

# Eye Care Centers of America Ratings Affirmed and Off Watch; New Ratings Assigned

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**Credit Rating:** B/Stable/--

## Rationale

On Jan. 19, 2005, Standard & Poor's Ratings Services affirmed its ratings on Eye Care Centers of America Inc., including the 'B' corporate credit rating. All ratings were removed from CreditWatch, where they were placed with developing implications on Dec. 7, 2004. The outlook is stable.

At the same time, Standard & Poor's assigned its 'B' bank loan rating to Eye Care Centers' proposed \$190 million secured credit facility. A recovery rating of '3' also was assigned to the loan, indicating that lenders can expect a meaningful recovery of principal (50%-80%) in the event of a default. In addition, a 'CCC+' rating was assigned to Eye Care's proposed \$150 million subordinated note issuance.

Proceeds from the credit facility and subordinated notes, along with \$163 million in equity contribution, will be used to fund the buyout of Eye Care Centers by Moulin International and Golden Gate Capital. Moulin International (unrated), a Hong Kong based optical frames manufacturer and distributor, will own a controlling equity interest in the company. Pro forma for the transaction, Eye Care will have about \$315 million in funded debt.

Ratings on the San Antonio-based specialty optical retail chain reflect Eye Care Centers' participation in the increasingly competitive and promotional optical retail

industry, its small size relative to key competitors, and high debt leverage. The company, which is the third-largest optical retail chain in the U.S., benefits from its satisfactory market position in the relatively stable, but highly competitive and fragmented, U.S. optical retail market. Eye Care faces strong competition from industry leader Luxottica S.p.A., owner of Lenscrafters and Cole Vision, which has much larger chains in terms of sales and store locations, and thus benefits from greater economies of scale. Still, industry fundamentals remain positive, supported by favorable demographics, product innovations, and the growing role of managed care in this industry. Eye Care Centers operates 377 stores, primarily in the superstore format, under nine different brands. The company's strategy to cluster stores in its target markets to maximize operating efficiencies has enabled it to attain the No. 1 or No. 2 share position in most of its largest regional markets.

Eye Care's focus on the value strategy has helped differentiate the company from its competitors. The company shifted its merchandising strategy in the fall of 2001 to middle and low price points from higher price points, including private-label sales. Operating performance has remained relatively stable over the past few years due to the good execution of the value strategy. Improved product assortment and inventory management, as well as increased promotions, has contributed to positive sales trends. Same-store sales increased 2.1% during the nine months ended Sept. 30, 2004, following a 0.3% decline in fiscal 2003. Although operating margins narrowed due to the increasing mix of lower-margin branded frames and costs related to store openings, profitability remains healthy, with operating margins exceeding 23%. Margins are expected to benefit from sourcing initiatives under a proposed supply agreement with Moulin International. Still, the optical retail environment has become increasingly promotional, and this could result in margin pressure in the future.

Pro forma for the transaction, debt leverage increases to about 6.2x from 5.1x for the 12 months ended Sept. 30, 2004, as the company will add about \$80 million of incremental debt. However, the preferred stock held by Golden Gate Capital has debt-like characteristics because of a put option that the company can exercise after four years and the potential that this could be refinanced with debt at Eye Care Centers. If the debt-like preferred is included in the leverage calculation, total debt to EBITDA is more than 7.0x. Cash flow protection measures are thin,

but adequate for the rating, with EBITDA interest coverage remaining at about 2.0x. Credit protection measures are expected to improve modestly over the next few years as Eye Care uses free cash flow to reduce debt, as required by the terms of the credit facility.

Eye Care Centers will become a subsidiary of Moulin International, but the combined company's business and financial profile does not differ materially from that of Eye Care alone. Moulin International, with \$160 million in sales and \$39 million of EBITDA in fiscal 2003, is a Hong Kong-based optical frames manufacturer and distributor, which will have a controlling equity interest in Eye Care. Pro forma for the acquisition, Eye Care represents the majority of Moulin's consolidated sales and EBITDA, at 69% and 58%, respectively.

#### *Liquidity.*

Liquidity will be adequately provided by cash flow from operations and availability under the proposed \$25 million revolving credit facility. Pro forma for the transaction, Eye Care will have full availability under the revolver, which matures in 2010. Debt amortizations are nominal at about \$1.65 million per year until the term loan matures in 2012. Due to capital spending to fund store openings, the company generates a modest amount of free cash flow, reaching about \$16 million in fiscal 2003. Cash flow from operations and availability under the revolver are expected to be sufficient to fund capital spending and working capital needs.

#### *Recovery analysis.*

The proposed bank loan is rated 'B', the same as the corporate credit rating, with a recovery rating of '3', indicating the expectation for a meaningful recovery of principal (50%-80%) in the event of a default. The \$190 million secured credit facilities consist of a \$165 million term loan due 2012 and a \$25 million revolving credit facility due 2010. The borrower will be Eye Care Centers of America Inc. and the loan will have a downstream guarantee from holding company ECCA Holdings Corp. and upstream guarantees from the borrower's direct and indirect domestic subsidiaries. The credit facility will be secured by a first-priority security interest in substantially all assets of the borrower, including the capital stock of its subsidiaries. The facility is expected to contain covenants including a minimum interest coverage ratio and a maximum

ratio of total consolidated adjusted debt to EBITDAR. Standard & Poor's expects Eye Care to have adequate cushion under these covenants.

Standard & Poor's simulated default scenario contemplates an increasingly competitive optical retail market, with larger competitors offering steep discounts to gain market share. This environment would cause a significant decline in sales and profitability at Eye Care. However, given the company's satisfactory position in many of its markets, we believe that Eye Care would continue to be a viable business and could be reorganized. The distressed scenario assumes a 300-basis-point interest rate increase and an additional 300-basis-point increase due to credit quality deterioration. By applying a 3.5x EBITDAR multiple, our simulated default indicates expected recovery of 50%-80%.

## Outlook

The outlook is stable. Adequate financial flexibility and stable operating trends provide support for the ratings. Eye Care's focus on a value strategy while pursuing moderate growth, along with planned debt reduction to improve credit protection measures, is expected to help mitigate increasing competitive pressures from much larger industry players.

## Ratings List

Corporate credit rating	B/Stable/--
Secured bank loan	B (Recovery rtg: 3)
Subordinated debt	CCC+

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