Research Update:

Essity Affirmed At 'BBB+/A-2' On Sufficient Metric Headroom To Absorb Raw Material Price Volatility; Outlook Stable

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Rating Action Overview

- We expect Essity to effectively handle the current inflationary environment thanks to active sales price management supported by its strong branded portfolio, leading us to forecast the S&P Global Ratings-adjusted debt to EBITDA to remain below 3.0x.
- We revised up our management and governance assessment to strong from satisfactory, reflecting our view of Essity's management good track record executing its strategy consistent with the evolution of industry environment and company's internal capabilities.
- We affirmed our 'BBB+/A-2' long- and short-term issuer credit ratings and 'K-1' Nordic regional scale ratings on Essity.
- The stable outlook reflects our view that, despite inflationary headwinds, Essity will maintain credit metrics commensurate with the current rating, with adjusted debt to EBITDA within the 2.5x-3.0x range.

Rating Action Rationale

We believe Essity will contain profitability erosion arising from raw material price headwinds. We expect Essity will post an S&P Global Ratings-adjusted EBITDA margin of 16.0%-16.5% in 2021, representing a contraction of 330-380 basis points (bps) against the company's peak of 19.8% in 2020. The company is proactively mitigating the jump in prices of pulp (14% of company's total operating costs in 2020), energy (4%), and oil-based products (about 5%), alongside rising freight costs. Efforts include multiple sales price increases, ongoing cost-savings initiatives (expected in the low end of the Swedish krona (SEK) 500 million–SEK1,000 million by year-end 2021, according to management guidance), and new product launches with higher average sales price. We expect the sales price increase implemented by the company to take about 12-18 months to deliver full benefit on margins. As such, we believe profitability will only gradually improve to the 17.0%-17.5% area in 2022, absent any further substantial increase of raw material prices over the current levels.

We believe Essity's management will execute its strategy and achieve its revised financial targets, supported by its global brands and leading market share. During its capital market day on Nov. 3, 2021, Essity announced its revised growth target of more than 5% per year (including acquisitions) and confirmed its plan to achieve 17% return on capital employed by 2025, realized with structural cost-saving measures in procurement and manufacturing operations. In our view, Essity is well positioned to meet its targets as management is increasingly focusing on its branded offering (close to 85% of total sales according to our estimates), which includes well-known brands like Tork and Tena supporting innovations and premium prices. According to Essity's management, the group has increased its market share in almost 70% of its branded portfolio in the retail segment in the past 12 months. We believe Essity's management has a solid track record in strengthening the group's market shares in the recent years. According to Euromonitor, over the past four years Essity has further strengthened its No. 2 position in the retail hygiene market in Western Europe, with regional market share close to 12%, slightly narrowing the gap with leading player Procter & Gamble Co. (34.5% share of the regional market). We also observed similar trends in core emerging markets such as China and Latin America.

In our view, the newly announced reorganization of Essity's business divisions will help the group sharpen its consumer focus. The new divisions are Consumer Goods (61% of proforma sales in the nine months to September 2021), Professional Hygiene (21%), and Health & Medical (18%). We believe this change gives management more control of its end markets, translating into deeper consumer knowledge and ability to anticipate their changing preferences. We believe this will allow the company to further strengthen its competitive edge on sustainable product innovation. Furthermore, we expect this revised focus on customers, alongside its ongoing digital transformation, will ultimately support more effective forecasting and management of promotions in each countries with tangible benefits on Essity's inventory management and average sales price.

We expect Essity will sustain adjusted debt to EBITDA below 3.0x in 2021-2022, even in the event of additional bolt-on acquisitions. We acknowledge Essity's acquisition strategy will be centered on strengthening the performance in its core categories in each of the new divisions, prioritizing the expansion of the Health & Medical business area, in our view. Another pillar of the acquisition strategy is the penetration of adjacent categories such as skin care offering. Essity recently acquired from Johnson & Johnson three sports tape brands (in the Health & Medical division): Elastikon, Coach, and Zonas. We understand there is potential within the professional hygiene division to expand into new offering such as cleaning chemicals solutions. Our base-case scenario incorporates Essity's external growth plans. We understand the company remains committed to sustaining a solid investment-grade rating, which is grounded in an S&P Global Ratings-adjusted debt to EBITDA ratio below 3.0x. We currently believe Essity will keep its leverage slightly below this target in 2021 and close to 2.5x next year assuming some bolt-on acquisitions. Our base case does not consider any large debt financed acquisitions in the next 24 months.

Outlook

The stable outlook reflects our view that Essity will manage raw material price hikes thanks to its established brand portfolio supporting sales price increases and product innovation. We believe

Essity's operating performance will improve in the coming quarters thanks to the ongoing recovery in the professional channel as well as early effects of sales price increases. We also expect the group will maintain relatively solid credit metrics, with adjusted debt to EBITDA of 2.5x-3.0x.

Downside scenario

We could consider lowering the rating if, due to the current inflationary environment, consumers become a lot more price sensitive and shift to private-label products. Under this scenario we would expect Essity's market position to deteriorate and operating performance would likely weaken, translating into adjusted debt to EBITDA exceeding 3x and remaining there.

We could also consider a negative rating action if we were to observe an aggressive financial policy that led to increased financial leverage, because of large debt-funded acquisitions or unexpectedly large shareholder distributions, pushing debt to EBITDA above 3x for a prolonged period.

Upside scenario

We could consider an upgrade if, thanks to a consistently robust performance in its three divisions, Essity generates very solid free operating cash flow and uses it to improve its leverage ratios, with debt to EBITDA approaching 2x. Achieving these targets consistently also depends on the group's commitment to adapt its future debt-funded acquisitions to said targets.

Company Description

Essity is a Swedish health and hygiene group created when Svenska spun off its hygiene division in 2017. It produces, markets, and sells personal care and tissue products in over 150 countries worldwide. Its top brands include TENA for incontinence products, Tempo for consumer tissues, TORK in the professional business, and Leukoplast in the medical business.

As of today, Essity operates through three main divisions:

- Personal care (38% of 2020 sales). It includes adult incontinence products (global market leadership), baby care (such as baby diapers, pant diapers), and feminine care products (pads, panty liners, tampons), as well as medical solutions (wound care, compression therapy, and orthopedics) following the BSN acquisition in 2017. Its global and regional brands include Libero, Libresse, Nosotras, Saba, TENA, Leukoplast, and Jobst. Roughly 10% of the personal care sales are generated through retailers' brands (private label). It distributes personal care products through the retail trade, online sales, pharmacies, care institutions, hospitals, and e-commerce.
- Consumer tissues (41% of 2020 sales). Essity is the world's second-largest supplier of consumer tissues and offers toilet paper, household towels, handkerchiefs, facial tissues, wet wipes, napkins, and face masks. The group's own brands include Lotus, Tempo, Zewa, and Vinda. It also offers retailers' brands (32% of consumer tissue sales). It sells consumer tissue products through retailers and e-commerce.
- Professional hygiene (21% of 2020 sales). The group develops and markets complete hygiene solutions under the global leading brand Tork. These include toilet paper, paper hand towels, napkins, hand soap, hand lotion, hand sanitizer, tissue, soap, hand lotion, dispensers, cleaning and wiping products, and service and maintenance for companies and office buildings, universities, healthcare facilities, restaurants, hotels, and other public venues.

Essity shares are listed on Nasdaq Stockholm. Essity's market capitalization was US$23.3 billion as of November 2021.

Our Base-Case Scenario

Assumptions

- Essity's reported sales declining by 1.0%-1.5% in 2021. Our assumptions include limited organic growth of about 1.0%-1.5%, a roughly 0.5%-1.0% positive impact from the integration of Asaleo (six months consolidation), and negative 3%-4% FX headwinds. In our view, Essity's organic growth will be primarily driven by higher average sales prices in the consumer tissues and personal care segments to partly compensate input-cost hikes. In the professional hygiene division, we expect the sales rebound to continue in the fourth quarter, given less stringent lockdown measures in some of Essity's end markets such as hotels, restaurants, catering, commercial buildings, and schools.
- We believe the COVID-19 environment has increased consumers focus on hygiene, which will favor Essity's product categories such as tissues and hand towels and sanitizer in the next few years. We therefore estimate Essity's top line will expand at 5.0%-5.5% in 2022 on the back of more normalized activities in the professional hygiene business, higher average sale prices and full year consolidation of Asaleo.
- We expect the S&P Global Ratings-adjusted EBITDA margin to contract to 16.0%-16.5% in 2021 (19.8% in 2020). In our view, Essity's proactive approach to increasing sales prices and launching new products will partially contain further profitability erosion. We also factor in annual cost-savings of SEK500 million-SEK1,000 million. This includes the early effects of the Manufacturing Roadmap, leading to optimization of the production structure, productivity improvements, and raw material and energy savings that will be more evident from next year. These savings will be partly offset by costs associated with Essity's digital transformation plan (SEK1.4 billion over 2021-2024).
- S&P Global Ratings-adjusted EBITDA margin to increase to the 17%-17.5% range in 2022 as the group benefits from sales price increases, ongoing cost-savings, and improving operating leverage in the professional hygiene business.
- Relatively high working capital outflow of SEK1.5 billion-SEK 2 billion primarily reflecting the higher value of sales and inventories due to the raw material price increase.
- Annual capital expenditure of SEK7.0 billion-SEK7.5 billion over the next two years (about 6% of sales then reducing to around 5% from 2023). Our assumptions include SEK1.2 billion investment to support Essity's digital transformation, enabling value chain automation and greater predictability based on high-quality data collection and advanced analytics.
- SEK11.0 billion-SEK11.5 billion acquisitions in 2021, which primarily includes the acquisitions completed as of today such as ABIGO (25% remaining shares of SEK225 million), ASALEO for a total consideration of about SEK3.5 billion (63.8% of remaining shares), Productos Familia (acquiring 45.8% additional shares to reach 95.8% ownership) for about SEK6 billion and sports tape brands from Johnson & Johnson. We estimate SEK5.0 billion in annual acquisitions from 2022 onward.
- Dividends to Essity's shareholders of about SEK 4.7 billion in 2021 (SEK5.0 billion-SEK 5.5 billion including dividends to minorities). In 2022 we assume annual dividends to Essity's shareholders to rise to SEK5.0 billion-SEK5.2 billion.

Key metrics

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures over 2021-2022:

- Adjusted Debt to EBITDA of 2.5x-3.0x; and
- Adjusted free operating cash flow to DEBT of about 10% in 2021 and recovering to the 15%-20% range from 2022.

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)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Strong (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 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, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Full Analysis: Essity AB, Sept. 6, 2021

Ratings List

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