

Research Update:

Alfa Laval AB 'BBB+' Ratings Placed On CreditWatch Negative On Potential Takeover Of Neles Oyj

July 14, 2020

S&PGR Places Alfa Laval AB 'BBB+' Ratings On CreditWatch Neg

Rating Action Overview

- On July 13, 2020, Alfa Laval AB (publ) (Alfa Laval) announced it is launching a public cash tender offer on the listed Finnish company Neles Oyj (Neles) for an equity value of €1.73 billion (approximately SEK17.8 billion).
- If successful, the transaction should result in Alfa Laval's S&P Global Ratings-adjusted debt more than doubling from its 2019 year-end level, depressing the group's credit metrics from current levels.
- We are therefore placing our 'BBB+' ratings on Alfa Laval and the debt issued by its subsidiary Alfa Laval Treasury International AB on CreditWatch with negative implication.
- The CreditWatch placement reflects the risk that we could downgrade Alfa Laval by one or two notches following the acquisition. The extent of the downgrade would depend on Alfa Laval's capital structure following the acquisition, potential remedial actions to reduce leverage, and the combined group's ability to restore credit ratios to a level commensurate with an intermediate financial profile, such as funds from operations (FFO) to debt above 30% and free operating cash flow (FOCF) to debt of about 20% by the end of 2022.

Rating Action Rationale

Alfa Laval intends to acquire 100% of Neles, with the takeover process continuing until October 2020. On July 13, 2020, Alfa Laval entered into a combined agreement with Neles, according to which Alfa Laval will launch a public cash tender offer on the listed Finnish company for an equity value of €1.73 billion (approximately Swedish krona [SEK] 17.8 billion). The transaction will be funded from debt and available cash. Adding the €92 million of net debt outstanding at Neles, the offer represents a total enterprise value of €1.82 billion (approximately SEK18.8 billion). The takeover process is conditional on a minimum two-thirds acceptance by Neles' shareholders and, in compliance with Finnish equity market regulations, the transaction may include a squeeze-out process if 90% of shareholders tender their shares.

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If successful, the acquisition will lead Alfa Laval's S&P Global Ratings-adjusted debt to more than double from its end-2019 level (SEK 13.1 billion), depressing the group's credit metrics from current levels. If the transaction goes ahead, we expect adjusted FFO to debt will fall to about 30% on a pro-forma basis, including Neles on a full-year basis, over our 2021-2022 forecast horizon, and anticipate FOCF to debt of about 20%. The CreditWatch placement reflects the risk that we could downgrade Alfa Laval by one or two notches if it acquires Neles. The extent of the downgrade will ultimately depend on Alfa Laval's capital structure following the acquisition, potential remedial actions to reduce leverage, and the combined group's ability to restore credit ratios to a level commensurate with our intermediate financial profile, such as FFO to debt above 30% and FOCF to debt of about 20% by the end of 2022. We appreciate that, because Neles is a listed company, the combined entity's final capital structure will depend on any possible counter-offer, potentially improved terms in the Alfa Laval offer, the size of the final stake purchased by Alfa Laval, and any requirement to buy out minority shareholders. Alfa Laval's current price-per-share offer represents an about 30% premium to Neles' shares recent trading. We note that an acquisition of this magnitude was not part of our base case scenario for 2020, given the current macro environment (see "Alfa Laval AB" published June 4, 2020).

Neles is a clear strategic fit and will contribute to about 13% of combined EBITDA, but is exposed to some business volatility, and is marginally less profitable than Alfa Laval's operations. Following the spin-off of Metso minerals effective June 30, 2020, we consider Neles' (formerly Metso Corp.) credit standing as weaker than that of Alfa-Laval. We take into consideration its limited size, with reported pro-forma revenue of €660 million in 2019, expected to fall by about 5% in 2020, as well as its reliance on a narrow offering (primarily valves for the flow control business), and exposure to potentially volatile oil and gas (37% of 2019 revenue) and petrochemicals and chemicals (21%) sectors. At the same time, we acknowledge the company's good profit margins for valve operations, and management's ambitions to achieve a reported EBITA margin of 15% over the cycle. We also recognize the strategic fit of Neles for Alfa Laval, in particular for its fluid-handling operations, with a customer base known to both companies and reinforced ability to cross-sell and expand, especially in services, valves control, and connectivity. Additionally, within the oil and gas sector, Neles has limited exposure to upstream production and 70% of its business is driven by operating expenses and maintenance and repair needs.

For more information see "Neles Downgraded To 'BB/B'; Withdrawn At Company's Request," published July 1, 2020, on RatingsDirect)

We believe the integration of Neles would have a slight dilutive impact on Alfa Laval's EBITDA margins and could prevent them returning to 18%-21% over 2021-2022 as we previously expected. In 2019, Neles generated €97 million EBITA on a pro-forma basis, representing a 14.7% margin on sales, and a S&P Global Ratings-adjusted EBITDA margin of about 17.9%. The COVID-19 pandemic will affect Neles' profitability metrics in 2020 and we forecast that Neles' adjusted EBITDA margin will hover at about 16% on a full-year basis. During first-quarter of 2020, Neles' sales fell 12%, with cancellation or postponement of site works likely to have been more pronounced during second-quarter.

CreditWatch

We aim to resolve the CreditWatch placement around the closing of the transaction, once we have greater visibility on the outcome of Alfa Laval's current bid on Neles.

If the takeover attempt is successful and largely debt funded, we are likely to downgrade Alfa-Laval by one or two notches. The extent of the downgrade will ultimately depend on Alfa-Laval's capital structure following the acquisition, potential remedial actions to reduce leverage, and the combined group's ability to restore credit ratios to a level commensurate with our intermediate financial profile, such as FFO to debt above 30% and FOCF to debt of about 20% by the end of 2022.

If the bid fails or is withdrawn, we could affirm our 'BBB+' rating with a negative outlook, assuming we do not have to factor in adverse developments with respect to Alfa-Laval's financial policy and stand-alone operating performance.

Company Description

Alfa Laval is a leading global supplier of products and solutions for heat transfer, separation, and fluid handling. As of year-end 2019, the group reported revenue of SEK46.5 billion (approximately €4.5 billion), an increase of 12.5% year on year. Its adjusted EBITDA margin stood at of 19.0%, in line with the historical trend of 18%-21%.

Alfa Laval's main products are:

- Heat transfers used in heating, cooling, and ventilation systems, representing more than 30% of market share and 40% of the group's revenue in 2019;
- Separators and decanters to separate liquids from other liquids or solids, representing 25%-30% of market share and 17% of 2019 revenue; and
- Sanitary fluid-handling equipment, including pumps, valves, and fittings (where an acquired Neles would likely fit), representing a 10%-12% market share and 22% of the group's consolidated revenue in 2019.

Liquidity

We consider Alfa Laval's liquidity as strong, considering the Neles acquisition is 100% pre-funded and sources-to-uses ratios is above 1.5x over the coming 12 months and over the coming 24 months. We believe the group's geographic and end-market diversity should enable it to absorb high-impact, low-probability events in some sectors without the need for 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 investment-grade rating. Although not included in our liquidity analysis, Alfa Laval's SEK2 billion commercial paper program is fully available.

Assuming the Neles acquisition takes place in the coming months, principal liquidity sources as of June 30, 2020 will be:

- Cash and short-term investments of about SEK7 billion;
- Cash FFO of SEK5.0 billion in 2020 and SEK6.0 billion in 2021;
- An undrawn €900 million (approximately SEK9.3 billion) revolving credit facility, maturing in June 2022, about a third of which we would expect will be drawn for the acquisition; and
- A fully committed debt financing extended by Skandinaviska Enskilda Banken AB (SEB) and sized to fund the majority of the acquisition outflow. The line is medium-term and available subject only to completion of the tender offer.

Principal liquidity uses as of the same date include:

- Neles acquisition for an enterprise value of €1.82 billion, (approximately SEK18.8 billion), including refinancing of Neles' existing net debt of €92 million;
- Debt repayments of SEK1.1 billion over the coming 12 months and SEK2 billion over the following 12 months;
- Working capital outflows up to SEK300 million in 2020, increasing to SEK0.5 billion–SEK 1.5 billion in 2021 on recovering sales volumes;
- About SEK1.0 billion in capital expenditure annually over 2020-2021; and
- No dividend payment in 2020, returning to about SEK2 billion in 2021, assuming that the recovery in earnings is confirmed.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/CWNeg./--

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)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Neles Downgraded To 'BB/B'; Withdrawn at company's request July 01, 2020

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

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

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.

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