Delta Galil Industries Ltd

April 10, 2024

Rating Affirmation

'ilAA-' Rating Affirmed; Outlook Stable

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Overview

Key Strengths	Key Risks
• Wide geographic spread. • Long-term relationships with leading apparel companies for brand development, design and production. • Relatively low leverage.	• Competitive environment. • Exposure to volatility in raw material prices and transportation costs. • Exposure to exchange rate fluctuations.

Revenue decreased for Delta Galil Industries Ltd. ("Delta" or "the Company") by about 8.6% in 2023, and its EBITDA margin slightly weakened. Revenue decreased due to a decline in sales in all of the Company's fields of operation excluding Delta Israel (neutralizing forex effects), due to the global slowdown that led to inventory accumulation by some of the Company's clients, and, as a result, to an increase, among other things, in discounts and promotions. In addition to the decline in sales that led to lower gross profit, the lower EBITDA margin was also due to the signing of new license agreements and new activities that will be launched in 2024, and to the devaluation of the Euro against the U.S. dollar. We note that despite a decrease in gross profit, the Company posted a higher gross margin in 2023 as a result of an improvement in its customer mix, lower transportation costs and higher rate of Direct to Consumer sales, mitigated by lower profitability in the Company's plants due to lower production volumes. In 2023, Delta posted an adjusted EBITDA margin of 12.3% compared to 13.5% in 2022. Its debt to EBITDA and FFO (funds from operations) ratios weakened to 2.6x and 31.3% from 2.4x and 35.3%, respectively. On the other hand, the Company posted a larger operating cash flow, largely due to lower inventory following the sale of previous years' inventory and slower acquisition of new inventory.

We estimate that 2024 will continue to be challenging against the backdrop of global macroeconomic conditions and low growth in Delta's countries of operation, which will likely result in only moderate growth in the apparel industry. We believe the Company's main challenge this year is the successful launch of brands and licenses acquired or signed in 2023, while balancing working capital needs and increasing its factories' utilization rate, in order to bring about an improvement in EBITDA margin after the decline mainly last year. We understand that 60%-70% of the clothing products the Company produces are basic products that do not depend on changes in trends in the apparel industry or on marcoeconomic conditions. As a result, the risk created due to the lower order volumes is mitigated by the Company's ability to reduce inventory over a longer period of time and without the need to offer significant discounts on products. We expect the Company to post an adjusted debt to EBITDA ratio of about 2x-3x and adjusted EBITDA interest coverage of about 8x-11x in 2024, both commensurate with the current rating.

Outlook

The stable outlook reflects our assessment that in the next 12 months, Delta will continue to post positive free cash flow alongside stable operating performance, adjusted debt to EBITDA of 2x-3x and EBITDA interest coverage significantly above 6x.

Downside Scenario

We may consider a negative rating action if the Company posts adjusted debt to EBITDA of 3.5x over time. This scenario could materialize, for example, if the Company makes debt-financed investments or distributes aggressive dividends. We may also consider a negative rating action the Company's operating performance weakens, or if long-term low demand in the apparel industry will be expressed, among other things, in higher-than-expected inventory levels and in working capital outflows. A deterioration in the Company's liquidity profile may also negatively pressure the rating.

Upside Scenario

We may consider a positive rating action if the Company's business and financial profiles materially improve, as reflected in its competitive position and EBITDA base, while it maintains an adjusted debt-to-EBITDA ratio below 2x over time.

Base Case Scenario

Key Assumptions

- 6.5%-7.5% sales growth in 2024 and 2025 against the backdrop of moderate organic growth in the apparel sector and following the launch of new brands and licenses, taking into account the competitive environment in the industry.
- Adjusted EBITDA of $255 million - $265 million in 2024 and $280 million - $290 million in 2025.
- Adjusted EBITDA margin of 13%-14% in 2024 and 2025, a slight improvement compared to 2023.
- Annual capex of $65 million - $75 million for maintenance, investing in new factories and in a logistics center and opening and renovating stores.

Key Metrics

Financial Metric	2023A	2024E	2025E
Debt/EBITDA	2.6x	2x-3x	2x-3x
FFO/debt	31.3%	30%-35%	33%-38%
EBITDA/interest expense	6.6x	8.0x-11.0x	8.5x-11.5x

A - actual. E – Estimate.

Base Case Projections

Sales growth and a slight improvement in profitability

We estimate that the Company’s sales will grow by 6.5%-7.5% in 2024 due to sales of new brands and licenses, a change in the product mix and moderate natural growth in the apparel industry following normalization of inventory levels among the Company's clients, alongside a lower volume of discounts compared to 2023. We expect this growth will lead to a certain temporary decrease in operating cash flow due to the Company's need to stock up on inventory.

We expect a 13%-14% adjusted EBITDA margin in 2024, compared with about 12.3% in 2023. This improvement will be supported, inter alia, by a higher utilization rate in the Company's factories, by cost-cutting processes that began in previous periods and are expected to bear fruit this year, and by lower raw material prices.

A slight decrease in existing financial debt

We believe the Company's planned investments, such as the investment required to launch the Bath & Body Works and Victoria's Secret brands in Israel and Passionata, as well as investments required to open and renovate stores, will not increase the Company's debt. We note that our base case scenario does not take into account material acquisitions, which if carried out may lead to higher leverage.

Company Description

Delta Galil Industries Ltd. is a public company founded in 1975 and first offered to the public in 1982. The Company is engaged in the design, development, production, marketing and sale of underwear products, socks, children's clothing and sportswear, as well as the development, production, design, marketing, distribution and sale of branded products in the jeans and outerwear categories and related products for women. The Company operates in four business sectors: Brands, Private label, 7 For All Mankind jeans brand and Delta Israel (public company, 80% holding). Bare Necessities and Organic

Basics activities are included under 'Others'. Most of the Company's shares are held directly and indirectly by Mr. Isaac Dabah (~49% of the Company's shares), by Mr. Noam Lautman (~10%), institutional investors and the public (~41%).

Business Risk

Delta Galil's business risk profile is underpinned by extensive geographic distribution reflected in sales in about 90 countries, in worldwide development, production and distribution centers and in long-term relationships with leading customers such as Skims, Nike, Victoria's Secret, Calvin Klein and Walmart. About 58% of the Company's sales in 2023 were attributed to the Company's brands (including Delta Israel, 7 For All Mankind and other licensed international brands) and the remainder to private labels and ‘other’. The apparel market is characterized by many years of growth on the one hand and by many competitors and intense price competition on the other. The Company sells its products through brand stores chains and retail chains as well as online. The Company's growth strategy includes, among other things, the acquisition of companies and brands in its fields of operation, the latest of which were the acquisition of the Organic Basics online brand, which sells environmentally friendly underwear and sportswear, in July 2022, and the acquisition of the Passionata brand, which markets women’s underwear, in 2023. In 2023 Delta also signed license agreements for the sale of several other brands starting in 2024, and opened Victoria's Secret and Bath & Body Works stores in Israel.

On the other hand, the Company’s business risk profile is constrained due to the fact that, as is common in the industry, the Company does not have long-term contracts with its customers, but it should be noted that the relationships with them last for many years, some over 25 years. In addition, the Company operates in a competitive environment that pressures profitability.

Delta is exposed to volatility in the prices of raw materials such as cotton and various synthetic materials, to transportation costs and to fuel prices. The Company is also exposed to exchange rates fluctuations as it operates in several currencies different from its operating currency (U.S.D), mainly the Shekel and the Euro, but it uses hedging to minimize this exposure. We assess the Company's fields of operation as competitive and therefore, when the prices of raw materials rise, its ability to raise prices for its customers is limited.

Financial Risk

Delta Galil's financial risk profile is underpinned by relatively low leverage reflected in an adjusted debt to EBITDA ratio of 2.6x, an FFO to debt ratio of 31.3% and an EBITDA interest expense coverage ratio of 6.6x in 2023. We believe that the fact that some of the products sold by the Company are basic products somewhat mitigates the volatility of its cash flows, as these are products are less subject to frequent changes in the apparel industry or in the macroeconomic situation, and therefore their inventory accumulated in previous years can be sold at small or no discounts at all. On the other hand, we believe that the macroeconomic conditions will remain challenging in 2024 against the backdrop of low growth in Europe, the U.S. and Israel, and will limit growth in the apparel industry. In addition, Delta is expected to invest in its new brands and licenses, increasing wage and rent expenses and partly offsetting the positive effects resulting from higher utilization rates in the Company's factories, from cost-cutting processes and from lower raw material prices.

Table 1.
Delta Galil Industries Ltd. – Financial Summary (Mil. $)
Industry Sector: Real Textile & Apparel

	2023	**2022**	**2021**	**2020**	**2019**
Revenue	1,857.7	2,031.5	1,951.0	1,446.2	1,690.2
EBITDA	228.9	275.1	291.1	116.7	197.7
Funds from operations (FFO)	185.1	231.2	242.5	81.8	158.9
Interest expense	34.5	32.7	35.2	32.6	33.9
Cash interest paid	31.2	26.9	33.1	33.0	30.6
Cash flow from operations	224.0	31.5	166.5	208.6	146.6
Capital expenditure	59.7	61.3	34.5	25.3	33.6
Free operating cash flow (FOCF)	164.3	(29.7)	132.0	183.3	113.0
Discretionary cash flow (DCF)	135.5	(61.1)	114.9	176.8	101.6
Cash and short-term investments	174.5	190.9	230.1	230.8	108.3
Gross available cash	174.5	190.9	230.1	230.8	108.3
Debt	591.3	655.2	600.6	782.5	703.9
Equity	768.4	710.3	649.2	476.4	506.9
Adjusted ratios					
Annual revenue growth (%)	(8.6)	4.1	34.9	(14.4)	12.8
EBITDA margin (%)	12.3	13.5	14.9	8.1	11.7
Return on capital (%)	10.9	14.2	15.4	1.0	10.4
EBITDA interest coverage (x)	6.6	8.4	8.3	3.6	5.8
FFO cash interest coverage (x)	6.9	9.6	8.3	3.5	6.2
Debt/EBITDA (x)	2.6	2.4	2.1	6.7	3.6
FFO/debt (%)	31.3	35.3	40.4	10.5	22.6
Cash flow from operations/debt (%)	37.9	4.8	27.7	26.7	20.8
FOCF/debt (%)	27.8	(4.5)	22.0	23.4	16.1
DCF/debt (%)	22.9	(9.3)	19.1	22.6	14.4

Liquidity

We are examining the Company's liquidity on an expanded stand-alone basis - excluding Delta Israel, since Delta is unable to service debt from its public subsidiary’s cash balances without a preliminary decision on dividend distribution. We assess the Company’s liquidity as “adequate”, based on our assessment that the ratio between the Company's sources and uses will exceed 1.2x in the next 12 months.

We estimate the Company's main sources and uses in the 12 months starting January 1, 2024, to be as follows:

Principal Liquidity Sources:	Principal Liquidity Uses
• About $80 million in cash and cash equivalents. • Cash FFO of $95 million - $105 million. • Dividends of about $7.1 million received from Delta Israel in February 2024.	• Short-term credit and ongoing maturities of long-term loans and bonds of about $55 million. • Maintenance and committed capex totaling $30 million - $40 million. • Dividends of about $9 million distributed in March.

Debt Maturities

Year	2024	2025	2026	2027	2028 onwards
Maturities (Mil. $)	55	51	51	36	95

Covenant Analysis

Compliance expectations

The Company has several covenants towards banks and bond holders. As of December 31, 2023, the Company had sufficient headroom on its financial covenants. We expect the Company to maintain sufficient headroom on all covenants in the near future.

Requirements

The Company’s financial covenants include, inter alia, an equity requirement of at least $180 million and a maximum debt to cap requirement of 60%.

Modifiers

Diversification/portfolio effect: Neutral

Capital structure: Neutral

Liquidity: Neutral

Financial policy: Neutral

Management and governance: Neutral

Comparable ratings analysis: Positive

Environmental, Social, And Governance

ESG factors are an overall net neutral consideration in our credit rating analysis of Delta-Galil Industries Ltd.

We consider the apparel industry to be increasingly subject to environmental and social concerns, including the environmental footprint and the labor conditions of the supply chain workforce, largely in lower-wage countries. This risks could lead to changing shopping habits and consumer preferences in the medium term, as well as increasing scrutiny from regulators, as envisaged in the U.S. and in Europe, which together represent about 80% of Delta's total revenue.

However, for now, the regulatory landscape is not yet so stringent that it would force the group to implement a fullscale circularity business model. This underpins our view that environmental issues remain a neutral consideration. The Company’s environmental target plan includes, among other things, a 25% reduction in the products’ average environmental footprint, 100% use of sustainable cotton and recycled polyester, zero hazardous chemicals and reduction in water consumption and wastewater recycling.

Recovery Analysis

Rationale

- We are affirming our ‘ilAA-’ rating, identical to the issuer rating, on unsecured bond series A and F. The recovery rating for these series is ‘3’.
- Our recovery prospect assessment is constrained to the 50%-70% range despite the simplified waterfall, due to our assessment that on the path to default the Company will exchange unsecured debt for secured or senior debt.

Simulated default assumptions

- Simulated year of default: 2029
- Heightened competition in the segments of operation or a sharp increase in raw material prices that Delta will not be able to pass on to its customers will negatively pressure the Company’s cash flows and liquidity, such that it is unable to meet its debt service payments.
- The Company will continue to operate as a going concern, an assessment supported by its geographical spread and by the wide variety of products it develops, produces and markets.
- In the process of the Company's deterioration, it will use 85% of its committed credit facilities.

Simplified Waterfall

- EBITDA at emergence: about $73 million
- Industry EBITDA multiple: 6.0x

- Gross enterprise value as going concern based on EBITDA multiple: about $438 million
- Administrative costs: 5%
- Available value to cover secured debt: about $416 million
- Secured debt claims: about $298 million
- Net value available for unsecured debt: about $118 million
- Unsecured debt claims: about $77 million
- Recovery expectations for unsecured debt: 50%-70% (constrained as noted above)
- Recovery rating for secured debt (1 to 6): 3

All debt amounts include six months' prepetition interest.

Mapping Recovery Percentages To Recovery Ratings

Recovery expectations (%)	Description	Recovery rating	Notching above/below issuer rating
100%	Full recovery	1+	+3 notches
90%-100%	Very high recovery	1	+2 notches
70%-90%	Substantial recovery	2	+1 notch
50%-70%	Meaningful recovery	3	0 notches
30%-50%	Average recovery	4	0 notches
10%-30%	Modest recovery	5	-1 notch
0%-10%	Negligible recovery	6	-2 notches

Recovery ratings are capped in certain countries to adjust for reduced creditor recovery prospects in these jurisdictions. Recovery ratings on unsecured debt issues are generally also subject to caps (see Step 6, paragraphs 90-98 of Recovery Rating Criteria For Speculative-Grade Corporate Issuers, December 7, 2016, for further detail). ICR--Issuer credit rating.

Reconciliation

In order to create a basis for comparison with other rated companies, we adjust the data reported in the financial statements which we use to calculate financial ratios. The main adjustments we made to Delta Galil Industries Ltd’s consolidated data for 2023 are as follows:

- Adjusting debt for pension obligations.
- Adjusting debt for bank guarantees due to rental agreements, royalty agreements and acquisitions of subcontractors and others.

Table 2.

Delta Galil Industries Ltd.--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. $) for the Fiscal Year Ended Dec 31, 2023

	Debt	Shareholders' equity	EBITDA	S&P Global Ratings' adjusted EBITDA	Cash flow from operations	Capital expenditure
Reported Amounts	**291.8**	**737.9**	**234.7**	**228.9**	**230.8**	**53.0**
S&P Global Ratings adjustments						
Cash taxes paid	--	--	--	(12.7)	--	--
Cash interest paid	--	--	--	(31.2)	--	--
Trade receivables securitizations	6.8	--	--	--	(6.8)	--
Reported lease liabilities	257.3	--	--	--	--	--
Postretirement benefit obligations/deferred compensation	4.1	--	--	--	--	--
Share-based compensation expense	--	--	2.1	--	--	--
Income (expense) of unconsolidated companies	--	--	(0.8)	--	--	--
Nonoperating income (expense)	--	--	--	--	--	--
Noncontrolling interest/minority interest	--	30.5	--	--	--	--
Debt: Guarantees	31.3	--	--	--	--	--
EBITDA: Other (situational)	--	--	(7.1)	--	--	--
EBIT: Other (situational)	--	--	--	--	--	--
Capital expenditure: Other	--	--	--	--	--	6.7
Total adjustments	**299.5**	**30.5**	**(5.8)**	**(43.8)**	**(6.8)**	**6.7**
S&P Global Ratings adjusted amounts						
	Debt	**Equity**	**EBITDA**	**Funds from operations**	**Cash flow from operations**	**Capital expenditure**
Adjusted	**591.3**	**768.4**	**228.9**	**185.1**	**224.0**	**59.7**

Related Criteria And Research

- Principles Of Credit Ratings, February 16, 2011
- Methodology: Industry Risk, November 19, 2013
- Country Risk Assessment Methodology And Assumptions, November 19, 2013
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, December 16, 2014
- Recovery Rating Criteria For Speculative-Grade Corporate Issuers, December 7, 2016
- Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Group Rating Methodology, July 1, 2019
- Environmental, Social, And Governance Principles In Credit Ratings, October 10, 2021
- Methodology For National And Regional Scale Credit Ratings, June 8, 2023
- Corporate Methodology, January 7, 2024

- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, January 7, 2024
- S&P Global Ratings Definitions, June 9, 2023

Ratings List

Delta Galil Industries Ltd.	Rating	Date when the rating was first published	Date when the rating was last updated
Issuer rating(s)			
Long term	ilAA-/Stable	27/03/2022	04/04/2023
Issue rating(s)			
Senior Unsecured Debt			
Series A,F	ilAA-	27/03/2022	04/04/2023
Issuer Credit Rating history			
Long term			
March 27, 2022	ilAA-/Stable		

Additional details	
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