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Research Update:

Sweden-Based Machinery Manufacturer Alfa Laval Downgraded To 'BBB+'; Off Watch; Outlook Stable

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Overview

- On May 22, 2014, Sweden-based machinery manufacturer Alfa Laval AB completed the acquisition of Norway-based submerged pumping systems manufacturer Frank Mohn A/S.
- The acquisition price of approximately Norwegian krone (NOK)13 billion was debt financed, implying a heavy debt increase.
- We are consequently lowering our rating on Alfa Laval to 'BBB+' from 'A-'.
- The stable outlook reflects our expectations that the company will show improving credit metrics over the coming two years, thanks to gradual debt reductions.

Rating Action

On May 26, 2014, Standard & Poor's Ratings Services lowered its long-term corporate credit rating on Sweden-based machinery manufacturer Alfa Laval AB to 'BBB+' from 'A-'. The outlook is stable.

At the same time, we removed the rating from CreditWatch where we had placed it on April 7, 2014.

Rationale

The downgrade follows the announcement that Alfa Laval had completed the acquisition of Norway-based submerged pumping systems manufacturer Frank Mohn A/S (not rated). We understand the transaction, valued at approximately NOK13 billion (Swedish krona (SEK)14 billion, or US$2.1 billion), has been financed through debt, implying that the company's debt level will almost quadruple at the time of the acquisition. Although we expect a gradual decrease in debt over the coming years, we project that the increased debt level will cause Alfa Laval's consolidated adjusted funds from operations (FFO)-to-total debt ratio to weaken to 30%-35% in the next 12 months and about 37%-43% in 2015 following the acquisition (pro forma). These levels are not commensurate with the previous 'A-' rating.

Our "strong" assessment of the the company's business risk profile remains unchanged for now. However, we think that the acquisition will meaningfully diversify Alfa Laval's product lines and enlarge the company's earning base.

Furthermore, Frank Mohn has a strong position within its core market. We assume the acquisition will have a moderately positive impact on the consolidated margins, given that Frank Mohn has historical margins at 25%-30%. In 2013, Alfa Laval generated strong adjusted EBITDA of about SEK5.8 billion with margins at 19.3%. In 2014, we assume continued robust performance of approximately SEK7.5 billion-SEK8.0 billion for the consolidated group, based upon 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 consolidated group's sales following the acquisition.

We have reassessed Alfa Laval's financial risk profile as "intermediate," versus "modest" in our previous base case, following the large increase in debt linked to the acquisition. We view the large debt-financed acquisition as a material deviation from our previous expectations. We now expect debt to increase to about SEK17 billion-SEK19 billion at year-end 2014. Nevertheless, thanks to strong free cash flows, we note meaningful deleveraging potential, despite substantial dividends in the past. Alfa Laval reported discretionary cash flow of about SEK2.4 billion in 2013.

Under our base case, we assume:

- The NOK13 billion (SEK14 billion) acquisition of Frank Mohn to close in the second half of 2014.
- About 20% increase in revenues of the consolidated group.
- An EBITDA margin of about 20%.
- A moderate increase in capital expenditures for the consolidated group compared with Alfa Laval's historical stand-alone levels of about SEK500 million-SEK550 million per year.

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

- About 30%-35% of FFO to debt at year-end 2014.
- Debt to EBITDA of 2.2x-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 that the company used a SEK12 billion bridge facility to finance the acquisition; the remainder was drawn from the committed credit facilities in place and cash in hand. We understand management plans to re-finance the bridge facility before it is classified as a short-term loan.

On March 30, 2014, we calculated the company's liquidity sources as comprising:

- Cash and liquid assets of about SEK1.6 billion.
- A five-year multicurrency revolving credit facility of an approximate total of SEK5.5 billion, maturing in April 2017, and other long-term committed facilities of about SEK1 billion. Those facilities were undrawn at March 31, 2014, but we expect that about SEK1 billion were drawn to finance the acquisition in the second quarter of 2014.
- Our expectation of annual FFO of more than SEK4 billion in 2014,

improving to about SEK5 billion post-acquisition in 2015.

At the same date, we calculated the following cash uses:

- About SEK1.2 billion million of short-term maturities from the 12 months started March 30, 2014.
- About SEK600 million-SEK700 million in capital expenditures over 2014-2015 annually.
- Roughly SEK1.5 billion in dividends in 2014.

Outlook

The stable outlook reflects our expectation that Alfa Laval will continue to report strong operating performance that will continue to lead to solid operating cash flows and debt reduction in the coming two years.

We expect adjusted FFO to debt of about 35%-40%, adjusted debt to EBITDA of about 2x, and positive free operating cash flow to debt, in line with the current rating. We currently don't project any further large acquisition. However, we don't exclude minor bolt-on acquisitions in the range of SEK500 million and SEK1 billion annually.

Upside scenario

Given Alfa Laval's strong cash flow generations, we see some potential for a one-notch upgrade over the longer term. However, a positive rating action would hinge on company's ability to sustain a strong financial performance that exceeds the requirements of the current rating. At the same time, we would need to observe clear guidance with regards to the company's financial policy and acquisition levels, and credit ratios such as FFO to debt and debt to EBITDA above 50% and below 2x, respectively.

Downside scenario

We would consider lowering the rating if Alfa Laval were to continue to undertake significantly more aggressive debt-financed acquisitions, or aggressive shareholder returns, that resulted in credit ratios outside our expectations. However, we consider the possibility of these scenarios to be only moderately likely.

Ratings Score Snapshot

Corporate Credit Rating: BBB+/Stable/--

Business risk: Strong

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

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

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 ratings 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

Downgraded; Outlook Action

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

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