Summary of the rating report

Schön Klinik SE

30 March 2020

EULER HERMES Rating

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Issuer rating

Schön Klinik SE		30 March 2020 Issuer rating	BBB-
		Outlook	Negative
Industry	Holding of shares in companies that specialise in the construction, acquisition and operation of hospitals	2019 revenue (FC)	€ 882 mn
		Employees in 2019	Approx. 10,500

BUSINESS RISK		ANCHOR RATING	Modification 1	STANDALONE RATING	Modification 2	ISSUER RATING
Moderate	→	BBB-	Operational risks →	BBB-	External influences →	BBB-
FINANCIAL RISK						
Moderate / slightly increased						

BUSINESS RISK	Moderate

- Good market position in attractive medical disciplines
- Moderate growth potential due to demographic trends, acquisitions and internationalisation
- Structural changes due to regulation, demographics and digitalisation
- Rising cost and innovation pressure

OPERATIONAL RISKS	- 0

- Operational risks handled appropriately overall

FINANCIAL RISK	Moderate / slightly increased

- Reduced earnings power is currently at the lower end of the ‘satisfactory’ range, plans for improvement
- Generally good cash flow
- Solid financial flexibility
- Satisfactory capital structure

EXTERNAL INFLUENCES	± 0

- No external influences of relevance for the rating

Financial ratios *	2017 actual	2018 actual	2019 forecast
EBITDA margin (%)	12.8	9.5	8.3
ROCE (%)	1.0	-0.9	-1.8
Equity-to-total assets ratio (%)	38.8	35.6	32.5
Leverage (%)	50.7	53.4	57.9
Total liabilities / EBITDA	8.6	11.9	12.7
Net debt / EBITDA	5.6	7.6	8.4
EBITA interest coverage (net)	2.3	1.7	1.0
EBITDA interest coverage (net)	4.5	4.1	3.0

* Adjusted on the basis of EHR's analytical principles

Rating rationale

Euler Hermes Rating has given Schön Klinik SE a BBB- rating. We expect the rating to decline over the next twelve months. Financial ratios have recently weakened due to a delay in the alignment of structural costs with changes in market conditions. The Group mounted a comprehensive response to these developments, but depending on how the COVID-19 pandemic evolves, unplanned earnings risks might materialise and implementation gains from the reorganisation might emerge more slowly in the short term.

Moderate business risk due to specialisation in an increasingly demanding market environment

In our view, the Schön Klinik Group has a **moderate business risk**. Rating strengths include a good market position from the Group's specialisation in attractive medical growth disciplines, large business opportunities from privately insured patients and generally low sector volatility. The Group enjoys sustainable potential for growth in Germany due to demographic trends, national acquisitions and systematic expansions of its service portfolio. We also see further potential in Europe's metropolitan regions. We see rating weaknesses in the generally high dependence on regulatory factors and the systemic decoupling of cost trends from income trends. As the health sector becomes increasingly digitalised, we expect to see the emergence of new business, supply and value creation models alongside growing pressure for change over the medium and long term, much as has happened in other sectors. In our view, Schön Klinik is responding proactively to structural change, adapting its corporate culture and identifying and leveraging digitalisation opportunities. Among other things, the Group has started to integrate new business models via a mental health platform, aiming to shape the growing market for online therapies and position itself and its core competencies appropriately.

Moderate to slightly increased financial risk due to generally sound cash flows and financing with recently weakened earnings power and earnings risks due to COVID-19 pandemic

We consider the Schön Klinik Group's **financial risk** to be **moderate to slightly increased**. Earnings power has been declining progressively in recent years, pushing down the capital structure to a satisfactory level. Its performance was weakened by an unexpectedly strong decline in foreign patients, one-off effects, up-front costs for the international expansion and adverse regulatory impacts (FDA). To boost earnings power, the Group carried out a sweeping reorganisation and decentralisation, while administrative cost-cutting significantly reduced structural costs. We expect that these actions will stabilise earnings power, repayment periods and interest coverage ratios at a satisfactory level in the medium term. Negotiated budgets generally provide considerable reliability for planning and solid cash flows, which we view as a rating strength. In the short term, the Group's economic performance strongly depends on the currently unpredictable progression of the COVID-19 pandemic, the utilization of available ICU capacity and the severity of cases. This may cause unplanned earnings risks to materialise. In worst case scenarios, we expect that high political and social impacts might prompt modifications to the Hospital Relief Act in order to stabilise the health system. We rate the current financial flexibility as solid.

No modifications to the anchor rating

We believe the operational risks are consistent with the anchor rating. There are no external factors of relevance to the rating. Therefore, no modifications were made to the anchor rating.

Rating history

	06 May 2014 - 30 May 2017	10 January 2018	13 December 2018	30 March 2020
Rating	BBB	BBB	BBB-	BBB-
Outlook	Stable	Negative	Stable	Negative

Company

Rating subject SKS: extensive corporate reorganisation in connection with succession plan

Schön Klinik SE ("SKS"), headquartered in Prien am Chiemsee, is the parent and financial holding company of the Schön Klinik Group. The Group has been reorganising its corporate structure since 2013. The main motivation for the reorganisation was to lay the structural groundwork for the gradual, long-term hand-off of the company to the next generation. It also aims to improve the available options for funding growth and operations. The Group's fixed assets were remeasured as part of the corporate reorganisation.

SKS shareholders, management and board of directors

Over 75% of Schön Klinik SE is owned by the Schön family holding company and, as of 2016, less than 25% by the Carlyle Group, an investment firm. The group managing directors of Schön Klinik SE are Dr Mate Ivančić (CEO), Christopher Schön (COO) and Daniel Kunzi (CFO). The seven-member board of directors consists of Mr and Mrs Schön, Christopher Schön, Constantin Schön, Dr Astrid Wimmer and two Carlyle representatives.

SHD: Holding and management company

Schön Klinik Holding SE holds nearly 90% of the equity in the individual hospitals and also serves as a management holding company. The remaining equity is held by Schön Klinik SE.

Schön Group: one of Germany's largest hospital operators

The Schön Klinik Group is one of the largest private-sector hospital operators in Germany. The Group and its hospitals generated approx. € 882 million in gross revenue in 2019. Around 111,000 episodes of in-patient care were provided in 2019. The hospitals have approx. 5,200 beds. The Schön Klinik Group employed around 10,500 people as of 31 December 2019. Its main competitors are Rhön Klinikum AG, Helios Kliniken GmbH, the Asklepios Group and Sana Kliniken AG. The Schön Klinik Group has positioned itself in the market as a specialised high-end provider. Around 25 % of its patients are privately insured, self-payers or have supplemental health insurance.

Medical specialities: orthopaedics, psychosomatics and neurology

The Schön Klinik Group's German hospitals are located in Bavaria, Hamburg, Hesse, Schleswig-Holstein and North Rhine-Westphalia. It generates around 88% of its revenue with acute care and around 12% with rehabilitative care. Its medical specialities are orthopaedics, psychosomatic medicine, neurology, surgery and internal medicine. Its London clinic has been in operation since August 2018. The Group took over an eating disorder treatment facility in Birmingham in mid-2017.

EULER HERMES Rating

Business risk

Market risk

Low cyclical sensitivity with large regulatory factors

In Germany, the hospital market is considered part of the "primary health market". It is divided into three roughly equal segments of public, private and non-profit hospitals and has a market volume of around € 89.0 billion. The national market environment is subject to very few economic dependencies since the health insurance system is so well established in Germany and almost all costs are covered. The market for foreign patients (around € 1.2 billion in market volume), by contrast, is much more volatile because political and/or economic changes immediately affect demand. The hospitals' economic performance is usually affected by significant regulatory factors, particularly with regard to hospital planning (beds, care places) and hospital funding. Two major developments are significantly shaping the sector. First, demand is rising for medical services, particularly advanced services, which are subject to constant fee reductions. This increases pressure to improve efficiency and increasingly blurs the boundaries between outpatient care, inpatient care and rehabilitation. Second, digitalisation and the entry of tech firms in the health market have changed the nature of value generation and interactions between market participants, and are gradually fusing the primary (conventional healthcare) and secondary health markets (privately funded healthcare services).

Sector profitability is low due to price regulation, excess capacity and coverage of losses by municipalities

Profitability in the hospital sector is currently weak, with EBITDA margins averaging between 3% and 4%. Private hospital operators are more profitable, according to our analyses, achieving average satisfactory EBITDA margins of between 7% and 8% by leveraging economies of scale from specialisation, collectively bargained shop agreements and better process efficiencies. Around one third of hospitals operate at a loss. Hospital profitability has been adversely affected by the high cost of maintaining medical equipment and personnel, including significant idle capacity in some cases, as well as the regulated, systemic decoupling of costs from income, the shift from inpatient to outpatient care, wage and salary adjustments under collective bargaining agreements and, most recently, more stringent audits by the German Health Insurance Medical Service (MDK). The coronavirus pandemic has presented a number of short-term one-time effects. We see hospitals being confronted with additional, temporarily higher administrative expenses and coronavirus-related costs as they get ready to treat COVID-19 patients (including PPE, provision and expansion of ICU capacity) and a loss of revenue from elective and outpatient procedures. Due to hospitals' systemic importance, we generally expect that the established economic impact on hospitals will be largely offset by statutory provisions and economic impact payments based on the adoption of the Hospital Relief Act. More modifications may occur depending on the continued evolution of the pandemic and the hospitals' financial situation.

Special charges from coronavirus pandemic increase earnings risks

High barriers to market entry in the hospital sector

The hospital sector overall is highly regulated and has high barriers to market entry. Among other things, public-sector hospitals enjoy de facto government protection of their territories under the state requirements plan for hospitals. Risks usually only arise due to regulatory intervention or changes in the hospital plan.

Rising substitution risk from digitalisation and a shift from inpatient to outpatient care, among other factors

Due to the growing integration and harmonisation of outpatient care with inpatient care (due to the shift from inpatient to outpatient care), we forecast that inpatient cases and/or hospitalisation times for certain procedures will be reduced or these procedures will be provided on an outpatient basis.

In addition, we expect that technological progress and greater connectedness will increase interactions between physicians, patients and new or different actors in the health market (including tech companies), resulting in the establishment of new treatment and therapy methods and platform solutions over the medium to long term.

Medium-term growth prospects between 2% and 3% (CAGR)	After adjusting for the coronavirus effects, we expect inpatient case numbers to increase in relevant departments over the medium to long term due to demographic trends and rising life expectancy in Germany associated with an increase in "diseases of civilisation" and increasing case complexity (i.e. multimorbidity). This trend is also supported by a growing range of therapies afforded by advances in medical technology, therapy and pharmacology. We put the average long-term growth prospects for the hospital sector between 2% and 3% (CAGR). However, this will be offset by disproportionately high cost increases in future. In our view, the changes in the age structure and diagnosis-related groups will lead to rising health care costs as treatments become more costly and involved due to higher patient ages (greater care needs, longer post-surgery recovery).
Structural change increases pressure to cut costs, innovate and consolidate	In the hospital market, change is mainly driven by regulatory, technological and (socio-) demographic trends. Once the coronavirus pandemic subsides, we expect hospital funding to become a more pressing political issue and reform pressure to increase, especially with a view to strengthening the system and health care in general and ensuring that nurses and medical staff receive adequate pay. Over the medium and long term, we expect tighter regulation and definitions of standards, which will likely permanently weigh on income and costs, especially for hospitals not deemed "systemically important". Technological progress will lead to new care and organisational schemes in the long term. In the medium term, it will temporarily drive up the need for investment capital in order to implement these schemes. Looking at the size of the investment backlog at many hospitals, we expect this structural margin squeeze will soon be joined by a quality gap. Urbanisation will create a disproportionate shortage of skilled labour in some rural regions as well as changes in regional health care structures. In our view, rising transparency and patients' quality awareness will make them more willing to travel greater distances and make co-payments for advanced medical services.
Change momentum still moderate to slightly dampened	The primary health market is still rather underdeveloped in terms of digitalisation compared to other sectors, according to our observations. Structural change is mainly driven by the secondary health market, especially by national and international technology firms that have entered the health market and, in some cases, adopted rather disruptive approaches. We thus expect to see the emergence of new business, supply and value creation models alongside growing pressure for change over the medium and long term, much as has happened in other sectors. We would describe the medium-term momentum for change as moderate to slightly dampened overall due to strong regulation in the sector, insufficient investment capital and high barriers to market entry.

Market risk
In summary, we view the market risk for specialised private hospital providers as moderate to slightly increased. Our assessment reflects the low sector volatility ensured by the established public/private health insurance system. The barriers to market entry are high, while demographic trends represent stable growth drivers. We see rating weaknesses in the high dependence on regulatory factors along with a systemic decoupling of costs from income, which can have a disproportionately large short-term adverse impact on market participants, depending on how the coronavirus pandemic evolves and how the government structures economic impact payments.

Execution

Analysts

- Joerg F. Walbaum, Senior Rating Analyst/ Project Manager
- Gundel Bergknecht, Senior Analyst

Rating committee

- Holger Ludewig, Director
- Matthias Peetz, Senior Analyst

Principle sources of information

- Consolidated financial statements (audit reports) 2017, 2018, 2019
- Excerpts from internal reporting
  (e.g. business development 2019, financing overview, etc.)
- Market analyses
- Information on strategy and company planning
- Documents on the corporate structure
- Interviews with the management

Rating methodology

- Euler Hermes Rating GmbH Issuer Rating Methodology of May 2016
  (https://www.ehrg.de/seiten/Methodology_Issuer%20Rating_20171114.pdf)

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Rating categories

Category	Explanation
AAA	In the opinion of EHRG, AAA rated entities demonstrate an excellent credit quality and the lowest default risk.
AA	In the opinion of EHRG, AA rated entities demonstrate a very high credit quality with a very low default risk.
A	In the opinion of EHRG, A rated entities demonstrate a high credit quality with a low default risk.
BBB	In the opinion of EHRG, BBB rated entities demonstrate a medium credit quality with a moderate default risk.
BB	In the opinion of EHRG, BB rated entities demonstrate a medium-low credit quality with a slightly increased default risk.
B	In the opinion of EHRG, B rated entities demonstrate a low credit quality with an increased default risk.
CCC	In the opinion of EHRG, CCC rated entities demonstrate a very low credit quality with a high default risk.
CC	In the opinion of EHRG, CC rated entities demonstrate a very low credit quality, an event of default is very likely.
C	In the opinion of EHRG, C rated entities demonstrate a very low credit quality, an event of default is imminent.
D / SD	D rated entities have defaulted, as defined by the rating agency. The rated entity is assigned an SD rating (Selective Default) if it has only defaulted on certain debt obligations.
PLUS (+) **MINUS (–)**	Rating categories from AA to CCC are modified by a PLUS (+) or MINUS (-), where required, in order to show their relative position within the rating category.

Definition of financial ratios

Earnings power

EBITDA-margin

EBITDA margin
Numerator
EBITDA
Denominator
Total revenues

Returns

ROCE
Numerator
Adjusted operating result (= EBIT)
Denominator
Net debt + economic equity (= capital employed)

Return on total assets
Numerator
Adjusted operating and financial result + interest expense
Denominator
Adjusted total assets

Cashflow-Return on Investment

Cash flow return on investment (Cash flow ROI)
Numerator
EBITDA
Denominator
Adjusted total assets

Capital Structures

Indebtedness

Equity-to-total assets ratio
Numerator
Adjusted equity (= economic capital)
Denominator
Adjusted total assets

Leverage
Numerator
Net debt
Denominator
Net debt + economic equity (= capital employed)

Net debt

Net debt
Bonds
+ Liabilities to banks
+ Bill liabilities
+ Other interest-bearing liabilities
+ Operating lease liabilities
+ Adjustments for ABS/factoring transactions
- Cash and cash equivalents

Deleveraging potential

Total liabilities / EBITDA
Numerator
Total assets - economic capital (= total liabilities)
Denominator
EBITDA

Net debt / EBITDA
Numerator
Net debt
Denominator
EBITDA

Interest coverage

EBIT interest coverage
Numerator
Adjusted operating result (= EBIT)
Denominator
Interest expenses

EBITDA interest coverage
Numerator
EBITDA
Denominator
Interest expenses

Disclaimer

Company Inc. (client and rated entity) engaged Euler Hermes Rating GmbH to conduct a rating on 1 April 2015. The company was visited on 20 November 2019.

The Rating Committee of Euler Hermes Rating GmbH reviewed the rating process, issued the rating notation and approved the rating report in its current form on 18 December 2019. This rating report was given to the client on 11 February 2020, thereby concluding the rating process.

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In accordance with the statement of 11 February 2020 the client declared that it will use the rating for internal purposes only. The rating is not intended for public disclosure or for publication for subscribers. According to the regulations (EC) No. 1060/2009 of the European Parliament and of the Council the rating is therefore considered a private rating which is not accredited in the context of regulatory purposes. The rating is subject to a voluntary, unpublished monitoring process.

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Hamburg, 7. April 2020