S&P Global
Ratings

RatingsDirect®

Research Update:

Consumer Health Group Reckitt Benckiser Downgraded To 'A-/A-2' On Agreement To Acquire Mead Johnson; Outlook Stable

Primary Credit Analyst:
Maxime Puget, London (44) 20-7176-7239; maxime.puget@spglobal.com

Secondary Contact:
Barbara Castellano, Milan (39) 02-72111-253; barbara.castellano@spglobal.com

Table Of Contents

Research Update:

Consumer Health Group Reckitt Benckiser Downgraded To 'A-/A-2' On Agreement To Acquire Mead Johnson; Outlook Stable

Overview

- Hygiene and consumer health group Reckitt Benckiser Group PLC (RB) is acquiring infant nutrition manufacturer Mead Johnson in an all-cash transaction totaling $17.9 billion.
- In our view, this acquisition will enable RB to diversify in the high-margin branded infant nutrition business and gain leading market positions in the U.S. and Asia.
- We are lowering our long- and short-term corporate credit ratings on RB to 'A-/A-2' from 'A+/A-1' and removing the ratings from CreditWatch.
- The stable outlook reflects our view that the strong free cash flow capacity of the combined entity should enable the group to deleverage continuously in the two years after closing.

Rating Action

On March 15, 2017, S&P Global Ratings lowered its long- and short-term corporate credit ratings and issue ratings on hygiene and consumer health group Reckitt Benckiser Group PLC (RB) to 'A-/A-2' from 'A+/A-1'.

At the same time, we removed the ratings from CreditWatch with negative implications where they were placed on Feb. 3, 2017. The outlook is stable.

We are also assigning our 'A-' issue rating to the $20 billion acquisition facilities and a £1 billion revolving credit facility (RCF).

Rationale

The downgrade reflects our view that RB should continue to grow profitably in hygiene and consumer health products with the addition of Mead Johnson's (MJ) infant formula and children nutrition businesses. We forecast that MJ will account for about 20% of the combined entity's revenues and EBITDA in 2018. The transaction is subject to approval from shareholders and regulators and is expected to close in the third quarter of 2017, according to the companies.

The all-cash and fully-debt funded nature of the transaction ($17.9 billion, including net debt) means that RB will have substantially higher debt leverage (more than 4x) once the transaction is completed. That said, we anticipate that RB will be able to gradually deleverage and reach adjusted debt to EBITDA of about 3.5x in the two years after closing, thanks to its strong free cash flow capacity of about £2 billion annually. Cash flow growth in 2018-2019 should be supported, in our view, by positive revenue growth prospects in hygiene and health products despite flat growth at MJ and in the home products segment.

We consider the acquisition to be positive for RB's business because it will diversify its product range in consumer health and increase its exposure to growing emerging markets such as Asia and Latin America. These markets will now account for about 40% of revenues with a significant presence in the large, but very competitive Chinese consumer market. MJ will bring its global leading positions in the large ($46 billion) and growing (3%-5% annual growth) infant formula and children nutrition product segments, with notably strong market shares in the U.S. and Asia. MJ also brings a well-recognized global brand Enfa and operates a high-margin business (EBITDA margin >25%) that is noncyclical, highly cash generative, and has strong pricing power.

In our view, there are integration risks as MJ will be RB's largest-ever acquisition, however, the company has a good track record with previous companies such as SSL International PLC (Durex and Scholl brands) and Boots Healthcare International (Nurofen and Strepsils), now core businesses of RB. RB will also operate in new areas of operational risk, notably a changing regulatory environment in China with regards to infant formula, which is currently constraining margins. We also note that RB will compete with larger players such as Nestlé, Danone in Asia, and Abott in the U.S. It will also need to evolve in a fast-changing retail environment in China (premiumization of category, the rise of e-commerce and baby stores, ban on Hong Kong sales), to which MJ has been late to adapt to.

On a stand-alone basis, RB's main strengths continue to be the low cyclicality and high profitability (EBITDA margin of 27%-28%) of its business. It has leading market positions in the highly profitable and growing segments of hygiene products (41% of revenues in 2016) and consumer health (34%), despite the latter still being highly fragmented (notably in over-the-counter drugs). We see the group continuing to expand in emerging markets; particularly in underpenetrated developing markets such as China and India as sales growth prospects appear subdued in North America and Europe (especially in Russia).

RB has a portfolio of 19 global brands and a wide product range, although some of its product categories are relatively niche and discretionary (such as air fresheners). Its business has strong operating efficiency with good working capital management and low capital expenditure (capex) intensity, enabling RB to reinvest in product innovation and marketing. However, some operational risks have emerged with a £300 million provision and contingent liabilities in 2016, mainly for compensation to victims who purchased a defective humidifier sanitizer product between 2001 and 2011 in Korea.

Our base case for 2018-2019 for the combined entity assumes:

- Revenue growth of £13 billion–£14 billion, based on health and hygiene products growing at 3%-4%, home products growing at 1%-2%, and MJ

generating flat-to-slightly negative revenues;
- Adjusted EBITDA margin of 28%-29%, supported by the favorable effect of rising sales of high-margin products like health and hygiene, an EBITDA margin of about 27% for MJ, and limited operating cost savings. We assume no further provisions related to legal costs in South Korea after those in 2016;
- Free operating cash flows of about £2.0 billion-£2.2 billion annually, assuming some negative working capital movements and capex of about £350 million;
- Discretionary cash flows (DCF) of about £1.0 billion-£1.3 billion, assuming about £1.0 billion of annual cash dividend payments, £150 million of annual acquisitions, and no share buybacks; and
- Adjusted net debt of about £14 billion-£15 billion, which includes borrowings, pension deficit, and operating lease commitments. We apply a 10% haircut on cash balances to reflect the limited amount of restricted cash within the group.

Based on these assumptions, we arrive at the following credit measures:
- Debt to EBITDA of 3.9x in 2018 and 3.5x in 2019 (two years after closing);
- Funds from operations (FFO) to debt of about 15%-20%; and
- DCF to debt of about 5%-10%.

Liquidity

We assess RB's liquidity as strong, based on our expectation that liquidity sources should exceed liquidity uses by more than 1.5x over the next 12-24 months. We project that RB will have significant headroom (>30%) under its financial covenants on its drawn bank lines. We note that RB has raised $20 billion of fully-underwritten credit lines to fund its acquisition of MJ and a five-year £1 billion RCF for related liquidity needs.

We anticipate the following principal liquidity sources over the next 12 months:
- Cash and cash equivalents and short-term investments of about £885 million as of Dec. 31, 2016;
- Undrawn committed credit facilities of £3.5 billion maturing in 2021; and
- Forecast cash FFO of about £2.4 billion-£2.5 billion in 2017 and 2018.

We anticipate the following principal liquidity uses over the same period:
- Short-term debt of about £1.6 billion as of Dec. 31, 2016, which is mainly drawn commercial paper and $500 million in unsecured notes due in September 2018;
- Forecast maximum working capital intrayear movements of about £150 million annually;
- Forecast total capex of about £350 million annually;
- Our assumption of £150 million in annual acquisitions; and
- Forecast cash dividend payments of about £1.1 billion-£1.2 billion annually and no share buybacks.

Outlook

The stable outlook on RB reflects our view that the group will continue to generate solid cash flow generation thanks to the expansion of its highly profitable consumer health and hygiene businesses. We believe that RB will focus on investing in emerging markets, while gradually integrating MJ and deleveraging its capital structure. Our base case assumes that RB will generate a free cash flow base of about £2.0 billion-£2.2 billion annually, with debt leverage decreasing from above 4x post acquisition to 3.5x adjusted debt to EBITDA at the end of 2019.

Upside scenario

We could raise the ratings if RB is able to deleverage faster than expected in 2018 due to higher-than-expected earnings and cash flow growth. This could be the result of a rebound in European sales, a strong increase in profitability in emerging markets, and additional financial measures such as noncore asset disposals. We would view positively RB reaching adjusted debt to EBITDA of 2x-3x and DCF to debt of 10%-15%.

Downside scenario

We would consider lowering the ratings if we saw a lasting deterioration in operating performance, with the EBITDA margin declining to below 25% on a sustained basis. This could arise from a loss of market share in health and hygiene products due to increased competition, lower growth in Asia, and a lack of successful new product launches. We could also consider a downgrade if debt leverage was likely to remain above 4x at the end of 2018, signalling a lower-than-expected deleveraging path and difficulties to remedy it over the medium term. We would also view negatively a significant increase in shareholder remuneration--compared to our base-case scenario--after the transaction closes.

Ratings Score Snapshot

Corporate Credit Rating: A-/Stable/A-2

Business risk: Excellent
- Country risk: Intermediate risk
- Industry risk: Low risk
- Competitive position: Excellent

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: a-

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 rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Corporates - Industrials: Key Credit Factors For The Branded Nondurables Industry, May 07, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, 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: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 07, 2013
- 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. 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Reckitt Benckiser Group PLC		
Reckitt Benckiser PLC		
Corporate Credit Rating	A-/Stable/A-2	A+/Watch Neg/A-1
Reckitt Benckiser Treasury Services PLC		
Senior Unsecured	A-	A+/Watch Neg
Commercial Paper	A-2	A-1/Watch Neg

New Rating

Reckitt Benckiser Group PLC		
Senior Unsecured	A-	

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com

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.globalcreditportal.com and at spcapitaliq.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.