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Research Update:

Sweden-Based SCA's Announced Spin-Off SCA Hygiene Assigned 'A-/A-2' Preliminary Ratings; Outlook Stable

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Overview

- Hygiene and forest products group Svenska Cellulosa Aktiebolaget SCA (SCA) has announced the creation of SCA Hygiene, which it intends to spin off following shareholder approval.
- SCA plans to transfer its existing bonds to SCA Hygiene, following bondholders' pending consent.
- We have assigned our preliminary 'A-/A-2' issuer ratings to SCA Hygiene, and are assigning our preliminary 'A-' issue rating to the senior unsecured bonds once they are transferred to SCA Hygiene.
- The stable outlook on SCA Hygiene reflects our view that it will be able to focus on growing the hygiene business, improving its profit margin, and generating healthy cash flow while maintaining adjusted debt to EBITDA at about 2.5x.

Rating Action

On Oct. 27, 2016, S&P Global Ratings assigned its preliminary 'A-/A-2' long- and short-term corporate credit ratings to SCA Hygiene, the hygiene company that Svenska Cellulosa Aktiebolaget (SCA) intends to spin off from the group. The outlook is stable.

At the same time, we assigned our preliminary 'K-1' short-term Nordic national scale rating to SCA Hygiene.

We are also assigning our preliminary 'A-' issue rating to the approximately €1.9 billion senior unsecured notes issued by SCA, once SCA transfers them to SCA Hygiene and they become its senior unsecured obligations.

Rationale

We understanding that SCA intends to spin off SCA Hygiene once it receives shareholders' approval--the vote will take place at the annual general meeting in April 2017. In the meantime, SCA Hygiene will exist as part of the group, and SCA will only transfer its existing bonds to SCA Hygiene if bondholders express consent. Additionally, during this transition phase, SCA will still offer a direct guarantee on the bonds and continue to own 100% of SCA Hygiene. If the spin-off is approved, SCA Hygiene will be independent from SCA, and we will convert our preliminary ratings on the company to final ones. At that point, there will be no more rated debt at SCA. Until the conclusion of the spin-off, we will continue to rate SCA on the basis of the current group credit profile that includes both the forest and the hygiene divisions.

We base our preliminary ratings on SCA Hygiene on SCA's group credit profile post spin-off.

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 tissue (consumer and away-from-home) and personal care products (primarily baby diapers as well as 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. SCA has strong market positions in most markets and is the clear market leader in incontinence products. We expect the group will maintain an 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 believe that the separation of the hygiene business from the forest products business reduces and stabilizes capital expenditures (capex) needed. We expect SCA Hygiene's capex will be about 6% of total sales moving forward. We believe that SCA Hygiene's ability to generate stronger free operating cash flow counterbalances the fact that large land and forest assets are going to remain in SCA's scope. We understand that SCA continues to be interested in external growth opportunities, and we assume that the size of potential acquisitions will be commensurate with maintaining adjusted debt to EBITDA at about 2.5x and fund from operations (FFO) to adjusted debt above 30%.

In our base case, we assume:
- SCA Hygiene's sales growth 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 end-June 2016. Slower economic growth in Europe will limit sales growth, although higher penetration rates for incontinence will likely boost sales in the personal care division.
- Slightly weaker adjusted EBITDA margins in 2016, but still at about 16% and very slowly improving in the following years as growth takes place in lower-margin emerging markets. Part of this should be offset by ongoing efficiency measures.
- Capex of about 6.0%-6.5% of the revenues in 2016 and beyond.
- Pro forma dividends being maintained between 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 on a pro forma basis at about 2.2x at year-end 2016 and 2.1x in 2017.
- FFO to debt of about 32% in 2016 on a pro forma basis, improving in the following years.

- Discretionary cash flow (DCF) to debt below 10% in 2016 and 2017.

Liquidity

We assess SCA Hygiene's liquidity as adequate. We expect sources to uses will be higher than 1.2x. We believe that the difference between sources and uses will be positive, even if forecast EBITDA declines by 15%, and we assume that the company will maintain good access to different financing sources, as SCA did.

We estimate that liquidity sources will include:
- SEK4.2 billion in cash available at SCA as of June 30, 2016, will be transferred to SCA Hygiene;
- Pro forma adjusted FFO of about SEK11.5 billion in 2016; and
- Undrawn bank lines maturing in 2019 and 2021 amounting to €2.0 billion or SEK18.8 billion (as of June 30, 2016).

We estimate that liquidity uses will include:
- Debt maturities of SEK11.0 billion for the 12 months from June 30, 2016;
- About SEK5 billion of debt to finance SCA's forest activities during the spin-off process, which will be repaid upon completion;
- Working capital cash absorption of about SEK100 million in 2016;
- Maintenance capex of SEK4.5 billion in 2016; and
- Dividends paid to SCA Hygiene's shareholders of SEK3.6 billion or 70% of 2016 free operating cash flow.

Outlook

The stable outlook on SCA Hygiene reflects our expectation that it will slowly improve profitability in the next two years on the back of increased focus on the hygiene activities. We expect that SCA Hygiene will be less capital-intensive than SCA pre-spin-off and consequently more cash-generative. Furthermore, we expect SCA Hygiene will maintain credit metrics near current levels, with an adjusted FFO-to-debt ratio of at least 30% and debt to EBITDA of about 2.5x.

Upside scenario

We consider an upgrade is unlikely over the next few years due to SCA's growth focus, which is likely to limit any pronounced improvement in the group's financial risk profile. However, we could consider a higher rating if the group's credit metrics improved significantly over an extended period, for example, FFO to debt of above 45% and debt to EBITDA of below 2x.

Downside scenario

We could consider a negative rating action if SCA were to diverge materially from its established revenue and profitability trends due a significant deterioration of its market position in key markets and products that translates in lower revenues and operating margin. This could trigger a review of the business risk profile and would probably also affect the financial ratios and the financial risk profile assessment. 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 below 30% and the debt to EBITDA above 2.5x on a prolonged basis could also trigger a negative rating action.

Ratings Score Snapshot

Corporate Credit Rating: A-(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 (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria And Research

Related Criteria

- Criteria - Corporates - Industrials: Key Credit Factors For The Branded Nondurables Industry - May 07, 2015
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012

- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013

Ratings List

New Rating

Sca Hygiene Ab

Corporate Credit Rating	A-(prelim)/Stable/A-2(prelim)
Nordic Regional Scale	--/--/K-1(prelim)
Senior Unsecured	A-(prelim)

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