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Avon's transformation plans: Cleansing its corporate woes?

by Ernest SIM

Avon Products Inc. is the largest direct selling beauty company across the globe. Through Avon's 6mn worldwide brand representatives (independent contractors who earn a commission through sales), the company sells a range of products which include cosmetics, personal care and fashion products. In Q3 2015, the 130-year old beauty company reported an unexpected loss - the profit margin was in the red at -41.81%, a stark contrast to the previous quarter profit margin of 1.84% (see Table 1). Avon's earnings took a hit due to various reasons – taxes enacted in Brazil, one of Avon's top 10 markets by market share, as well as a strong US dollar impacting Avon's revenues. Furthermore, in North America, the declining number of active brand representatives continued to place a drag on Avon's topline.

3 months ending	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016
Profit margin (%)	1.84	-41.81	-20.74	-12.70	2.30
Operating margin (%)	5.73	1.38	3.91	0.60	6.63
EBIT to interest expense (X)	2.94	0.76	1.95	0.24	2.86
Total debt to T12M EBITDA (X)	4.44	5.71	8.69	7.66	7.50
Current ratio	1.37	1.38	1.07	1.38	1.47

Table 1: Financial data for Avon Products Inc. *Source: Bloomberg*

The drastic deterioration in profits had weakened Avon's credit profile substantially. The EBIT (earnings before interest, taxes) to interest expense ratio, fell from 2.94x in Q2 2015 to 0.76x in Q3 2015 while total debt to trailing 12-months EBITDA (earnings before interest, taxes, depreciation and amortization) increased from 4.44x in Q2 2015 to 5.71x in Q3 2015 (see Table 1). Reflecting the worsening creditworthiness of Avon, the RMI-CRI 1-year Probability of Default (PD) surged from 200 bps to above 400 bps on November 13, 2015 (see Figure 2).

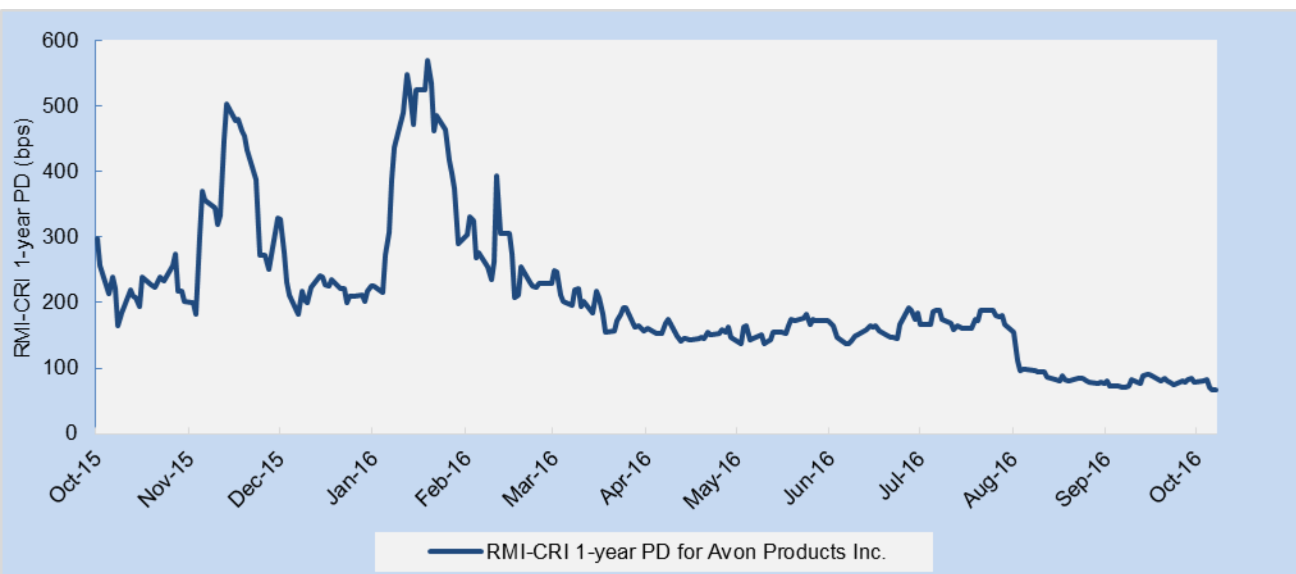

Figure 1: RMI-CRI 1-year PD for Avon Products Inc. *Source: RMI-CRI*

Following the downturn in its financial health, Avon conducted a strategic review before entering into a partnership with private equity firm Cerberus Capital Management, L.P. on December 17, 2015, selling an 80% interest in its faltering North American unit and 16.6% preferred equity in its global unit. With Avon's USD 605mn strategic partnership with Cerberus, the partnership presented Avon cash to bolster liquidity and to fund debt. Avon had since then displayed signs of recovery in its credit health and liquidity. Avon's current ratio grew from 1.07x in Q4 2015 to 1.47x in Q2 2016 (see Table 1). The EBIT to interest expense ratio increased from 1.95x in Q4 2015 to 2.86x in Q2 2016 (see Table 1). Total debt to trailing 12-month EBITDA has also decreased gradually since Q4 2015. Correspondingly, the PD has plunged, from a peak of above 500bps at the start of 2016 to under 100bps in Oct 2016 (see Figure 1).

While Avon seeks to improve its capital structure as it commits towards opportunistically reducing debt, other initiatives undertaken by the beauty company are aimed at increasing its earnings. Avon has rolled out a 3-year transformation plan that encompasses enhancing its brand by tapping the use of social media and adopting greater cost cutting measures with targeted cost cuts of USD 350mn. The beauty company's efforts to reduce costs centers on a revamp of IT infrastructure, downsizing of corporate structures as well as optimizing its supply chain infrastructure by paring back on its underutilized manufacturing and distribution facilities. Consequently, Avon's operating margin has rebounded, rising to 6.63% in Q2 2016 from 0.60% in Q2 2015, indicating an improvement in operational efficiency (see Table 1). The company's profit margin also increased to a recent Q2 2016 profit margin at 2.30% - the first positive profit margin in the past four quarters (see Table 1).

Looking ahead, despite Avon making headway through its divestment of some of its North American businesses as well as cost discipline, Avon's direct selling business should be reevaluated given its heavy reliance on representatives for growth in sales volume. Nonetheless, Avon's attempts to grow its brand through the use of social media campaigns to drive topline growth should be lauded although such benefits might take time before it gets pronounced.

Credit News

Botswana puts state-owned BCL Mine under liquidation on losses

Oct 8. Botswana's government will put its largest copper and nickel producer, BCL Mine Limited under provisional liquidation amid losses. The Mineral Resources Minister said that the government could not afford the cost required to keep the firm running. A decline in copper quality and the slump in commodity prices have made the cost of maintaining the mines unbearable. The government has applied to the high court to place the mine under provisional liquidation and will continue to pay the salaries of 5,000 workers. In 2015, BCL mine incurred a BWP 1.2bn loss in operating costs. (Reuters)

Venezuela's PdVSA bonds fall after lack of interest for debt-maturity extension

Oct 7. Petróleos de Venezuela SA (PdVSA) bonds fell after its proposal to extend the maturities on USD 5.3bn of its debt failed to garner sufficient interest from investors. In a news release, the state-owned oil company said that less than 50% of the aggregate principal amount of the bonds has been tendered. Struggling with reduced output and a decline in oil prices, the company had proposed to exchange up to USD 7.1bn of the two 2017 notes for a 8.5% bond maturing in 2020. The failure underscores investors' concerns about the country's reserves, which fell below USD 12bn while the country and the company faced USD 15bn of debt maturing in 2017. (WSJ)

Air-bag maker Takata weighs US bankruptcy filing

Oct 7. Takata Corp., the Japanese air bag supplier, which has been involved in numerous deaths and injuries, is said to consider a US bankruptcy filing as one option for addressing the ballooning recall costs and clearing a path for an outside investor. According to the management, the bankruptcy filing might help the firm negotiate an accord with auto makers, a move that allows Takata to strike a separate deal with a PE firm or automotive supplier currently bidding to give the company a fresh cash infusion. (WSJ)

Hanjin, Ashley Furniture battle over cargoes, storage fees

Oct 7. More than a month after Hanjin Shipping filed for bankruptcy protection, customers are still fighting with the company to retrieve their goods. Left with a logistical mess, Ashley Furniture Industries Inc is asking the court to withhold damages from fees it owes to Hanjin. The shipping company, however, refused to release Ashley's cargo until it is paid in full. Ashley Furniture had about 700 containers aboard Hanjin ships when the company filed for bankruptcy. In the aftermath of the bankruptcy filings, some ports were unwilling to unload Hanjin ships for fear they wouldn't be paid and Hanjin was reluctant to send some of its ships into ports in the US where they could be seized by creditors. (WSJ)

Swissco joins debt restructuring frenzy

Oct 5. With no exception for other ailing firms in the offshore sector, Singapore-listed rig and vessel chartering group Swissco Holdings announced yesterday that it is seeking to restructure USD 100mn worth of bonds, including a USD 2.85mn coupon payment due on Oct. 16, and that it has discussed with lenders and investors who hold redeemable exchangeable preferred shares in two Swissco's subsidiaries. Although the company has not mentioned its inability to pay the next coupon, some market analysts are concerned about its vulnerable cash position. (Straits Times)

Singapore court approves judicial management for troubled Swiber (Reuters)

Fitch cuts outlook for Wells Fargo to 'negative' (Reuters)

Indian rating downgrades drops to 5-year low (ET)

Regulatory Updates

Basel officials say some banks may face capital requirement increases

Oct 7. New guidelines by the Basel Committee may compel some banks to raise a significant amount of funds to meet capital requirements. Outlier banks, or banks whose risk weightings diverge considerably from the industry average, have been suspected of manipulating internal risk models to trim their own capital requirements. This practice of creating low risk weightings for outlier banks has led to a change of the existing capital adequacy framework. The new rules by the Basel Committee however, are so drastic that some regulators are concerned that lenders in their jurisdictions would be placed at a serious disadvantage to other banks. (WSJ)

US banks roll out callable bonds to meet Fed debt rules

Oct 5. Large US banks have issued callable bonds to meet the total loss absorbing capital (TLAC) requirement set by the Federal Reserve. The new feature, which allows the bond issuer to redeem the bond one year before maturity, is expected to become a banking industry standard. Policy makers want systemically important banks to reduce their reliance on short term funding so bonds with a one year maturity do not qualify as a TLAC instrument. The issuance of callable bank bonds have been well received by investors. According to recent bond sales, JP Morgan received USD 4.5bn of orders for its USD 2.5bn 5-year bond while Goldman Sachs received USD 7.6bn for its USD 2.25bn issue. (FT)

IFRS 9 an implementation challenge for APAC banks

Oct 4. According to Fitch, the migration to IFRS 9, or its local equivalent, is likely to create operational challenges across mfgany of Asia-Pacific's banking systems, as the new paradigm might have a negative initial effect on capital, and raise the volatility of earnings and regulatory capital ratios. IFRS 9, which will be implemented in 2018 for most major APAC markets, requires banks to switch to recognizing and providing for expected credit losses (ECL) on financial assets from the current practice of providing only when losses are incurred. (Reuters)

Deutsche Bank talks with Justice Department said to continue (Bloomberg)

ECB lowers emergency funding cap for Greek banks (Business Times)

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