

Research Update:

Del Monte Foods Inc. Rating Raised To 'B' On Continued Deleveraging; Outlook Stable

October 5, 2021

Rating Action Overview

- U.S.-based Del Monte Foods Inc. continues to demonstrate improvement in operating performance, achieving 11% revenue growth and higher profitability in its first fiscal quarter that led to an improvement in leverage to about 3.5x for the 12 months ended Aug. 1, 2021, from about 10x in the same period the previous year.
- We believe the company will sustain leverage under the mid-5x area and that it has the ability to generate positive free cash flow.
- As a result, we raised our issuer credit rating on Del Monte to 'B' from 'B-'. We also raised our issue-level rating on its debt to 'B' from 'B-'. The recovery rating remains '3', indicating our expectation for meaningful (50%-70%; rounded estimate: 65%) recovery in the event of a default.
- The stable outlook reflects our forecast for strong revenue growth and our expectation that the company will be able to offset inflation headwinds with productivity and pricing actions such that leverage will be in the low-3x area in fiscals 2022 and 2023. We also expect at least break-even free cash flow generation in 2022 and above \$50 million in 2023.

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Rating Action Rationale

The upgrade reflects continued deleveraging, driven by revenue growth, productivity improvements, and lower debt balances. Del Monte's sales grew about 11% in the first fiscal quarter (ended Aug. 1, 2021) of its fiscal 2022 (ending May 1, 2022), primarily due to strong demand for the company's shelf-stable product portfolio of branded packaged fruits, vegetables, and beverages, partially offset by the company's planned exit of lower-margin private label business. U.S. consumers continue to cook more at home than they did pre-pandemic, but the overall packaged fruit and vegetable categories declined year-over-year due to a tough comparison to last year's pantry-loading period at the onset of the pandemic. Del Monte was able to overcome the tough comparison and category declines, increasing dollar share of vegetables 17% and fruits 8%. It underperformed the categories in tomatoes and broths, but it believes this is due to it benefitting disproportionately in the quarter a year ago when competitors faced supply

chain issues. Overall, the company increased its share by two points in the quarter, primarily due to distribution gains in the club, convenience, and dollar store channels, as well as price increases and continued innovation. Recent innovations include riced vegetables, "better-for-you" pocket pies, bone broths, and bubble tea. We believe these innovations are key in helping Del Monte add product diversity to its portfolio, gain shelf space with existing customers, and win new distribution, as well as offset potential future category declines as consumers increasingly eat away from home and eventually shift their purchasing habits back toward private label. In addition to robust revenue growth, the company generated healthy profitability. The company is benefitting from the success of its plan to pivot to an asset-light manufacturing model and right-size its cost structure, which eliminated about \$68 million of annual costs over the past year. The mix shift to higher-margin branded products and price increases across all categories improved margins further. Del Monte also continues to reduce its revolver usage compared with previous years. This combination of EBITDA growth and lower debt balances drove considerable deleveraging to about 3.5x through the first fiscal quarter (compared with 3.8x at the end of fiscal 2021 and nearly 10x in the first quarter a year ago).

Management has identified specific productivity and pricing actions to offset most of the inflation expected this year. Like most other food companies, Del Monte is experiencing high inflation across commodities, packaging, labor, and transportation. We believe it can offset most of the inflation this year through price increases and productivity initiatives, including reducing overhead spending, using rail instead of trucking freight, and reducing waste, among other things. So far, the company reports that it has not seen any material decline in volumes from higher prices. Historically the category has been highly price sensitive due to heavy discounting and a high degree of private label competition. However, since Del Monte changed its pricing strategies and consumers have preferred brands during the pandemic, the category is experiencing less price elasticity. Overall, the company's products are less expensive, shelf-stable alternatives to fresh produce, so demand could remain strong if prices for fresh produce become excessively high, if unemployment remains high, or if consumers continue to spend more time at home. That said, demand for Del Monte's products could be uneven over the next one to two years as the pandemic subsides and the economy continues to re-open.

Leverage has improved considerably, but free cash flow generation is still relatively weak. Our leverage forecast for Del Monte might otherwise be indicative of higher ratings. However, the company's free cash flow generation is still relatively weak, mainly due to very high interest costs and the company's need to increase its working capital spending to bolster inventory. The company is no longer relying on parent Del Monte Pacific Ltd. for working capital support. We expect modestly positive free cash flow in fiscal 2022, improving to over \$50 million by fiscal 2023. We believe the company will refinance or replace its 11.875% senior secured notes over the next six to 12 months with lower cost debt, which should significantly improve cash flow generation, but this is not yet incorporated in our base case forecast.

Outlook

The stable outlook reflects our forecast for strong revenue growth and our expectation that the company will be able to offset inflation headwinds with productivity and pricing actions such that leverage will be in the low-3x area in fiscals 2022 and 2023. We also expect at least break-even free cash flow generation in 2022 and above \$50 million in 2023.

Downside scenario

We could lower the rating if leverage approached 6x or we no longer believed the company would generate meaningful free cash flow. This could happen if:

- Cost savings were insufficient to offset higher input cost inflation, leading to significant EBITDA margin erosion compared with our expectations;
- Revenue declined due to an inability to effectively expand distribution or depressed demand for packaged fruits and vegetables as the economy re-opens and consumers eat more away from home; or
- More aggressive financial policies such as a large debt-financed acquisition or dividend.

Upside scenario

We could raise the rating if we believed the company would sustain leverage under 5x over the long term and if it:

- Demonstrated sustained organic growth by continuing to expand its distribution and achieve higher average prices;
- Demonstrated good working capital and inventory management, resulting in consistent free cash flow generation;
- Realized its planned pricing and productivity initiatives to offset inflation, resulting in stable EBITDA margin; and
- Demonstrated conservative financial policies by not making large, debt-financed dividends or acquisitions.

Company Description

Del Monte Foods Inc. is the U.S. subsidiary of Del Monte Pacific Ltd., which is dual-listed on the Singapore and the Philippine Stock exchanges. Del Monte manufactures products primarily under the Del Monte brand in the packaged vegetable and fruit categories. Other brands include Contadina and College Inn. Del Monte Pacific is 71% owned by NutriAsia Pacific Ltd. and Bluebell Group Holdings Ltd., which are controlled by the Campos family of the Philippines.

Our Base-Case Scenario

- U.S. GDP to grow by 5.7% in 2021 and 4.1% in 2022.
- Fiscal 2022 revenue grows in the 7%-9% range primarily due to good demand for its branded products, driven by expanded distribution, new product introductions, and continued high at-home food consumption. Fiscal 2023 revenue grows in the 3%-4% area primarily due to expanded distribution.
- S&P Global Ratings-adjusted EBITDA margin improves to 13%-13.5% in fiscal 2022 from about 11.5% in fiscal 2021. The improvement is primarily due to price increases, the realization of the remainder of the cost savings from its asset-light initiatives completed in 2021, and further productivity improvements, which collectively are more than enough to offset cost inflation.

EBITDA margin remains flat or declines modestly in fiscal 2023, as additional inflation is only partially offset by further productivity improvements and pricing.

- Capital expenditure (capex) in the range of \$25 million-\$30 million annually, which represents mostly maintenance.
- Modestly positive free operating cash flow in fiscal 2022 driven by good operating performance, partially offset by higher working capital requirements for rebuilding inventory levels to meet demand. Free cash flow generation improves significantly to above \$50 million in fiscal 2023, mostly due to lower working capital needs.
- No debt repayment beyond repaying its seasonal asset-based lending (ABL) facility balances.
- Our base case forecast does not assume the company refinances its high interest notes, but we acknowledge the notes are callable in May 2022 and the company is likely to pursue a refinancing that could significantly reduce its interest cost.

Based on these assumptions, we arrive at the following leverage metrics:

- Adjusted debt to EBITDA in the low-3x area through fiscal 2023,
- EBITDA interest coverage in the mid- to high-2x area through fiscal 2023, and
- Operating cash flow to debt of about 7%-8% in fiscal 2022 and in the low- to mid-teens percentage area in fiscal 2023.

Liquidity

We assess Del Monte's liquidity as adequate. We expect sources of cash will exceed uses by more than 1.2x over the next 12 months even if EBITDA were to decline 15%. We believe the company has sound relationships with banks and its risk management is prudent enough to support adequate liquidity. We believe the company has had an inconsistent track record in the credit markets given its history of operating missteps and very high leverage. We believe this is reflected in the company's high interest costs. However, we acknowledge the company's standing in credit markets could improve if its operating performance continues to improve as we expect.

Principal liquidity sources:

- Minimal cash balance as of Aug. 1, 2021;
- Availability of about \$104 million (as of Aug. 1, 2021) under the \$450 million ABL facility due in 2026; and
- Positive FFO of about \$110 million over the next 12 months.

Principal liquidity uses:

- Peak seasonal working capital requirement of up to \$130 million over the next 12 months, and
- Total capex of about \$25 million over the next 12 months.

Covenants

The company must comply with a 1x fixed-charge coverage ratio when availability falls to less than 10% of the commitment amount; it is only applicable if there is a default or the company enters

cash dominion. The company enters cash dominion if ABL availability falls below \$40 million.

We do not expect the covenant to be triggered over the next 12 months, and if it were to be triggered, we expect the company to maintain adequate cushion of at least 15%.

Group Influence

The issuer credit rating on Del Monte Foods incorporates our assessment that the company is strategically important to Del Monte Pacific, because we believe the group will likely provide additional liquidity, capital, or risk transfer in most foreseeable circumstances. This is supported by Del Monte Pacific's history of working capital and capital structure support of Del Monte Foods during its periods of stress. Del Monte Foods represents more than half of the group's EBITDA. The group credit profile has continued to improve due to Del Monte Foods' better profitability and cash flow, as well as sustained growth in Asian operations. The group's S&P Ratings-adjusted leverage was about 3.9x for the 12 months ended Aug. 1 2021, compared to about 6.8x in the same period the previous year. While Del Monte Foods is strategic to the group, we believe it operates more as a stand-alone company than as a division of the group.

Issue Ratings - Recovery Analysis

Key analytical factors

The company's capital structure comprises:

- A \$450 million ABL revolver due in 2026 (unrated; subject to a springing maturity 91 days before the maturity of the senior notes), and
- \$500 million senior secured notes due in 2025.

Del Monte is the borrower on the unrated \$450 million ABL revolver. Guarantors include holdings, an organized wholly owned subsidiary of Del Monte Pacific, and all existing and future material domestic subsidiaries of holdings (the guarantors). The ABL facility is secured by a first-priority lien on the borrower's and guarantors' working capital assets (the ABL collateral).

Del Monte is the borrower of the \$500 million secured notes. Guarantors are the same as on the ABL. The notes are secured by a permitted first-priority lien on all of the borrower's and guarantors' assets that are not ABL collateral, including 100% of the borrower's capital stock of subsidiary guarantors and 65% with respect to controlled foreign subsidiaries, and a second-priority lien on the ABL collateral.

Simulated default assumptions

- Our simulated default scenario contemplates a default in the first half of 2024 due to sharp declines in demand for the company's products, leading to constrained liquidity from higher ABL balances because the company cannot generate the cash flow to repay its borrowings from its high seasonal working capital needs.
- We assume the ABL is 80% drawn at default, because of the company's high seasonal borrowings and intra-year working capital needs.
- Debt service assumption: \$77 million (assumed default year interest plus amortization)

- Minimum capital expenditures assumption: \$24 million
- Operational adjustment: \$25 million
- EBITDA at emergence: \$126 million
- Implied enterprise value multiple: 6x

Simplified waterfall

- Gross recovery value: \$754 million
- Net recovery value for waterfall after administrative expenses (5%): \$716 million
- Obligor/nonobligors valuation split: 100%/0%
- Collateral value available to priority debt: \$716 million
- Estimated priority claims: \$369 million
- Collateral value available to secured debt: \$348 million
- Estimated senior secured claims: \$530 million
- --Recovery range for senior secured debt: 50%-70% (rounded estimate: 65%)

Ratings Score Snapshot

Issuer credit rating: B/Stable/--

Business risk: Weak

- Country risk: Very low
- Industry risk: Low
- 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: Negative (-1 notch)

Stand-alone credit profile: b

Entity status within group: Strategically important (no additional impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Upgraded; Outlook Action

	To	From
Del Monte Foods, Inc.		
Issuer Credit Rating	B/Stable/--	B-/Positive/--

Issue-Level Ratings Raised; Recovery Ratings Unchanged

Del Monte Foods, Inc.		
Senior Secured	B	B-
Recovery Rating	3(65%)	3(65%)

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