12 March 2020

Corporates

# 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 a state-of-the-art brewhouse as well as a filling-line technology (KHS, Krones) from scratch. Chocheli controls GBC via building technology company Mixori (ready-mixed concrete), which owns 63.5%. The other shareholders GIG (active, supervisory board representation) and PSP (passive) are independent owners. Today, GBC mainly produces beer and non-alcoholic soft drinks (lemonades, cola, and juices).

## Key metrics

| | | Scope estimates | | |
|---|---|---|---|---|
| **Scope credit ratios** | **2018** | **2019F** | **2020F** | **2021F** |
| EBITDA/interest cover (x) | 7.6x | 4.3x | 3.9x | 4.0x |
| Scope-adjusted debt (SaD)/EBITDA | 2.3x | 3.0x | 2.6x | 2.5x |
| Scope-adjusted funds from operations/SaD | 37% | 26% | 28% | 30% |
| Free operating cash flow/SaD | -9% | -11% | 10% | 13% |

## Rating rationale

**Scope Ratings has today affirmed the issuer rating of BB-/Stable for Georgia-based Georgian Beer Company JSC. The agency has also affirmed the rating of BB for the senior unsecured debt category and corporate bond (ISIN- GE2700603725).**

The affirmation reflects our view of the company's unchanged business and financial risk profiles, despite weaker financial metrics in 2019.

**GBC's business risk profile** (rated BB-) benefits from the company's significant market shares in Georgia's beer sector, a fiercely contested and saturated market. We expect GBC to not only maintain its domestic market shares but to also increase exports. GBC's Bavaria beer remains one of its bestsellers locally, generating around 30% of its total beer sales. An extension of the licence to sell Bavaria together with the launch of new brands would help the company keep its overall market shares in the beer sector. In the short-to-medium term, we expect no significant deterioration in market share, supported by new product launches in small but fast-growing niche sub-sectors, including Gurieli iced tea and alcohol-free beer Zedazeni.

Despite a gradual increase in the share of exports in total sales in recent years, diversification continues to be the weakest aspect of GBC's business risk profile, due to the limited exposure to one country and one industry. GBC is seeking to grow organically through several measures, including enhancements to distribution channels and operating efficiency.

EBITDA margins weakened in 2019 due to the consolidation of the Georgian retail market, increased raw material prices, and higher-than-estimated selling costs caused by new entrants onto the Georgian beer market. We believe GBC can keep profitability margins above 20% going forward, supported by: i) lower maintenance expenses for new fridges, as these are covered by insurance; ii) a reduced marketing cost threshold for upcoming years, which offsets potential profitability pressures from key accounts; and iii) a decrease in procurement prices.

### Ratings & Outlook

| | |
|---|---|
| Corporate ratings | BB-/Stable |
| Senior unsecured rating | BB |


### Analysts

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

Zurab Zedelashvili
+49 69 667738 947
z.zedelashvili@scoperatings.com


### Related methodology

Corporate Rating Methodology


### 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

Bloomberg: SCOP

GBC's **financial risk profile** is rated BB. The expected deterioration in credit metrics in 2019 mainly driven by decreased profitability and externally financed capex. We assume that leverage, measured by Scope-adjusted debt (SaD)/EBITDA, will rise significantly from below 2.3x to around 3.0x and that funds from operations (FFO)/SaD will fall below 30%. Management has confirmed annual expected capex in the mid single-digit million range (GEL) for 2020-2021. This leaves GBC's free operating cash flows room to deleverage. Our rating case incorporates free operating cash flows and discretionary cash flows of above GEL 5m throughout 2020-2021 and leverage gradually returning to below 3.0x.

The 2019 increase in the National Bank of Georgia's refinance rate by 300 bps will put pressure on the company's EBITDA interest coverage in the short-to-medium term. We expect debt protection, as measured by Scope-adjusted EBITDA interest coverage, to remain at a modest level, in the range of 4x in 2020-2021. Expected positive free operating cash flow in 2020-2021 should be sufficient to cover (re)-financing needs. This translates into an adequate liquidity profile.

Most cash inflows from operations (90%) are exposed to the domestic market. There is also significant exposure to imported raw material and packaging material positions. This may affect GBC's gross margin profile further if the Georgian currency continues to devalue against the euro/US dollar in 2020-2021. Going forward, the impact of potential downside/turbulence on small-scale economies vulnerable to external shocks (e.g Covid-19 or fluctuation of oil prices), reflected in the continued devaluation of the Georgian currency against the Euro/US dollar, may be felt by market players in the Georgian beer sector. We view forex risk as one of the main constraints on GBC's financial risk profile.

We maintain one notch of rating uplift on the GEL 25m (ISIN GE2700603725) senior unsecured bond compared to the issuer rating, based on a recalculated recovery rate. Although our recovery analysis indicates relatively high recovery rate for a senior unsecured debt, we have limited the uplift for the instrument to one notch (above average recovery) due to uncertainty surrounding the resolution of distress/default and small-scale emerging market risk. Recovery expectations are based on future liquidation in a hypothetical default scenario after 2021, and with the assumption that secured credit lines were drawn.

## Outlook and rating-change drivers

The Stable Outlook reflects our expectation that GBC's credit metrics will improve to an FFO/SaD of around 30% and without significantly exceeding a SaD/EBITDA of ratio of 3x.

A positive rating action could be warranted if FFO/SaD exceeds 35% on a sustained basis and SaD/EBITDA consistently trends below 3x. A negative rating action could result from a deterioration in credit metrics, as indicated by an FFO/SaD of below 30% and a SaD/EBITDA of above 3.5x on a sustained basis.

## Rating drivers

| Positive rating drivers | Negative rating drivers |
|---|---|
| • Second largest Georgian beer brewer by sales volume<br>• Low maintenance capex due to state-of-the-art production facilities<br>• High margins enable free cash generation | • Relatively small scale compared to international consumer goods peers<br>• Mostly exposed to one country and one industry (beverages)<br>• Apparent margin pressure due to ongoing retail market consolidation<br>• Significant foreign exchange dependence |

## Rating-change drivers

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

## Financial overview

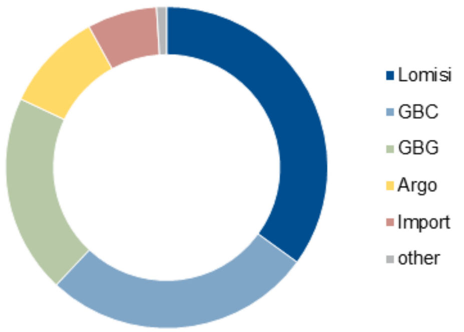
| | | Scope estimates | | |
|---|---|---|---|---|
| **Scope credit ratios** | **2018** | **2019F** | **2020F** | **2021F** |
| EBITDA/interest cover (x) | 7.6x | 4.3x | 3.9x | 4.0x |
| SaD/EBITDA | 2.3x | 3.0x | 2.6x | 2.5x |
| Scope-adjusted FFO/SaD | 37% | 26% | 28% | 30% |
| FOCF/SaD | -9% | -11% | 10% | 13% |
| **Scope-adjusted EBITDA in GEL m** | **2018** | **2019F** | **2020F** | **2021F** |
| EBITDA | 20.5 | 18.2 | 18.9 | 17.8 |
| Operating lease payments in respective year | 0 | 0 | 0 | 0 |
| Other | 0 | 0 | 0 | 0 |
| Scope-adjusted EBITDA | 20.2 | 18.2 | 18.9 | 17.8 |
| **Scope-adjusted funds from operations in GEL m** | **2018** | **2019F** | **2020F** | **2021F** |
| EBITDA | 20.5 | 18.2 | 18.9 | 17.8 |
| less: (net) cash interest as per cash flow statement | -3.2 | -4.2 | -4.8 | -4.4 |
| less: cash tax paid as per cash flow statement | 0.0 | 0.0 | 0.0 | 0.0 |
| add: depreciation component, operating leases | 0 | 0 | 0 | 0 |
| Scope FFO | 17.3 | 13.9 | 14.1 | 13.3 |
| **Scope-adjusted debt in GEL m** | **2018** | **2019F** | **2020F** | **2021F** |
| Reported gross financial debt | 55.2 | 54.9 | 51.8 | 46.8 |
| Cash, cash equivalents | -8.5 | -0.6 | -2.2 | -2.9 |
| SaD | 46.7 | 54.3 | 49.6 | 43.9 |

## Business risk profile

**Competitive position – overview**

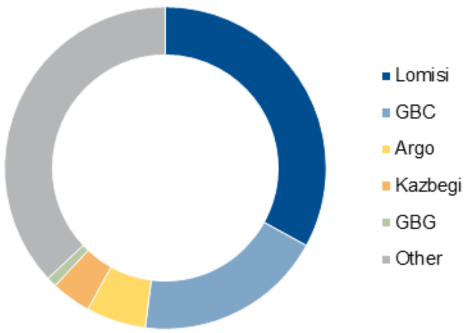
GBC's competitive position is supported by its leading position on the Georgian beer market and relatively high profitability margins. Nearly all GBC's product sales volumes either remained constant or increased in 2019. The company's top line decreased by 6% compared to 2018, mainly affected by rebates and discounts for marketing purposes. Despite fierce competition on the saturated Georgian beer market, we expect GBC to maintain its market shares on the domestic beer market and increase export sales. Bavaria remains one of the bestselling products on the local market, generating around 30% of GBC's total beer sales. An extension of the licence to sell Bavaria together with the launch of new brands would help the company to keep its overall market shares on the beer market. We expect a slight decline in the premium and upper mainstream segments caused by competitors' launched production of Löwenbräu, Krusovice, Heineken and Amstel. Initial research by GBC indicates that it increased its market shares by 200 bps in 2019, despite the downward trend in carbonated soft drink consumption in Georgia.

**Figure 1: Georgian beer market shares**




Source: GBC

**Figure 2: Georgian carbonated soft drinks market shares**

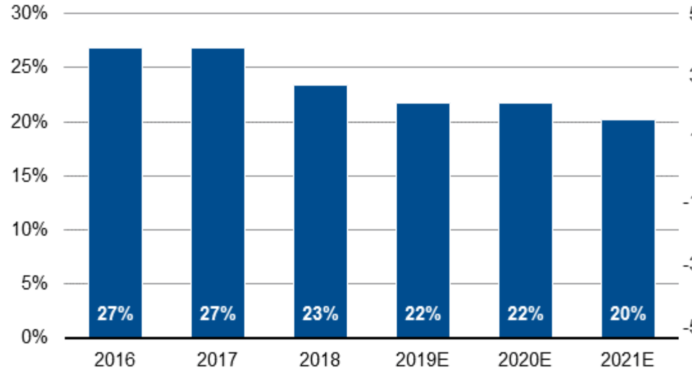



Source: GBC

In the short-to-medium term, we expect no significant deterioration in GBC's market share, supported by new product launches in relatively small but fast-growing sub sectors like Gurieli iced tea, alcohol-free zedazeni beer and several new beer brands.

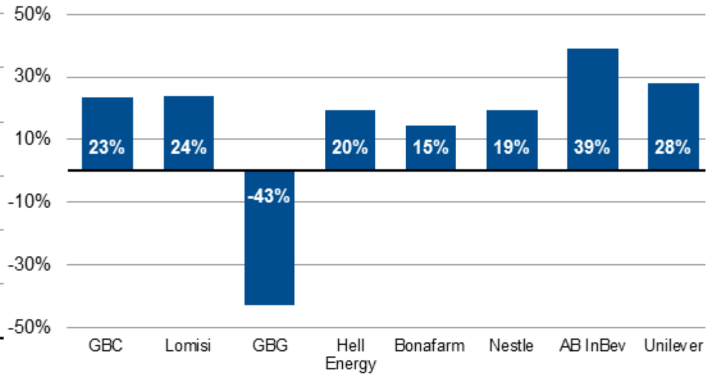
Despite a gradual increase in the share of exports in total sales (climbing to 10%), diversification continues to be the weakest aspect of GBC's business risk profile, mainly constrained by limited exposure to one country and one industry. Management's organic growth strategy includes increasing exports to neighbouring countries as well as enhancing distribution channels and operating efficiencies.

**Figure 3: EBITDA margin trends GBC**




Source: GBC, Scope estimates

**Figure 4: Peer comparison consumer goods EBITDA margin 2018**




Source: GBC

**Modest profitability**

The share of retail customers in GBC's sales portfolio structure increased by 10 pps in 2019 and accounted for more than 30% of total sales in Georgia. As we anticipated, the bargaining power of retail market (key accounts) negatively impacted the company's operating profitability. The latter is the main reason for the drop in EBITDA margins from 23% to 21% in 2019. In addition, increased raw material prices and higher-than-expected marketing costs caused by fierce competition on the beer market reduced EBITDA. We believe that GBC will be able to keep profitability margins above 20% going forward, supported by: i) lower maintenance costs for new fridges covered by insurance; ii) a reduced threshold for marketing costs, which will counterbalance potential profitability pressures from key accounts; and iii) lower procurement prices for raw materials.

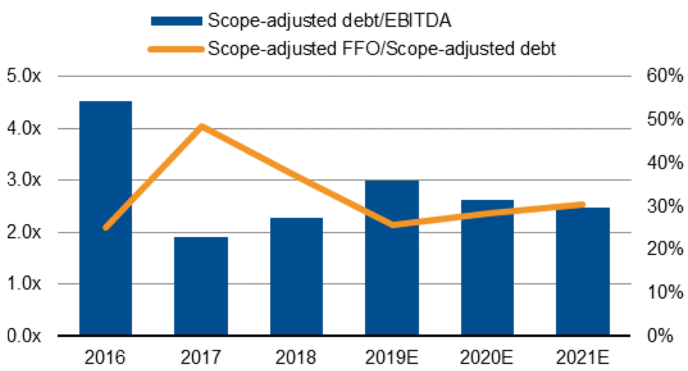
## Financial risk profile

**Comfortable credit metrics despite weaker performance in 2019**

We expect a slight deterioration in GBC's credit metrics in 2019, mainly driven by decreasing profitability and high expected capex. The leverage, as measured by SaD/EBITDA, will increase considerably: from below 2.3x to above 3.0x in 2019. We believe the company will require external financing for higher-than-expected capex investments in 2019, primarily to decrease subsequent maintenance expenses by purchasing fridges. We understand that GBC will only pursue growth opportunities to a limited extent over the next few years, focusing on organic growth. Annual expected capex in the mid single-digit million range (GEL) in 2020-2021, as confirmed by GBC's management, will leave room for deleveraging with free operating cash flows. Our rating case incorporates free operating cash flows and discretionary cash flows in the range of GEL 5m in 2020 and 2021 and leverage gradually returning to below 3.0x (2020E: 2.6x; 2021E: 2.5x).

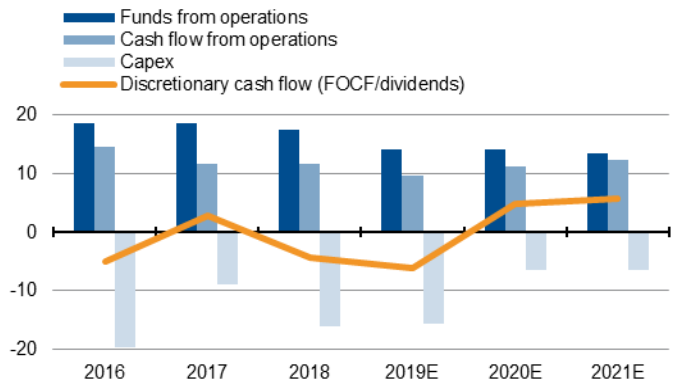
GBC's bond prospectus includes financial covenants referring to leverage (<4x) and debt service coverage (>1.1x). Any significant changes in the company's future capital investment programme and/or shareholder remuneration policy and/or debt-financed acquisitions are therefore unlikely.

**Figure 5: Leverage**




Source: GBC, Scope estimates

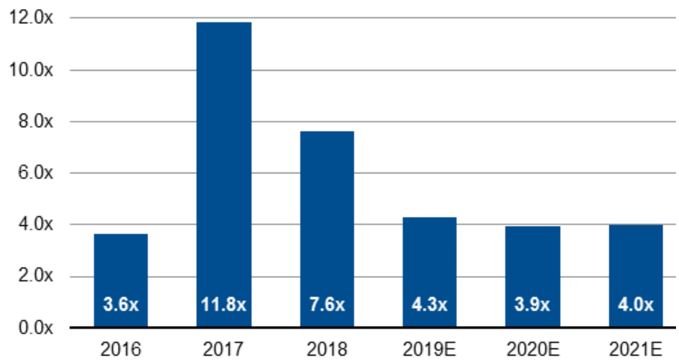
**Figure 6: Cash flow generation**




Source: GBC, Scope estimates

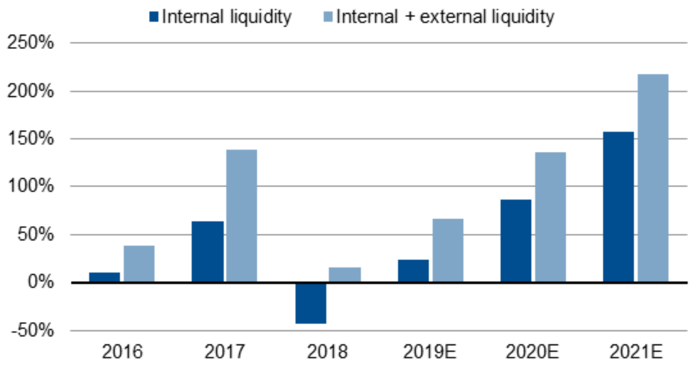
The 2019 increase in the National Bank of Georgia's refinance rate by 300 bps will put pressure on GBC's EBITDA interest coverage in the short-to-medium term. We expect debt protection, as measured by Scope-adjusted EBITDA interest coverage, to remain at a modest level, in the range of 4x in 2020-2021.

**Figure 7: EBITDA cash coverage**




Source: GBC, Scope estimates

**Figure 8: Liquidity profile**




Source: GBC, Scope estimates

**Liquidity remains adequate**

We view GBC's liquidity as adequate. Even though committed credit lines of GEL 4.5m were partially drawn in 2019, expected positive free operating cash flow in 2020-2021 in the range of GEL 5m should be sufficient to fully cover (re)-financing needs. In addition, the company's liquidity profile benefits from the bullet repayment structure of the GEL 25m bond, which matures in 2023.

GBC has a good relationship with local bank TBC, one of the country's largest private banks, as well as international financial institutions like the European Bank for Reconstruction and Development.

**Financial risk: BB**

Partial refinancing of existing euro-denominated loans after the placement of the GEL 25m bond has significantly mitigated GBC's euro-exposed debt structure. Financial leases, which represent around 22% of total debt, are denominated in euro.

Most cash inflows from operations (90%) are exposed to the domestic market. The company is also significantly exposed to imported raw material and packaging material positions (hops, malt, bottles). This may affect GBC's gross margins profile further if the Georgian currency continues to devalue against the euro/US dollar in 2020-2021. Going forward, the impact of potential downside/turbulence on small-scale economies vulnerable to external shocks (e.g Covid-19 or fluctuation of oil prices), reflected in the continued devaluation of the Georgian currency against the euro/US dollar, may be felt by market players in the sector. We see foreign exchange dependence, together with emerging country risk and the transformation/consolidation of the Georgian food retail market, as some of the main rating constraints for GBC's financial risk profile.

**BB rating on GBC's GEL 25m senior unsecured bond**

We maintain one notch of rating uplift on the GEL 25m (ISIN GE2700603725) senior unsecured bond compared to the issuer rating, based on a recalculated recovery rate. Although our recovery analysis indicates relatively high recovery rate for a senior unsecured debt, we have limited the uplift for the instrument to one notch (above average recovery) due to uncertainty surrounding the resolution of distress/default and small-scale emerging market risk. Recovery expectations are based on future liquidation in a hypothetical default scenario after 2021, and with the assumption that secured credit lines were drawn.

## Outlook

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A positive rating action could be warranted if FFO/SaD exceeds 35% on a sustained basis and SaD/EBITDA consistently trends below 3x. A negative rating action could result from a deterioration in credit metrics, as indicated by an FFO/SaD of below 30% and a SaD/EBITDA of 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**

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

**London**

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

**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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