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Research Update:

Alfa Laval Upgraded To 'A-' On Strong And Resilient Financial And Operational Performance; Outlook Stable

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Overview

- We think Swedish industrial machinery manufacturer Alfa Laval has shown strong, resilient operating and financial performance over several years.
- Strong, stable cash flow generation has helped Alfa Laval maintain financial and business risk profiles above its targets, despite shareholder distributions and acquisitions.
- We are raising our rating on Alfa Laval to 'A-' from 'BBB+'.
- The stable outlook reflects our expectations that the company will continue to show strong credit metrics over the coming two years, despite continued soft demand.

Rating Action

On May 8, 2013, Standard & Poor's Ratings Services raised its long-term corporate credit rating on Sweden-based industrial machinery manufacturer Alfa Laval AB to 'A-' from 'BBB+'. The outlook is stable.

Rationale

We raised the rating because of the resilience of Alfa Laval's operating performance and strong credit metrics even in times of significant market downturns, relative to its rated peers. We anticipate that the company will maintain its solid cash flow performance and moderate financial policy, balancing expected ongoing acquisitions and shareholder distributions to sustain credit measures commensurate with the rating.

We also believe that Alfa Laval, with its three core product areas of heat exchange, separation, and fluid handling, is very well positioned in areas of future potential growth, such as energy, process, sanitary, marine, pharmaceutical, and food.

We consider that Alfa Laval's late-cycle profile, strong market position, good pricing power, and good cost flexibility will allow the company to maintain a stable performance. We also expect acquisitions to continue at about Swedish krona (SEK) 1.5 billion-SEK2 billion per year, but not to materially hit the financial risk profile.

Our current base-case scenario assumes a slight decrease in sales because of continuing soft end markets on the back of slow economic conditions throughout 2013, especially in Europe. However, according to our macroeconomic base case, we expect Europe to return to growth in 2014, with the Americas and China strengthening even further, all of which should clearly benefit Alfa Lava's end markets.

We do expect some decrease in the EBITDA margin in 2013, which was slightly more than 18% in 2012, owing to weaker sales and a slight change of product mix. However, we also see 2013 as a trough year, because the reported gross margin is stable at 37%, and we think the operating margin will improve again in 2014 as sales growth returns. In view of all these factors, we expect funds from operations (FFO) to debt to remain around our target ratio of 50%, thanks to the company's strong cash generating ability and disciplined approach to acquisitions.

The rating reflects our view of the company's "strong" business risk profile and "modest" financial risk profile. Support for the rating comes from the group's leading market positions, good cost flexibility, strong profitability, a high share of stable aftermarket sales, and a fairly diverse earnings base. In addition, Alfa Laval enjoys strong, stable cash generation and, in our view, demonstrates good liquidity management. Offsetting these strengths is the group's exposure to demand cyclicality and meaningful competition and what we see as a shareholder-friendly financial policy.

Liquidity

We consider Alfa Laval's liquidity position to be "strong", with a sources-over-uses ratio of more than 2x. On March 31, 2012, the company's liquidity sources consisted of:

- Cash and liquid assets of about SEK1.7 billion, of which we consider about SEK700 million to be excess cash.
- A five-year multicurrency revolving credit facility of $420 million and €301 million (equivalent to SEK5.2 billion, of which SEK3.5 billion was unutilized). The facility matures in April 2016, and includes two one-year extension options.
- Our expectation of annual FFO of about SEK4 billion in 2013 and thereafter.

This compares with the following near-term expected cash calls:

- $25 million maturing in December 2013 and €100 million maturing in 2014.
- Our base-case assumptions of potential acquisitions of SEK1.5 billion-SEK2 billion in 2013 and thereafter.
- At the group's annual general meeting (AGM) on April 23, 2013, the board of directors was authorized to buy back up to 5% of the total number of outstanding shares before the next AGM in 2014. The board might not fully use this mandate if the group identifies suitable acquisition targets in the period.

Outlook

The stable outlook reflects our expectation that Alfa Laval will continue to balance investments, acquisitions, and shareholder payouts to maintain adequate cash flow protection ratios for the 'A-' rating. We expect a continued strong operating performance in the coming two years, despite continuing soft end markets.

At the current rating level, we expect adjusted FFO to debt of about 50%, adjusted debt to EBITDA of less than 2.0x, and free operating cash flow to debt of more than 20%. In the case of a larger acquisition, we would expect the company to return to rating-commensurate metrics in 12-24 months.

We see limited potential for a further upgrade, given the combination of business and financial risk. However, we would consider raising the rating if the company demonstrated a sustained, strong financial performance exceeding the current rating requirements, as well as further strengthening of the business risk profile, for example coming from even stronger diversification.

Conversely, we would consider lowering the rating if Alfa Laval were to adopt significantly more aggressive financial behavior that led to credit ratios outside our expectations, notably on the back of large debt-funded acquisitions or aggressive shareholder returns. These two aspects are the main factors with the greatest likelihood of negatively affecting the rating, although we consider the chances of them happening to be only moderately likely.

Related Criteria And Research

- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Key Credit Factors: Criteria For Rating The Global Capital Goods Industry, April 28, 2011
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008

Ratings List

Upgraded

	To	From
Alfa Laval AB		
Corporate Credit Rating	A-/Stable/--	BBB+/Positive/--

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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 Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's 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.