LR GLOBAL Holding AG
Germany, Retail

STABLE

BB-

Corporate profile

Founded in 1985, LR Global Holding GmbH produces and sells various consumer goods focusing on health, nutrition and beauty. LR has a niche product orientation and a premium pricing strategy. Its exclusive brand is 'LR Health and Beauty'. We believe LR's main USP is its distribution form as a direct seller via the internet and the use of a large number of sales partners (about 300,000) to generate revenues in what the company calls a 'social selling' platform. LR has no physical store network. Based in Germany, the company markets about 300 different beauty and healthcare related products in a total of 28 countries. Customers are usually quality and lifestyle-oriented individuals wishing to buy non-mass produced, natural products with price being of lesser importance.

The company is fully owned by German private equity investors Quadriga Capital and Bregal Capital (no longer represented), which took over LR Global from Apax Partners in 2014.

Key metrics

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover (x)	7.4	19.3	4.8	4.2
Scope-adjusted debt (SaD*)/EBITDA (x)	14.1	7.2	6.7	6.1
Scope-adjusted FFO/SaD (%)	5	14	10	11
FOCF/SaD (%)	5	11	5	5

*including EUR 125m shareholder loan

Rating rationale

Scope Ratings has affirmed its issuer rating of BB-/Stable on Germany-based LR Global Holding GmbH, together with a senior secured debt rating of BB-.

The rating action reflects LR's generation of double-digit sales growth rates for a number of quarters now, which were also maintained in the first six months of 2021. This has paved the way for a marked improvement in key credit metrics compared to 2019. In particular, the coverage of Scope-adjusted net interest by EBITDA improved significantly in 2020, although this was also supported by the slight delay of the bond issuance to 2021. Even factoring in the bond's higher interest burden in 2021, we believe that interest coverage will stay comfortably above 3x, the threshold for the present ratings. For the time being – and ahead of a likely IPO later in 2022 – we have mainly considered LR's interest coverage because adjusted debt is 'inflated' by the EUR 140m shareholder loan issued by the company' private equity owner Quadriga Capital.

The issuer rating continues to reflect 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 as part of a direct-selling concept. The risks posed by LR's small absolute size (about EUR 300m in sales estimated for 2021) are, in our view, effectively mitigated by a favourable positioning both on the product side and with regard to its addressable direct-selling market. Additional rating support is provided by LR's comparatively good operating margins (about 13% on EBITDA). Diversification continues to be a drag on the ratings, as LR is active in one niche market and has fairly high product concentration.

Ratings & Outlook

Corporate ratings	BB-/Stable
Short-term rating	-
Senior secured rating	BB-

Analysts

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Related Methodology

Corporate Rating Methodology: July 2021

Rating Methodology: Retail and Wholesale Corporates March 2021

Rating Methodology: Consumer Products September 2021

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Bloomberg: RESP SCOP

LR's **business risk profile** (assessed at BB-) benefits from high double-digit monthly revenue growth since 2019, which has even accelerated during the coronavirus crisis and was still at 13% for the first half of 2021. 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 size and motivation of the sales force, which is catering to rising demand from affluent and less price-sensitive consumers.

The company's business risk profile is further supported by its comparatively good operating margins and high operating leverage. In 2020, LR had an EBITDA margin of 13%, a solid level relative to retailing peers. With the exception of 2018 (an outlier for several reasons), profitability ranged between 6% and 12%, which is a good level for a retailer, although relatively volatile. Since 2018, the operating margin has continued to increase, fueled by significant sales growth. LR's ability to achieve both significant sales growth and strong margin expansion is a function of its comparatively low fixed cost base as the whole sales force is not employed by the company. Diversification does not support the ratings due to exposure to a niche market and a relatively high concentration on certain product groups. The aloe vera products in particular generate about 40% of total sales, with an increasing trend (just about 33% in 2016). This is partly mitigated, in our view, by good customer and geographic diversification as the company is active in 28 mainly European countries in total, comparing well to similarly sized peers.

LR's **financial risk profile** (assessed at BB-) is supported by the comfortable interest coverage with EBITDA of above 4x. We estimate that it will remain at this level even after the full-year impact of the high-yield EUR 125m bond (not effective on a twelve-months basis for 2021). Our financial risk assessments of leveraged buyout (LBO) companies with sizeable shareholder loans, like LR, use interest coverage because it correctly reflects the economic consequences of financial debt, whereas leverage-based credit metrics in an LBO context are strongly distorted by large shareholder loans, which usually accrue interest. While our assessment thus focusses on interest cover, we have also taken the effect of the shareholder loan on other credit metrics into account. LR's financial risk profile is further supported by the company's ability to generate free operating cash flows, due to its very low maintenance capital expenditure and well-managed working capital. However, we expect working capital to absorb more cash than usual in 2021, as supply-side bottlenecks have prompted management to accelerate raw material purchases. This will constrain free operating cash flow generation to EUR 8m in 2021 according to our base case, also reflecting higher tax and interest payments than last year. LR's financial risk profile is constrained by some historical volatility in operating performance. This appears to relate only to conditions in Turkey in 2018, which was a much more important country to LR at the time. In recent years, sales have rebounded strongly in line with significant EBITDA growth – also confirmed by 2020 interim results – while gross financial debt has been scaled back gradually.

LR's liquidity is adequate as it benefits from a solid cash buffer of around EUR 30m in 2020-2021, positive free operating cash flow and immaterial short-term debt.

In our recovery scenario we assumed a hypothetical default in 2022, simulating a scenario in which the company's main financial debt consists of the new senior secured bond. Our recovery analysis was based on a going concern approach with a distressed enterprise value of EUR 68m. The result was an 'average' recovery expectation (30%-50%), which translates into the same rating as the issuer rating.

Outlook and rating change drivers

The Outlook is Stable, reflecting our expectation that cash interest cover will remain above 3x after the bond issuance.

A positive rating action could be warranted by a demonstration that the company can continue significant sales growth even after the Covid-19 crisis, benefitting critical size. In addition, cash interest cover of above 4x on a sustained basis could be supportive, e.g. driven by an extended/continued acceleration of sales and operating performance after Covid-19.

A negative rating action is possible if cash interest cover falls below 2.5x on a sustained basis. This could result from a deterioration in LR's operating performance or the further recapitalisation of shareholder loans.

Rating drivers

Positive rating drivers	Negative rating drivers
• Favourable product positioning creates strong growth • Favourable product positioning creates strong growth • Covid-19 has accelerated growth due to consumers' increased health awareness • Free operating cash flow generation	• Small overall size in large underlying consumer goods and retail markets • Strongly dependent on leading brands (aloe vera) • Limited diversification with one core product group

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Cash interest cover of above 4x on a sustained basis • Continuation of sales growth even after the coronavirus crisis	• Cash interest cover of below 2.5x on a sustained basis

Financial overview

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover (x)	7.4	19.3	4.8	4.2
Scope-adjusted debt (SaD)/EBITDA (x)	14.1	7.2	6.7	6.1
Scope-adjusted debt (SaD)/EBITDA (excl. SHL, x)	4.7	2.1	2.9	2.5
Scope-adjusted funds from operations/SaD (%)	5	14	10	11
Free operating cash flow/SaD (%)	**5**	**11**	**5**	**5**
Scope-adjusted EBITDA in EUR m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	20	37	38	40
Operating lease payments in respective year	0	0	0	0
Other	0	0	0	0
Scope-adjusted EBITDA	**20**	**37**	**38**	**40**
Scope-adjusted funds from operations in EUR m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	20	37	38	40
less: (net) cash interest as per cash flow statement	-2	-1	-7	-9
less: cash tax paid as per cash flow statement	-2	1	-5	-5
add: depreciation component, operating leases	0	0	0	0
Scope-adjusted funds from operations	**14**	**37**	**26**	**27**
Scope-adjusted debt in EUR m	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt	112	104	143	143
Shareholder loan	186	186	146	146
less: cash and cash equivalents	-21	-29	-36	-43
add: cash not accessible	0	0	0	0
add: pension adjustment	0	0	0	0
Guarantees	1	1	1	1
Scope-adjusted debt	**279**	**262**	**254**	**247**

Business risk profile

Industry

Integrated retailer

We have assigned a blended industry risk of BBB+ to LR as the company is both a producer (60% of products sold are produced in-house) and a distributor (via online channels). Thus, the two industries which apply are consumer products (A) and retail (BBB). Within the consumer products markets, LR concentrates on the niche segment of health, nutrition and beauty, while its retail business focuses on its specialised 'multi-layer marketing' or social selling concept.

Competitive position

Market shares

Good market shares

While LR is a relatively small company in the context of the multi-billion underlying non-durable consumer goods markets, it has a much smaller addressable market based on its selling concept. The company is not represented in supermarkets or pharmacies, which account for a large part of the underlying market. In our view, LR has two distinct features mitigating this size disadvantage. Firstly, the company is positioned in certain health-related niche segments, which have attractive growth characteristics due to prevailing 'green and healthy' shopping trends, and due to the present coronavirus crisis. Secondly, its potential to generate future revenue growth is also underscored by its large self-employed sales force (about 300,000 partners), which are increasingly incentivised in accordance with an entrepreneurial approach. Partners benefit from individual discounts on their own private sales as well as from additional cash bonuses based on the overall revenue they realise from their recruited network of customers. Sales partners can also gain benefits such as eligibility for a company car.

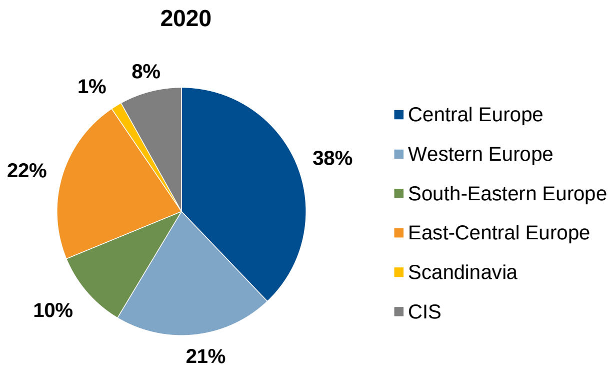
We believe these are effective mitigants against LR's small overall scale, in the context of a market in which direct selling and social media channels represent only a fraction – although an increasing one – of a product's total global demand. LR already proved its ability to generate significant above-market growth before the coronavirus crisis (January and February 2020 revenues grew by 26.1% and 19.8%, respectively). Growth has continued on a double-digit basis in 2021 (gross sales Q1 +15%, Q2 +13%), also helped by the launch of innovative product ranges. The company's market shares in its five key countries, based on the market size available to the direct selling channel, ranges between 5% and 40%, according to PwC. Larger direct selling peers are Amway (generalist), Herbalife or Avon, which are focused on nutrition and beauty, respectively.

Limited diversification

We believe diversification continues to be 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, together account for about 50% of total group sales today, compared to about 40% in 2016, while its addressable market consists solely of direct sales. Thus, product (group) concentration is relatively high.

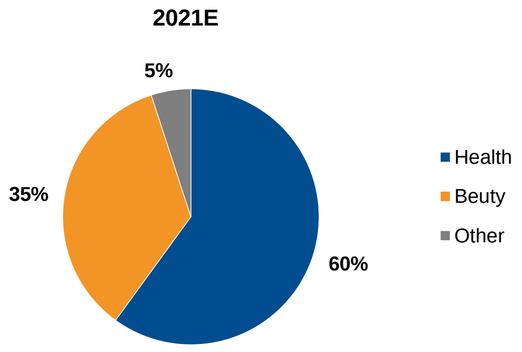
While product concentration does not support the ratings, geographic exposure is more positive. LR is active all over Europe and in 2021 the company has already accessed the Korean market, the third-largest direct selling market globally. LR is represented in a total of 28 countries. We hold a positive view of the company's online channels, which account for about two-thirds of total sales, while other categories are more difficult to allocate fully. We understand that part of the subscription takes place online, while the offline part is generated by partners allocating business elsewhere (LR does not prescribe how its partners should do business). This is also due to different sales channels being used in different countries.

Figure 1: Regional



Source: Scope estimates

Figure 2: Products



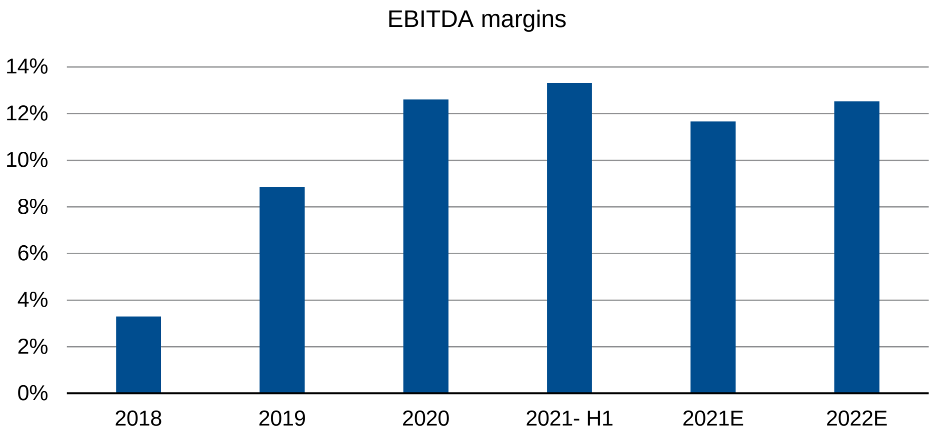
Source: Scope estimates

Satisfactory profitability

Profitability

As a highly integrated producer of non-durable consumer goods LR has comparatively good operating margins. With the exception of 2018 (an outlier year for several reasons) the company's profitability ranged between 6% and 12%, which is a good level for a retailer. Since 2018 the operating margin has continued to increase, fueled by significant sales growth. While sustainability is a valid question in the context of the coronavirus crisis, which allowed LR to benefit from demand for health-related products, LR's sales have grown by 20% monthly since October 2019 – already well in advance of the crisis. We attribute this 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 for some of LR's popular products have even risen recently. Additional growth drivers are the company's innovations (about 10% 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. The strong rise in the sales force in the first half of 2021 (+7.5% year-over-year) is another growth driver.

Figure 3 Margin evolution



Source: Annual reports

Financial risk profile

BB- rated financial risk profile

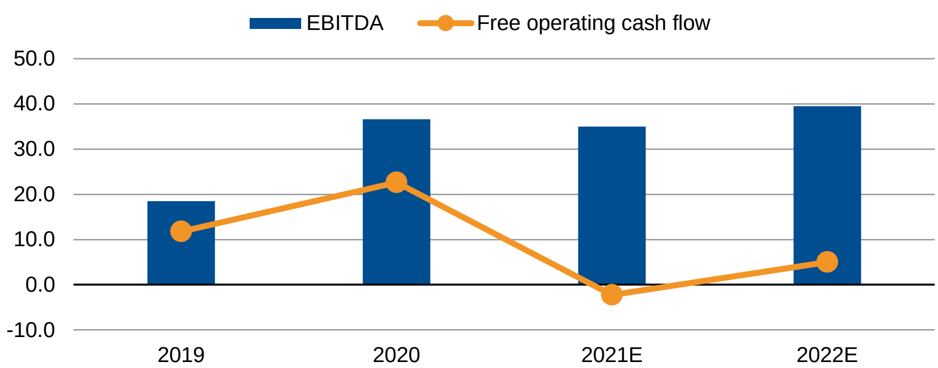
LR's financial risk profile is supported by comfortable interest coverage with EBITDA of above 4x, estimated to remain at that level even after the full-year impact of the high-yield EUR 125m 7.25% bond (not fully effective on a twelve-months basis for 2021). As most of the bond proceeds have been used for the premature repayment of the company's bank loans, the bond constitutes LR's only financial debt (apart from leasing obligations). Our financial risk assessments of LBO companies with sizeable shareholder loans (like LR) focus on interest coverage because it reflects more correctly the economic consequence of financial debt, whereas leverage-based credit metrics in an LBO context are strongly distorted by large shareholder loans, which usually accrue interest.

LR's financial risk profile is further supported by the company's ability to generate free operating cash flows, due to its very low maintenance capital expenditure and well-managed working capital. However, we expect working capital to absorb more cash than usual in 2021, as supply-side bottlenecks in the wake of the coronavirus crisis have prompted management to accelerate raw material purchases. Inventory levels were thus much increased in the second half of 2021, but should normalise in the important 'Christmas quarter', which is usually strong for LR. This will constrain free operating cash flow generation in 2021 according to our base case, also reflecting higher tax and interest payments than last year. Total year 2021 interest payments are also elevated by a one-off EUR 5m consideration in connection to a fee initially paid by the shareholder for the early repayment of the company's bank debt in 2021. The latter is now accounted for as interest payment at LR, balanced by a cash contribution of the same dimension from the shareholder to LR. Adjusting for this, EBITDA projected for 2021 will cover interest by about 4x. Free cash flow generation is also likely to be significantly depressed in 2022 by management's plan to build a new logistics center in Ahlen as well as by its aim to invest in a new Greenfield digitalisation platform, which is likely to stretch into 2023.

LR's financial risk profile is slightly constrained by some historical volatility in operating performance. This appears to relate only to conditions in Turkey in 2018, which was a much more important country to LR at the time. In recent years, sales have rebounded strongly in line with significant EBITDA growth – also confirmed by recent interim results – while gross financial debt has been scaled back gradually.

We do not view negatively the headline decline in third-quarter 2021 sales in a year-on-year comparison. This is due to the very high base reached in the same quarter of 2020, as the coronavirus crisis triggered positive demand for LR by preventing customers from travelling (which usually prompts lower demand for LR).

Figure 4: Depressed free cash generation



Source: Scope estimates

Adequate liquidity

LR's liquidity profile benefits from a solid cash buffer of around EUR 30m in 2018-2020 (EUR 18.5m at 30 September 2021 – somewhat lower due to the inventory build-up), positive free operating cash flow and immaterial short-term debt (only leases). We therefore see LR's liquidity profile as adequate.

Average bond recovery

In our recovery scenario we assumed a hypothetical default in 2022, simulating a scenario in which the company's main financial debt consists of the new senior secured bond. Our recovery analysis is based on a going concern approach with a distressed enterprise value of EUR 68m. The resulting 'average' recovery expectation (30%-50%) translates into the same rating as the issuer rating.

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