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Research Update:

Sweden-Based SCA Hygiene Preliminary 'BBB+/'A-2' And 'K-1' Ratings Affirmed And Extended; Outlook Stable

Primary Credit Analyst:
Barbara Castellano, Milan (39) 02-72111-253; barbara.castellano@spglobal.com

Secondary Contact:
Gustav Liedgren, Stockholm (46) 8-440-5916; gustav.liedgren@spglobal.com

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Research Update:

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Overview

- The spin-off of SCA Hygiene from Sweden-based forest and hygiene group SCA is still pending, and the transaction is expected to be completed after the shareholders' approval during the second quarter of 2017.
- The creation of SCA Hygiene has been completed and currently it is 100% controlled by SCA. At the end of November, the bondholders gave their consent to the transfer of SCA's existing bonds to SCA Hygiene.
- We believe that the spin-off process is proceeding in line with the company's initial guidelines and we are therefore affirming our preliminary 'BBB+/'A-2' and 'K-1' ratings on SCA Hygiene, and extending them for another three months.
- The stable outlook reflects our view that SCA Hygiene's operating performance and 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 Jan. 24, 2017, S&P Global Ratings affirmed its preliminary 'BBB+/A-2' long- and short-term corporate credit ratings and its 'K-1' short-term Nordic regional scale rating on Sweden-based SCA Hygiene AB and extended the ratings for another three months. The outlook is stable.

Rationale

The ratings on SCA Hygiene continue to reflect our view of the company's strong business risk profile and intermediate financial risk profile.

SCA Hygiene's business risk profile is supported by the group's strong market positions, stable profitability, limited product substitution risk, and positive demand growth prospects. Our assessment reflects the group's leading market positions in tissues (consumer and away from home) and personal care products (primarily baby diapers, but also feminine hygiene and incontinence products). These products are characterized by stable end-user demand in mature markets and have very good growth prospects in emerging markets as disposable incomes and living standards improve.

We believe that the inclusion of BSN Medical 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. SCA Hygiene has strong market positions in most markets and is the clear market leader in incontinence products. We expect the group will maintain an S&P Global Ratings-adjusted EBITDA margin in the range of 16% in the next years.

SCA Hygiene's financial risk profile is supported by the hygiene products division's track record of healthy and steady cash generation. We expect SCA Hygiene's capital expenditures (capex) will be about 6% of total sales moving forward. After the BSN acquisition, 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 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 are seeing a lot of merger and acquisition activity in the personal care market, 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 2017.
- 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.
- 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%.

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 Hygiene maintains solid relationships with banks, has good access to the capital markets, and can rely on different sources of funding.

Principal liquidity sources include:
- 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 include:
- 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 antitrust 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 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 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 Hygiene 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 Hygiene 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: Intermediate
- 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

Ratings Affirmed

SCA Hygiene AB	
Corporate Credit Rating	BBB+(prelim)/Stable/A-2(prelim)
Nordic Regional Scale	--/--/K-1(prelim)
Senior Unsecured	BBB+(prelim)

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com

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.