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Research Update:

Machine Maker Alfa Laval Outlook Revised To Stable On Stronger Results From Recovering End Markets; Affirmed At 'BBB+'

Primary Credit Analyst:
Mikaela Hillman, Stockholm + 46 84 40 5917; mikaela.hillman@spglobal.com

Secondary Contact:
Per Karlsson, Stockholm (46) 8-440-5927; per.karlsson@spglobal.com

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Overview

- Alfa Laval's order intake has improved, driven by gradual recovery of its end markets, notably of the oil and shipping sectors, and we believe this trend will continue through 2019.
- We expect this will lead to strongly positive free operating cash flow that in turn will help Alfa Laval to continue reducing its debt.
- We are therefore revising our outlook on Alfa Laval to stable from negative and affirming our 'BBB+' ratings.
- The stable outlook reflects that, thanks to its strong market position, Alfa Laval should be able to benefit from revitalizing market conditions, resulting in a gradual improvement in profitability and reduced debt.

Rating Action

On May 23, 2018, S&P Global Ratings revised its outlook on Sweden-based machinery manufacturer Alfa Laval AB to stable from negative.

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

Rationale

The outlook revision follows Alfa Laval's strong order intake in 2017 and first-quarter 2018--when orders increased by 14% and 16%, respectively--which we believe will lead to improving profitability and cash flow generation over 2018 and 2019. There is a gradual, but clear improvement in the company's more volatile end markets, particularly the oil sector, where the oil price appreciation has enabled new investments, and shipping, with increasing demand for new vessels and recovery for tankers (see "Global Shipping Is On Course For Recovery In 2018, But All Eyes Are On Orderbooks," published Feb. 13, 2018, on RatingsDirect). We also believe that Alfa Laval's marine environment applications in ballast water treatment and sulfur oxide reduction will continue to drive growth in the near to medium term in light of new environmental regulations.

We expect that Alfa Laval's higher volumes, together with the cost-saving initiatives over the past couple of years, should enable the company to gradually improve its profitability. We now forecast sales growth of about 5%-10% in 2018, and the EBITDA margin to improve to about 19.5% from 19.1% in 2017.

Alfa Laval continued to use part of its free operating cash flow (FOCF) to reduce debt during 2017, resulting in continued gradual improvement in credit measures during the year. Funds from operations (FFO) to debt stood at 35.7% at end-2017, up from 29.0% at end-2016. We note that management is planning somewhat higher investments than previously, to ensure capacity to meet the higher demand. Furthermore, we do not rule out that the company will grow through small bolt-on acquisitions. However, we expect that the group will continue to use some of its FOCF for debt reduction, resulting in its adjusted debt level dropping to about Swedish krona (SEK)11.5 billion-SEK12.5 billion (€1.13 billion-€1.23 billion) in 2019. We believe the combined effect will lead to a continued gradual strengthening of Alfa Laval's credit ratios, including FFO to debt improving to about 40%-44% in 2018, before approaching 50% in 2019. We continue to forecast that Alfa Laval will be able to generate positive discretionary cash flow to debt of above 15%, which it was able to do also during softer industry conditions in 2016-2017.

The rating continues to reflect Alfa-Laval's market-leading positions in heat transfer (30%-35% market share), separation (25%-30%), and fluid handling (10%-12%) through its key products--heat exchangers, separators, pumps, and valves. We view Alfa Laval as having satisfactory customer, end-market, and geographic diversification. Its solutions are used in a wide range of industrial processes, and, although energy and shipping represent about 40% of sales, the group has broad end-market diversity; its products are used in the manufacturing of food, chemicals, and pharmaceutical, as well as in engineering, waste-water treatment, and indoor climate control. These markets are also more stable than the aforementioned, which alongside its service sales (about 30% of sales), somewhat mitigate the volatility from some of its core sectors. That said, Alfa Laval is of moderate size compared with larger and more diversified capital goods peers like Atlas Copco, ABB, and Siemens. We view as positive for the rating the company's flexible cost structure, which has enabled the group to sustain its EBITDA margin at about 18%-21%, despite its exposure to the volatile oil and gas and shipping sectors, where investment levels saw a material drop over 2014-2017.

We note there is some investment need to resolve capacity constraints, which has followed from strong order intake. Although we are not concerned about the somewhat higher capital expenditures (capex), we believe that the broad-based industrial transformation could lead to an ongoing need for higher investments and research and development spending in the near term.

In our base case, we assume:

- The shipping and oil and gas industries will continue to show a gradual, but firm, recovery in investment 2018-2019, resulting in continued growth in order intake.

- A 5%-10% increase in the group's consolidated revenues in 2018, driven by the strong order intake over the last year, and about 2%-5% in 2019.
- An EBITDA margin of 19%-20% in 2018, with some further improvement in 2019, due to increasing volumes and cost-efficiency measures.
- Capex of about SEK1.0 billion-SEK1.2 billion annually in 2018-2019, up from about SEK675 million in 2017, reflecting the group's announced capacity investment.
- Dividends of about SEK1.8 billion in 2018 and 2019.
- The possibility of small-to-midsized bolt-on acquisitions of up to SEK1.5 billion.

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

- FFO to debt of about 40%-44% in 2018, improving to about 48%-52% in 2019.
- FOCF to debt of about 29%-33% in 2018 and 37%-41% in 2019.

Liquidity

We consider Alfa Laval's liquidity to be strong, with a sources-to-uses ratio of about 4.4x and 2.9x over the coming 12 and 24 months, respectively. 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%. We also believe that the groups geographic and end-market diversification 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, high standing in credit markets as supported by its repeated access to capital markets, and solid investment-grade rating.

We estimate that principal liquidity sources for the 12 months from March 31, 2018, include:

- Cash and short-term investments of about SEK2.8 billion;
- Cash FFO of about SEK5.5 billion in 2018 and 2019; and
- A five-year multicurrency revolving credit facility, maturing in June 2021, with two tranches of €400 million and $544 million, respectively (totaling SEK8.7 billion), both of which are currently undrawn.

We estimate that principal liquidity uses include:

- No material debt maturities over the coming 12 months, and about SEK3 billion in the 12 months thereafter;
- About SEK1.0 billion-SEK1.2 billion in capex annually over 2018-2019; and
- Annual dividends of about SEK1.8 billion.

Outlook

The stable outlook reflects our expectation that Alfa Laval will continue to benefit from recovering end markets, and that strong order intake and gradual improvement in profitability should lead to improving FOCF generation over the coming two years. While we do not rule out some small-to-midsized bolt-on acquisition, we consider management has demonstrated commitment to deleveraging, and we expect that the company will be able to continue delivering discretionary cash flow of about 15%, resulting in a gradual improvement in credit ratios.

Downside scenario

We could lower the rating if Alfa Laval's credit ratios did not improve in line with our expectations, including FFO to debt of about 40%-44% in 2018 and improving to about 48%-52% in 2019. This could follow significant debt-financed acquisitions or shareholder returns, which we consider unlikely at this stage.

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 restructuring expenses, or from an unexpected weakening of end markets, 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. We could, however, raise the rating if Alfa Laval's EBITDA margin improved markedly and the group increased its diversification, or strengthened its position through strategic bolt-on acquisitions. Rating upside could also stem from a material strengthening of credit ratios, including FFO to debt sustainably above 60% over the business cycle.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/--

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

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 ratings analysis: Positive (+ 1 notch)

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.

Analytical conclusions

We rate Alfa Laval's debt 'BBB+', in line with the issuer credit rating, since no significant elements of subordination risk are present in the capital structure.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Capital Goods Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Alfa Laval AB		
Issuer Credit Rating	BBB+/Stable/--	BBB+/Negative/--

Ratings Affirmed

Alfa Laval Treasury International AB	
Senior Unsecured	BBB+

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com

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. 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.