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ISSUER COMMENT

JBS' Purchase of Marfrig Unit Is Credit Negative for JBS, Credit Positive for Marfrig

From Credit Outlook

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JBS S.A. (Ba3 review for downgrade) said Monday that it would buy a poultry and pork business from Marfrig Alimentos S.A. (B2 review for downgrade) for BRL5.85 billion ($2.8 billion). The deal is credit negative for JBS because despite longer-term business benefits, the acquisition will increase leverage this year and pressure free cash flow. Following the deal announcement, we placed JBS' Ba3 rating on review for downgrade. The deal is credit positive for Marfrig because it will reduce its debt load.

JBS S.A. JBS will acquire Marfrig's Seara Brasil business and smaller Zenda leather operations entirely through the assumption of Marfrig bank debt maturing in 2013-17. Consequently, we expect leverage at JBS to rise to around 4.5x by the end of 2013 from 4.3x as of March, including our standard adjustments. We expect higher leverage from the acquisition will be partly offset by an increase in Seara's EBITDA margin to about 7% over the next few months and a recovery in JBS' poultry and US beef segments.

We expect JBS' free cash flow to be negative for the year, pressured by additional working capital needs and capital spending. On the positive side, JBS may be able to renegotiate some terms of the assumed debt. However, the resumption of an acquisitive posture by the company remains a constraint on the rating.

Although Seara has struggled recently, it has a well-known brand in Brazil with a strong portfolio of processed products. For JBS, acquiring Seara will increase the weighting of higher margin and less-volatile processed products in its portfolio.

Marfrig Alimentos S.A. For Marfrig, the deal will reduce debt and improve liquidity. We expect pro forma adjusted leverage to decline to 5.0x from 6.6x as of March. Following the deal, about 53% of Marfrig's revenues will come from its international operations, Moypark and Keystone, up from 37% as of 2012, with the balance generated by the Brazilian beef segment.

The sale of Seara is part of Marfrig's plan to reduce debt and working capital needs after it reported wide losses in the first quarter. The Seara business has been the main weak spot in Marfrig's recent operating performance, especially because the US drought last year led to higher feed costs. Marfrig has also struggled with the costs of integrating plants it acquired from BRF - Brasil Foods S.A. (Baa3 stable) in mid-2012. Over the past two quarters, the company has generated BRL1.1 billion in adjusted negative free cash flow, which consumed the proceeds of an equity follow-on offering in December. We placed Marfrig's ratings under review for downgrade last month.

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