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Research Update:

Alfa Laval 'BBB+' Rating Affirmed On Sound Balance Sheet After Unsuccessful Tender Offer On Neles; Off Watch

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Rating Action Overview

- Swedish capital goods company Alfa Laval has announced it will not complete the tender offer for the shares in Neles Oyj because less than 50% of shareholders agreed to tender the shares, easing the risk of a material increase on the company's leverage.
- We anticipate a 10%-12% revenue decline in 2020 from Swedish krona (SEK) 46.5 billion in 2019, following pressure from COVID-19 and subdued oil prices, and EBITDA margin slightly below 17%, when accounting for restructuring costs that we estimate at SEK1 billion in fourth-quarter 2020, from 19% in 2019; moreover, we continue to expect strong cash flow of SEK4 billion-SEK 5 billion, leading to our funds from operations (FFO) to debt remaining above 50% over 2020-2021.
- We are therefore affirming our 'BBB+' long-term issuer credit rating on Alfa Laval and removing it from CreditWatch, where we placed it with negative implications July 14, 2020.
- The stable outlook reflects our expectation that the company's FFO to debt will remain sustainable above 45%, supported by robust free operating cash flow (FOCF) that we expect at SEK4 billion-SEK5 billion annually on average for 2020 and 2021.

Rating Action Rationale

Alfa Laval's decision to walk away from the Neles takeover is credit supportive. This led us to remove the rating from CreditWatch and has eased the risk of material increase of debt on its accounts. Moreover, the stronger than we had anticipated cash in 2020 could lead our FFO to debt at about 50% for the following couple of years. We've reviewed upward our base-case scenario on Alfa Laval following third-quarter 2020 results, reflecting better-than envisaged cash generation. We now believe that the company's balance sheet will be strong enough to sustain a 'BBB+' rating. Alfa Laval reached 33% of Neles' share capital. The tender offer was conditional on that the number of shares would reach more than 50%, so Alfa Laval did not proceed. We understand that the company has acquired shares in Neles outside the tender offer for about SEK1.5 billion (representing about 8.5% of total shares in Neles) over third- and fourth-quarter 2020. We assume the company will hold on to these shares, although these could be sold again now that the majority stake wasn't reached.

Weak global macroeconomic conditions sparked by the COVID-19 pandemic, subdued oil prices, and volatility in the shipping industry are dampening demand for some of Alfa Laval's products. For the first nine months of 2020, order intake was down 7.3% compared with the same period a year earlier (4.4% organically) to SEK30.6 billion, and sales 8.3% (5.1% organically) to SEK30.8 billion. Demand pressure is coming from parts of the Energy and Marine divisions, caused by the pandemic and the subdued oil prices. Marine and energy represents about 60% of sales. Although the bulk of end customers are relatively less volatile than pure oil and gas upstream players or shipyards, we expect continued low demand for these two segments going into 2021 and do not expect that the green energy transition, which drives demand in HVAC and refrigeration, will fully compensate for the demand drop in the near term. The food and water segment has as expected been resilient through the pandemic. Based on that, we forecast revenue to contract 10%-12% in 2020 to SEK41 billion-SEK42 billion in 2020 from SEK46.5 billion in 2019. For 2021, we expect sales to be flat or fall by up to 5%. We expect the company to return to growth in 2022 by up to 5%.

Alfa Laval has managed to sustain profitability throughout the pandemic. Thanks to cost saving initiatives and productivity improvements, adjusted EBITDA margin remained at about 19% for the first nine months of 2020, the same as in 2019. Our base-case scenario incorporates our estimate of SEK1 billion restructuring costs in fourth-quarter 2020 as the company needs to adjust for lower demand on some of its end markets. This leads to adjusted EBITDA for 2020 to be slightly below 17% from 19% in 2019. For 2021, we see profitability lever to come back to historical levels of about 19%.

Strong FOCF is supporting Alfa Laval's credit metrics, although returns to shareholders and small bolt-on acquisitions could impair deleverage form 2021 onward and stabilize FFO to debt at about 50%. FOCF has been remarkably strong for the first nine months of 2020 at SEK4.1 billion, up from SEK1.8 billion over the same period in 2019. Moreover, the company's cancellation of dividends in 2020 resulted in our adjusted net debt falling to about SEK8.7 billion as of Sept. 30, compared with SEK13.1 billion year-end 2019. We expect Alfa Laval's debt to average SEK10 billion-SEK 11 billion for 2020-2021 and FOCF to be SEK4 billion-SEK4.5 billion annually. Still, while the company cancelled dividends to protect its balance sheet and liquidity, under our base-case scenario, we forecast that for 2021, distributions to shareholders could be higher than the usual payout ratio, which averaged 39% over the past couple of years. We therefore see dividends for 2021 to surge to about SEK4 billion, more than 2x dividends paid in 2019. Under our base-case scenario, we also assume up to SEK1 billion per year for small bolt-on acquisitions.

S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. Reports that at least one experimental vaccine is highly effective and might gain initial approval by the end of the year are promising, but this is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by the middle of next year. We use this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Outlook

The stable outlook reflects our expectation that Alfa Laval will continue to benefit from its strong FOCF despite weak demand from some end markets, maintaining FFO to debt at about 50% for both 2020 and 2021. We expect that the low order intake from parts of its energy and marine sectors will continue to weigh on volume into 2021, but expect a gradual recovery from there. The targeted cost restructuring program will likely weigh on EBITDA margins in 2020, which will be slightly lower than 17%, but we expect a recovery to about 19% in 2021.

Downside scenario

We could lower the rating if Alfa Laval's credit ratios materially depart from our expectations, including FFO to debt below 45% with no prospects for short-term recovery. This could follow significant debt-financed acquisitions or higher than envisaged shareholder returns.

We could also lower the rating if Alfa Laval's profitability materially deteriorates from historical levels, specifically if its EBITDA margins dropped significantly below 18% without near-term prospects for recovery. This could stem from further substantial ongoing restructuring expenses, or from a sharper weakening of end markets than what we expect, resulting in declining sales volume and order intake, in the absence of sufficient counterbalancing measures from the company.

Upside scenario

We see limited rating upside over the coming two years. A positive rating action could stem from a material strengthening of credit ratios, including management's commitments to maintain a stronger balance sheet, leading to FFO to debt materially above 60% notwithstanding the business cycle.

Company Description

Alfa Laval is a leading global supplier of products and solutions for heat transfer, separation, and fluid handling. As of end-2019, the company reported revenue of SEK46.5 billion (€4.2 billion), up slightly more than 14% against 2018. Alfa Laval reported an adjusted EBITDA margin of 19% for 2019, virtually unchanged from 2018 and in line with its historical trend of 18%-21%.

The company's main products are:

- Heat exchangers, used in heating and cooling applications for example, representing more than 30% of market share and 40% of its revenue in 2019;
- Separators and decanters to separate liquids from other liquids or solids, representing 25%-30% of market share and 17% revenue in 2019; and
- Fluid handling equipment, including pumps, valves, fittings, and tank equipment for sanitary applications and marine and offshore pumping, representing 10%-12% market share and 22% of consolidated revenue in 2019.

The products are used in a wide range of industrial applications for heating, cooling, separation, and transportation of products such as oil, water, chemicals, beverages, food, pharmaceuticals, and starch.

Alfa Laval first listed on the Stockholm Stock Exchange in 1901, where it remained for 90 years, until Tetra Pak bought the company in 1991. It returned to the stock exchange on May 17, 2002. As of Dec. 31, 2019, Tetra Laval B.V., ultimately owned by Tetra Pak, controls 29.1% of Alfa Laval's capital. Free float as of the same date represented about 50% of shares outstanding. The company's market capitalization was about SEK82.3 billion (€8.0 billion) as of Nov. 11, 2020.

Our Base-Case Scenario

Assumptions

- The COVID-19 pandemic, coupled with subdued oil prices and volatility in the shipping industry, denting demand for Alfa Laval's products over the near-to-medium term.
- Revenue falling 10%-12% in 2020, and up to 5% in 2021 based on relatively weak oil and gas and marine orders. We expect a gradual recovery from second-half 2021 and forecast 2022 sales growth of about 3%-7%. Therefore, the top line figure would be SEK41 billion-SEK42 billion in 2020, down from SEK 46.5 billion in 2019.
- EBITDA margin deteriorating to slightly lower than 17% in 2020, because of a difficult operating environment, and including our estimate of about SEK1 billion one off costs for the targeted restructuring program, down from 19.0% in 2019, but recovering to about 19% in 2021.
- Neutral working capital outlays in 2020, and up to SEK1.5 billion in 2021 on a conservative basis, on recovering sales volume, against a cash outflow of more than SEK2 billion for 2019.
- Gross capital expenditure (capex) of about SEK1.1 billion in 2020, increasing to about SEK1.3 billion annually in 2021-2022, same as in 2019.
- No dividend payment in 2020. Given the company's strong cash balance, we foresee dividends up to SEK4 billion, before normalizing to about SEK2 billion per year thereafter.
- No or limited bolt-on acquisitions in 2020, apart from the shares acquired in Neles for about SEK 1.5 billion. We forecast small bolt-on acquisitions of up to SEK1 billion per year thereafter.

Key metrics

Table 1

Alfa Laval AB--Key Metrics*

	--Fiscal year ended Dec. 31--				
	2018a	2019a	2020e	2021f	2022f
(Mil. SEK)					
Revenue	40,666	46,517	41,000-42,000	38,000-43,000	39,000-44,000
EBITDA	7,771	8,830	6,900-7,100	7,600-8,000	8,000-8,400
Free operating cash flow (FOCF)	3,693	3,725	4,250-4,750	4,000-4,500	4,000-4,500
Debt/EBITDA (x)	1.6	1.5	1.3-1.7	1.3-1.7	1.3-1.7
FFO/debt (%)	46.0	50.7	50-55	48-53	53-58
FOCF/debt (%)	29.2	28.4	40-45	About 35	About 35

*All figures adjusted by S&P Global Ratings. SEK--Swedish krona. a--Actual. e--Estimate. f--Forecast.

Liquidity

We consider Alfa Laval's liquidity strong, with a sources-to-uses ratio of about 2.2x over the coming 12 months started Oct. 1, 2020, and 1.5x over the coming 24 months. We also believe that the group's geographic and end-market diversity should enable it to absorb high-impact, low-probability events in some sectors without refinancing. Other supportive factors include Alfa Laval's solid relationships with banks, its high standing in credit markets as supported by its repeated access to capital markets, and the solid investment-grade rating. Although not included in our liquidity analysis, the company's SEK2 billion commercial paper program is fully available and not utilized.

Principal liquidity sources include:

- Unrestricted cash and short-term investments of about SEK7.1billion as of Sept. 30, 2020
- Cash FFO of SEK5.0 billion-SEK6.0 billion in coming 12 months and SEK5.5 billion-SEK6.5 billion the 12 months thereafter
- A fully undrawn €900 million revolving credit facility, maturing in June 2022

Principal liquidity uses include:

- Debt repayments of SEK1.0 billion over the coming 12 months and SEK7.1 billion over the following 12 months when its €500 million bond comes due
- Working capital outflow up to SEK 2.5 billion-SEK2.6 billion for the following 12 months and SEK3.0 billion-SEK3.1 billion over the flowing 24 months when assuming SEK2 billion on intrayear working capital swing
- About SEK1.3 billion in capex per year
- Dividend payments up to SEK4.2 billion over the next 12 months, then about SEK2.0 billion over the following 24 months
- SEK1 billion for the acquisition of Neles' shares

Issue Ratings--Subordination Risk Analysis

Capital structure

Alfa Laval's capital structure consists of senior unsecured debt issued at its financing subsidiary, Alfa Laval Treasury International AB. The gross debt stood at SEK 12.0 billion at year-end 2019.

Analytical conclusions

We rate Alfa Laval's debt 'BBB+', in line with the issuer credit rating, because no significant elements of subordination risk are present in the capital structure, supported by the group's modest financial risk profile.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/--

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Modest

- Cash flow/Leverage: Modest

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

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Alfa Laval AB		
Issuer Credit Rating	BBB+/Stable/--	BBB+/Watch Neg/--
Alfa Laval Treasury International AB		
Senior Unsecured	BBB+	BBB+/Watch Neg

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings 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.