LR Global
Germany, Consumer Goods, Retail

SCOPE B+ STABLE

Corporate profile

Founded in 1985, LR Global Holding GmbH (LR) is a producer and seller in various categories of consumer goods focusing on health, nutrition and beauty (see below for sales breakdown). LR has a niche product orientation and a premium pricing strategy. Its exclusive brand is 'LR Health and Beauty'. LR's unique selling point is its distribution concept of 'Social Selling', which entails selling mainly via online channels and subscription models (80% of sales), with the remainder generated by offline channels. The company has no physical stores but relies on many self-employed sales partners (about 300,000). The Germany-based company markets about 600 beauty and healthcare-related products to 27 countries. Customers are usually quality and lifestyle-oriented individuals conscious to buy non-mass-produced, natural products, with price being of lesser importance.

Key metrics

			Scope estimates	
Scope credit ratios	2018	2019	2020F	2021F
EBITDA cash interest cover (x)	1.8	10.7	8.1	2.9
Scope-adjusted debt (SaD)/EBITDA including shareholder loan (x)	37	14	8	9
SaD/EBITDA excluding shareholder loan (x)	12	4.7	3.9	3.8
Free operating cash flow/SaD (%)	-3	5	7	5

Rating rationale

Scope Ratings has assigned a B+/Stable issuer rating to German consumer goods and direct selling company LR Global Holding GmbH. The senior secured debt category has been rated at B+.

The issuer rating reflects our business risk assessment, supported by the company's good position as a manufacturer of premium non-durable consumer goods with health and lifestyle-related attributes. The largely inhouse-produced goods are distributed in a direct-selling concept. The risks posed by LR's small absolute size (about EUR 270m in sales estimated for 2020) are, in our view, effectively mitigated by a favourable positioning both on the product side and with regard to its addressable market of direct-selling. Additional rating support is provided by LR's comparatively good operating margins, although we believe the company's diversification is a drag on the ratings.

The issuer's financial risk profile benefits from its comparatively good cash-interest coverage in a leverage buyout (LBO) context as well as its ability to generate sustained free cash flow. However, leverage and some credit metrics volatility in the past are constraints.

The **business risk profile** (rated BB-) benefits from high monthly revenue growth since 2019 of at least 20% that has even accelerated during the coronavirus crisis. In our view, this is due to the long-term customer trend for increased healthcare awareness and sustainable, quality-oriented, fast-moving consumer goods with perceived health and nutritional benefits. LR almost solely relies on a direct-selling concept involving a self-employed sales force with entrepreneurial incentivisation. Revenue generation within this referral model, without a physical shop network, thus depends on the sales force's motivation and drive towards affluent and less price-sensitive consumers. An additional support for the business risk profile is the company's comparatively good operating margins and high operating leverage. In 2020, we expect LR to generate an EBITDA margin of more than 12%, a solid level relative to retailing peers.

Ratings & Outlook

Corporate ratings	B+/Stable
Short-term rating	-
Senior secured rating	B+

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Related methodology

Corporate Ratings Methodology, February 2020

Rating Methodology: Consumer Products, September 2020

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With the exception of 2018 (an outlier for several reasons), profitability ranged between 6% and 12%, a good level for a retailer, although at a relatively high volatility. Since 2018, the operating margin has continued to increase, fuelled by significant sales growth. While sustainability is a valid question in the context of the coronavirus, which is positive for health-related products, LR's sales have grown by 20% every month since October 2019 – thus already well in advance of the current crisis.

LR's **financial risk profile** (rated B+) is supported by the comfortable cash coverage of about 3x, estimated to remain at that level even after the placement of the high-yield EUR 140m bond later in 2020. (Our financial risk assessments of LBO companies with sizeable shareholder loans, like LR, use cash coverage as it correctly reflects the economic consequence of financial debt, whereas leverage-based credit metrics in an LBO context are strongly distorted by large shareholder loans.) An additional support to the financial risk profile is the issuer's ability to generate free operating cash flows, due to its very low maintenance capital expenditure and well-managed working capital. The financial risk profile is constrained by the company's leverage (about 4x excluding the shareholder loan) and some historical volatility in operating performance, which appears to have related only to the situation of the company and to conditions in Turkey in 2018, which was a much more important country to LR at the time. During recent years, sales have rebounded strongly in line with significant EBITDA growth – additionally confirmed by 2020 interim results – while gross financial debt has been scaled back gradually.

Scope notes that in early 2018, the European Food Safety Authority (EFSA) released a scientific opinion regarding the use of botanicals in food that contain hydroxyanthracene derivatives (HADs), which concluded that as a class of compounds HADs are genotoxic and carcinogenic unless demonstrated otherwise. The opinion declined to identify a safe daily intake of HADs in food supplement products.

Outlook and rating-change drivers

Stable Outlook

The Outlook is Stable, reflecting our expectation of the EBITDA-cash-interest cover remaining above 2.5x after the bond issuance.

Ratings upside

A positive rating action could be warranted by EBITDA-cash-interest cover of significantly above 3x on a sustained basis, which may be driven by an extended acceleration of sales and operating performance after the Covid-19 crisis and significantly diminished churn rates of sales channels.

Ratings downside

A negative rating action could be possible if the cash-interest cover falls below 2.0x on a sustained basis, which may result from a deteriorating operating performance or a further recapitalisation of shareholder loans.

Rating drivers

Positive rating drivers	Negative rating drivers
• One of the largest direct-selling companies in Europe • Favourable product positioning, creating strong growth • Covid-19 acting as a growth accelerator via increased health awareness among consumers • Free operating cash flow generation	• Overall small size in large underlying consumer goods and retail markets • Strongly dependent on leading product groups (Aloe Vera) • Limited diversification overall

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Cash-interest cover of significantly above 3x	• Cash-interest cover of below 2x

Financial overview

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
EBITDA cash interest cover (x)	1.8	10.7	8.1	2.9
SaD/EBITDA including shareholder loan (x)	37	14	8.4	8.7
SaD/EBITDA excluding shareholder loan	12	4.7	3.9	3.8
Scope-adjusted funds from operations/SaD (%)	-1	5	9	7
Free operating cash flow/SaD (%)	-3	5	7	5
Scope-adjusted EBITDA in EUR m	**2018**	**2019**	**2020F**	**2021F**
EBITDA	0	18	31	29
Operating lease payments in respective year	5	-	-	-
Other	3	2	0	0
Scope-adjusted EBITDA	8	20	31	29
Scope-adjusted funds from operations in EUR m	**2018**	**2019**	**2020F**	**2021F**
EBITDA	0	18	31	29
less: (net) cash interest as per cash flow statement	-3	-1	-3	-9
less: cash tax paid as per cash flow statement	-4	-2	-5	-2
add: depreciation component, operating leases	4	-	-	-
Scope-adjusted funds from operations	-3	15	23	18
Scope-adjusted debt in EUR m	**2018**	**2019**	**2020F**	**2021F**
Reported gross financial debt	91	112	153	147
Shareholder loan	185	186	139	139
less: cash, cash equivalents	-16	-21	-32	-38
Cash not accessible	0	0	0	0
Guarantees	0	1	1	1
add: operating lease obligation	12	0	0	0
Scope-adjusted debt				
including shareholder loan	273	279	261	243
excluding shareholder loan	88	93	122	110

Business risk profile

Investment grade industry risk

In our view, LR is firmly rooted in two industries: i) non-durable consumer goods (a major part of products is made in-house using its own brand, LR Health and Beauty); and ii) retail, as it distributes almost all products via its own sales activities, concentrating heavily on the online channel. LR does not operate brick-and-mortar shops.

The combination of the two industries' risks (retail and consumer goods) results in an industry risk assessment of BBB+.

Competitive position

Market shares

Small scale, but good niche positioning

While LR is a small company in the context of the multi-billion-euro underlying non-durable consumer goods market, its addressable market is even smaller based on its selling concept. LR is not represented in supermarkets or pharmacies, which account for a large part of the underlying market. LR has, in our view, two distinct features mitigating this size disadvantage. First, the company is positioned in health-related niche segments, which have attractive growth characteristics due to prevailing 'green and healthy' shopping trends, which have even accelerated during the coronavirus crisis. Secondly, its potential revenue growth is underscored by its large self-employed sales force (about 300,000 partners) that are increasingly incentivised according to entrepreneurial aspects. Partners benefit both from individual discounting on their own private sales as well as from additional cash bonuses based on overall revenue realised from their recruited networks of customers. Sales partners can also gain benefits such as eligibility for a company car.

We think these are effective mitigants against LR's small overall scale, in the context of a market in which direct selling and social media channels represent only a fraction – although an increasing one – of a product's total global demand. LR has already proved an ability to generate significant above-market growth before the coronavirus crisis (January and February 2020 revenues grew by 26.1% and 19.8%, respectively). The company's market shares in its five key countries, based on market size available to the direct selling channel, range between 5% and 40%, according to PwC.

Figure 1: Top five country exposures

EUR m	2020E sales	Market share MLM
Germany	85	15%
Poland	22	5%
France	31	12%
Czech Republic	23	17%
Greece	15	35%
	176	
	66%	of group sales 2020E

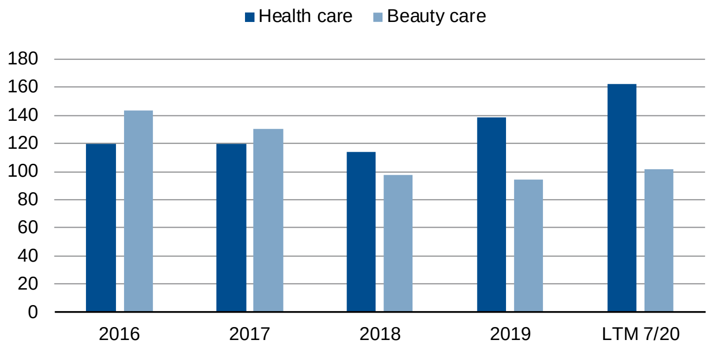
Source: Scope, LR

Diversification

Diversification is limited

We believe diversification is the weakest competitive positioning element for LR, based on its niche product presence as well as its addressable market. Its two largest 'health'-related product groups, aloe vera and nutritionals, today together account for about 50% of total group sales, compared to about 40% in 2016, while its addressable market consists solely of direct sales. LR's high product (group) concentration could become an issue if the European Commission moves forward with plans to restrict or prohibit the use of certain aloe vera substances in consumer products.

Figure 2: Sales by segment, 2016-2019



Source: LR, Scope

Figure 3: Product diversification, 2016-2019

Source: LR, Scope

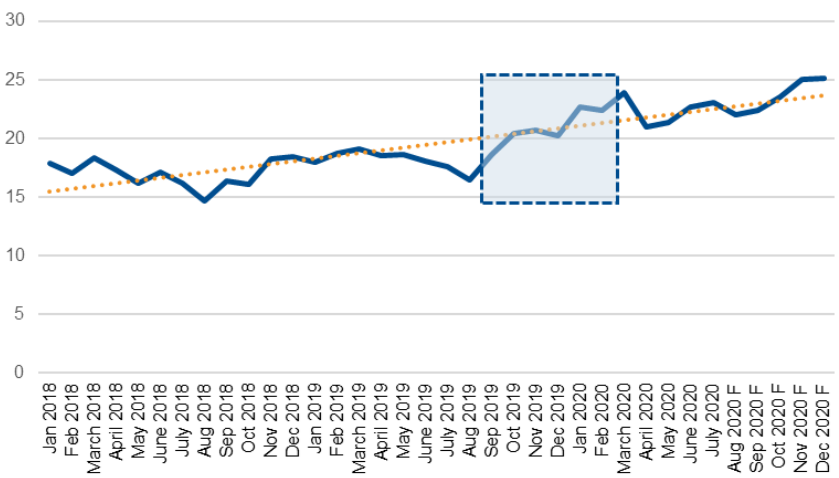
While product concentration thus does not support the ratings, LR's geographic exposure is more positive. LR is active all over Europe, with plans to expand to Korea. Its representation also covers 28 countries. We hold a positive view of the company's online channels, which represent about two-thirds of total sales, while the other categories (offline, subscription) are more difficult to exactly allocate. We believe part of the subscription also takes place online, while the offline part is generated by partners allocating business elsewhere (LR does not prescribe on how revenues should be generated by partners), also due to the different sales channels used in different countries.

Operating margins

Comparatively good operating margins

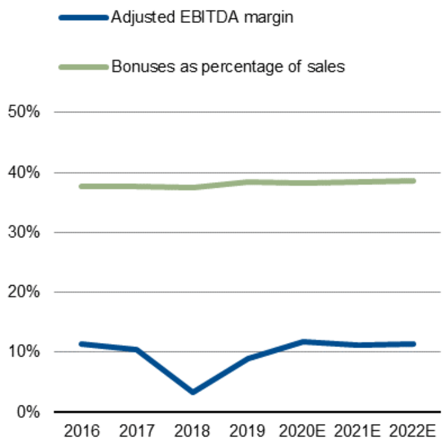
As a highly integrated producer of non-durable consumer goods, LR has good operating margins relative to retail peers. With the exception of 2018 (an outlier year for several reasons), the company's profitability ranged between 6% and 12%, a good level for a retailer. Since 2018, the operating margin has continued to increase, fuelled by significant sales growth. While sustainability is a valid question in the context of the coronavirus crisis, which benefits from demand for health-related products, LR's sales have grown by 20% monthly since October 2019 – thus already well in advance of the crisis.

Figure 4: Growth is picking up significantly



Source: LR, Scope

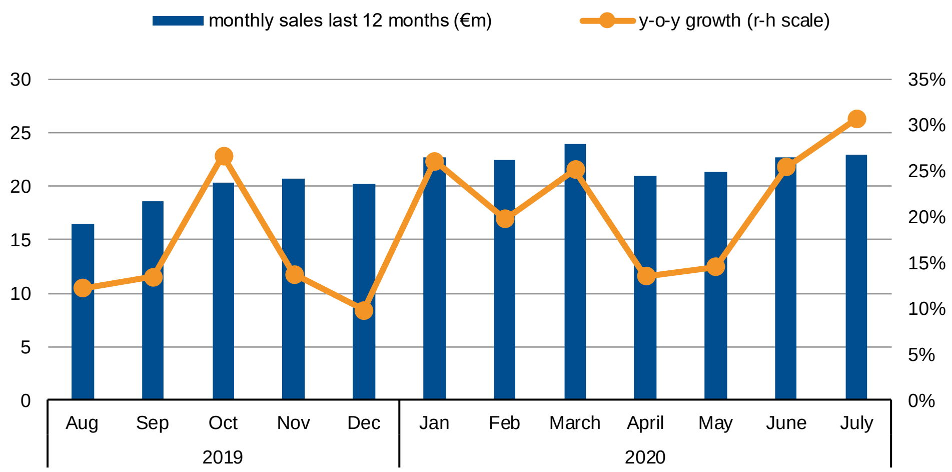
Figure 5: Operating margins and cost structure



Source: LR, Scope

In our view, this is attributed to favourable global consumer trends focused on well-being along with the increasing consumption of healthy, 'green' and high-quality products. Therefore, although LR sells online (generally a transparent platform for very price-sensitive customers), price is unimportant for most of its customers. According to management, prices on some of LR's popular products have even recently increased. Additional growth drivers are the company's innovations (about 15% of sales today are from new products, compared to none four years ago) and incentivisation programme. The self-employed sales force also results in lower fixed costs. Thus, revenue increases have a more direct effect on profitability than for most competitors.

Figure 6: Strong sales growth in last 12 months



Source: LR, Scope Ratings

Business risk profile rated BB-

We assess LR's business risk profile at BB-. This includes the investment grade category for industry risk on a blended basis and our competitive positioning assessment (BB-).

Financial risk profile

We made the following adjustments and assumptions to financial figures:

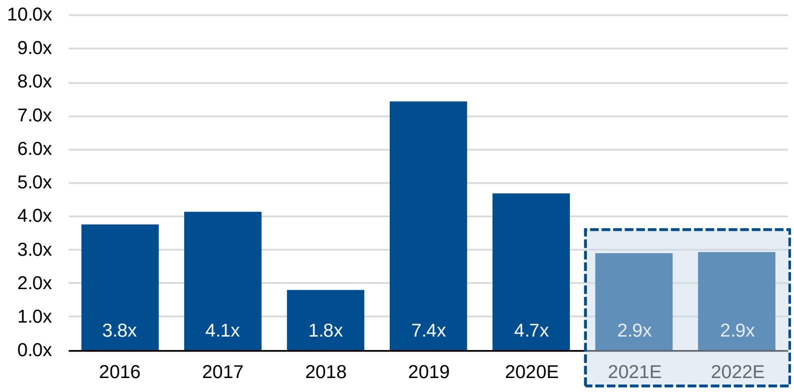
Scope assumptions and adjustments

- 10% lower sales than management forecasts in 2020-2021, despite the significant growth confirmed by the company's seven-month sales performance
- Gross margins and bonus pay-out margins to remain the same during the forecasted period as per management's guidance, with roughly 70% of variable costs (bonuses and material costs)
- Reported EBITDA adjusted by exceptional items for 2017-2019 with restructuring costs
- Additional haircut on available cash due to the end of the business year not fully reflecting working capital needs (reduced inventory from Christmas shopping, also resulting in low trade receivables at end-December and higher liabilities towards sales partners due to accrued annual bonuses)
- Annual capex at low-single-digit millions of euros, assuming limited capital investment needs (mainly the digitalisation of software platforms)
- No consideration of pensions as pension obligations are fully funded by plan assets
- Net present value of operating lease obligations added to Scope-adjusted debt (pre-2019, as IFRS 16 implemented since 1 January 2019); free operating cash flow adjusted for short-term leasing obligations to be repaid

Credit metrics

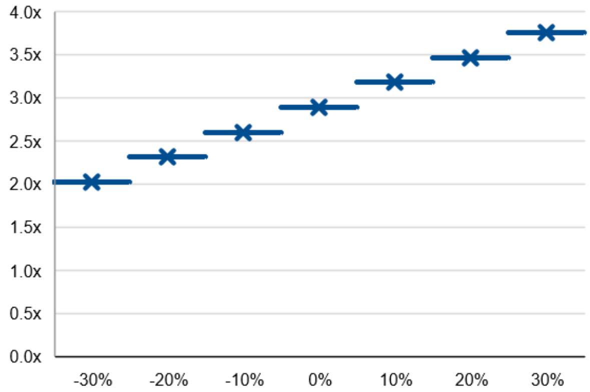
LR's financial risk profile (rated at B+) is supported by its comfortable cash coverage of about 3x, even after the placement of the high-yield EUR 140m bond later in 2020.

Figure 7: EBITDA interest cover



-Source: LR, Scope

Figure 8: Sensitivity of EBITDA reflected in EBITDA cash cover



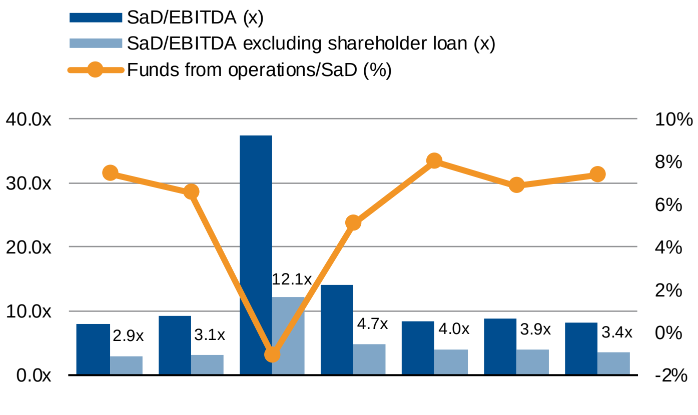
Source: LR, Scope

More importantly, we consider the EBITDA cash-interest cover ratio when assessing the financial risk of LBO companies with sizeable shareholder loans. We expect LR's EBITDA interest cover to stay close to 3.0x, benefiting from the accruing nature of the payment-in-kind interest on shareholder loans and the rapidly growing profit margins driven by the flexible cost structure (except in 2018). Our sensitivity analysis shows that EBITDA interest cover remains above 2.0x if EBITDA falls short of our forecasts by 30%.

We point out the sharp deterioration in credit metrics in 2018, which appears to be a one-off driven by a deterioration in Turkish operations since 2017, a period during which the sales exposure to the market was substantial and the Turkish lira devaluation was an additional factor to have caused a drop in sales from EUR 40m to mid-single-digit millions of euros. This reflected negatively on account of earnings volatility. During recent years, sales rebounded strongly in line with the significant EBITDA growth, confirmed by 2020 interim results, and gross financial debt was gradually scaled back. While LR's main markets are presently Eurozone countries, foreign exchange risk is not material presently. However, to the extent the company envisages to do business outside of the Eurozone, it could become an issue again.

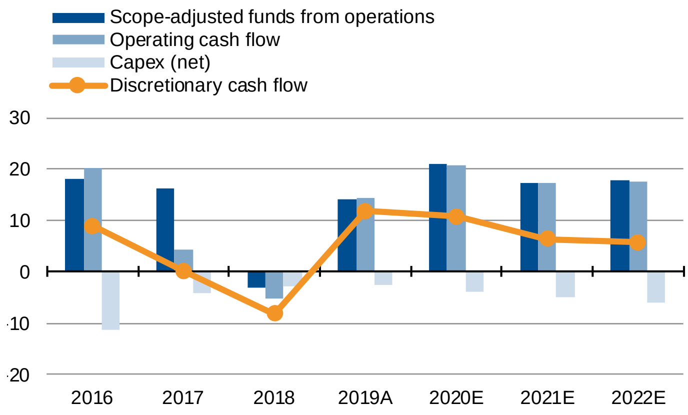
We are confident that the company's operating performance will contribute to leverage being sustained at current levels, bolstered by minimised foreign exchange risks. Lease contracts related to IFRS 16 assets and liabilities, mainly from rental contracts of premises and car leasing as part of LR's car programme, amounted to around EUR 19m as of 2019.

Figure 9: Leverage



Source: LR, Scope

Figure 10: Cash flow generation



Source: LR, Scope

Liquidity

Liquidity adequate

LR's adequate liquidity benefits from a solid cash buffer of around EUR 30m during 2018-2019, positive free operating cash flow and immaterial short-term debt.

Long-term debt ratings

Senior secured bond

LR plans later in 2020 to issue a EUR 140m senior secured corporate bond with a four-year maturity. Bond proceeds are intended for refinancing existing bank loans (EUR 94m) and partially repaying the shareholder loan (by EUR 46m) granted in the context of the LBO in 2014.

We have set the bond's hypothetical default year for 2022, simulating a scenario in which the company has issued the new senior secured bond and proceeds were used according to plan. The recovery analysis is based on a distressed enterprise value of EUR 61m. The recovery expectation translates into the same rating as the issuer rating.

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