Research Update:

Alfa Laval 'BBB+' Rating Affirmed On Improving Leverage And Operating Performance; Outlook Stable

May 21, 2019

Rating Action Overview

- Alfa Laval has exhibited robust operating performance over the last few fiscal quarters, growing its order intake by 23% from end-2017, to Swedish krona (SEK) 45 billion at end-2018.
- Our adjusted EBITDA margin for 2018 and for first-quarter (Q1) 2019 improved to slightly more than 19%, with free operating cash flow (FOCF) improving to about SEK3.7 billon, representing about 9% of sales.
- Given management's focus on operational improvement and balance sheet strengthening, funds from operations (FFO) to debt reached about 46% at end-2018, and we forecast further improvement to this metric over 2019.
- We are therefore affirming our 'BBB+' rating on Alfa Laval.
- The stable outlook reflects our expectation that Alfa Laval will continue improving its leverage metrics, with FFO to debt over the cycle above 45%, sustained by FOCF that we expect at SEK4 billion-SEK5 billion.

PRIMARY CREDIT ANALYST

Marta Bevilacqua
Milan
+ (39)0272111298
marta.bevilacqua
@spglobal.com

SECONDARY CONTACT

Per Karlsson
Stockholm
(46) 8-440-5927
per.karlsson
@spglobal.com

ADDITIONAL CONTACT

Industrial Ratings Europe
Corporate_Admin_London
@spglobal.com

Rating Action Rationale

Alfa Laval displayed robust operating performance and improved credit metrics in 2018 and Q1 2019, specifically FFO to debt of 46% at end-2018 (versus 34.7% for end-2017), with expectation of further improvement over the course of 2019.

We forecast that Alfa Laval will sustain this improved operating performance through 2019, with our adjusted EBITDA margin at about 19% for 2019, which would translate into FOCF between SEK4 billion and SEK5 billion for the year.

Over 2018 and first-quarter 2019, the company's operating performance was supported by good conditions in its core end markets. This translated into an increased order intake, reaching SEK45 billion at end-2018, up by 23% against end-2017, and SEK12.2 billion for Q1 2019, up by 22% against Q1 2018. That said, over the remainder of 2019, we expect some softening of demand for

Alfa Laval's products, given the very high levels reached in 2018 and Q1 2019. We still expect the company will grow its top line at a moderate pace, and we see revenue increasing over 2019 by about 5% to SEK42.6 billion, against SEK40.7 reached at end-2018 (+15.2% year on year). This, together with management's focus on deleveraging to strengthen its balance sheet, should lead to FFO to debt at about 50% at end-2019. Moreover, we expect the company to be able to sustain FFO to debt above 45% over the cycle, thanks to its improved cost base and the launch of new products.

Over the last couple of years, Alfa Laval continued to use part of its FOCF, resulting in continued, gradual improvement in credit measures. This improved the FFO-to-debt ratio to 46% in 2019 from 30% at end-2016. That said, we note that management is planning somewhat higher investments, which under our assumptions will be about SEK1.5 billion per year, as well as some wrap-up of research and development (R&D) of about 2.5% of sales. We see this sustaining further sales and volume after years during which the company has somewhat underspent R&D and expansion capital expenditure versus peers.

Furthermore, we do not rule out that the company will grow through small bolt-on acquisitions, which we see in the range of SEK1 billion per year.

We understand that the application of International Financial Reporting Standard (IFRS) 16 would have a slightly negative effect on Alfa Laval's credit metrics, which would have been higher without IFRS 16. This because debt for 2019 would increase under IFRS 16 by about SEK2.8 billion for the right of use assets, whereas our adjustment at the end of 2018 was SEK1.8 billion. That said, we expect Alfa Laval will be able to absorb higher adjusted debt, thanks to its steady operating performance. Therefore, for 2019 we expect Alfa Laval's adjusted debt to reach SEK12.3 billion, about SEK500 million lower than in 2018.

The rating continues to reflect Alfa Laval's solid position in its core businesses. The company holds leading positions in its core technologies: heat exchangers and separators. Alfa Laval has 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. The company's track record as a reliable supplier of quality products and its global service network underpin its strong brand name. Alfa Laval is also well positioned to benefit from its environmental products for ballast water treatment and for scrubbers, which gained importance in 2016 after the International Maritime Organization introduced stricter norms on ballast water treatment as well as demands on sulfur reduction in ships' exhaust gases. We believe that Alfa Laval will continue to benefit from demand for energy-efficient solutions. In addition, its geographic diversity reduces the impact of regional cyclicality.

We believe Alfa Laval's strong profitability in the industries it operates supports its business risk. Thanks to the company's efforts to reduce costs and the good supportive market conditions in 2018, the EBITDA margin reached nearly 20%. We view as positive for the rating the company's flexible cost structure, which has enabled it 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. As seen in the past, investment levels in the oil and gas and marine divisions are the largest risk for Alfa Laval's EBITDA margin. The weakening demand from oil and gas and marine-related products led to reduced profitability in 2016 to 16.2% compared with historically high levels of about 19% on average.

Broad end-market diversity counterbalances Alfa Laval's moderate size, although energy and shipping represent about 40% of sales.

Outlook

The stable outlook reflects our expectation that Alfa Laval will continue to benefit from supportive, albeit softening, demand from its end markets. Moreover, the strong order intake and gradual improvement in profitability should lead to improving FOCF generation over 2019 and 2020. While we do not rule out some small-to-midsize bolt-on acquisitions, we consider management has demonstrated a commitment to deleveraging. We therefore expect the company to continue improving its leverage metrics with FFO to debt over the cycle above 45%. For 2019 we expect FFO to debt to be at around 50%.

Downside scenario

We could lower the rating if Alfa Laval's credit ratios materially depart from our expectations, including FFO to debt below 40%. 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. Rating upside could stem from a material strengthening of credit ratios, thanks to management's commitments to maintain a strong balance sheet leading to FFO to debt sustainably above 60% over the business cycle.

We could also raise the rating if Alfa Laval's EBITDA margin improved markedly from current levels and the company increased its diversification, or strengthened its position through strategic bolt-on acquisitions.

Company Description

Alfa Laval is a leading global supplier of products and solutions for heat transfer, separation, and fluid handling. As of end-2018, the company reported revenue of SEK41 billion, representing an increase of slightly more than 15% against 2017. The company reported an adjusted EBITDA margin of 19.1% at end-2018, virtually unchanged against 2017 and in line with its historical trend of 18.0%-21.0%.

The company's main products are:

- Heat exchangers used for example heating and cooling applications, representing more than 30% of market share and 44% of its revenue in 2018.
- Separators and decanters to separate liquids from other liquids or solids, representing 25%-30% of market share and 18% revenue in 2018; and
- Fluid handling equipment, including pumps, valves, fittings or tank equipment for sanitary applications as well as for marine and offshore pumping, representing 10%-12% market share and 23% of the consolidated revenue in 2018.

Alfa Laval's products are used in a wide range of industrial applications for the 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. Alfa Laval returned to the stock exchange on May 17, 2002. As of Jan. 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 represents about 53% of Alfa Laval's outstanding shares. The company's market capitalization was about SEK88.7 billion (€8.2 billion) as of May 21, 2019.

Our Base-Case Scenario

- Due to softening investment in shipping and oil and gas, we expect consolidated revenue to increase by 4%-5% in 2019 then flatten out in 2020, against about 15% growth in 2018. As such, the 2019 top-line figure would be about SEK42 billion-SEK43 billion in 2019 and 2020.
- An EBITDA margin at around 19.0% in 2019, softening slightly to around 18.5% in 2020, against 19.1% recorded in 2018.
- Working capital outflows up to SEK300 million in 2019, reducing to SEK20 million-SEK50 million in 2020, against a cash outflow of more than SEK500 million for 2018.
- Gross capex of about SEK1.5 billion annually in 2019-2020, in line with 2018. That said, we understand the company is expecting lower capex from 2020.
- Annual cash dividends of about SEK2.1 billion for 2019 and 2020, representing an 18% increase from the disbursement in 2018.
- The possibility of small-to-midsize bolt-on acquisitions of SEK1 billion per year.
- Our assumption of SEK400 million cash inflow for the air heat exchanger business, which closed on April 30, 2019.

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

- FFO to debt of 50%-55% improving to 55%-60% in 2020;
- FOCF at SEK4 billon–SEK5 billion; and
- FOCF to debt of about 35% in 2019, improving to about 40% in 2020.

Liquidity

We consider Alfa Laval's liquidity to be strong, with a sources-to-uses ratio of about 2.5x over the 12 months started April 1, 2019, and 3.6x over the next 24 months.

We also believe that the company'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, high standing in credit markets as supported by its repeated access to capital markets, and our solid investment-grade rating on the company. Although not included in our liquidity analysis, we note that Alfa Laval's SEK2 billion commercial paper program in place is fully available.

At the same time, the company's history of mergers and acquisitions limits our liquidity assessment, as it occasionally undertakes small bolt-on acquisitions utilizing its cash sources.

We estimate Alfa Laval's principal liquidity sources for the 12 months from April 1, 2019, include:

- Cash and short-term investments of about SEK3.6 billion when factoring in our assessment of trapped cash amounting to about SEK2 billion.
- Cash FFO of about SEK5 billion–SEK6 billion per year in 2019 and 2020.
- A fully undrawn multicurrency revolving credit facility, maturing in June 2021, with two tranches of €400 million and $544 million, which we expect the company will renew well ahead of maturity. These amount to about SEK9.5 billion.
- Cash proceeds from the disposal of the air heat exchanger business amounting to SEK400 million.

We estimate Alfa Laval's principal liquidity uses for the 12 months from April 1, 2019, include:

- Debt repayments of SEK3.8 billion for the next 12 months. We included about SEK502 million short-term debt in our liquidity analysis, related to asset available for sale. For the subsequent 24 months, the amount decreases to SEK1.3 billion.
- Working capital outflows of up to about SEK250 million in the next 12 months, reducing to about SEK30 million for the subsequent 24 months.
- About SEK1.5 billion in capex annually over 2019-2020.
- Annual dividends of slightly more than SEK2 billion.

Covenants

The company's credit facilities carry one financial covenant that requires net financial debt to be less than 3.5x EBITDA, which is, however, not tested owing to the investment-grade issuer credit rating.

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.

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: 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

- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Capital Goods Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, 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

Related Research

- Alfa Laval AB, March 22, 2019
- Machine Maker Alfa Laval Outlook Revised To Stable On Stronger Results From Recovering End Markets; Affirmed At 'BBB+', May 23, 2018

Ratings List

Ratings Affirmed	
Alfa Laval AB	
Issuer Credit Rating	BBB+/Stable/--
Alfa Laval Treasury International AB	
Senior Unsecured	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. 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.