producer holds significant market shares in the country at present – a situation which we do not expect to change in the foreseeable future.

Good profitability

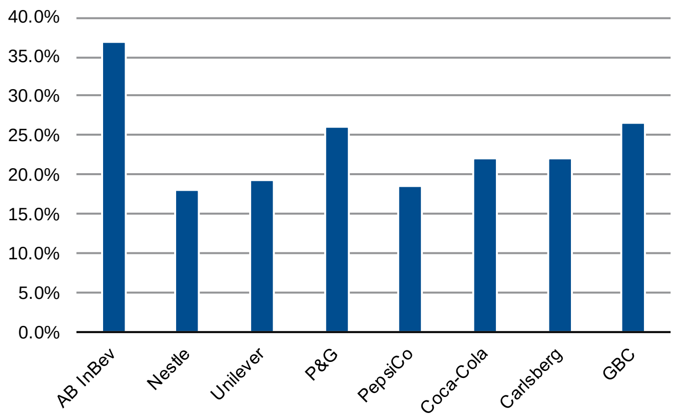
The EBITDA margin of about 25% compares well to peers, even on a global scale. GBC achieved EBITDA margins in excess of 25% in three of the last five years. Margins only dropped to about 22% in 2015, when revenues fell by 19% due to the introduction of an excise tax on beer. For the immediate future, we believe that GBC margins could trend slightly lower due to the Georgian food retail segment's expected consolidation. Presently, food retail in Georgia is still dominated by traditional, small-scale bazaar formats which we believe will be significantly crowded out by modern supermarket chains. This could mean stronger bargaining power for retailers, resulting in margin pressure for consumer goods producers.

Figure 2: EBITDA margin trends GBC
EBITDA margin trends GBC



Source: Annual reports, Scope estimates

Figure 3: Peer comparison consumer goods
EBITDA margin 2017



Source: Annual reports

Weak diversification

As a relatively small player on an absolute scale, GBC does not compare favourably to larger multinational consumer goods companies with regard to diversification as it is, by and large, focused on one country and one industry (beverages). This might improve in future following the management's plan to significantly increase its export share of sales which is currently at about 5%. We believe that the company's product and customer diversification is significantly more robust than its regional and industrial diversification as GBC's product range encompasses a relatively large number of individual beverages in different end-user markets. As a nationwide distributor, GBC also has wide customer diversification, in our view, with about 15,000 points of sale ranging from small bazaar-style shops to large supermarkets.

Organic growth strategy

Management plans to achieve organic growth through a number of actions, including increasing exports to neighbouring countries as well as enhancing its distribution channels and capabilities.

Business risk rated BB-

Based on the above, Scope rates GBC's business risk profile 'BB-'.

Financial risk profile

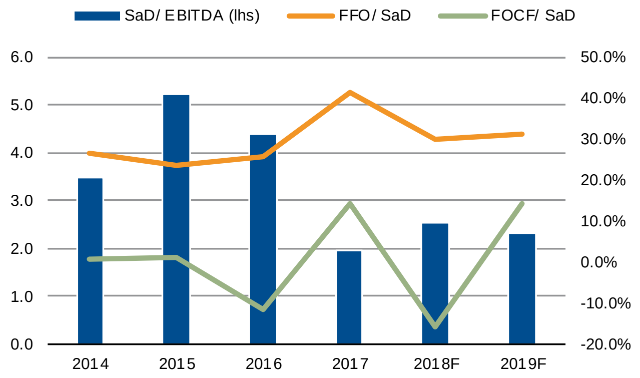
Comfortable credit metrics

Scope views GBC's balance sheet as strong due to the company's significant and fairly stable level of operating profitability thus far, enabling satisfactory free cash generation. Historically, this has led to the build-up of a very comfortable equity ratio exceeding 50% of total assets. As no dividend payments or acquisitions have been made in the past, the company's credit metrics remain at a healthy level, as demonstrated by the FFO-to-SaD ratio of more than 40% in 2017 and SaD coverage by EBITDA of about 2x (these are estimates as the final 2017 annual report is not yet available). These are comparatively high levels with regard to the rating. In addition, free cash flow generation made a remarkable recovery, with about GEL 5m in cash likely to have been generated in 2017, compared to a negative GEL 9m in 2016. While the previous year's performance was entirely due to high capital expenditure of almost GEL 20m, mainly for the aseptic filling line supporting the company's growth ambitions, capital expenditure in 2017 was almost down to maintenance levels of about GEL 7m. The level of free cash generation remains heavily dependent on capital expenditure, as working capital absorption is less meaningful. Especially in years of heavy investment, free operating cash flow is negative. GBC has been able to continue generating free cash based on maintenance capital expenditure.

Slight deterioration probable in 2018

In the current year, we expect a further positive operating performance based on significant sales growth of more than 10% (mainly based on strong expected demand for GBC's non-beer products, in particular juices, following the installation of its new filling technology). We assume that this development will be accompanied by slightly lower profitability as retailers are likely to gain bargaining power vis-a-vis suppliers. In addition, GBC is likely to maintain high sales and marketing expenses in the coming years to build brands. As a consequence, credit metrics are likely to deteriorate in 2018 as GBC embarks upon its new investment for growth programme with another peak in capital expenditure of an estimated GEL 22m in 2018. The programme will be funded by a new domestic bond of GEL 20m to be placed in May 2018. While this is likely to open up the potential for international growth via exports – benefiting the rating via stronger diversification – the immediate effects are negative as the initial investments will lead to higher financial debt, depressing key credit metrics and leading to negative free cash flows in 2018. Specifically, we expect leverage, as expressed by SaD over EBITDA of about 2.5x compared to 2x in 2017.

Figure 4: Key credit metrics 2015-2019F
GBC key credit metrics



Source: Scope estimates

Figure 5: Free operating cash flow trends

GEL m	2016	2017	2018e	2019e
Operating CF	14.9	16.8	15.1	16.7
Working capital	-4.1	-4.8	-1.3	-2.2
Capital expenditure	-19.5	-6.3	-22	-7
thereof, maintenance	5	5	5.4	5
FOCF	**-8.7**	**5.7**	**-8.2**	**7.5**

Source: Scope

Adequate liquidity

Scope believes GBC's liquidity profile to be adequate. This is based on relatively low short-term debt maturities of about GEL 5m per year and availability of more than GEL 5m in multi-year committed credit lines in addition to about GEL 5m in balance sheet cash. In addition, the company generates positive free operating cash flows in years not characterised by expansionary spending.

Conservative financial policy

Historically, GBC's management has not implemented any aggressive forms of financial policy. No acquisitions or dividend payments have been made. Cash flows earned have been used to strengthen equity. Consequently, the company has truly reflected family ownership values, in our view. We do not expect this situation to change for the time being. Bank covenants prescribe a maximum financial leverage of 3x which can be seen as an effective ceiling to large discretionary spending. Future dividend payments are possible but subject to bank approval. GBC is in compliance with its financial covenants and is expected to continue to do so for the foreseeable future.

Financial risk rated BB

Based on the above, Scope rates GBC's financial risk profile BB.

Minus one notch for evolving market dynamics

Scope deducts one notch to reflect the evolving dynamics of both the Georgian country and the consumer goods industry. This is to account for potential downside in fast-moving economies and industries, such as the consumer goods industry in Georgia, as the food retail segment appears to be undergoing strong consolidation at present potentially changing competitive dynamics profoundly in the near future.

Above-average recovery prospects

Scope's recovery assessment looks at recovery values for bond holders in a hypothetical case of default. While this possibility may appear remote from today's perspective, we have assumed a significant fall in revenues in 2019 as a consequence of new market entrants and significant price erosion for the companies' products. Scope calculated a recovery rate of above 60% for the GEL 20m senior unsecured bond (existing bank loans and vendor loans are secured debt), all available credit lines were deemed fully drawn at default. This equates to Scope's 'above average' (50-70%) recovery category, resulting in a one-notch uplift for the bond compared to the issuer rating (in our hypothetical default case, based on distressed EBITDA of about GEL 15m and an exit multiple of 4).

Outlook

The Outlook is Stable and reflects Scope's expectation that GBC's credit metrics will be able to stay above 30% with regard to the FFO-to-SaD ratio without significantly exceeding a level of 3x with regard to the SaD-to-EBITDA ratio. A positive rating action could be warranted by the FFO-to-SaD ratio exceeding 35% on a sustainable basis and the SaD-to-EBITDA ratio sustainably trending below 3x. A negative rating action could result from a deterioration in credit metrics as indicated by the FFO-to-SaD ratio falling below 30% and the SaD-to-EBITDA ratio increasing above 3.5x on a sustained basis.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris

33 rue La Fayette
F-75009 Paris

Phone +33 1 82885557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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