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Research Update:

# Sweden-Based Machinery Manufacturer Alfa Laval 'A-' Rating Placed On CreditWatch Negative On Planned Acquisition

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## Table Of Contents

Overview

Rating Action

Rationale

CreditWatch

Ratings Score Snapshot

Related Criteria And Research

Ratings List



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Research Update:

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## Overview

- On April 7, 2014, Sweden-based machinery manufacturer Alfa Laval announced plans to acquire Norway-based submerged pumping systems manufacturer Frank Mohn.
- We expect the acquisition price of approximately Swedish krona (SEK)14 billion to be predominantly debt financed.
- We are placing our 'A-' long-term rating on Alfa Laval on CreditWatch with negative implications.
- The CreditWatch placement reflects the likelihood that we would downgrade Alfa Laval by one notch if the acquisition of Frank Mohn materializes along the terms currently made public by Alfa Laval.

## Rating Action

On April 7, 2014, Standard & Poor's Ratings Services placed its 'A-' long-term corporate credit rating on Sweden-based machinery manufacturer Alfa Lava AB on CreditWatch with negative implications.

## Rationale

The CreditWatch placement follows the announcement that Alfa Laval plans to acquire Norway-based submerged pumping systems manufacturer Frank Mohn A/S (not rated). We understand Alfa Laval plans to finance the transaction through debt, implying that the company's Standard & Poor's-adjusted debt will almost quadruple to about SEK19 billion ($2.9 billion) at the time of the acquisition. Although we expect a gradual decrease in debt over the following years, the increased debt level may cause Alfa Laval's consolidated adjusted funds from operations (FFO)-to-total debt ratio to fall to about 30%-35% in the next 12 months and about 35%-40% in 2015 following the acquisition (pro forma). These levels are not commensurate with our current assessment of Alfa-Laval's "modest" financial risk profile and the 'A-' rating.

Although the acquisition could marginally enhance our view of Alfa Laval's business risk profile, it is unlikely to prompt us to revise our assessment upward from the "strong" category. The acquisition could diversify Alfa Laval's product lines and enlarge the company's earning base. Frank Mohn also appears to hold a strong position within its core market for submerged pumping systems for the shipping and offshore industry. We would also assume that the acquisition could have a moderately positive impact on the consolidated margins, given Frank Mohn has reported historical margins above Alfa Laval's. In 2013, Alfa Laval generated strong adjusted EBITDA of about SEK5.8 billion, representing a margin over revenues of 19.4%. We assume a continued robust performance in 2014. Initially, we could foresee the enlarged group generating EBITDA of approximately SEK7.5 billion-SEK8.0 billion, pro forma for the acquisition on a full-year basis, based on a recent healthy order intake and high level of aftermarket service revenue. Still, we acknowledge Frank Mohn's large exposure to the inherently volatile shipping and oil and gas sector, which we estimate will represent 30% of the combined group's sales following the acquisition.

We currently assess Alfa Laval's financial risk profile as "modest." However, following the possible large increase in debt that would result from the proposed acquisition, our view of the company's financial risk profile could change, potentially placing Alfa Laval in the low range of our "intermediate" category. Nevertheless, thanks to strong free cash flows, we could expect meaningful deleveraging potential, however offset by sizable dividends which we assume will be around SEK1.5 billion annually. This would also be largely dependent on the timing and size of any future acquisitions. Alfa Laval reported discretionary cash flow of about SEK2.4 billion for full-year 2013.

Assuming the acquisition takes place, our base case is likely to include the following main parameters:

- The SEK14 billion acquisition of Frank Mohn to close in the second half of 2014.
- A 20%-25% increase in revenues from the acquisition.
- An EBITDA margin of about 20%.
- Moderately higher capital expenditures for the combined group compared with Alfa Laval's historical stand-alone levels of about SEK500 million-SEK550 million per year.

Based on these assumptions, we would arrive at the following credit measures:

- About 30%-35% of FFO to debt at year-end 2014 (pro forma for the acquisition, with the actual ratio to depend upon the timing of the transaction close).
- Debt to EBITDA of approximately 2.5x.

## Liquidity

We consider Alfa Laval's liquidity to be "strong," with a sources-to-uses ratio of more than 1.5x. We understand from management that they have a committed bridge facility in place to finance SEK12 billion of the acquisition. The remaining financing will be drawn from the existing committed credit facilities. We also understand from management that the company plans to refinance the bridge facility within the coming year.

On Dec. 31, 2013, we calculated the company's liquidity sources as comprising:

- Cash and liquid assets of about SEK1.5 billion.
- A five-year multicurrency revolving credit facility maturing in April 2016 and committed facilities of about SEK5.5 billion in total.

- Our expectation of annual FFO of about SEK4 billion in 2014, improving to about SEK5 billion post-acquisition in 2015.

At the same date, we calculated the following cash uses:
- About SEK150 million of short-term maturities over 2014.
- About SEK600 million-SEK700 million in capital expenditures over 2014-2015 annually.
- Approximately SEK1.5 billion in dividends in 2014.

## CreditWatch

The CreditWatch placement reflects the likelihood of a one-notch downgrade following the acquisition of Frank Mohn. We aim to resolve the CreditWatch in the next three months as we gain greater visibility on details of the transaction's close and once we have reviewed the likely pro forma metrics for the enlarged groupin more detail. We will also review recent operating performance trends and discuss with management the company's future financial policy, including its view on dividends and future acquisitions.

We could remove the rating from CreditWatch and affirm it if the acquisition is not completed or if we were to take the view that reductions in debt led to a recovery of credit ratios in line with our "modest" financial risk profile category in the coming 18-24 months. For the rating to remain at 'A-', we would expect credit ratios to improve to almost more than 50% by year-end 2015.

## Ratings Score Snapshot

Corporate Credit Rating: A-/Watch Neg/--

Business risk: Strong
- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Modest
- Cash flow/Leverage: Modest

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: Negative (-1 notch)

## Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Capital Goods Industry, Nov.19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

## Ratings List

Ratings Affirmed; CreditWatch Action

| | To | From |
|---|---|---|
| Alfa Laval AB | | |
| Corporate Credit Rating | A-/Watch Neg/-- | A-/Stable/-- |

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