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Research Update:

Mattress Firm Holding Corp. Upgraded To 'B+' On Improved Operating Performance And Debt Reduction; Outlook Stable

Primary Credit Analyst:

Diya G Iyer, New York (1) 212-438-4001; diya.iyer@standardandpoors.com

Secondary Contact:

Ana Lai, CFA, New York (1) 212-438-6895; ana.lai@standardandpoors.com

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Research Update:

Mattress Firm Holding Corp. Upgraded To 'B+' On Improved Operating Performance And Debt Reduction; Outlook Stable

Overview

- Mattress Firm Holding Corp. continues to exceed our performance expectations and reduce debt faster than we anticipated.
- We are raising our corporate credit rating on the company to 'B+' from 'B'.
- We are also raising our issue-level rating on the company's term loan to 'B+' and on the company's asset-based revolver to 'BB' given our recovery ratings that remain unchanged.
- The stable outlook reflects our view that Mattress Firm will continue to gain market share and realize synergies from its Sleep Train and other acquisitions in the coming year.

Rating Action

On Sept. 24, 2015, Standard & Poor's Ratings Services raised its corporate credit rating on Houston-based specialty bedding retailer Mattress Firm Holding Corp. to 'B+' from 'B'. The outlook is stable.

Concurrently, we raised the issue-level rating on the company's term loan to 'B+' from 'B'. The '3' recovery rating is unchanged and indicates our expectation for meaningful recovery in the event of a payment default at the lower end of the 50% to 70% range. We also raised the issue-level rating on the company's asset-based revolver to 'BB' from 'BB-'. The '1' recovery rating is unchanged and indicates very high (90% to 100%) recovery in the event of a payment default.

Rationale

The upgrade reflects the company's credit metrics have strengthened ahead of our expectations primarily because of EBITDA growth and debt pay down using internally-generated cash. Mattress Firm paid \$55 million in revolver and term loan borrowings from excess cash flow during the second quarter of 2015, with continued strong top line gains from new and acquired stores. This is offset with drag on EBITDA margins from increased marketing and product costs as the company enters new markets but we expect those investments to result in continued profitability growth long term.

Through the latest quarter revenues were up 61.2% on account of unit growth

and comparable-store sales (comp) growth of 2.8% (versus a strong 9.7% growth in the second quarter of 2014). A 3.3% increase in average unit price drove comp growth and was partially offset by a 0.5% same-store unit decline. Growth from new units reflects acquisitions totaling 668 stores in 2014 and 71 new stores in the second quarter of 2015.

We believe Mattress Firm's strategy to grow via acquisitions remains effective, though recognize it has already doubled its store count in the past two years, and more than doubled sales and reported EBITDA between 2011 and 2014, taking share from smaller regional players. After nine acquisitions through 2014, we believe the company is now focused on integration and small bolt-ons for the rest of the year. We also expect Mattress Firm to continue to achieve sales lift from converting underperforming Mattress Discounters & Sleep Country stores (West Coast) to the Sleep Train banner, with 92 of 167 already rebranded. Other assumptions in our forecast for fiscal 2015 include:

- U.S. real GDP growth and real consumer spending growth in the low-single digits, helping drive low-single-digit growth in discounter transactions as pent-up demand moderates;
- More than 40% sales growth reflecting net new stores partly from acquisitions as well as increased store productivity;
- Flat gross margin but an increase in EBITDA margin following 2014 margin decline from marketing and other investments;
- No share repurchases in coming year; and
- About \$15 million annual acquisitions starting 2016.

Post-acquisition, Sleep Train continues to do well with low-double-digit comp growth. Mattress Firm has executed even on this larger integration effectively, with limited rebannered, already realizing \$10 million of the \$20 million of synergies originally expected by 2017. Overall, we believe the company's negative working capital model to fund growth and purchasing advantage relative to regional chains has helped Mattress Firm continue generating stronger free cash flow and credit metrics, resulting in an improved financial risk profile.

Overall, we do not expect the company to pursue significant mergers and acquisitions in the coming two to three years, assuming \$15 million for small annual bolt-ons. Mattress Firm has already deleveraged to 4.3x in the 12 months through the latest quarter from 5x following the acquisition. We expect leverage in the high-3x area, interest coverage in the mid-4x range, and funds from operations (FFO) to debt of 18% by fiscal year end.

Liquidity

Liquidity is "adequate", indicating that Mattress Firm should be able to withstand adverse market circumstances over the next 12 months while maintaining sufficient liquidity to meet its obligations.

Principal Liquidity Sources:

- Balance sheet cash of \$10.6 million as of the second quarter of 2015;

- Availability under its \$125 million revolver, with no borrowings through latest quarter; and
- Cash funds from operations of \$160 million.

Principal Liquidity Uses:

- Modest debt amortization;
- Capital expenditure of \$110 million 2015 and about \$90 million annually thereafter; and
- Use of excess cash for bolt-on acquisitions, assumed to be up to \$15 million annually,

Other relevant aspects of the company's liquidity, based on our criteria, are as follows:

- We believe liquidity sources will exceed uses by at least 1.2x or more over the next year;
- We expect net liquidity sources to be positive, even if forecasted EBITDA declines by 15%; and
- Light maturity schedule and no issues anticipated with credit facility covenant cushions.

Outlook

The stable outlook incorporates our assessment that Mattress Firm's credit metrics and market position could continue to improve over the next year if the company can continue to successfully integrate acquisitions and reduce debt ahead of our expectations. However, we believe execution risk is a major factor that could derail this aggressive strategy into new geographies, specifically related to the company's ability to maintain its margin profile as it grows. We also remain cautious on the industry's particular vulnerability to economic headwinds.

Downside scenario

We could lower the rating if performance falls significantly below our projections because of flat sales and margin contraction. Under this scenario, revenue growth would slow significantly and gross margin would shrink more than 100 bps, with leverage approaching 5x, accompanied by tightened liquidity, flat free operating cash flow, and interest coverage below 3.0x. We could also lower our rating if the company takes on additional debt to fund another sizable acquisition in the next year.

Upside scenario

To consider an upgrade, Mattress Firm would deliver performance well ahead of our expectations, with revenue growth 10 to 20 percentage points ahead of expectations and gross margin expansion of more than 100 bps. At that time, leverage would be in the low-3.0x range, interest coverage would be in the 6x range and FFO/debt would be in the high-20% area. We consider this scenario unlikely in the next year given acquisition integration and potential for further deals as part of the company's expansion strategy.

Ratings Score Snapshot

Corporate Credit Rating: B+/Stable/--

Business Risk: Weak

- Country Risk: Very Low
- Industry Risk: Intermediate
- Competitive Position: Weak

Financial Risk: Aggressive

- Cash Flow & Leverage: Aggressive

Anchor: b+

Modifiers:

- Diversification: Neutral (No Impact)
- Quality of Capital Structure: Neutral (No Impact)
- Liquidity: Adequate (No Impact)
- Financial Policy: Neutral (No Impact)
- Management and Governance: Fair (No Impact)
- Comparable Rating Analysis: Neutral (No Impact)

Recovery Analysis

Key analytical factors

- Our recovery analysis incorporates a simulated default scenario that contemplates a default occurring in 2019, which occurs because a significant decline in economy, increased costs, ineffective ability to manage growth, and a step-up in the competitive environment
- That said, we assume the company would emerge from a bankruptcy event and that lender recoveries would be maximized with the company as a going concern, and have valued the company using a 5x multiple applied to our projected emergence-level EBITDA
- The recovery rating assigned to Mattress Firm Holding Corp.'s \$125 million asset-backed lending (ABL) facility reflects both the senior position of the facility, the first-lien collateral pledge that includes working capital assets, estimated ABL borrowings on the path of default, and the impact of our estimated emergence valuation
- The recovery rating assigned to the \$720 million secured term loan reflects a combination of the estimated emergence value remain following the satisfaction of priority claims in conjunction with the facility's first-lien collateral pledge.

Simulated default assumptions

Standard & Poor's simulated default scenario contemplates a protracted decline in the economy with an associated decline in consumer discretionary income levels, which all leads to lower spending by consumers on bedding products and a steep decline in company sales and margins. Additionally, our default

scenario incorporates a significant increase in competition and an unprofitable expansion in adjacent markets.

Our simulated default scenario assumes:

- Availability under the ABL of approximately 60%, which takes into account the springing fixed-charge covenant that we think would apply in a distressed scenario. It also assumes an estimate for the company's borrowing base and the ABL is fully drawn up to the assumed level of availability;
- LIBOR increases by about 175 bps by 2019, our assumed year of default; and
- Margin on the ABL revolver increases by 100 bps, reflecting the simulated credit deterioration under our scenario and the fees or increased pricing associated with obtaining a waiver/amendment of financial covenants
- Estimated gross EV at emergence: \$525 million
- Simulated year of emergence: 2019
- EBITDA at emergence: \$105 million
- EBITDA multiple: 5x

Simplified waterfall

- Net EV after 5% administrative costs: ~\$500 million
- Valuation split % (obligors/nonobligors/unpledged): 100/0/0
- ABL and Priority claims: \$76.8 million
- Term loan facility claims: \$705.4 million*
- --Recovery expectations: 50%-70%

All debts amounts include six months of prepetition interest.

Related Criteria And Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Revised Revolver Usage Assumptions For Recovery Analysis In Corporate Ratings, Nov. 20, 2014
- Methodology For Applying Recovery Ratings To National Scale Issue Ratings, Sept. 22, 2014
- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Retail And Restaurants Industry, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

Ratings List

Upgraded

	To	From
Mattress Firm Holding Corp. Corporate Credit Rating	B+/Stable/--	B/Stable/--

Mattress Holding Corp.

Senior Secured

US\$720 mil term bank ln due 2021	B+	B
Recovery Rating	3L	3L
US\$125 mil asset-based revolver bank ln 2019	BB	BB-
Recovery Rating	1	1

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