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## Research Update:

# Sweden-Based SCA Hygiene Preliminary Long-Term Ratings Lowered To 'BBB+' On Proposed BSN Acquisition; Outlook Stable

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## Overview

- Svenska Cellulosa Aktiebolaget (SCA), the owner of SCA Hygiene has announced its intention to acquire BSN Medical, a Germany-based health care group, for €2.7 billion. We assume this company is going to be part of SCA Hygiene's perimeter.
- The acquisition will be entirely financed with new debt that we assume will be allocated to SCA Hygiene when its spin-off from SCA is completed, resulting in weaker credit metrics than is commensurate with an 'A-' rating.
- We are therefore lowering our preliminary long-term ratings on SCA Hygiene to 'BBB+' from 'A-' and affirming our preliminary 'A-2' and 'K-1' short-term ratings.
- The stable outlook reflects our view that the BSN acquisition has a mild positive impact on SCA Hygiene's business risk profile and that cash flow generation will be sufficient to maintain S&P Global Ratings-adjusted debt to EBITDA of 2.5x-3x over the medium term, after being above 3x in 2017.

## Rating Action

On Dec. 20, 2016, S&P Global Ratings lowered its preliminary long-term corporate credit rating on Sweden-based SCA Hygiene AB to 'BBB+' from 'A-'. The outlook is stable.

The preliminary 'A-2' short-term corporate credit and 'K-1' short-term Nordic regional scale ratings were affirmed.

At the same time, we lowered our preliminary issue ratings on SCA Hygiene's debt to 'BBB+' from 'A-'.

## Rationale

The downgrade follows SCA's announcement that it has made a firm proposal to acquire BSN Medical (BSN) for a total consideration of €2.7 billion. We understand that the transaction would be entirely funded with new debt. We assume that BSN will be integrated with SCA Hygiene, which is currently 100% controlled by SCA. The spin-off of SCA Hygiene from SCA is in progress and is expected to be completed after the shareholders' approval during the second quarter of next year.

We believe that the inclusion of BSN in SCA Hygiene has an incremental positive effect on SCA Hygiene's business risk profile. We assume it will add about 9% to the group's sales and increase the EBITDA margin by about 0.3% in the first year. This acquisition expands SCA Hygiene's product offering in the health care segment, which enhances the group's growth prospects for the coming years. It can be the first step to build a distinct revenue pillar (basic medical supplies) that over time could improve the diversity of earnings. We understand that most of BSN's products do not have technologically complex features, and this is consistent with SCA Hygiene's average product profile, which should make the integration of the two companies smoother. We believe that integration problems should be limited, given that BSN has a solid set-up in terms of product positioning and production processes. We do not envisage any significant effect on geographic diversity, since the geographic exposure of the two companies is similar.

The decision to finance the acquisition entirely through debt will lead to deterioration of SCA Hygiene's ratios, in our view. We project that, in 2017, the debt-to-EBITDA ratio will likely be at about 3.2x, while funds from operations (FFO) to debt will probably be below 30%. We expect debt to EBITDA will return to 2.5x-3x and the FFO to debt will improve to 30% in the following two years at the latest, provided that the company does not embark on new large debt-funded acquisitions.

We understand that the group maintains a commitment to a "solid investment-grade rating," but we consider that the increased focus on the personal care business after the spin-off from SCA might increase the ambition for external growth. In fact, we see that, in the personal care industry, there is a lot of merger and acquisition activity, and a few opportunities could arise over the next few years. The weakness of the ratios for the current financial risk profile is captured in our negative adjustment under our comparable ratings analysis.

In our base case, we assume:
- SCA Hygiene's sales growth in 2017 will be largely supported by strong growth in emerging markets, which constituted 41% of total personal care sales and 31% of total tissue sales as of June 30, 2016. Slower economic growth in Europe will limit sales growth, although higher penetration rates for incontinence products will likely boost sales in the personal care division. BSN's contribution will be limited to the second part of the year.
- Slightly weaker adjusted EBITDA margins in 2017, but still at about 16%, with very slow improvement in the following years as growth takes place in lower-margin emerging markets. Part of this should be offset by ongoing efficiency measures and by the inclusion of BSN, which should have a positive impact of about 0.3% on the group's EBITDA.
- Capital expenditure (capex) of about 6.0%-6.5% of revenues in 2016 and beyond.

- Pro forma dividends of Swedish krona (SEK) 3.5 billion-SEK4.0 billion (about €360 million-€420 million) per year in 2017 and 2018.

Based on these assumptions, we arrive at the following credit measures:

- Debt to EBITDA of 3.2x in 2017; and
- FFO to debt of about 25%.

We are aware that the proposed transaction is subject to antitrust approval, but given the nature of BSN's products, we do not see significant risks that the deal could be stopped for regulatory reasons.

### Liquidity

We assess SCA Hygiene's liquidity as adequate. The sources to uses ratio is at least 1.2x and we forecast that the gap between sources and uses would remain positive even if EBITDA declined by 15%. We continue to believe that SCA maintains solid relationships with banks, has good access to the capital markets, and can rely on different sources of funding.

Principal liquidity sources:

- Available cash, expected at about SEK3.6 billion at year-end 2016;
- FFO generated in 2017 estimated at about SEK14.5 billion;
- Undrawn bank lines maturing in 2019 and 2021 amounting to €2.0 billion (or SEK18.8 billion); and
- SEK26.4 million of debt issuance (initially bridge lines) to finance the BSN acquisition in 2017.

Principal liquidity uses:

- Debt maturities estimated at about SEK5.0 billion in 2017, taking into consideration short-term debt at SCA Hygiene and BSN;
- Working capital cash absorption estimated at about SEK150 million-SEK180 million in 2017;
- Maintenance capex expected at about SEK4.9 billion in 2017;
- SEK26.4 billion payment for the BSN acquisition;
- SEK3.9 billion dividend payment assumed in 2017; and
- An anti-trust provision in 2017, expected to amount to about SEK1.0 billion.

## Outlook

The stable outlook reflects our expectation that SCA Hygiene will slowly improve profitability in the next two years on the back of an increased focus on the hygiene activities and the successful integration of BSN. We realize that the integration of a completely new business can be challenging, but we observe that SCA Hygiene has a successful track record of past acquisitions. An adjusted FFO-to-debt ratio of at least 30%, and debt to EBITDA in the range of 2.5x-3x, would be commensurate with the current rating. We are aware that these targets will probably not be met in 2017 as an immediate consequence of the acquisition, but we believe they will be achievable over the next three years.

### Upside scenario

We could consider raising the rating if the group's credit metrics improved significantly over an extended period, for example, with FFO to debt well above 30% and debt to EBITDA at 2.5x. However, we believe that SCA has a growth focus, which might limit any pronounced improvement in the group's financial risk profile.

### Downside scenario

We could consider a negative rating action if SCA were to diverge materially from its established revenue and profitability trends, due for example to a significant deterioration of its position in key markets and products that translated into lower revenues and operating margin. This could trigger a review of the business risk profile and probably also affect the company's financial ratios and, in turn, our financial risk profile assessment. An aggressive financial policy that led to increased financial leverage, due to large debt-funded acquisitions or unexpectedly large shareholder distributions, pushing FFO to adjusted debt below 30% and debt to EBITDA above 3x for a prolonged period, could also trigger a negative rating action.

## Ratings Score Snapshot

Corporate Credit Rating: BBB+(Prelim)/Stable/A-2(Prelim)

Business risk: Strong
- Country risk: Low
- Industry risk: Low
- Competitive position: Strong

Financial risk:
- Cash flow/Leverage: Intermediate

Anchor: a-

Modifiers
- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Liquidity: Adequate
- Financial policy: Neutral
- Management and governance: Satisfactory
- Comparable rating analysis: Negative

## Related Criteria

- Criteria - Corporates - Industrials: Key Credit Factors For The Branded Nondurables Industry, May 07, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

## Ratings List

Downgraded; Ratings Affirmed

| | To | From |
|---|---|---|
| SCA Hygiene AB | | |
| L-T Corporate Credit Rating | BBB+(prelim)/Stable | A-(prelim)/Stable |
| S-T Corporate Credit Rating | A-2(prelim) | A-2(prelim) |
| Senior Unsecured | BBB+(prelim) | A-(prelim) |
| Nordic Regional Scale | K-1(prelim) | K-1(prelim) |

L-T--Long term. S-T--Short term.

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.