Research Update:

United Natural Foods Inc. Upgraded To 'B+' On Improved Revenues And Leverage; Outlook Stable

October 15, 2021

Rating Action Overview

- U.S.-based wholesale food distributor United Natural Foods Inc.'s (UNFI's) higher earnings and free cash flow generation are driving an improvement in S&P Global Ratings-adjusted leverage.
- As a result, we raised our issuer credit rating on UNFI to 'B+' from 'B' and the senior unsecured notes rating to 'B-' from 'CCC+'.
- At the same time, we raised our rating on the company's $1.8 billion secured term loan due 2025 to 'BB-' from 'B.' The improved recovery rating reflects our expectation for substantial recovery ('2'; rounded estimate: 70%) in the event of default.
- The stable outlook reflects our expectation that the company will continue to improve its sales through cross-selling and new customer wins with adjusted EBITDA margins remaining in the low-3% area despite consumer behavior partly normalizing following the elevated demand during the pandemic. We also believe the company will continue to pursue debt reduction, with debt to EBITDA remaining around 4.5x on a sustained basis.

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Rating Action Rationale

The upgrade reflects UNFI's improved operating performance and credit metrics. The company continued to post strong results in fiscal 2021 (ending July 31, 2021), with fourth-quarter sales increasing about 1.6% from the third quarter thanks to market share gains driven by cross-selling between the company's conventional and natural businesses and customer wins as food-at-home demand remained robust throughout the year. The company's retail operations are also benefiting from a supportive grocery environment with retail sales growing about 3% year over year in fiscal 2021. The company was also able to improve its profitability during the year through operational efficiency gains, in particular by generating additional benefits from its 2018 Supervalu acquisition through reduced restructuring and integration-related expenses.

The company used its excess cash flow, including from asset sale proceeds, to reduce net debt by more than $300 million compared to the end of fiscal 2020. As a result, adjusted debt to EBITDA improved to 4.7x as of the end of fiscal 2021. While we anticipate sales growth to slow due to the

partial return to food away from home, we believe the company will continue to reduce leverage through earnings growth and debt pay-down with adjusted leverage remaining around the mid-4.5x area on a sustained basis. As such, we revised our assessment of the financial risk profile to aggressive from highly leveraged.

In our view, UNFI still faces challenges from its relatively low margins and customer concentration, despite its large scale. UNFI's profitability has improved but remains thin, with adjusted EBITDA margin in the low-3% area, about 70 basis points below its pre-Supervalu levels, and we expect profit levels to stay about flat over the coming 12 months as tailwinds are offset by labor and supply chain challenges. There is some upside potential over time as integration with Supervalu progresses and if the company can further leverage its scale in the growing natural and organic food distribution space.

In addition, in October 2020 the company announced a long-term supply agreement with Key Food Stores Co-Operative Inc. to serve as its primary grocery wholesaler with expected sales of approximately $10 billion over 10 years. We note persistent risks in the highly competitive wholesale food distribution space and, in particular, with UNFI's concentrated exposure to Whole Foods, which makes up nearly 20% of total sales with a contact that runs through 2027. Therefore we view the company's competitive position to be relatively worse than other rated 'BB-' peers. Therefore, we use a negative comparable rating analysis score that brings down the anchor score by a notch to 'b+' from 'bb-'.

Outlook

The stable outlook reflects our expectation that the company will continue to improve its sales through cross-selling and new customer wins with adjusted EBITDA margins remaining in the low-3% area despite consumer behavior partly normalizing following the elevated demand during the pandemic. We also believe the company will continue to pursue debt reduction, with debt to EBITDA remaining around 4.5x on a sustained basis.

Upside scenario

We could raise our rating on UNFI if:

- The company further improves its competitive standing in the industry including by sustaining its margins above the mid-3% area or having less customer concentration; or
- The company is able to maintain adjusted debt to EBITDA below 4x on a sustained basis.

Downside scenario

We could lower our rating on UNFI if:

- Operating results weaken with adjusted EBITDA margins declining by more than 50 basis points below our forecast, causing adjusted leverage to exceed 5x on a sustained basis; or
- The company's financial policy becomes more aggressive with a large debt-funded acquisition or share repurchases that would materially increase its leverage.

Company Description

UNFI is a leading distributor of natural, organic, and specialty foods; produce; and conventional grocery and nonfood products in the U.S. and Canada. The company operates through two reportable segments, wholesale and retail. It maintained 55 distribution centers and warehouses offering nearly 300,000 products consisting of national, regional, and private label brands as of July 31, 2021. The company serves approximately 30,000 unique customer locations, including customers acquired from the Supervalu acquisition, primarily located across the U.S. and Canada.

Our Base-Case Scenario

- S&P Global Ratings economists expect U.S. GDP will increase 5.7% in 2021 and 4.1% in 2022.
- We anticipate UNFI's total sales to grow to about $27.8 billion in fiscal 2022 due to food-at-home spending remaining elevated, increased cross-selling with existing customers, good prospects in the natural and organic segment, and assuming retail grocery operations are maintained.
- S&P Global Ratings' adjusted EBITDA margin will remain in the low-3% area as sales leverage and incremental benefits from the Supervalu integration are offset by higher benefit costs and continued pricing pressure in the highly competitive environment.
- We assume no share repurchases or dividends.

Although UNFI did not have pension debt before the Supervalu acquisition, we estimate that Supervalu adds about $500 million in after-tax multi-employer pension plan (MEPP) and single employer obligations that will remain for the retail and wholesale business. We adjust debt for MEPP liabilities and contributions. We consider the company's obligation to each MEPP as debtlike, and our debt adjustment includes our estimate of a company's share of the underfunded portion of each significant plan. We will be watching closely for further developments that could affect this liability stemming from the American Rescue Plan Act of 2021.

Liquidity

We view UNFI's liquidity profile as adequate. Although we forecast its liquidity sources will be about 2.6x its uses over the next 12 months and that net sources will remain positive even if EBITDA declines 15%, our assessment is limited by qualitative factors. Specifically, we anticipate the company would need to refinance its capital structure to absorb high-impact, low-probability adversities based on its high level of capital spending and reliance on its revolver to fund its substantial working capital needs.

Principal liquidity sources

- Cash and cash equivalents of about $41 million as of July 31, 2021;
- Cash funds from operations of about $400 million in the coming 12 months; and
- About $1.2 billion available borrowings under the $2.1 billion revolving credit facility at the end of fiscal 2021 (matures in 2023).

Principal liquidity uses

- Annual capital spending of $300 million-$325 million;

- Seasonal peak working capital borrowings of $200 million;
- About $15 million of mandatory debt amortization ; and
- No share repurchases assumed.

Covenants

The senior secured term loan does not require the company to maintain financial covenants but has certain other incurrence-based and negative covenants. The asset-based lending (ABL) credit facility is subject to a fixed-charge coverage ratio if availability on the revolver falls below either 10% of the borrowing base or $235 million, whichever is greater. Given the current revolver availability, we do not anticipate any covenant compliance issues.

Issue Ratings - Recovery Analysis

- We raised our rating on the company's $1.8 billion secured term loan due 2025 to 'BB-' from 'B'. The improved recovery rating reflects our expectation for substantial recovery ('2'; rounded estimate: 70%) in the event of default. Since last year's refinancing transaction, the company prepaid an aggregate of $ 271 million under its term loan facility with about $1 billion outstanding as of July 31, 2021. The facility is secured by a first-lien priority interest in all non-ABL collateral, including real property with certain exceptions, and a second-lien priority interest in ABL collateral, which also support the recovery rating.
- We do not rate the company's $2.1 billion ABL revolving credit facility. The borrowers under the ABL facility are United Natural Foods Inc. and United Natural Foods West Inc., and with respect to the Canadian tranche, UNFI Canada Inc. The U.S. tranche of the ABL is guaranteed by each wholly owned domestic subsidiary of UNFI and, with respect to the Canadian tranche, by each domestic and Canadian subsidiary of UNFI, with certain exceptions. The facility is secured by a first lien on U.S. and Canadian receivables and inventory and related assets (ABL collateral) along with a second-priority interest in substantially all other assets (excluding real estate).
- We raised our rating on the senior unsecured notes due 2028 to 'B-' from 'CCC+'. The '6' recovery rating on the notes is unchanged, indicating our expectation for negligible (0%-10%; rounded estimate: 0%) recovery in the event of a payment default or bankruptcy.
- Our hypothetical default scenario contemplates increased competition in Natural and Organic wholesale distribution, putting pressure on UNFI's market share and hurting sales volume and cash flows.
- We estimate a gross recovery value of about $1.9 billion assuming that by emergence the company will be able to reorganize itself and improve operating efficiency to a level that can generate about $292 million in emergence EBITDA. This represents a decline of about 50% from current levels. We further applied a 6.5x EBITDA multiple to reflect the company's operating platform in the food distribution business and also the level of real estate that the company owns.
- Simulated year of default: 2025
- EBITDA multiple: 6.5x.

Simplified waterfall

- Emergence EBITDA: about $292 million
- Less: Administrative expenses: about $95 million
- ABL-related claims: about $1.2 billion.
- Senior secured term loan claims: about $1.0 billion
- Recovery expectations: 70%-90% (rounded estimate: 70%)
- Unsecured notes claims: $523 million
- Recovery expectations: 0%-10% (rounded estimate: 0%)

*All debt claims include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating: B+/Stable/--

Business risk: Fair

- Country risk: Very low
- Industry risk: Intermediate
- Competitive position: Fair

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: bb-

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

Related Criteria

- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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**
United Natural Foods Inc.		
Issuer Credit Rating	B+/Stable/--	B/Positive/--
Issue-Level Ratings Raised; Recovery Ratings Revised		
United Natural Foods Inc.		
Senior Secured	BB-	B
Recovery Rating	2(70%)	3(65%)
Issue-Level Ratings Raised; Recovery Ratings Unchanged		
	To	**From**
United Natural Foods Inc.		
Senior Unsecured	B-	CCC+
Recovery Rating	6(0%)	6(0%)

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