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Research Update:

Swedish Hygiene And Health Group Essity 'BBB+/A-2' Ratings Affirmed; Outlook Still Stable

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Overview

- In 2017 Essity benefited from the integration of BNS, helping the group cope with the increase in pulp price that affected particularly the Consumer Tissue division's operating performance.
- We believe that Essity will continue to post positive results in the Personal Care division in 2018, but pressure on the Consumer Tissue segment will persist, due to the still-rising raw material costs and industry overcapacity issues in Europe.
- We are therefore affirming our 'BBB+/A-2' and 'K-1' ratings on Essity.
- The stable outlook reflects our view that Essity's operating performance and cash flow generation will be sufficient to maintain adjusted debt to EBITDA below 3x in 2018 and thereafter.

Rating Action

On April 20, 2018, S&P Global Ratings affirmed its 'BBB+/A-2' long- and short-term issuer credit ratings on Sweden-based hygiene and health group Essity AB. The outlook is stable. At the same time, we affirmed our 'K-1' Nordic regional scale rating on the group.

Rationale

The affirmation reflects our expectation that Essity will continue to cope with the increasing pulp cost in 2018, following last year's demonstrated resilience when pulp cost rose sharply. This is thanks to having increased selling prices, in particular for consumer tissues, and the positive trend in demand in the personal care division.

The sharp increase in pulp cost in 2017 hit Essity's Consumer Tissue division (39% of 2017 sales), among the group's other productions that use pulp. However, at the same time, the group benefited from its enlarged presence in the medical solutions business, thanks to the acquisition of medical solutions company BSN and the positive trend in global demand for incontinence products. At end-2017, the group's reported comparable operating margin remained steady (11.8% versus 11.7% in 2016).

We note that Essity maintains a strong focus on cost structure efficiency. In 2017, under its "cure or kill" efficiency program, the group closed factories in baby care products in Mexico and in hygiene products in India. We believe that continued pressure on costs in the tissue division might lead the group to take new efficiency measures this year in order to achieve a leaner cost structure. We also assume that the medical service operations will continue to support the group's revenue growth and operating performance. We believe that the BSN integration will produce its full effect this year and that it will go smoothly.

Our analysis of Essity's creditworthiness incorporates the group's leading position in consumer tissues, professional tissues, baby care, feminine care, and incontinence products. In our view, several of the group's products are consumer staples, and the group benefits from the increasing penetration of higher hygiene standards in emerging markets. However, we note that large peers like Procter & Gamble and Kimberly Clark make competition fierce and that an increasing presence of white-label (generics) producers creates pressure on prices. We believe that the widening expansion in emerging markets offers growth prospects, but we believe that this might translate into some margin dilution, given the lower average profitability in these markets.

After the BSN acquisition, Essity's financial metrics approached the weaker end of our thresholds for the current rating. We note that Essity has completed several acquisitions in the past few years. Because we understand that the group is committed to maintaining an investment-grade rating, we assume that any significant new acquisition will be completed only if it does not trigger a downward revision of the financial risk profile.

In our base case, we assume:

- Essity's sales growth in 2018 will be supported by growth in emerging markets, which constituted 37% of total personal care sales and 34% of total tissue sales in 2017. In terms of products, we believe that medical solutions and incontinence products will continue to perform well. We expect overall revenue growth, including full year impact of BSN acquisition, of about 3.0%-3.5% in 2018.
- Total sales to increase by 1%-3% from 2019 and thereafter, primarily thanks to demand growth in personal care products in matured markets and emerging markets, while sales growth in consumer tissue and professional hygiene will slow, particularly in matured markets.
- An S&P Global Ratings-adjusted EBITDA margin at 17.0% in 2018, just slightly below the 2017 level, hindered by the higher raw material prices, particularly paper and pulp prices, in the Consumer Tissue segment and supported by the full effect of the BSN acquisition. However, we expect slow improvement in the following years as growth takes place in lower-margin emerging markets.
- Capital expenditures (capex) of about 6% of revenues in 2018 and beyond.
- Dividends of about Swedish krona (SEK) 4.0 billion in 2018 based on proposed dividend of SEK5.75 per share for this year. Thereafter, we expect dividends to increase by around 3%-4% annually from 2019.

- No significant acquisitions in 2018. We anticipate the group will spend SEK500 million and SEK1 billion on acquisitions in 2018 and from 2019, respectively.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures:

- Debt to EBITDA at 2.7x in 2018 and 2.4x in 2019
- Funds from operations (FFO) to debt at 28% in 2018 and 32% in 2019.

Liquidity

The short-term global scale rating is 'A-2' and the short-term Nordic scale rating is 'K-1'. We assess Essity's liquidity as strong. We project that Essity's sources of liquidity will cover uses by more than 1.5x for the next 12 months. We believe Essity demonstrates a high standing in credit markets; the group frequently issues bonds and has access to the commercial paper market (SEK15 billion Swedish program and €800 million Belgian program). Also, we believe Essity maintains solid relationships with its diverse and creditworthy banking groups.

Principal liquidity sources:

- Cash available of SEK4.1 billion at end-2017;
- Cash FFO of about SEK14.5 billion-SEK15.5 billion annually; and
- Two undrawn bank lines maturing in 2021 and 2023 totaling to SEK19.2 billion.

Principal liquidity uses:

- Debt maturities amounting to about SEK6.5 billion in 2018 and SEK6.0 billion in 2019;
- Working capital outflow of about SEK200 million-SEK300 million each year;
- Annual capex of about SEK6.5 billion-SEK7.0 billion each year;
- Dividends of SEK4.0 billion in 2018 and SEK4.2 billion in 2019; and
- SEK500 million acquisitions in 2018 and SEK1 billion in 2019.

Outlook

The stable outlook on Essity reflects our expectation that in 2018 it will maintain a stable or slightly declining operating margin. This is based on our view that the expected improvements in personal care coming from the full effect of the BSN acquisition will be offset by the increase in raw material costs, notably the rising pulp cost's impact on the consumer tissue division. We expect Essity to maintain an adjusted FFO-to-debt ratio at about 30% and debt to EBITDA below 3x, in line with the current rating.

Downside scenario

We could consider a negative rating action if Essity were to diverge materially from its established revenue and profitability trends, due a significant deterioration of its market position in key markets and products or due to the inability to cope effectively with the increase in raw material costs. This could result in weaker-than-expected cash generation, dropping the leverage ratios below the level consistent with the current rating. An aggressive financial policy that leads to increased financial leverage, due to large debt-funded acquisitions or unexpectedly large shareholder distributions, and pushes FFO to adjusted debt markedly below 30% and debt to EBITDA above 3x on a prolonged basis could also trigger a negative rating action.

Upside scenario

We could consider an upgrade if, thanks to a consistently solid track record in its three divisions, Essity generates very solid free operating cash flow and uses it to improve the leverage ratios, with FFO to debt improving to the upper end of the 30%-40% range and debt to EBITDA approaching the 2x range. We note that the achievement of these targets on a consistent basis depends also on the appetite for external growth. Considering the group's recent transactions, we understand that acquisitions remain essential to its growth strategy.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/A-2

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

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: bbb+

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)

- Comparable ratings analysis: Neutral (no impact)

Issue Ratings--Subordination Risk Analysis

All existing bonds have been issued by Essity AB, the rated entity. There is no relevant financial debt in other subsidiaries or vehicles and there are therefore no structural subordination issues.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - Industrials: Key Credit Factors For The Branded Nondurables Industry, May 7, 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: Methodology: Industry Risk, Nov. 19, 2013
- 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: 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. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Essity AB	
Issuer Credit Rating	BBB+/Stable/A-2
Nordic Regional Scale	--/--/K-1
Senior Unsecured	BBB+

Commercial Paper	K-1

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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.capitaliq.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.