

Eye Care Centers of America Inc. 'B' Corporate Credit Rating Affirmed; Off Watch Dev

Rationale

On July 12, 2006, Standard & Poor's Ratings Services affirmed its ratings, including its 'B' corporate credit rating, on San Antonio, Texas-based Eye Care Centers of America Inc. (ECCA) All ratings are removed from CreditWatch, where they were placed with developing implications on May 3, 2006.

The outlook is positive. The company's total funded debt outstanding was \$315 million as of April 1, 2006.

The rating affirmation is based on Standard & Poor's expectations that ECCA's financial profile will remain largely unchanged following its acquisition by HVHC Inc. (BB/Stable/—), a wholly owned subsidiary of Highmark Inc. (A/Stable/—), a provider of health care services in Pennsylvania. HVHC is a for-profit holding company that provides vision services and sells related merchandise through its wholly owned subsidiaries, primarily Davis Vision Inc. and Viva Optique Inc.

ECCA entered into a merger agreement with HVHC in May 2006. The merger transaction, valued at \$622.6 million, has been approved by the board of directors of both companies and is expected to close in the third quarter of 2006. Although ECCA will become a subsidiary of HVHC following the acquisition, each subsidiary will have its own financing with no cross guarantees, and with restrictions on dividends. Both HVHC and ECCA debt are also nonrecourse to the parent company Highmark. In addition, we believe that the degree of parent support will be limited despite its acquisition by a subsidiary of a company with a stronger credit profile.

The positive outlook reflects our expectation that potential synergies under HVHC's ownership could lead to sales and earnings growth over time. Purchasing costs synergies and overhead expense savings are expected to contribute to modest margin improvements. In addition, ECCA could benefit from

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B/Positive/—

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additional revenues from the inflow of Davis managed care customers into ECCA stores. There is opportunity to grow sales from vision managed care, as this accounts for about 33% of overall sales at ECCA, compared to 52% at Davis' vision retail stores.

The ratings on ECCA, a specialty optical retail chain, reflect its high debt leverage and thin cash flow protection measures, as well as its participation in the increasingly competitive and promotional nature of the optical retail industry, and its small size relative to key competitors.

ECCA, the third-largest optical retail chain in the U.S. as measured by net revenues, benefits from its satisfactory market position in the relatively stable and fragmented U.S. optical retail market. Industry fundamentals remain positive, supported by favorable demographics, product innovations, as well as the growing role of managed care in this industry. ECCA operates 385 stores primarily in the superstore format. The company's strategy to cluster stores in its target markets to maximize operating efficiencies has enabled ECCA to attain the No. 1 or No. 2 position in most of its largest regional markets. However, ECCA faces strong competition from industry leader Luxottica SpA, owner of Lenscraftster and Pearl Vision, which are much larger chains in terms of sales and store locations, and thus benefit from greater economies of scale. Still, ECCA's focus on the value strategy has helped differentiate the company from its competitors and achieve relatively consistent operating results.

ECCA's operating performance has remained relatively stable over the past few years due to the good execution of its value strategy. Improved product assortment and inventory management, as well as increased promotions have contributed to positive sales trends. Same-store sales increased 5% in the quarter ended April 1, 2006, and 3% in fiscal 2005. Margins have expanded modestly due to price increases, a shift to higher-margin products, and cost savings from its China direct sourcing initiatives. Still, the optical retail environment has become increasingly promotional in terms of pricing. Increased promotions by competitors can result in margin pressure.

Pro forma for the transaction, debt leverage remains high at over 6.0x for the 12 months ended April 1, 2006. 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. ECCA obtained an amendment to its existing senior secured credit facilities to gain waivers for the change in control, as well as permission to repurchase portions of its subordinated notes due 2015.

Liquidity

Following the transaction, liquidity will be adequately provided by cash flow from operations and availability under a \$25 million revolving credit facility. Debt amortizations are nominal until the term loan matures in 2012 at about \$1.65 million per year. Due to limited capital spending to fund store openings, ECCA generated modest free cash flow of about \$20 million in fiscal 2005. Cash flow from operations and availability under the revolver are expected to be sufficient to fund capital spending and working capital needs.

Recovery analysis

Standard & Poor's affirmed its 'B' bank loan rating and its '3' recovery rating on ECCA's \$190 million secured credit facilities, which consist of a \$165 million term loan facility due 2012 and a \$25 million revolving credit facility due 2010. (For the complete recovery analysis, see Standard & Poor's research report dated Jan. 19, 2005.)

Outlook

The outlook is positive. Ratings could be raised over the intermediate term if ECCA can achieve synergies from its affiliation with HVHC, resulting in a strengthening of its credit protection measures. The outlook could be revised to stable if positive synergies do not materialize or integration issues result in weaker-than-expected operating results.

Ratings List

Eye Care Centers of America Inc.

Ratings Affirmed And Removed From CreditWatch Developing

	To	From
Corporate credit rating	B/Positive/—	B/Watch Dev/—
Senior secured debt	B	B/Watch Dev
Recovery rating	3	3
Subordinated debt	CCC+	CCC+/Watch Dev

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