Research Update:

Coca-Cola HBC AG Outlook Revised To Negative On Weaker Credit Metrics From Russian Business Suspension; Ratings Affirmed

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Rating Action Overview

- On March 8, 2022, the Coca-Cola Co. (TCCC) announced the suspension of its Russian business operations following the military intervention in Ukraine. Russia and Ukraine account for about 21% of total volumes and 20% of total EBIT for Coca-Cola HBC AG (CCH), the exclusive license-holder of TCCC-related products in the region.
- In addition to this sizable disruption in earnings and cash flows, CCH will invest in the integration of the recently acquired Coca-Cola Bottling Company of Egypt S.A.E. (CCBCE), and it faces general high commodity cost inflation.
- We forecast materially weaker credit metrics in 2022, with S&P Global Ratings-adjusted EBITDA margins of about 12.5%-13.0% and weaker free operating cash flow (FOCF, after lease payments) generation that should translate into S&P Global Ratings-adjusted debt to EBITDA close to or slightly above 2.5x.
- We revised our outlook to negative from stable and affirmed our 'BBB+/A-2' long- and short-term issuer credit ratings on CCH. We also affirmed our 'BBB+' issue ratings on its senior unsecured notes.
- The negative outlook reflects reduced rating headroom and relatively higher volatility compared with our previous base case. We could lower the rating on CCH over the next 18-24 months if, for example, S&P Global Ratings-adjusted debt to EBITDA approached 3.0x with no prospects for rapid improvement.

Rating Action Rationale

We anticipate material disruptions coming from the suspension of TCCC's business in Russia. Russia and Ukraine together accounted for about 21% of CCH's total volumes (2.4 billion unit cases) and about 20% of total EBIT (about €799 million) in 2021. Russia alone represented about 15.5% of volumes and generates about €1 billion in annual sales. Given the uncertainty regarding the duration of the announced TCCC's business suspension, and with the ultimate decision resting with TCCC, we estimate an overall drop in revenue for CCH of at least 10% in 2022 to about €6.4 billion, and reduced adjusted EBITDA margins to about 12.5%-13.0% (15.7% in 2021), since Russia is also one of the most profitable markets for the group. We project materially weaker FOCF versus previous levels due to lower operating profit and working capital outflows from the business interruption. Moreover, in January 2022, CCH completed the cash-funded acquisition of CCBCEfor $427 million, with potential further adjustments for milestone payments and minority share purchases. We forecast adjusted debt to EBITDA close or slightly above 2.5x in 2022. The group's financial policy with a target leverage (company's reported net debt to comparable EBITDA) of 1.5x-2.0x supports the current rating, although we assume it will take more time for it to reduce leverage to within this publicly stated target.

We assume higher volatility around our base case, including the integration of CCBCEand high commodity cost inflation. CCBCE is set to contribute about €400 million (euro-equivalent) in annual sales in a large and high-growth market, but its operating margins are lower than the group average. CCH intends to invest in the business in order to improve profitability toward its average levels, but this brings additional investment and execution risks. The commodity cost inflationary environment is an additional challenge. Although CCH retains leading (No. 1 or No. 2) market positions in its geographies thanks to the very strong brand equity of the Coca-Cola products, we think these headwinds could put additional pressure on its EBITDA margins, cash flow conversion, and credit metrics. For 2023, once the company absorbs the shock from 2022's sharp volume reduction from TCCC's Russian business suspension, we project a return to overall revenue growth of about 5%-7% and we anticipate a gradual and moderate improvement of adjusted EBITDA margins to about 13.0%-13.5% with improved annual FOCF generation of over €250 million.

We highlight additional risks coming from the future of the Russian operations beyond 2023. CCH will face renewal for its licenses with TCCC, including in Russia, at the end of 2023. It operates 10 production plants with 56 production lines in the country. The renewal decision ultimately rests with TCCC and we have very limited visibility about the final possible decision. In our current base case, considering the track record of renewal at maturity, we assume the license to be extended beyond 2023. However, depending on the final arrangements between TCCC and CCH, we will evaluate their effect on the company's business and credit metrics, acknowledging additional volatility around our base case.

Under our base case, we expect leverage to remain below 3.0x thanks to the strong brand equity power of Coca-Cola portfolio brands and good geographical diversity, supporting the current ratings. We anticipate organic revenue growth in key geographies to somewhat mitigate the decline from revenue in Russia in 2022. Growth should come from Nigeria, Egypt, and continued recovery in the foodservice channel in established markets following the easing of pandemic lockdown restrictions throughout 2021. We also anticipate the company will maintain a prudent approach to discretionary spending. We assume reduced capex of about €400 million in 2022 given the suspension of the large and highly profitable Russian market. CCH has a good execution track record and an ability to outperform its addressable market and gain market shares with balanced growth in terms of volume, price, and product mix. We also note that the company's business risk profile relies on the strong brand equity power of the Coca-Cola brand with dominant value market share in the sparkling category (74% of total CCH's total revenue), close to 50% on average across its key markets. There is good geographic diversity with presence in both mature and emerging markets, with the top five countries (Russia, Italy, Nigeria, Poland,

and Romania) accounting for about 50% of annual sales in 2021.

Outlook

The negative outlook reflects the expected material weakening in credit metrics 2022 mainly coming from the suspension of the Russian business operations and headwinds from the inflationary environment. In this context, the negative outlook indicates a reduced rating headroom than previously anticipated combined with relatively higher volatility. Under our projections, we anticipate adjusted debt to EBITDA to increase close or slightly above 2.5x (up from our estimates for 1.3x-1.4x in 2021), with an annual FOCF of €50 million-€100 million for 2022.

Downside scenario

We could lower our ratings on CCH over the next 18-24 months if we observed sharper-than-expected decline in profitability such that our adjusted net debt to EBITDA reaches 3.0x with no prospects for a rapid improvement. This could materialize if suspension-related costs in Russia are higher than anticipated, for example, or if the company is not able to mitigate the high inflationary pressures through effective pricing and product mix adjustments.

Upside scenario

We could revise the outlook to stable if CCH maintains adjusted debt to EBITDA comfortably below 3.0x. This scenario could stem from a gradual improvement in profitability from 2023 onward associated with healthy cash flow generation. This would demonstrate CCH's ability to navigate the short-term disruption of Russian operations, the integration of its activities in Egypt, and headwinds coming from the current inflationary environment.

Company Description

Headquartered in Switzerland, CCH is a branded beverages manufacturer of sparkling drinks, waters, juice, ready-to-drink tea, energy, coffee, and others. The company produces and distributes most of its products (about 96% of total revenue) under an exclusive license from TCCC (A+/Negative/A-1) for select countries. CCH is the third-largest Coca-Cola bottling company globally by volumes, producing 2.4 billion units per year from 56 manufacturing plants in 28 countries (as of Dec. 31, 2021). In January 2022, the company completed the acquisition of Coca-Cola's Egyptian bottling company. TCCC has suspended its operations in Russia due to the fallout of the Russian military conflict with Ukraine. CCH in its current form traces back to 2000, when Greece-based Hellenic Bottling Company S.A. merged with Coca-Cola Beverages Ltd.

The company reports its results under three geographical segments:

- Established markets (Austria, Cyprus, Greece, Italy, Northern Ireland, Republic of Ireland, and Switzerland) – 24.4% of total volumes, 34.6% of reported revenue, and 36.2% of reported EBIT in 2021.
- Developing markets (Baltics, Croatia, Czech Republic, Hungary, Poland, Slovakia and Slovenia) – 17.2% of total volumes, 19.1% of reported revenue, and 12.9% of reported EBIT in 2021.
- Emerging markets (Armenia, Belarus, Bosnia and Herzegovina, Bulgaria, Egypt [from 2022

onward], Kosovo, Moldova, Montenegro, Nigeria, Romania, Russia, Serbia, and Ukraine) – 58.3% of total volumes, 46.4% of reported revenue, and 51% of reported EBIT in 2021.

CCH's main markets in 2021 were Russia, Italy, and Nigeria, which together accounted for about 42.6% of total volumes. In 2021, CCH reported total net sales revenue of about €7.2 billion (€6.1 billion in 2020) and adjusted EBITDA of approximately €1.1 billion (€1.05 billion in 2020).

As of Dec. 31, 2021, TCCC owns approximately 21% of CCH's share capital; Luxembourg-based private investment holding company Kar-Tess Holding holds a further 23%; and the remainder is freely floating on the London (premium listing) and Athens stock exchanges.

Our Base-Case Scenario

Assumptions

- Close to 10% net revenue decline, to about €6.4 billion in 2022, due to the Russian business suspension and Ukraine business disruption. This will be only modestly offset by the consolidation of the recently acquired Egyptian Coca-Cola bottler. We project a return to revenue growth of about 5%-7% in 2023, with stronger revenue growth in established markets mainly stemming from the planned sugar and plastics tax implementation in Italy (about 12%-13% of total company sales in 2021). Considering the very limited visibility around the duration of the suspension of Russian operations, we conservatively assume no sales contribution for 2023.
- Drop in adjusted EBITDA margins to about 12.5%-13.0% in 2022, primarily due to the effect of the suspended operations on operational leverage and the dilutive impact from the lower-margin Egyptian bottling business and commodity cost inflation. We assume margins will slightly improve in 2023, assuming some operational and inflationary pressure normalization.
- For 2022, we assume some working capital outflows linked to suspended Russian operations and we assume annual capex of close to €400 million. Our FOCF forecast for 2023 contemplates annual capex of about €430 million-€450 million with normalized working capital movements.
- Common ordinary dividend distribution of about €260 million in 2022, subject to shareholder meeting approval, and our assumption for 40%-50% of ordinary dividend distribution from 2023 onward, in line with the company's publicly stated target policy.
- About €400 million-€420 million cash outflows linked to the acquisition of the Coca-Cola Egyptian bottling company in 2022, and no acquisitions in 2023.

Key metrics

- Adjusted net debt to EBITDA close to or slightly above 2.5x in 2022, with a modest decline in 2023; and
- Reported FOCF (after lease payments) of about €50 million-€100 million in 2022 and more than €250 million for 2023.

Liquidity

We continue to assess CCH's liquidity profile as strong, reflecting our calculation that sources of cash should exceed uses by more than 1.5x over the next 24 months, with no material debt maturities until November 2024 when its €600 million 1.875% fixed-rate senior unsecured notes are due. This is further supported by the group's well-established track record in accessing capital markets and bank financing. CCH is not subject to any financial covenants.

We expect principal liquidity sources for the 12 months from Dec. 31, 2021 will include:

- €800 million of committed available undrawn revolving credit facility (RCF) maturing beyond the next 24 months;
- Available cash and cash equivalents of about €1.6 billion; and
- Our forecast of cash funds from operations (FFO) of €610 million-€630 million in 2021 and €660 million-€680 million in 2022.

We expect principal liquidity uses over the same period will include:

- About €381.7 million of short-term debt within the 12 months from Dec. 31, 2021, and €53 million within the subsequent 12 months;
- Cash acquisition outflows of about €400 million-€420 million for the acquisition of the Egyptian Coca-Cola bottling company, of which about €390 million incurred in January. This amount is subject to final adjustments, including milestone payments for performance in 2021 and further minority stake acquisitions by CCH;
- Our forecast of net annual working capital outflows of €160 million-€170 million, including intrayear swings of about €100 million;
- Our forecast of annual capex of €400 million-€450 million; and
- Ordinary cash dividend distribution of about €260 million in 2022, subject to board approval; we assume ordinary dividend payout of 40%-50% from 2023 onward.

Issue Ratings - Subordination Risk Analysis

Capital structure

CCH's capital structure chiefly comprises €2.4 billion of senior unsecured notes, issued out of its financial subsidiary, Coca-Cola HBC Finance B.V.; €160 million of finance leases; and long- and short-term bank loans.

Analytical conclusions

We rate the outstanding senior unsecured notes 'BBB+', in line with the issuer credit rating on CCH, supported by limited subordination risk in the capital structure. The finance leases and local bank loans are considerably lower than the 50% threshold of overall debt that is commensurate with a notching for subordination risk under our methodology.

Ratings Score Snapshot

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

Business risk: Satisfactory

- Country risk: Moderately High
- Industry risk: Low
- Competitive position: Satisfactory

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 additional impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

- Group credit profile: bbb+
- Entity status within group: Moderately Strategic (+1 notch)

ESG credit indicators: E-2, S-3, G-2

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
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013

- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

- Coca-Cola HBC AG's Credit Profile Can Absorb Proposed Acquisition Of Coca-Cola Bottling Co. Of Egypt, Aug. 16, 2021
- Coca-Cola HBC AG, April 26, 2021

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Coca-Cola HBC AG		
Issuer Credit Rating	BBB+/Negative/A-2	BBB+/Stable/A-2
Coca-Cola HBC Finance B.V.		
Senior Unsecured	BBB+	
Commercial Paper	A-2	