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Research Update:

Alfa Laval Outlook Revised To Negative On Weaker Operating Conditions; 'BBB+' Ratings Affirmed

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Table Of Contents

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Overview

- Alfa Laval's order intake has weakened, mostly due to its exposure to the volatile oil and gas and shipping sectors.
- We believe this will lead to lower sales and profitability during 2016–2017 than we previously expected.
- We are revising our outlook on Alfa Laval to negative from stable and affirming our 'BBB+' ratings.
- The negative outlook indicates that we could downgrade Alfa Laval if its profitability deteriorated, with EBITDA below 18%, without near-term prospects for recovery.

Rating Action

On May 20, 2016, S&P Global Ratings revised its outlook on Sweden-based machinery manufacturer Alfa Laval AB to negative from stable.

At the same time, we affirmed our 'BBB+' long-term corporate credit rating on Alfa Laval, and our 'BBB+' issue rating on the company's senior unsecured debt.

Rationale

The outlook change follows the downward revision of our forecasts on Alfa Laval's profitability and cash flow over 2016 and 2017. We now see a risk that the company's EBITDA and credit ratios will be low for the rating.

Over the past few quarters, Alfa Laval's order intake has dipped, due to weak demand from the upstream oil and gas and shipping industries. In total, those sectors represent about 40% of the group's sales. We don't expect these industries to recover in the short term, and we now expect Alfa Laval's revenue to decline by about 10%-15% in 2016. As a result of lower volumes in the process technology and marine and diesel divisions, we expect the EBITDA margin to decline by about 150 basis points (bps) to 300bps in 2016, compared with 18.8% in 2015. Furthermore, we cannot rule out potential restructuring costs during 2016 or 2017, given management's recent announcement that a strategic review of its business is ongoing.

The ratings continue to reflect Alfa-Laval's market-leading positions in advanced core technology and plate heat exchangers. The strong business risk profile reflects the company's robust position in its core business and its satisfactory customer, industry, and geographic diversification. It also reflects the company's good cost position, which has historically resulted in above-average industry profitability.

We believe management has been proactive in the past, taking measures that led to high and relatively stable margins, despite the company's exposure to volatile sectors. Alfa Laval has historically reported EBITDA margins in the range of 18%-21%, which we view as above average for the sector. However, we now expect lower product demand to put pressure on profitability and we see a risk that the margins won't remain commensurate with our assessment of a strong business risk profile. This will likely predominantly result from the generally weak economic conditions and difficult operating conditions that we expect the shipping and oil and gas sectors will continue to face over the coming years.

In 2015, Alfa Laval's operating performance was strong, and the company used most of its high free operating cash flow (FOCF) to reduce debt, implying credit measures improved rapidly during the year. In our new base case, however, we expect that cash flow will weaken substantially compared with 2015 and our previous base case. We now forecast funds from operations (FFO) to debt will decline to 30%-35%, compared with 37.6% at year-end 2015. On the positive side, we continue to expect Alfa Laval will generate positive FOCF, still leading to some debt reduction. We forecast FFO to debt to remain at levels in line with the lower end of our intermediate financial risk category.

In our base case, we assume:

- The shipping and oil and gas industries will continue to face difficult operating conditions in the coming year, a 10% decline of order intake for Alfa Laval in 2016, and weak order inflow in 2017.
- As a result, we expect a 10%-15% decrease in the group's consolidated revenue in 2016.
- An EBITDA margin of 15%-19% in 2016, due to lower volumes and potential restructuring costs, with some improvement in 2017.
- Capital expenditure (capex) of about Swedish krona (SEK) 850 million (about $102 million).
- Dividend payments amounting to about SEK1.8 billion in 2016.
- No major acquisitions.
- Modest debt reduction using free cash flow.

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

- FFO to debt declining toward 30%-35% in 2016, recovering to about 33%-37% in 2017.
- FOCF to debt of about 20%-22% in 2016-2017.

We continue to regard Alfa Laval's business risk profile as strong and its financial risk profile as intermediate, resulting in an anchor of either 'a-' or 'bbb+'. Given the risk of weaker margins and cash flows during 2016, we now use the lower anchor of 'bbb+'. At the same time, we have removed the one-notch deduction we previously applied to the anchor, based on our comparable ratings analysis.

Liquidity

We consider Alfa Laval's liquidity to be strong, with a sources-to-uses ratio of more than 1.5x. The company's credit facilities carry one financial covenant that requires net financial debt to be less than 3.5x EBITDA. We expect Alfa Laval will maintain ample headroom under this covenant. We believe that liquidity would remain sufficient to cover uses even if EBITDA fell unexpectedly by 30%. Other supportive factors include Alfa Laval's solid relationships with banks, high standing in credit markets, and the likely ability to absorb high-impact, low-probability events without refinancing.

Principal liquidity sources:

- As of March 31, 2016, cash and short-term investments of about SEK1.9 billion;
- FFO of about SEK4 billion in 2016 and 2017; and
- A five-year multicurrency revolving credit facility, maturing in June 2019, with two tranches of €400 million and $544 million, respectively (totaling SEK8.1 billion), both of which are currently undrawn.

Principal liquidity uses:

- Reported short-term debt of about SEK1.0 billion;
- About SEK800 million-SEK850 million in capex annually over 2016-2017; and
- Annual dividends of roughly SEK1.6 billion-SEK1.7 billion.

Outlook

The negative outlook indicates that we could downgrade Alfa Laval if its profitability deteriorated. We see a one-in-three possibility that Alfa Laval's profitability could deteriorate to a level that is not commensurate with the current rating over the next 12-18 months. This could happen in the event of larger revenue and EBITDA contraction than we currently anticipate, or if profitability becomes more volatile.

Downside scenario

Specifically, we could lower the ratings if Alfa Laval's profitability deteriorates from historically above-average levels, with EBITDA margins below 18% without near-term prospects for recovery. This could stem from continued decline in sales volume and order intake, driven by continued weak demand from the shipping and oil and gas markets, in the absence of sufficient counterbalancing measures from the company.

We could also lower the ratings if Alfa Laval's credit ratios deteriorate, including FFO to debt below 30%. This could also follow significant debt-financed acquisitions or shareholder returns, which we consider unlikely at this stage, however.

Upside scenario

We could revise the outlook to stable if Alfa Laval's EBITDA margin were to remain above 18% and FFO to debt comfortably above 30%. This could happen from an earlier-than-expected upturn in the company's end markets or improvement in its cost base that helped profitability remain at historical levels, despite declining sales.

Ratings Score Snapshot

Corporate Credit Rating: BBB+/Negative/--

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

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: bbb+

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: Neutral (no impact)

Related Criteria And Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Capital Goods Industry, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Alfa Laval AB		
Corporate Credit Rating	BBB+/Negative/--	BBB+/Stable/--
Senior Unsecured	BBB+	BBB+

Additional Contact:
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