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Research Update:

Coca-Cola HBC Outlook To Stable On Resilient Operating Performance Outside Russia; Ratings Affirmed

May 24, 2023

Rating Action Overview

- Coca-Cola HBC AG's (CCH) operating performance has been stronger than we expected following The Coca-Cola Co's (TCCC) decision to suspend sales of trademarked Coca-Cola products in Russia. S&P Global Ratings-adjusted debt leverage (excluding Russian business) was 2.1x at fiscal year-end 2022 (versus our original expectation of about 2.5x) supported by stronger generation of annual free operating cash flows (FOCF) close to €525 million.
- In our view, CCH is well positioned to navigate current macroeconomic challenges, especially in emerging markets (notably in Nigeria and Egypt). This is thanks to pricing and product-mix initiatives supported by its position in fast-growing categories and strong brand equity.
- We therefore revised our outlook to stable from negative 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 stable outlook reflects our view that CCH should be able to maintain good headroom in terms of credit metrics, with expected adjusted debt leverage of about 2.0x and FOCF generation of over €300 million annually in 2023 and 2024. This is supported by its leading brand equity in product categories that are reasonably resilient to macroeconomic challenges, in our view.

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Rating Action Rationale

Our outlook revision reflects CCH's stronger-than-expected operating performance after TCCC's 2022 decision to suspend sales of Coca-Cola products in Russia. CCH's robust 2022 operating performance reflected its successful pricing and mix initiatives as well as volume growth in key geographies, partly mitigated high input cost inflation. The contribution of the Coca-Cola Bottling Company of Egypt, acquired in January 2022, also helped offset the impact on volumes from our deconsolidation of the Russian business. Volumes and value share improve

within the non-alcoholic ready-to-drink (NARTD) segment, notwithstanding high inflation, thanks to its strategic positioning in fast growing categories--notably energy and low/no sugar products--and successful activations in its core sparkling categories. Average revenue per case increased by the low double digits in 2022, underpinned not only by pricing but also by product-mix improvements--with energy and sparkling continuing to increase their share and single-serve products growing on the back of recovering out-of-home consumption. However, its S&P Global Ratings-adjusted EBITDA margin took a 400 basis points hit from soaring commodity and energy prices and margin dilution linked to the integration of the Egypt business and our deconsolidation of the Russia business. That said, its S&P Global Ratings-adjusted EBITDA was higher than expected at €945.4 million (we previously forecast €828.4 million) supported by high top-line growth. CCH's higher revenue base and working capital discipline translated into much higher FOCF generation of €524.9 million, leading to 2.1x adjusted debt leverage versus the 2.5x we previously forecast.

The stable outlook also reflects our projections of good headroom in credit metrics over 2023 and 2024. Adjusted leverage should remain around 2x and FOCF will likely exceed €300 million annually. Our base case assumes 8%-9% revenue growth in 2023 driven by pricing initiatives, notably the carry-over of 2022 pricing, and ongoing mix improvements across main categories and channels. We see volumes slightly declining in 2023 as demand pressures from emerging and developing markets are only partly offset by low-single-digit growth in established markets. On the one hand, we see strong headwinds from Egypt and Nigeria as very high inflation is compounded by macroeconomic challenges, notably Nigeria's current bank notes shortage, but also high foreign-exchange (FX) volatility. On the other hand, fast-growing categories such as energy and no/low sugar sparkling drinks, as well as improving out-of-home consumption, should support low-single-digit volume growth in established markets. For 2024 we estimate CCH's revenue growth slowing to 5% as the lower pricing contribution is partly offset by a return to volume growth of about 3%. We forecast gradually rebounding profitability over 2023 and 2024 underpinned by prices catching up with stabilizing commodity and energy costs, together with efficiency improvements in Egypt.

We see some volatility around our base-case projections mainly coming from inflationary and demand headwinds in emerging markets, integration risk from the Egypt operations, exposure to FX volatility, and potential additional disruptions coming from the Russian operations. That said, our forecasted credit metrics and CCH's historically conservative financial policy create some headroom under the 'BBB+' rating.

Although we deconsolidate the operations in Russia from our adjusted credit metrics, given the sanctions and capital controls in place, the Russian operations remain self-funding and we anticipate this will remain the case over the next 12-24 months. On March 8, 2022, TCCC suspended the sales of trademark Coca-Cola products in Russia following the military intervention into Ukraine. This increased operational volatility and hit CCH's revenues significantly, considering Russia was its biggest market in terms of sales in 2021. Inventories of Coca-Cola trademark were run down until July 2022 and now CCH's Russian portfolio comprises only local brands. We understand that CCH is pausing investments in Russia, although it intends to retain control over the assets. We think the Russian operations will remain self-funding, with an ample cash balance of about €210 million and positive FOCF generation over our forecast period. This view is based on our understanding that the Russian operations can source local inventories, staff, and machinery. This self-sufficiency should enable CCH to redirect investments and focus on strategic initiatives elsewhere. At the end of 2023 (when the majority of TCCC license

agreements across several territories mature), we anticipate TCCC will renew its licenses with CCH based on CCH's extensive track record and relationship with TCCC as one of its key bottling partners. Regarding the license agreement in Russia, we have very limited visibility about the likely final decision of TCCC regarding the renewal. However, even if CCH does not retain its TCCC license, the company will still be able to sell local brands as these are not tied to a contractual relationship with TCCC.

We see CCH as strategically positioned to capitalize on positive organic growth trends in the industry and to navigate current inflationary, environmental, and volume pressures. Demand for non-alcoholic beverages should remaining resilient in CCH's addressable markets over 2023 and 2024, notably supported by being relatively staple and affordable, as well as positive underlying industry trends. We see continued growth coming from functional--sports, energy, and coffee--and low/no sugar sparkling drinks given consumers' increasing interest in general wellbeing. Meanwhile the more established categories remain stable sources of earnings. In our view, CCH is well positioned to navigate the currently challenging scenario thanks to its strong brand power, flexible product portfolio, and strategic positioning in dynamic categories. CCH also benefits from a balanced geographic mix that allows it to capitalize on sustainable volume growth coming from emerging (notably Nigeria and Egypt) and developing markets thanks to increasing penetration, while benefiting from stable established markets where growth is linked more to revenue growth management initiatives.

Outlook

The stable outlook reflects our view that, despite near-term inflationary and demand headwinds, CCH has sufficient operational and financial flexibility to maintain stable adjusted net debt to EBITDA of about 2.0x over the next 24 months. This is supported by its very strong market position in NARTD, a defensive consumer staples category, which should enable it to generate FOCF of more than €300 million per year.

Downside scenario

We could lower our ratings on CCH over the next 18-24 months if we saw a sharp decline in profitability coming from higher-than-expected inflationary and demand pressures, such that our adjusted net debt to EBITDA reaches 3.0x with no prospects of rapid improvement. This could also come from critical disruptions to the Russian operations or an unforeseen large debt-funded acquisition.

Upside scenario

We could raise the rating on CCH if we see sustained stronger-than-expected FOCF growth, resulting in FOCF to debt above 25% and adjusted net debt to EBITDA comfortably placed within a 1.5x-2.0x range. This scenario could stem from a swift rebound in profitability from an unexpected sharp drop in commodity prices, or CCH navigating current inflationary and demand pressures better than expected in key emerging markets. An upgrade would also be contingent on the company committing to maintain these ratios on a sustained basis. This would therefore entail an amendment to its stated target policy.

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 under an exclusive license from TCCC (A+/Stable/A-1) for select countries. CCH is the third-largest Coca-Cola bottling company globally by volumes, producing 2.7 billion units per year from 62 manufacturing plants in 29 countries (as of Dec. 31, 2022). In January 2022, the company completed the acquisition of Coca-Cola's Egyptian bottling company. TCCC has suspended its business 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)--23.7% of total volumes, 32.3% of reported revenue, and 44.1% of reported EBIT in 2022.
- Developing markets (Baltics, Croatia, Czech Republic, Hungary, Poland, Slovakia, and Slovenia)--17.7% of total volumes, 18.7% of reported revenue, and 16.1% of reported EBIT in 2022.
- Emerging markets (Armenia, Belarus, Bosnia and Herzegovina, Bulgaria, Egypt [from 2022 onward], Kosovo, Moldova, Montenegro, Nigeria, Romania, Russia, Serbia, North Macedonia, and Ukraine)--58.6% of total volumes, 49.0% of reported revenue, and 39.8% of reported EBIT in 2022.

CCH's main markets in 2022 were Russia, Italy, Nigeria, and Egypt, which together accounted for about 45.7% of total volumes. In 2022, CCH reported total net sales revenue of about €9.2 billion (€7.2 billion in 2021) and company adjusted EBITDA of €1.3 billion (€1.2 billion in 2021).

As of Dec. 31, 2022, TCCC owns approximately 21% of CCH's share capital; Luxembourg-based private investment holding company Kar-Tess Holding holds a further approximately 23%; and the remainder is freely floating on the London (premium listing) and Athens stock exchanges.

Our Base-Case Scenario

Assumptions

- Under our base case, we decided to deconsolidate the Russian perimeter from 2022 onward.
- Revenue growth of 8%-9% in 2023 primarily driven by pricing initiatives, notably the carry-over of 2022 pricing, and continuing mix improvements across categories and channels. A low-single-digit volume decline because of inflation and demand pressures in developing and emerging markets, partly offset by continuing product activations in established markets. For 2024 we see revenue growth of about 5% as the lower pricing contribution is partly offset by a return to volume growth of about 3%.
- Rebound in S&P Global Ratings-adjusted EBITDA margin to about 12.5% in 2023 driven by prices catching up with stabilizing commodity inflation, lower exceptional costs, and gradually improving efficiency in Egypt. We see margins improving toward 13% in 2024, assuming additional operational improvements and input costs retreating from elevated levels.

- For 2023, we assume limited €50 million positive working capital cash inflows mainly linked to declining volumes and inflation's easing impact on inventories. However, for 2024, we assume limited working capital outflows to support expected volume growth.
- Annual capex of 6.5%-7.0% of sales over 2023 and 2024 aimed at supporting organic growth, digitalization, and sustainability.
- Common ordinary dividend distribution of about €290 million in 2023, subject to shareholder meeting approval, and our ordinary dividend distribution assumption of 40%-50% of earnings from 2024 onward, in line with the company's publicly stated target policy.
- Limited annual discretionary spending related to bolt-on acquisitions over the next couple of years.

Key metrics

- Adjusted net debt to EBITDA around 2.0x over 2023 and 2024;
- Funds from operations (FFO) to debt of 40%-45% over 2023-2024; and
- Reported FOCF (after lease payments) of about €300 million over 2023 and 2024.

Liquidity

We continue to assess CCH's liquidity profile as strong, reflecting 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 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 March. 31, 2022 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 €1.3 billion, excluding Russia;
- Our forecast of cash FFO of €850 million-€900 million; and
- Limited cash inflow related to lower working capital requirements.

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

- Our forecast of intra-year working capital swings of about €100 million;
- Our forecast of annual capex of €550 million-€600 million; and
- Dividend payment of €280 million-€300 million in the next 12 months.

Environmental, Social, And Governance

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

Similar to other beverage bottling companies, CCH has moderate exposure to environmental risks related to plastic packaging waste, water scarcity, and health concerns. Governments are increasingly enforcing more stringent recycling rules, which could mean higher operating costs for CCH if it has to pay to collect and recycle plastic waste. For instance, in 2018 the EU introduced the first region-wide plastics strategy to achieve 100% recyclable plastic packaging by 2030 and reduce consumption of single-use plastics. CCH is committed to collecting and recycling 75% of primary packaging by 2025 (48% in 2022). It also aims to increase the share of recycled PET (or that from renewable sources) to 35% by 2025 and 50% by 2030 (10.5% in 2022). Changing consumer tastes and stricter health regulations on sugar content in drinks are risks for its sparkling beverages business. Therefore, CCH continues to invest in the expansion of its no- and low-sugar content drinks. The company is currently investing in own in-house production lines for recycled PET bottle preforms from cheaper feedstock--hot-washed PET flakes. While COVID-19 has hindered progress in achieving some of its targets, notably for primary packaging collection and use of recycled PET, we believe that CCH is taking proactive steps in the environmental aspects of sustainability.

As a beverage bottler, CCH could also face rising operating costs to source water and face rising tensions with local communities as natural resources become scarcer. The company is aiming to reduce water usage by 20% by 2025 in plants located in high-risk areas such as Nigeria, Russia, Greece, Cyprus, and Armenia.

Our assessment of CCH's management and governance as satisfactory is supported by the consistency of the business strategy, a strong track record of improving profitably in volatile emerging markets, and its balanced board composition.

Issue Ratings - Subordination Risk Analysis

Capital structure

CCH's capital structure chiefly comprises €2.9 billion of senior unsecured notes, issued out of its financial subsidiary, Coca-Cola HBC Finance B.V.; €206 million of finance leases; €168 million of commercial paper; and other 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+/Stable/A-2
Business risk:	Satisfactory
Country risk	Moderately High
Industry risk	Low
Competitive position	Satisfactory

Issuer Credit Rating	BBB+/Stable/A-2
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)

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

Ratings Affirmed; Outlook Action

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

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