

Market View

by Sergio Grasso



“Not everything will be clear at first... and that's the point”. Labcos, time for testing.

Those who have discussed this sector with me over the past three years are well aware of my long- standing skepticism, as well as the structural risks I've frequently highlighted across a number of companies. The sector in question is healthcare services, catering to both public and private end- markets, with customers ranging from individual patients to institutional clients such as hospitals.

While the sector represented a fundamentally sound “short call”, the execution timing of the strategy was challenged by a sharp repricing of risk in bullish credit markets occurred in H12023 and a broader positive sentiment, which materially distorted real valuations and delayed the realization of downside potential over an extended period.

This specific industry remains highly fragmented, albeit with increasing consolidation led by large incumbents holding dominant market shares. These players operate across multiple European jurisdictions, with limited international diversification outside Europe—typically no more than 5– 10% of group revenues are derived from operations outside their core geographies.

The COVID-19 pandemic acted as a powerful earnings catalyst, driving double-digit top-line and EBITDA growth across most regions over several quarters. The uplift in profitability was significant and persisted until late 2021. The step-change in EBITDA margins during the pandemic was notable.



However, one of the most striking concerns, at least for me, has been the lack of consistent and clear disclosure on results: many companies provided limited transparency on the magnitude of COVID-related tailwinds or on the normalization assumptions embedded in post-pandemic guidance. This opacity was among the most critical issues in assessing the credit quality for many borrowers. The adoption of IFRS 16 has probably further complicated the interpretation of financial figures and key performance metrics, introducing an additional layer of analysis—particularly for less attentive or less specialized investors.

It has therefore been extremely difficult to quantify the true scale of the extraordinary COVID-driven operating leverage during 2020–2021.

Despite these analytical challenges, operators in this space remained highly sought-after credits, benefiting from characteristics typically favored by investors: non-cyclical demand, aging population, regulatory oversight, strong brand names and/or market leaders, and scale advantages. There are clearly identifiable positives and visibility drivers that underpin a positive view.

At the core, sector fundamentals are driven by two key levers: volume growth and regulated pricing.

Following the post-COVID comedown, the market was expected to revert to more normalized organic growth rates in the range of 0.5–0.7% year-over-year. Within the peer group, before COVID we had different profiles: some corporates exhibited barely positive growth (~0.5%), while others registered low single-digit rates (~3%). The normalized EBITDA margins were expected to stabilize for the majority of the players, post pandemic, around 24–25%.

Naturally, this average view—intentionally broad and generic for this text—masks significant intra- sector dispersion. Operators active in different verticals or segments are exposed to distinct demand drivers and pricing elasticities, resulting in materially divergent financial and operating outcomes.

A second structural headwind for the sector, both historically and continuing today, is the imperative to achieve domestic and international scale and network expansion, particularly in logistics and collection infrastructure. This strategic necessity has fueled a wave of bolt-on M&A activity, frequently executed at elevated EV/EBITDA multiples (even 15-17X and probably more), both within existing geographies and in targeted expansion areas. While these transactions were often strategically justifiable, they had material implications for free cash flow generation and leverage profiles—particularly in terms of the debt-to-equity mix used to finance the deals and the resulting changes in balance sheet compositions pre-and post-acquisition. As a result, concerns have emerged regarding the medium-to long-term sustainability of capital structures for certain issuers, especially where aggressive expansion was pursued without commensurate earnings or, more critically, adequate cash flow accretion.

The increase of interest rates in Europe (from July 2022 onwards) has definitely been a problem for over-levered companies (you remember the debt collectors? They were not alone in suffering a business model that did not fit anymore with higher interest rates).

This brings us to the central question: in hindsight, were there identifiable stress signals that could have anticipated the onset of any specific fundamental credit deterioration? To answer this meaningfully, it is critical to distinguish idiosyncratic, issuer-specific factors from broader market trends or credit cycle conditions. The analysis, under my point of view, should remain bottom-up in nature, grounded in the fundamentals of each individual borrower rather than driven by macro-level narratives or high-level sector generalizations.

This analysis centers on a single corporate borrower. For the purpose of maintaining analytical neutrality and encouraging a more thoughtful engagement with the underlying credit fundamentals, I will deliberately refrain from disclosing the company's name.

Instead, I will present a selection of financial metrics, operational developments, strategic decisions, and capital structure characteristics that, when considered together, should provide sufficient context for the informed reader to identify the company. The objective is not only to assess the corporate's past and current credit profile, but also to highlight the patterns and red flags that may have been overlooked or underestimated by the market.

Acquisition Valuation:

The company was acquired for €4.5 billion, representing a 12x adjusted EBITDA multiple, broadly in line with sector transactions seen in 2020.

Leverage Trajectory:

Pre-COVID, net leverage through secured debt stood at ~6.0x.

By early 2021, leverage improved to 4.6x and remained at that level (pro forma adjusted) in 2022.

In 2023 and 2024, the net adjusted leverage rose above 8.0x, where it remains today (8.6x).

On an unadjusted basis, the net leverage exceeded 10.5x in both years and it stands currently at 11.8x.

A bloated capital structure (some analysts, mainly in CLO platforms, had the courage to complain about the downgrade to CCC at the end of 2024).

The increase in leverage stems from a combination of operational underperformance and a rapid series of high-multiple acquisitions—both sizable and fast-paced—executed from mid-2021 onward (more than 3 billion). In retrospect, the timing and return expectations of these transactions now appear overly optimistic, with the anticipated deleveraging strategy stalled and its trajectory of potential upside significantly pushed back. This situation bears resemblance to credit names like Altice France—without acquisitions in this case—where repeated commitments to “capital structure discipline” ultimately failed to materialize. The credit market lost patience with capital stacks burdened by excessive debt.

Investor sentiment on leverage tolerance remained all the time mixed. While some suggest that ~8.0x net leverage could be sustainable in the medium term, such views become increasingly difficult to justify when broader credit concerns—discussed below—are taken into account.

Post-COVID Strategy Execution:

The COVID-19 pandemic initially paused sector consolidation, as leading players rightly prioritized liquidity preservation in the balance sheet and cash generation. However, the aggressive post-pandemic M&A wave—and the failure to convert that strategic ambition into measurable financial outcomes—should have raised early red flags. The strategic messaging in presentations and transaction announcements frequently centered on themes like “reinforcing the company’s unique positioning” and “moving closer to patients”; while rhetorically compelling, these narratives lacked alignment with actual financial performance, exposing execution risks and undermining management’s credibility over time (the CEO left in March 2025).

EBITDA Underperformance:

The pro-forma adjusted EBITDA has declined significantly since 2022, with Personnel and SG&A costs as a percentage of revenues markedly higher than four years ago. Notably, the decline in EBITDA has outpaced the revenue pressures the business has faced over the past three years, highlighting possible structural inefficiencies and/or guaranteed inflationary pressures on the costs side. The company’s rigid and potentially not efficient operating model has failed to adapt to lower sales volumes, exacerbating the margins compression. At current levels—adjusted or not—EBITDA is insufficient to support the enlarged balance sheet created by the aggressive post-COVID acquisition strategy. Furthermore, the reduced EBITDA has been inadequate to absorb the goodwill impairment charges, which have materially impacted the operating income.

Interest Coverage Deterioration:

Interest coverage has dropped from a strong 5.5x in the years 2021–2022 to just 1.2x today (however the company is grappling with this low credit metric since 2023). This represents a material deterioration and is well below sustainable thresholds, especially in a rising rate environment (or in a world where rates are higher than the zero-interest rate environment courtesy of the European Central Bank which supported large scale M&As and balance sheets with not sustainable debt).

EBITDA Margin Pressure:

Despite ongoing synergy and efficiency initiatives, EBITDA margins have not recovered to pre-COVID levels. The current margin remains around 21–22%, highlighting the challenge of operating deleverage and persistent pricing pressures. While these pressures are largely external, they are not new—stemming from long-standing budgetary constraints imposed by public healthcare systems. The industry, therefore, should have remained structurally cautious about their potential impact (The former CEO, who has since departed, noted indeed in November 2024 that “the price pressures the business has faced have been a persistent factor over the past 25 years”.... ...For me this dynamic could remain sustainable, provided one does not have to contend with annual interest expenses on debt in the magnitude of approximately 275 million annually).

Free Cash Flow Erosion:

The free cash flow has remained negative since the end of 2022, with nine consecutive quarters of cash burn—despite ongoing efforts to mitigate it through cost-saving initiatives, capex control, and working capital management. Historically, the business has operated with a low capex-to-sales ratio, which limits the ability to create meaningful buffers or generate cash uplift through investment reduction. As a result, cash flow generation has structurally deteriorated. The company no longer produces meaningful free cash flow relative to its gross debt, which stays at €4.8 billion as of Q1 2025.

Liquidity Constraints:

The cash on the balance sheet is minimal, and the revolving credit facility (RCF) is partially drawn (this debt, ranks pari passu with SSNs and term loans, traded at 70 cents or lower). While the springing senior net leverage covenant may appear compliant on an adjusted basis, the validity of these adjustments is highly subjective and open to interpretation. I am not interested in dealing with these adjustments. From an operational standpoint, liquidity appears insufficient to support the business sustainably, raising near-term refinancing and solvency risks. The adjustments cannot mask the pressure coming from low levels of cash available to run the company.

The company has begun divesting non-strategic assets to generate proceeds for RCF repayment and short-term liquidity management. However, despite these efforts, concerns remain largely unaddressed regarding the overall debt burden—its servicing, and especially its refinancing prospects. One of the key credit mitigants, namely the favorable debt maturity profile, is eroding over time, diminishing its effectiveness as a support to the capital structure.

Instruments in the market and pricing:

It's striking how many investors remained blind or passive to the evolving financial results and ratings deterioration (at the beginning of 2022 the term loan was still rated B1, and the CFR was B2). Even the press reports and the confused news -accurate or not- they barely shook the confidence of many healthcare sector and labcos enthusiasts until the very last moment. Even throughout 2024, I frequently found myself clashing with overly optimistic views on the sector in general and regarding this company in particular.

Looking at price action and yield-to-worst (YTW) in the secondary market, it's notable that the senior secured notes (SSNs) of the corporate under exam, were trading at around 3.5% at the end of 2021— very close to Biogroup debt levels because this corporate shared the same amount of leverage

with the name under analysis—while the senior unsecured notes (SUNs) offered 150 basis point pickup yield over the secured debt instruments. That spread difference might seem embarrassing today, given the extreme price volatility over the past three years (the SUNs were above 70 cents at the beginning of 2020, today the bonds are under water); yet I still recall how, at the beginning of 2020, some investors with strong and unshakable convictions, believed that specific unsecured debt—already rated CCC!—would experience further spread compression relative to senior secured notes, especially within the healthcare sector where scale and network dimension apparently were more important than cash flow generation. Needless to say, that strategy proved to be disastrously wrong. Senior Unsecured Notes (SUNs) have underperformed as investments over the 2020–2023 period, with evidence of this trend observed across multiple sectors and various issuers.

I trust the reader and the HY investor is familiar with the credit under examination and the drivers behind the recent underperformance. Where is today the value breaking point? The sponsor's support is assured after all the money invested in the equity, but what demands or conditions are likely to be imposed to the lenders at this juncture? What is the willingness of the credit investors to extend the life of the company under the same shareholders and at what haircut on their positions?

Occasionally, summer weather is accompanied by rain.

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