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Research Update:

Denmark-Based Medical Technology Company Coloplast A/S Assigned 'BBB' Rating; Outlook Stable

May 5, 2022

Rating Action Overview

- Coloplast A/S is a global leader in intimate health care including developing and marketing of medical technology products, with revenue of about Danish krone (DKK) 19.4 billion and reported EBITDA of about DKK7.0 billion in 2021.
- Coloplast operates in a highly resilient industry with cash flow stability and credit metrics supported by stable market growth trends via demographics and long-standing customer loyalty, as well as expansion into other therapeutic areas following the recent acquisition of Atos Medical (global leader in voice and respiratory treatments).
- The acquisition, from PAI Partners, had an enterprise value of €2.16 billion and was structured as a cash payment including a €3.0 billion debt financing package with a bond bridge (€2.20 billion) and a revolving credit facility (RCF; €800 million). We understand that the bridge will be replaced by senior unsecured debt issuance of the same amount.
- We assigned our 'BBB' long-term issuer credit rating to Coloplast.
- The stable outlook reflects our view that the company will continue to deliver solid operating performance and cash flow supported by its business strategy, with high customer retention and stable EBITDA margins and expected S&P Global Ratings-adjusted debt to EBITDA in the lower end of the 2x-3x range in 2022-2023.

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Rating Action Rationale

Coloplast's technology leadership and resilient business model in intimate health care bring cash flow predictability and stable credit metrics. Coloplast focuses solely on developing and marketing products in intimate health care, and its investments in product innovation and technology have yielded solid revenue growth, with a 7% compound average growth rate (CAGR) since 2012. Furthermore, the group has diversified its portfolio of therapeutic areas with the acquisition of Atos Medical (global leader in voice and respiratory care). We expect Coloplast to have underlying revenue growth of 4%-8% over our forecast horizon and adjusted EBITDA margins to be in the mid-30% range, mirroring the expected market demand and its leading position in the industry. We view market share development in the group's specialized field as stable thanks to the high barriers to entry in the high value segments of chronic treatments, including strong technological and innovation capabilities to meet customer preferences. Coloplast's continuous investments in research and development (R&D) will secure its competitiveness in a technologically advanced markets such as chronic care. The group invests about 4% of sales in R&D, enabling it to retain its market share, with late gains in the share from new product launches and acquired assets. Coloplast's chronic care business model (about 80% of group sales in 2021) is supported by economic trends including an aging population, health care consumerism, and digital transformation, while sales and EBITDA is somewhat offset by price pressure, health care reforms (including reimbursement reforms and the introduction of tenders), and channel consolidation.

Coloplast operates in a highly competitive landscape with several larger global competitors and ongoing market consolidation. Our assessment of the group's business risk factors in intense competition from several global competitors. Although Coloplast is the No. 1 player globally in ostomy care (35%-40% estimated global market share) and continence care (40%-45%), the group ranks No. 4 in interventional urology (15%) and No. 5 in wound and skin care (5%-10%). We compare Coloplast with rated companies such as Johnson & Johnson, Smith & Nephew, and Stryker, which have competing products in adjacent or selected parts of the medical technology sector. These entities are somewhat larger and have more diversified manufacturing capabilities in other technological advanced areas with significantly larger operational and financial resources. This means they can invest significant amounts in product development, brand marketing, and other discretionary spending items to offset ongoing market consolidation. Furthermore, we view scale as an important factor, supporting the companies' pricing power, since the general industry trend is toward a continued reduction in health care spending. We estimate the group will experience price pressure of up to negative 1% annually with ongoing reimbursement reforms in the U.S. and the Netherlands (mainly affecting ostomy care and continence care segments) and France (wound care).

We expect Coloplast's record of optimizing its portfolio and cost management to support margin stability despite global economic issues. Despite the intimate health care sectors being negatively affected by ongoing reforms with tenders and price pressure, the group's equipment sales and operating performance remain resilient due to its strong market position and focus on product innovation to meet customer demand. We expect revenue and EBITDA growth to be driven by the increasing rollout and digital products to further capture market share in less competitive emerging markets. Although the pandemic cut into the volume of elective surgeries globally, the group's adjusted EBITDA margins remained at or above 36% in 2020 and 2021. However, we estimate they will slightly drop to 34%-35% in 2022 from raw material inflation, including increasing freight and energy costs. This will be partially offset through long-standing contracts with clinicians in hospitals, which we expect to further recover with the full return of elective surgeries in all business regions. Coloplast's adjusted EBITDA margins could recover based on a successful mix of productivity gains and operating efficiencies including a gradual reduction in restructuring costs.

A limited track record of larger debt-financed acquisitions and deleverage capacity constrains the rating on Coloplast. We expect adjusted debt to peak at about DKK17.9 billion in 2022. This includes external debt, credit institution fees, and modest lease and postemployment obligations, while being offset by unrestricted cash balances. Our rating assessment incorporate Coloplast's commitment to maintain a strong investment-grade balance sheet. Historically, the group's adjusted leverage level has been at or below 0.3x, and it has a limited track record of executing larger debt-financed acquisitions. We include in our base-case scenario smaller bolt-on mergers and acquisitions (M&A) because we expect the group will continue to focus on distribution channel improvements, portfolio expansion to adjacent areas, and early-stage technologies. Furthermore, the group will continue its dividend payouts to shareholders and executing share repurchase activities. We see potential rating upside if the group fully commits to deleveraging comfortably below 2x over larger discretionary spending activities. We forecast that EBITDA growth and strong free operating cash flow (FOCF) should enable adjusted debt to EBITDA of 2.0x-2.5x in 2022-2023. We view positively in our rating assessment Coloplast's ability to generate strong free cash flow based on moderate working capital and capital expenditure (capex) requirements. We forecast capex will increase over the next 12-24 months as the company invests in machinery and equipment to meet heightening demand for equipment installations and facilitate IT logistics with the integration of Atos Medical.

Atos Medical will complement Coloplast's existing portfolio and allows operational synergies with limited restructuring costs to support growth. The acquisition was completed Jan. 31, 2022, and will add to Coloplast's voice and respiratory operations. Headquartered in Sweden, Atos Medical is present in more than 75 countries with about 1,200 employees. It has a track record of high-single-digit organic growth, solid EBITDA margins, and high cash conversion. In 2021, Atos' pro forma sales (including 2021's acquisition of Tracoe Medical Group) was roughly Swedish krona (SEK) 2.2 billion and it recorded a SEK0.8 billion company-adjusted operating profit. Following the acquisition, Coloplast gains access to a new chronic care division, which will operate as a separate strategic business. Atos' segmental split is roughly 67% in laryngectomy, treatment of advanced laryngeal and hypopharyngeal cancer, and 33% in tracheostomy, a surgical procedure that creates an opening in the neck for direct access to the windpipe (trachea) to facilitate breathing. Atos is present in 30 countries and has a global market share of 80% in laryngectomy. It has limited competition due to high entry barriers, strong relationships with clinicians in hospitals, frequent personal engagement with users, and a loyal chronic user base. The global laryngectomy market had a 10% CAGR from 2015-2020, which we expect will continue for Atos due to increasing treatment penetration and consumption in existing markets and significant opportunities in new markets, for example Brazil, South Korea, and China. We assess the acquisition as credit-supportive for Coloplast due to new long-term growth prospects in a category with significant untapped market potential. Coloplast's management expects estimated run-rate operational synergies of up to DKK100 million from using existing infrastructure, with the full impact estimated in 2023-2024. Coloplast also estimates integration costs of up to DKK200 million split over 2022-2024, of which the vast majority relate to IT investments. We estimate that the acquisition will have a minimal margin dilution effect at the group level and low execution risks.

The operational and sustainability focus will spur Coloplast's long-term value creation. In 2020, the group announced its renewed business strategy (Strive25) focusing on four main areas: innovation, unparalleled efficiency, sustainability, and leadership and culture. During the strategy period, ending in 2025, Coloplast will continue to spend up to 2% of annual revenue in incremental innovation and commercial activities to drive growth and the group's value creation agenda. The most important initiative in this strategy period is to deliver on the clinical performance program in chronic care, and launch clinically differentiated products. The business strategy will mainly have a geographical focus in the U.S. and Chinese markets, with efficiencies targeted mainly in commercial execution, automation, seamless supply, network, and footprint. The group also wants to become more cost efficient in terms of distribution and packaging. A key strategic theme is automation at Coloplast's volume sites in China and Hungary. The aim is to be headcount neutral on a group level at all the manufacturing sites by year-end 2022-2023 while accommodating growth in production lines. Coloplast expects to see a positive scale effect in the business support organization spurred by further use of the group's business center and investments in IT. As a part of Strive25, the group has integrated sustainability into its corporate strategy. It has set two new priorities for sustainability: improving products and packaging and reducing emissions. It will invest up to DKK250 million allocated to sustainability efforts during the Strive25 period to become net-zero in scope 1 and 2 emissions and use 100% renewable energy.

S&P Global Ratings acknowledges a high degree of uncertainty about the extent, outcome, and consequences of the military conflict between Russia and Ukraine.

Irrespective of the duration of military hostilities, sanctions and related political risks are likely to remain in place for some time. Potential effects could include dislocated commodities markets--notably for oil and gas--supply chain disruptions, inflationary pressures, weaker growth, and capital market volatility. As the situation evolves, we will update our assumptions and estimates accordingly. See our macroeconomic and credit updates here: Russia-Ukraine Macro, Market, & Credit Risks. Note that the timing of publication for rating decisions on European issuers is subject to European regulatory requirements.

Outlook

The stable outlook on Coloplast reflects our view that the company's leading market positions and strong brand portfolio should enable it to sustain positive underlying revenue growth and maintain long-term S&P Global Ratings-adjusted EBITDA margins at or above 35%. The outlook also reflects our base-case assumption that Coloplast will continue to generate strong cash flows with S&P Global Ratings-adjusted debt to EBITDA of 2x-3x in 2022-2023.

Downside scenario

We could lower the rating if S&P Global Ratings-adjusted leverage is consistently at or close to 3x fuelled by large debt-funded acquisitions or material increases in investment needs or operational decisions to support the group's development that negatively affect margins. We could also lower the rating if Coloplast's operating performance weakens due to deterioration in its competitive position.

Upside scenario

We could upgrade the group if it outperforms our base-case scenario on strong growth in underlying revenue and market share with material improvement in its margins. We could also consider a positive rating action if Coloplast implements a more conservative financial policy with a track record of sustaining adjusted leverage comfortably at 1.5x-2.0x rather than discretionary spending.

Company Description

Founded in 1957 and headquartered in Denmark, Coloplast is a global leader in intimate chronic health care, involved with the development and marketing of medical technology products. It operates via five business segments: ostomy care, continence care, wound and skin care, interventional urology, and, following the acquisition of Atos Medical, voice and respiratory care.

Coloplast operates through 50 sales and manufacturing subsidiaries and is present in more than 80 countries, with roughly 58% of group sales in fiscal 2021 coming from European markets, followed by other developed markets (25%) and emerging markets (17%). For fiscal 2021 revenue was DKK19.4 billion while the company reported EBITDA of DKK7.0 billion. Coloplast is listed on the Danish Stock Exchange.

Our Base-Case Scenario

Assumptions

- Because of the Russia-Ukraine conflict, we forecast that global economic growth will slow to 3.4% this year and 3.2% in 2023. We expect U.S. GDP growth of 3.2% in 2022 and 2.3% in 2023 and eurozone growth of 3.2% in 2022 and 2.4% in 2023. For China, we forecast GDP growth of 4.8% in 2022 and 5% in 2023. However, many other countries in the emerging markets group will see their GDP remain well below year-end 2019 levels. We also expect higher and more persistent inflation following rising energy prices.
- For fiscal 2022, we expect revenue growth of 10%-15% with a high-single-digit positive contribution from the consolidation of Atos Medical. Excluding the acquisition, we estimate underlying growth of 4%-8% in the next two years.
- Higher input costs and some supply chain disruption. We expect margins to gradually improve in the medium term driven by operational synergies from the Atos acquisition, strong cost discipline, and continued efficiency improvements.
- S&P Global Ratings-adjusted annual FOCF will be DKK4 billion-DKK 5 billion in 2022-2024. This assumes capex of 4%-5% of sales and net working capital requirements of 23%-24% of sales.
- Smaller bolt-on M&A and continuing dividend payments aligned with its existing financial policy.
- S&P Global Ratings-adjusted net debt will be DKK17.4 million-DKK17.9 million in 2022-2024. This includes borrowings, credit institution fees, and leases, offset by unrestricted cash balances.

Key metrics

- Adjusted debt to EBITDA improving to slightly below 2.5x in 2022 and the lower end of 2.0x-2.5x in 2023.
- Adjusted funds from operations (FFO) to debt comfortably above 30% for 2022 and 2023, improving to close above 35% in 2024.
- Adjusted FOCF to debt of more than 24% in 2022 and 2023, improving close to 30% in 2024.

Liquidity

We assess Coloplast's liquidity as strong, assuming the following:

- Liquidity sources to uses for the upcoming 12 months of 1.5x or more and remaining above 1.0x over the subsequent 12 months following the acquisition of Atos Medical.
- Sources remaining higher than uses, even if forecast EBITDA declines by 30%.
- Sufficient covenant headroom for forecast EBITDA to decline by 30% without the group breaching coverage tests, and debt at least 25% below covenant limits.
- The likely ability to absorb high-impact, low-probability events without refinancing.
- Well-established, solid relationships with banks.
- Generally prudent risk management.

Sources of liquidity over the next 12-24 months include:

- Cash on the balance sheet of DKK800 million-DKK900 million as of Dec. 31, 2021.
- Undrawn RCF of about DKK5.9 billion maturing 2025.
- Positive FFO of DKK5.5 billion-DKK6.0 billion in next 12 month.
- A cash inflow, due to working capital changes, of DKK30 million-DKK35 million.

Uses of liquidity include:

- Annual capex of about DKK1.4 billion in the next 12 months.
- Dividends of about DKK4.0 billion-DKK4.5 billion in the next 12 months.

Covenants

The RCF will have a maximum 4.0x leverage financial covenant. We expect Coloplast to maintain at least 30% headroom on this covenant.

Environmental, Social, And Governance

ESG credit indicators: E-2, S-2, G-2

ESG factors have had no material influence on our credit rating analysis of Coloplast. The group is a leading medical products provider specialized in intimate health care. Coloplast's strong competitive position as a market leader and healthy cash flow allows it to focus on product innovation, user retention, and manufacturing capabilities, which underlines the value of the group's product offering. The company aims to mitigate its carbon footprint focusing on long-term sustainability through lean supply chain management, improvements in products and packaging, and reducing its carbon emissions. We view the group's governance, ownership, and management structures as sound, enabling forward-looking strategy development and decision-making, and view its ESG policy and targets as well-defined.

Issue Ratings - Subordination Risk Analysis

Capital structure

By year-end 2022, Coloplast's debt is expected to total about DKK17.2 billion including the senior unsecured debt of €2.2 billion (equivalent to DKK16.4 billion).

We understand the debt will be issued by Coloplast A/S and Coloplast Finance B.V. and will replace the existing bridge finance loan.

Analytical conclusions

We understand that Coloplast does not have material secured or priority debt obligations. Accordingly, we do not anticipate that subordination risks will affect the rating on the unsecured debt.

Ratings Score Snapshot

Issuer Credit Rating	BBB/Stable/--
Business risk:	Satisfactory
Country risk	Low
Industry risk	Low
Competitive position	Satisfactory
Financial risk:	Intermediate
Cash flow/leverage	Intermediate
Anchor	Bbb
Modifiers:	
Diversification/Portfolio effect	Neutral
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Strong
Management and governance	Satisfactory
Comparable rating analysis	Neutral
Stand-alone credit profile:	bbb

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

- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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

Ratings List

New Rating;	
Coloplast A/S	
Issuer Credit Rating	BBB/Stable/--