

Eye Care Centers of America Inc. Outlook Revised To Negative As Majority Owner Faces Petition

Rationale

On June 24, 2005, Standard & Poor's Ratings Services revised its outlook on Eye Care Centers of America Inc. (ECCA) to negative from stable.

The outlook revision follows the announcement that creditors of ECCA's majority shareholder, Moulin Global Eyecare Holdings Ltd., filed a winding-up (liquidation) petition against Moulin in a Hong Kong court. Although it currently appears that ECCA will be excluded from any debt restructuring agreement between Moulin and its creditors, Standard & Poor's believes that operating margins improvements previously anticipated from ECCA's supply agreements with Moulin now may not materialize. Furthermore, Standard & Poor's still has some concerns over possible spillover impacts resulting from the majority owner's financial difficulties, such as a potential change in control put or a buyout of Moulin's ECCA interest resulting in additional balance sheet debt.

The 'B' corporate credit, senior secured, and 'CCC+' subordinated debt ratings on San Antonio, Texas-based Eye Care Centers of America reflect the company's 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. Still, industry fundamentals remain positive, supported by favorable demographics, product innovations, and the growing role of managed care in this industry.

Credit Rating:
B/Negative/—

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Eye Care Centers operates 377 stores, primarily in the superstore format, under nine different brands. The company's strategy of clustering 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.

Operating performance has remained relatively stable over the past few years due to the good execution of a value strategy. Improved product assortment and inventory management, as well as increased promotions, have contributed to positive sales trends. Same-store sales increased 4.9% in the fiscal year ended Jan. 1, 2005, compared with a 0.3% decline in the prior year. Operating performance remained adequate in the first quarter ended March 31, 2005, with comparable-store sales increasing 2%. 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 21%. However, the optical retail environment has become increasingly promotional, and this could result in margin pressure in the future.

Following a leveraged buyout by Moulin and Golden Gate Capital in early 2005, debt leverage increased to about 6.4x for the 12 months ended March 31, 2005, from 5.4x the previous year, as the company added about \$80 million of incremental debt. 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 ECCA uses free cash flow to reduce debt, as required by the terms of its credit facility.

Liquidity

Liquidity is adequately provided by cash flow from operations and full availability under a new \$25 million revolving credit facility, 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 only a modest amount of free cash flow, which was about \$14 million in fiscal 2004. Cash flow from operations and availability under the revolver are expected to be sufficient to fund capital spending and working capital needs.

Recovery analysis

ECCA's bank loan is rated 'B', the same as the corporate credit rating, with a recovery rating of '3', indicating the expectation for a meaningful (50%-80%) recovery of principal in the event of a payment default. (See Standard & Poor's research report on ECCA dated Jan. 19, 2005, for the complete recovery analysis.)

Outlook

The outlook is negative. Ratings could be lowered if a change in control or buyout of the interest owned by Moulin in ECCA results in a deterioration of ECCA's financial profile. The outlook could be revised back to stable if ECCA's financial profile remains relatively unchanged following the resolution of Moulin's financial difficulties.

Ratings List

Outlook Revised To Negative

Eye Care Centers of America Inc.

	To	From
Corporate credit rating	B/Negative/—	B/Stable/—
Senior secured debt	B (Recov rtg: 3)	B (Recov rtg: 3)
Subordinated debt	CCC+	CCC+

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