Research Update:

KUO S.A.B. de C.V. Upgraded To 'BB' On Global Scale And To 'mxA' On National Scale Following Sale Of Its Aftermarket Business; Outlook Stable

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Rating Action Overview

- After selling its aftermarket business, KUO S.A.B. de C.V. announced that it will mainly use the proceeds to prepay debt, strengthening its capital structure, and consequently its financial credit metrics. Additionally, we believe that the company will focus more on a higher-growth potential and less-volatile industries such as pork meat production and branded foods, which account for about 50% of total revenue.
- Accordingly, we raised our global scale issuer credit and issue–level ratings on the company to 'BB' from 'BB-'. We also raised our national scale issuer credit rating to 'mxA' from 'mxA-'.
- The stable outlook on KUO reflects our expectation that it will maintain EBITDA margins above 10%, resulting in a weighted debt to EBITDA of about 2.5x and funds from operations (FFO) cash interest expense above 6x on a consistent basis, stemming from an increasing demand for the company's products in Asia and expected less volatile prices in raw materials for the pork meat segment.

Rating Action Rationale

The upgrade stems from an improvement in KUO's credit metrics due to the sale of its aftermarket business. The company announced the closing of the sale to Frasle Mobility for about $370 million. KUO will use the proceeds for debt prepayment, dividend distribution, and to strengthen its cash position. We view this transaction in line with the company's strategy to reduce its leverage and exposure to a volatile industry (auto suppliers). Therefore, KUO's credit metrics will significantly improve during the first quarter of 2025, such as debt to EBITDA of about 1.7x, much lower than our previous base-case expectation of about 3.1x. As a result, we revised our assessment of the company's financial risk profile to intermediate from aggressive.

KUO's EBITDA will remain resilient thanks to expected solid growth of the pork meat and chemicals segments. Although the aftermarket segment represented about 20% of the company's EBITDA, we believe that KUO will compensate for the EBITDA decline by expanding the pork meat segment. We expect this segment to remain healthy given strong product demand in Asia, mainly Japan and South Korea, coupled with higher sales prices. The segment's EBITDA jumped 102% during the third quarter of 2024, compared with the same quarter in 2023. Moreover, the chemicals business has been resilient during 2024 thanks to higher volume and prices of its main applications (asphalt and adhesives), as well as the company's ability to gain additional share from European competitors, which have had problems meeting demand because of the Middle East conflict.

KUO will also improve its capital structure with the proceeds from the sale. As a result, KUO will slightly extend its weighted average maturity to three years, resulting in a comfortable maturity schedule. We also expect the average cost of debt to slip to about 6.0% from 6.2% at the end of September 2024, while its liquidity position is supported by its available committed credit lines of about $290 million.

Outlook

The stable outlook on KUO reflects our expectation that it will maintain EBITDA margins above 10%, resulting in a weighted debt to EBITDA of about 2.5x and FFO cash interest expense above 6.0x on a consistent basis stemming from an increasing demand for the company's products in Asia and less volatile prices of raw materials for the pork meat segment.

Downside scenario

We could lower the ratings in the next 12 months if KUO's leverage metrics are not in line with the rating threshold, such as debt to EBITDA above 3.0x or FFO cash interest coverage below 6.0x. This could occur for the following reasons:

- A lower-than-expected demand for chemical end-products;
- Higher-than-expected raw material prices (grains and soy paste) for the pork meat segment, coupled with weaker-than-expected performance in the company's strategic channels (exports and Maxicarne stores' sales); and
- Softer demand in the company's transmission business.

Upside scenario

Although unlikely, we'll consider an upgrade in the next 12 months if the company improves its business and financial risk profile by posting a weighted average debt to EBITDA below 2.0x and FFO interest coverage above 9.0x on a consistent basis. This could occur if:

- Exports to China, Japan, South Korea, and the U.S. are higher than expected, coupled with considerably lower-than-expected raw material prices for the pork meat segment;
- Demand consistently grows for specialized products in the chemicals segment, coupled with greater diversification of products for other final uses, and an improved chemicals distribution segment;
- Higher-than-expected styrene prices, raising the chemical segment's profitability; and
- Higher demand for DCT transmissions for the Corvette and Mustang platforms, along with a larger backlog.

Company Description

KUO is a Mexican conglomerate that generated about 37 billion Mexican pesos (MXN) in revenue and MXN4.2 billion in EBITDA in the 12 months ended Sept. 30, 2024. The company manufactures and sells consumer products, plastics, chemicals, and auto parts, and it has a presence in more than 70 countries. It operates two segments: consumer and industrial. Its consumer products segment produces and sells pork meat and other products such as processed foods and beverages. The industrial segment includes the chemicals unit that manufactures and sells plastics and chemical applications, including synthetic rubber and polystyrene, and the automotive segment that produces and sells transmissions for light-, medium-, and high-performance vehicles.

Our Base-Case Scenario

Assumptions

- GDP growth in Mexico of 1.5% in 2024 and 1.2% in 2025, and GDP growth in the U.S. of 2.7% in 2024 and 2.0% in 2025, which will support demand growth in the company's two main markets and across its two segments.
- Average foreign exchange rate of MXN18.45 per $1 in 2024 and MXN20.75 per $1 in 2025, increasing KUO's export revenue, which represents about 48% of total revenue. As of Sept. 30, 2024, about 95% of the company's debt is denominated in U.S. dollars, and the remainder is in Mexican pesos. Despite the company's geographic diversification, most of its revenue is either in dollars or linked to it, providing the company with a natural hedge against currency fluctuations and its total debt.
- West Texas Intermediate crude oil price of $70 per barrel in coming years.
- Revenue to decrease 9.1% in 2024, mainly driven by the divestment of the aftermarket segment. In 2025, a 12.6% growth stemming from a recovery in styrene prices and volume in the chemicals segment and the expansion of the pork meat segment due to expected export growth (up to 45% of total sales), mainly to Japan, South Korea, and the U.S.
- The transmissions segment's revenue drops of 4.3% for 2024 and growth of 5.7% for 2025. Lower volume for the Corvette platform in 2024, given a slight decline in the backlog, and a recovery in volume in 2025.
- EBITDA of about MXN3.7 billion in 2024 and MXN4.1 billion in 2025. Higher EBITDA thanks to stable raw materials costs and commodity prices, mainly in the pork meat segment, in the following years. Corn prices to stabilize between $4.50 and $5.50 per bushel in 2025, much lower than the peak of $8 per bushel in 2022. We also expect a positive effect of inventories bought at low prices in 2024.
- Working capital requirements of MXN1.5 billion in coming years, mainly due to increased inventories of raw materials and commodities in the two segments.
- Capex of MXN1.3 billion in 2024 and MXN1.6 billion in 2025, mainly to expand capacity in the pork meat segment (including new farms, and processing and food plants).
- Dividend payments of about MXN424 million for 2024 and an extraordinary dividend payment of MXN1.7 billion for the aftermarket segment's divestment.
- Expected MXN6.6 billion of proceeds from the aftermarket segment's sale.

- Prepayment of about MXN4.3 billion in bank loans in 2025.
- Average annual dividends from joint ventures (JVs) of about MXN850 million in the following years.

Key metrics

KUO, S.A.B. de C.V.--Forecast summary

Period ending	Dec-31-2020	Dec-31-2021	Dec-31-2022	Dec-31-2023	Dec-31-2024	Dec-31-2025	Dec-31-2026	Dec-31-2027
(Mil. MXN)	2020a	2021a	2022a	2023a	2024e	2025f	2026f	2027f
Revenue	30,936	40,309	44,704	38,782	35,264	39,720	42,679	43,959
Gross profit	6,882	8,002	7,819	7,453	7,158	8,020	8,655	8,924
EBITDA (reported)	2,949	6,193	4,964	3,457	3,525	3,928	4,258	4,395
Plus: Operating lease adjustment (OLA) rent	--	--	--	--	--	--	--	--
Plus/(less): Other	1,697	(160)	(244)	248	135	152	34	(299)
EBITDA	4,646	6,033	4,720	3,705	3,660	4,080	4,292	4,097
Less: Cash interest paid	(967)	(757)	(848)	(896)	(901)	(376)	(376)	(376)
Less: Cash taxes paid	(562)	(599)	(868)	(869)	--	--	--	--
Plus/(less): Other	--	--	--	--	--	--	--	--
Funds from operations (FFO)	3,117	4,677	3,005	1,940	2,759	3,703	3,916	3,720
EBIT	2,187	5,221	3,008	1,605	2,140	2,166	2,395	2,527
Interest expense	1,137	951	1,013	1,043	942	417	417	417
Cash flow from operations (CFO)	2,834	4,536	1,278	2,210	2,099	3,026	2,853	3,004
Capital expenditure (capex)	1,055	2,771	1,426	872	1,328	1,556	2,057	2,119
Free operating cash flow (FOCF)	1,779	1,765	(149)	1,338	771	1,470	796	885
Dividends	201	395	438	--	424	1,660	529	531
Share repurchases (reported)	51	38	25	13	--	--	--	--
Discretionary cash flow (DCF)	1,528	1,332	(612)	1,325	346	(190)	267	354
Debt (reported)	16,757	15,063	13,711	11,669	12,635	8,366	8,366	8,366
Plus: Lease liabilities debt	1,717	1,484	1,583	1,337	1,278	1,222	1,168	1,117
Plus: Pension and other postretirement debt	416	408	360	372	360	360	360	360
Less: Accessible cash and liquid Investments	(4,813)	(4,379)	(2,333)	(1,832)	(2,936)	(4,909)	(4,968)	(5,424)
Plus/(less): Other	--	1,757	2,028	1,860	1,860	1,860	1,860	1,860
Debt	14,077	14,334	15,348	13,406	13,197	6,900	6,787	6,279
Equity	13,925	16,231	17,141	16,494	17,493	17,844	19,537	21,369
FOCF (adjusted for lease capex)	1,656	1,572	(757)	1,200	518	1,215	539	936
Interest expense (reported)	1,095	913	972	996	901	376	376	376
Capex (reported)	1,055	2,771	1,426	872	1,328	1,556	2,057	2,119
Cash and short-term investments (reported)	4,813	4,379	2,333	1,832	2,936	4,909	4,968	5,424
Adjusted ratios								
Debt/EBITDA (x)	3.0	2.4	3.3	3.6	3.6	1.7	1.6	1.5

KUO, S.A.B. de C.V.--Forecast summary								
FFO/debt (%)	22.1	32.6	19.6	14.5	20.9	53.7	57.7	59.2
FFO cash interest coverage (x)	4.2	7.2	4.5	3.2	4.1	10.8	11.4	10.9
EBITDA interest coverage (x)	4.1	6.3	4.7	3.6	3.9	9.8	10.3	9.8
CFO/debt (%)	20.1	31.6	8.3	16.5	15.9	43.9	42.0	47.8
FOCF/debt (%)	12.6	12.3	(1.0)	10.0	5.8	21.3	11.7	14.1
DCF/debt (%)	10.9	9.3	(4.0)	9.9	2.6	(2.8)	3.9	5.6
Lease capex-adjusted FOCF/debt (%)	11.8	11.0	(4.9)	8.9	3.9	17.6	7.9	14.9
Annual revenue growth (%)	11.3	30.3	10.9	(13.2)	(9.1)	12.6	7.4	3.0
Gross margin (%)	22.2	19.9	17.5	19.2	20.3	20.2	20.3	20.3
EBITDA margin (%)	15.0	15.0	10.6	9.6	10.4	10.3	10.1	9.3
Return on capital (%)	7.7	17.8	9.5	5.1	7.1	7.8	9.4	9.4
Return on total assets (%)	4.8	10.9	6.0	3.4	4.8	4.9	5.6	5.7
EBITDA/cash interest (x)	4.8	8.0	5.6	4.1	4.1	10.8	11.4	10.9
EBIT interest coverage (x)	1.9	5.5	3.0	1.5	2.3	5.2	5.7	6.1
Debt/debt and equity (%)	50.3	46.9	47.2	44.8	43.0	27.9	25.8	22.7
Debt fixed-charge coverage (x)	4.1	6.3	4.7	3.6	3.2	0.9	10.3	9.8
Debt/debt and undepreciated equity (%)	50.3	46.9	47.2	44.8	43.0	27.9	25.8	22.7

All figures are adjusted by S&P Global Ratings, unless stated as reported. a--Actual. e--Estimate. f--Forecast. MXN--Mexican peso.

Liquidity

We continue to assess KUO's liquidity as adequate, reflecting our expectation that liquidity sources will cover the company's cash uses for the next 12 months by at least 1.2x, while net sources remain positive even if forecast EBITDA declines 15% next year. We also view the company's debt maturity schedule as comfortable, with no significant maturities until 2027. We believe KUO has solid relationships with banks, as seen in its committed credit lines from five lenders and its loans from three banks, as well as generally prudent risk management, reflected in its smooth debt maturity and ongoing debt refinancing.

Principal liquidity sources

- Cash and short-term investments of about MXN1.5 billion as of Sept. 30, 2024;
- Available committed undrawn bank lines of about MXN5.3 billion for the next 12 months;
- Cash FFO of about MXN3.4 billion for the next 12 months; and
- Proceeds from the aftermarket segment's sale of about MXN6.6 billion received on Jan. 14, 2025.

Principal liquidity uses

- Short-term debt maturities of about MXN151.2 million as of Sept. 30, 2024;
- Working capital outflows of about MXN1.5 billion for the next 12 months;
- Seasonal working capital outflows of about MXN713.3 million for the next 12 months;
- Capex of about MXN1.5 billion for the next 12 months;
- Dividends of about MXN1.7 billion for the next 12 months; and
- Expected debt repayment of about MXN4.5 billion during January 2025.

Covenants

The senior notes have the following maintenance covenants, which include JVs for the calculations:

- Maintenance of debt charge coverage ratio interest expense above 2.0x; provided that the aggregate principal amount of all debt of no guarantor restricted subsidiaries to third parties, on a consolidated basis, does not exceed 30% of the consolidated debt of the company at any time.

The loans have the following covenants, which also include the JVs for the calculation:

- Net leverage: 3.25x (waiver request to amend the net leverage ratio [net debt to EBITDA] to 4.0x for the third and fourth quarters of 2023 and to 3.75x for the first quarter of 2024)
- Capitalization: 0.65x
- Interest coverage: 2.75x
- Debt of subsidiaries lower than 30% of total debt

Environmental, Social, And Governance

Environmental factors are a negative consideration in our credit rating analysis of KUO, reflecting its participation in the chemicals industry (25% of revenue) and in the automotive industry (30%). In our view, the company's core products aren't exposed to higher environmental risks than those that are standard for such industries. The company assigned more than MXN5.0 billion (about 12% of total capex) to environmental initiatives related to energy consumption, recycled water, thermal energy consumption, greenhouse gas emissions, and clean energy generation.

Issue Ratings--Recovery Analysis

Key analytical factors

- The recovery rating on KUO's $450 million senior unsecured notes 5.75% due 2027 remains at '3', indicating our expectation of meaningful recovery prospects (50%-90%) in the event of a payment default.
- Our simulated downside scenario considers an event of default in 2027 (during which KUO has to pay about 85% of its debt) caused by economic volatility in North America, leading to higher raw materials prices, a downturn in the automotive industry, and weaker demand for products, which would result in a 66% decline in KUO's EBITDA from its latest three-year average.
- We value KUO on a going-concern basis, given our view that the company's business diversification would represent a viable business model in the event of default.

Simulated default assumptions

- Simulated year of default: 2027
- EBITDA at emergence: MXN1.8 billion

- Implied enterprise value multiple: 5.0x

Simplified waterfall

- Net enterprise value (after 5% administrative costs): MXN10.0 billion
- Recovery rating: '3'
- Recovery expectations: 50%-90% (rounded estimate: 65%)

Rating Component Scores

Rating Component Scores

Component	
Foreign currency issuer credit rating	BB/STABLE/--
Local currency issuer credit rating	BB/STABLE/--
Business risk	4 - Fair
Country risk	3 - Intermediate Risk
Industry risk	3 - Intermediate Risk
Competitive position	4 - Fair
Financial risk	4 - Significant
Cash flow/leverage	4 - Significant
Anchor	bb
Diversification/portfolio effect	3 - Neutral/Undiversified
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Neutral
Comparable rating analysis	Neutral
Stand-alone credit profile	bb

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- General Criteria: National And Regional Scale Credit Ratings Methodology, June 8, 2023
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings list		
Upgraded		
	To	**From**
Kuo S.A.B. de C.V.		
Issuer Credit Rating	BB/Stable/--	BB-/Stable/--
CaVal (Mexico) National Scale	mxA/Stable/--	mxA-/Stable/--
Upgraded; Recovery Expectations Revised		
	To	**From**
Kuo S.A.B. de C.V.		
Senior Unsecured	BB	BB-
Recovery Rating	3(65%)	3(60%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.spglobal.com/ratings for further information. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings.