Voith GmbH & Co. KGaA
Germany, Capital Goods

SCOPE BBB STABLE

Corporate profile

Founded in 1867, Voith GmbH & Co. KGaA (Voith) is a 100% family-owned company in specialising in the mechanical engineering sector with headquarters in Heidenheim/Brenz, Germany. Voith's operating business is divided into four group divisions. Voith Hydro (a fully consolidated joint venture between Voith and Siemens founded in April 2000, in which Voith holds a majority 65% of all shares and voting rights) covers the entire life cycle and all components for large and small hydropower plants. Voith Paper serves the paper market with all types of paper machines–graphical paper, board and packaging paper, tissue paper as well as speciality papers such as bank notes – as well as with rebuilds of entire production facilities, partial rebuilds, services and spare parts and also fabric and roll-cover products. Voith Turbo can be split into mobility and industry subdivisions. The mobility subdivision produces drive components and solutions as well as braking systems for the commercial vehicle industry (in particular trucks and buses), the railway industry and also the marine segment. The industry subdivision produces various couplings, hydraulic systems and components, high-duty universal shafts, turbo gear units, actuators and control systems for steam and gas turbines. With Voith Digital Solutions, the company is currently establishing a fourth reporting division focussing on the development of new digital business solutions. Voith has more than 19,900 employees and reported revenues of EUR 4.2bn and EBITDA of EUR 310m for the business year 2016/17.

Key metrics

			Scope estimates	
Scope credit ratios	2015-16	2016-17	2017-18F	2018-19F
EBITDA/interest cover (x)	4.0x	4.4x	8.6x	8.9x
SaD/EBITDA	4.6x	1.7x	1.5x	1.4x
Scope-adjusted FFO/SaD	11%	32%	35%	43%
FOCF/SaD	-4%	7%	4%	10%

Rating rationale

Scope Ratings assigns a BBB issuer rating to Voith GmbH & Co. KGaA with a Stable Outlook. The short-term rating is S-2.

Voith's BBB issuer rating reflects Scope's view of the company's credit-supportive business risk profile. With regard to Voith's BBB category business risk profile, Scope believes that the main ratings support lies in the company's dominance of the hydro and paper markets. Voith sees itself as the market leader in the hydro industry with a market share of around 30% in FY 2016-17. Given its 67% revenue share in large projects in FY 2016-17 Voith seems to be positioned towards the large-scale project part of the market where it is likely to have an even higher market share. Regarding the paper market, Voith is a key player in the capital equipment business (new machines and major rebuilds) with a market share of around 35%. The company's favourable position in the largest and most vigorously growing market for board and packaging machines is also noteworthy. This market segment has a duopolistic structure with Voith and Valmet estimated to account for over 90% of the total market.

Ratings & Outlook

Corporate ratings	BBB/Stable
Short-term rating	S-2

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Related methodology

Corporate Methodology, January 2018

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In addition, Voith appears to lead the relatively small market for machines for speciality paper such as bank notes. Voith is very well positioned in the high-margin fabric and roll systems (37% of revenues in FY 2016-17) with the company believed to be the market leader in roll systems ahead of Xerium and number two in fabric systems behind Albany. The company's diversification with regard to end-markets served, products and geographic positioning also supports the ratings. Voith's business risk profile is weakened by the company's relatively low profitability. The company's EBITDA margin of 7.3% in FY 2016-17 was below the previous year's level of 8.6%. This was due to: i) higher restructuring expenses YoY; ii) higher start-up costs for Voith Digital Solutions; and iii) lower EBITDA in the Voith Turbo division as a result of reduced revenue from high-margin power and oil & gas products.

Scope believes that despite considerably improved credit metrics at FY-end 2016-17, Voith's BBB-rated financial risk profile is slightly weaker than its business risk profile from a ratings perspective. The sharp decline in Scope adjusted debt (SaD) from EUR 1.9bn at FY-end 2016 to EUR 560m at end-September 2017 is mainly attributable to the EUR 1.15bn proceeds from the disposal of shares in KUKA AG. Due to the reduced SaD, the company's SaD/EBITDA ratio has improved markedly to 1.7x, a level commensurate with an A rating. Nevertheless, Scope doubts the sustainability of this improvement. Voith has indicated that it intends to use its increased cash position for acquisitions.

Voith's financial risk assessment is weaker, in particular with regard to the free cash flow (FCF)/SaD ratio. The FCF/SaD ratio was below 5% until FY 2016-17, a level commensurate with a B rating. Even considering the reduced SaD level at FY-end 2017, the company's cash flow cover of 7% was still in the BB rating area. Scope expects cash flow cover to remain below 10% in the BB rating area. Moreover, Voith's financial risk profile is negatively affected by the reduced reported operating cash flow levels since FY 2012-13.

The company's sustained positive FCF development over the past 10 fiscal years (except for FY 2015-16) and very strong liquidity position support the ratings. Voith's total cash assets amounted to EUR 1,184m at end-September 2017 (EUR 683m at end-September 2016), comprising EUR 582m accounted for as cash and cash equivalents and liquid investments of EUR 602m (mainly time deposits). In addition, Voith has access to a syndicated revolving credit facility to the amount of EUR 770m due in 2021 at the level of the parent company which was undrawn at FY-end 2017. There are currently no larger maturities until 2020, when a Schuldschein loan of EUR 152m is due for repayment. All things considered, Voith's liquidity amply covers its maturities in 2018 and 2019.

Scope has a positive view of the company's conservative liquidity policy reflected in: i) a high amount of available cash on the balance sheet over the last financial year (cash accounted for 9-16% of total assets); and ii) its restrained dividend policy with limited dividend payments over the past years as well as a negligible extraordinary payment following the sale of KUKA AG shares.

Outlook

The Stable Outlook reflects Scope's expectation that the company's SaD-to-EBITDA ratio will not exceed 2.5x (a level commensurate with a BBB rating category) and that its FCF-to-net-debt ratio will remain below 10%. At present, the company's use of cash represents the greatest source of uncertainty in the short to medium term.

Scope may upgrade the rating if Voith's SaD-to-EBITDA ratio remains below 2.0x and its FCF-to-net-debt ratio improves to above 10% on a sustainable basis. A negative rating action could result if the company's SaD-to-EBITDA increased towards 3.0x on a sustainable basis, e.g. due to a potential future acquisition for significantly more than EUR 600m.

Rating drivers

Positive rating drivers	Negative rating drivers
• Leading market positions in hydro and paper • Diversification with regard to end-markets and products • Broad geographic footprint both company- and segmentwise • Very strong liquidity due to EUR 1.15bn in proceeds from the sale of KUKA AG shares in 2017	• Relatively low profitability due to restructuring expenses, start-up costs for Voith Digital Solutions, and lower revenue contribution from high-margin power and oil & gas products • Worsened funds from operations/operating cash flow over the last three fiscal years • Low cash-flow based credit metrics

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Company's SaD-to-EBITDA and FCF/SaD sustainably below 2.0x and above 10%, respectively	• SaD-to-EBITDA increasing towards 3.0x, for instance as a consequence of a potential future acquisition for more than EUR 600m

Financial overview

			Scope estimates	
Scope credit ratios	**2015-16**	**2016-17**	**2017-18F**	**2018-19F**
EBITDA/interest cover (x)	4.0x	4.4x	8.6x	8.9x
SaD/EBITDA	4.6x	1.7x	1.5x	1.3x
Scope-adjusted FFO/SaD	11%	32%	35%	43%
FOCF/SaD	-4%	7%	4%	10%
Scope-adjusted EBITDA in EUR m	**2015-16**	**2016-17**	**2017-18F**	**2018-19F**
EBITDA	368	310	345	364
Operating lease payment in respective year	48	40	42	42
Other	-7	-13	-13	-13
Scope-adjusted EBITDA	408	337	374	393
Scope funds from operations in EUR m	**2015-16**	**2016-17**	**2017-18F**	**2018-19F**
EBITDA	**368**	**310**	**345**	**364**
less: (net) cash interest as per cash flow statement	-43	-41	-23	-23
less: pension interest	-19	-13	-15	-16
less: cash tax paid as per cash flow statement	-81	-93	-65	-74
add: depreciation component operating leases	42	34	37	37
Other items	-59	-19	-81	-61
Scope funds from operations	215	178	198	227
Scope-adjusted debt in EUR m	**2015-16**	**2016-17**	**2017-18F**	**2018-19F**
Reported gross financial debt	1,332	634	594	574
deduct: cash, cash equivalents	-683	-1,184	-1,145	-1,157
Cash not accessible	228	228	228	228
add: pension adjustment	883	777	777	777
add: operating lease obligation	112	105	105	105
Scope-adjusted debt	1,872	560	558	527

Business risk profile

Global leader in hydro market

Voith's business risk profile is supported by its strong position in the hydro and paper markets. According to figures provided by Andritz, Voith's main competitor in the hydro division, in its current investor presentation, the global hydro equipment market (including large-scale hydropower projects [order volumes over EUR 100m] and small-scale hydropower projects [order volumes below EUR 100m]) has an annual market volume ranging between EUR 6-8bn. The hydro market is highly concentrated on the supply side with the top three suppliers (Voith, Andritz and GE) accounting for approx. 65% of the total market. Voith considers itself the market leader with a share of around 30% in FY 2016-17. Given its 67% revenue share of large projects in FY 2016-17 Voith seems to be positioned towards the large-scale project part of the market where it is likely to have an even higher market share. Scope believes that Voith's strong performance in large-scale projects can be explained by its high level of expertise in funding procedures and good relationships with banks.

Strong position in paper capital equipment

With a market share of around 35% Voith is well positioned in the capital equipment business (new machines and major rebuilds), a market with a total volume of EUR 2.1bn in FY 2016-17. The company is also key in the large and vigorously growing market for board and packaging machines. This segment has a duopolistic structure with Voith and Valmet estimated to account for over 90% of the total market. In addition, Voith seems to lead the relatively small market for machines for speciality paper such as bank notes. By contrast, Voith is a relatively small player in tissue, the second largest paper market segment in terms of volumes with above-average growth, commanding a market share of 12%. Voith seems to be very well positioned in high-margin fabric and roll systems (37% of revenues in FY 2016-17): seeing itself as the market leader in roll systems ahead of Xerium and number two in fabric systems behind Albany.

Pure niche player in turbo division

Voith Turbo is a niche player specialising in mechanical, hydrodynamic, electric and electronic drive systems, as well as braking systems. Worldwide, these systems are used in industrial plants, as well as in road and rail vehicles. Scope notes that the relevant markets in the turbo division are more competitive than the paper and hydro markets, as customers have a variety of options from industry participants.

Diversification through end-markets, broad product portfolio and geographic footprint

Scope views the mix of end-markets served, broad product portfolio and geographic footprint (with no dependence on a single country as Germany and China, the company's two largest single regional markets, account for approx. 13% of revenue each and the company's geographic footprint in individual segments also seems to be well balanced) as supportive of Voith's overall business risk profile.

Voith serves five key end-markets: energy, paper, transport & automotive, oil & gas and raw materials.

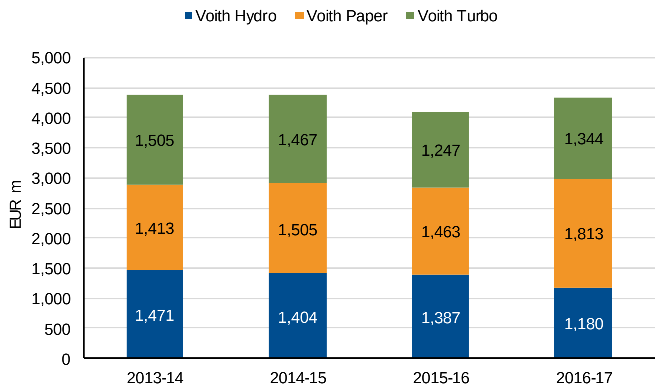
Energy end-market dominated by hydro power

In the energy market, Voith is positioned more towards the hydro power end-market, which accounted for 32% of its FY 2016-17 revenue. Here, Voith is a full-line supplier of equipment, covering all of the components for large and small hydropower plants: generators for all turbine types, Francis, Pelton, Kaplan, bulb and pump turbines, pumps, electrical and mechanical power plant equipment, as well as automation systems and services including spare parts and maintenance. The remaining 2% is generated by components for steam and gas turbines used in coal-fired power plants. The public sector accounts for a high share of hydro energy revenue, bringing in some 50%. The stability in Voith Hydro division's revenue and margin development are of particular note (Figure 5). This is largely explained by long-term construction contracts which span five to seven periods (recognised according to the percentage of completion method), thus smoothing the revenue curve.

Adverse trends such as low electricity prices and shale gas

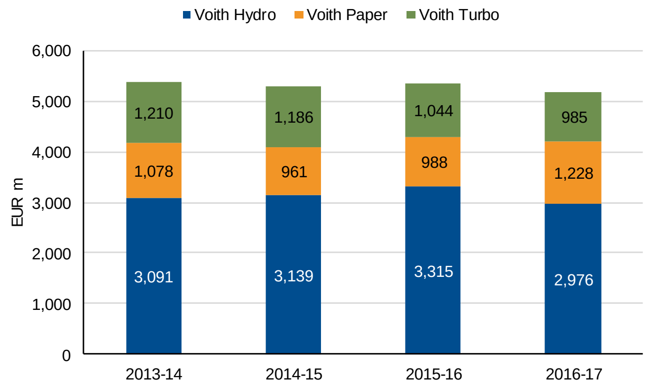
Global investment and project activity in the hydro power market has been affected by some adverse trends such as low electricity prices. In North America, the hydro power market is suffering (like all non-gas sources of electricity) from the increasing volume of shale gas being extracted. Due to this, many projects (in particular large-scale projects) have been postponed until further notice. Voith Hydro division's incoming orders reflect this market condition, falling for a third year in a row (Figure 1). The same is true for Andritz, Voith's main competitor (-11% YoY).

Figure 1: **Trend in incoming orders by division**



Source: Voith

Figure 2: **Trend in order backlog by division**



Source: Voith

Market opportunity in hydro still viable

There is, however, no cause for concern in Scope's view as: i) the order backlog of EUR 3bn at FY-end 2016-17 is still at a good level (Figure 2); and ii) there is still a viable market opportunity in hydro due to the need to upgrade a very old infrastructure, the lack of availability of attractive sites in some wind markets and the closure of some nuclear and coal capacities leading to a need for backup. According to Voith, around EUR 27bn of hydro power investments, comprising large- and small-scale projects, modernization of existing hydro power plants and aftermarket, are planned by 2020.

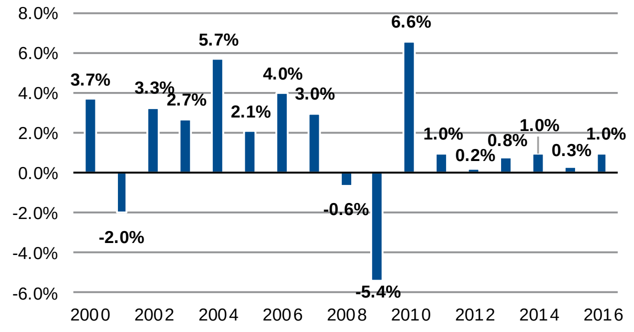
Improved profitability following restructuring

The paper industry has gone through structural changes triggered by the digitalisation of daily life. Demand for new machinery to manufacture graphic paper has fallen both significantly and permanently. Against this backdrop, Voith has restructured and resized its production capacities for graphic paper. On the capital equipment side, Voith is now focusing on machines for the board and packaging, tissue and speciality paper segments. Following restructuring, profitability has improved and seems to have stabilised at an EBITDA margin of around 10%.

Paper is a low growth industry with some attractive segments

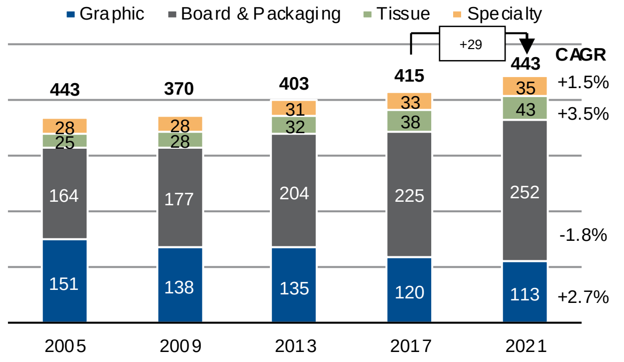
There has been a significant upturn in the paper machine market for new machines and rebuilds, particularly for board and packaging paper as well as tissue paper. This led to a considerable increase in order intake in FY 2016-17 (Figure 1). The same is true for Valmet (+76% order intake YoY) and Andritz (+15% order intake YoY). However, Scope has been given to understand that Voith is expecting the order intake in FY 2017-18E to level out again. The low growth in paper production seen over the past years is likely to continue in the coming years (Figure 3). There is particular growth potential for board and packaging paper in the wake of rising online shopping as well as for tissue paper in the emerging markets of Asia and Latin America in line with the strong growth of the middle class in these countries (Figure 4). According to Voith, the 29m tonne increase in paper production expected by 2021 will require about 100 additional paper machines. If this is the case, it would prove a significant growth driver, given: i) the average of seven to eight new machines sold per annum over the last five fiscal years; ii) the price of EUR 60-120m for a new machine; and iii) Voith's market shares. In contrast, the market for new graphical paper machines should continue to shrink.

Figure 3: **World production of paper, percentage change**



Source: RISI

Figure 4: **World paper production by segment**



Source: RISI

Diversification within the transportation end-market

The transportation market (20% of the company's revenue) is fairly diversified in terms of industries served and products. Voith provides the commercial vehicle market (40-45% of transportation revenue or EUR 360m) with automatic transmissions, hydrodynamic retarders and shock absorbers; rail vehicles with drive systems such as turbo-transmissions, bogie transmissions, anti-slip differentials, universal shafts, cooling systems, Scharfenberg couplings (automatic, semi-permanent) as well as bumpers and locomotive technologies; and the marine sector with Voith Schneider Propellers, Voith Water Tractors, Voith Cycloidal Rudders, Voith Turbo Fins, and Voith Water Jets. These industries differ with regard to underlying demand drivers. The commercial vehicle segment depends on the demand for trucks and buses, the rail sector is driven by urbanisation in emerging countries and government infrastructure projects, while the marine sector is driven by new ship building and freight charges.

Decreasing order intake in turbo division

The segments of the raw materials market that are of relevance for Voith are the mining sector and the steel industry. At 6%, oil & gas as well as the raw material markets account for only a low share of the company's revenue, however, this is a high-margin business. Given the drop in commodity prices, the level of investment in the mining, oil & gas sector has been weak, as companies focused on strengthening its balance sheets through reduced investments and targeted procurement savings. As a result, mining capex was down more than 60% from its peak level in 2012. A similar trend can be observed in the oil & gas end-markets. Customers in the oil & gas industry continued to cut costs in 2017, which had a negative effect on Voith's turbo business. All in all, the turbo division performed quite poorly over the last two fiscal years. Its order backlog fell for the third year in a row to EUR 985m at FY-end 2016-17 (Figure 2). In addition, a decline in demand from the major Chinese rail vehicle market for high-speed trains and special vehicles weighed on the segment's revenue. Given the recovery in commodity prices, a stabilisation or even a noticeable increase in capex by major miners and oil & gas companies seems probable.

Relatively low cyclicality in revenue and EBITDA

The overall solid diversification is underpinned by Voith's company revenue and EBITDA margin development over the past 10 fiscal years (Figure 5). In particular, Scope highlights the company's ability to absorb cyclical developments as seen in FY 2008-09, when the 12% drop in the paper segment's revenue was compensated for by other segments.

Figure 5: Profit breakdown by division, 2017E

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Voith Hydro	650	800	1085	1158	1228	1315	1388	1313	1313	1388	1381
YoY %		*23.1%*	*35.6%*	*6.7%*	*6.0%*	*7.1%*	*5.6%*	*-5.4%*	*0.0%*	*5.7%*	*-0.5%*
Voith Paper	1732	1984	1743	1723	1827	1738	1639	1430	1505	1456	1527
YoY %		*14.5%*	*-12.1%*	*-1.1%*	*6.0%*	*-4.9%*	*-5.7%*	*-12.8%*	*5.2%*	*-3.3%*	*4.9%*
Voith Turbo	1011	1161	1232	1349	1520	1551	1500	1409	1470	1397	1283
YoY %		*14.8%*	*6.1%*	*9.5%*	*12.7%*	*2.0%*	*-3.3%*	*-6.1%*	*4.3%*	*-5.0%*	*-8.2%*
Reconciliation	6	6	5	12	13	19	16	16	13	11	19
Total	3399	3951	4065	4242	4588	4623	4543	4168	4301	4252	4210
YoY %		*16.2%*	*2.9%*	*4.4%*	*8.2%*	*0.8%*	*-1.7%*	*-8.3%*	*3.2%*	*-1.1%*	*-1.0%*

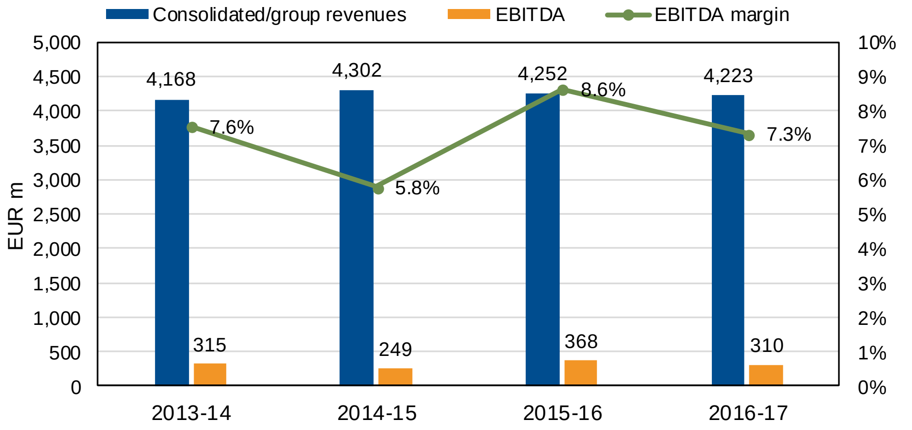
EBITDA by segment, EUR m	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Voith Hydro	35	29	64	79	96	109	112	102	99	103	111
Margin	*5%*	*4%*	*6%*	*7%*	*8%*	*8%*	*8%*	*8%*	*8%*	*7%*	*8%*
Voith Paper	207	210	207	185	201	144	143	65	114	125	147
Margin	*12%*	*11%*	*12%*	*11%*	*11%*	*8%*	*9%*	*5%*	*8%*	*9%*	*10%*
Voith Turbo	131	151	151	180	231	203	153	153	134	155	131
Margin	*13%*	*13%*	*12%*	*13%*	*15%*	*13%*	*10%*	*11%*	*9%*	*11%*	*10%*
Total	373	390	422	444	528	456	408	320	347	383	389
Margin	*11.0%*	*9.9%*	*10.4%*	*10.5%*	*11.5%*	*9.9%*	*9.0%*	*7.7%*	*8.1%*	*9.0%*	*9.2%*

Source: Voith

Business risk profile weakened by low profitability overall

In Scope's view, Voith's business risk profile is weakened by its profitability. The EBITDA numbers provided in Figure 5 do not include various cost items such as restructuring expenses and start-up costs for the digital solutions business. Adjusted for these items, Voith's total EBITDA margin in FY 2016-17 of 7.3% is below the previous year's level of 8.6% (Figure 6). This can be explained by: i) higher restructuring expenses YoY; ii) higher start-up costs for Voith Digital Solutions (-EUR 37m vs. -EUR 4m in FY 2015-16); and iii) lower EBITDA in the Voith Turbo division due to reduced revenue from high-margin power and oil & gas products. The Voith Digital Solutions division will continue to weigh on profits as Voith does not expect its digital solutions division to break even before FY 2021-22.

Figure 6: **Voith's revenue and EBITDA**



Source: Voith, Scope

Financial risk profile

Sharp improvement in credit metrics due to sale of KUKA AG shares

Voith's key credit metrics improved markedly in FY 2016-17 due to the sharp decline in SaD from EUR 1.9bn at FY-end 2016 to EUR 560m at FY-end 2017. This decline is mainly attributable to the EUR 1.15bn proceeds from the disposal of shares in KUKA AG. Voith used EUR 735m of these proceeds for debt repayments, in particular the repayment of corporate notes to the amount of EUR 600m. Due to the reduced SaD, the company's SaD/EBITDA ratio has improved considerably to 1.7x, a level commensurate with an A rating. Nevertheless, Scope doubts the sustainability of this improvement. Voith has indicated that it intends to use its increased cash position for acquisitions. Thus, in the medium term, Scope expects Voith's SaD-to-EBITDA ratio to rise.

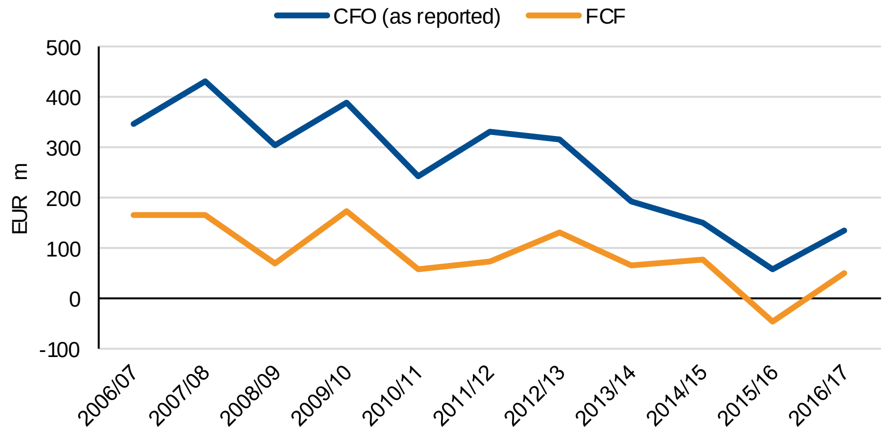
Financial risk profile negatively affected by low cash-flow based metrics

The financial risk assessment is weaker in particular with regard to the FCF/SaD ratio. FCF/SaD ratio was below 5% until FY 2016-17, a level commensurate with a B rating. Even considering the reduced SaD level at FY-end 2017, cash flow cover at 7% was still in the BB rating area. Scope expects cash flow cover to remain below 10%.

Lower operating cash flow and FCF levels

Voith's financial risk profile is held back by reduced reported operating cash levels since FY 2012-13 (Figure 7). This was, in particular, due to restructuring costs as well as start-up costs for the digital solutions business. Moreover, operating cash was affected by increased working capital requirements. The company explains this partly with the higher share of clients from China, who generally offer lower amounts of advance payments (approx. 10% of the total project volume compared to over 20% in Europe) and higher receivables from customer-specific contracts. In order to counteract decreased cash levels from operations, Voith has slashed its total capex which is currently EUR 20-30m above its maintenance capex. According to Voith, the capex level before FY 2012-13 largely reflected the conclusion of its investment cycle, and its medium-term plan budgets capex of approx. EUR 100m.

Figure 7: **Trend in OCF and FCF, in EUR m**



Source: Voith, Scope

Start-up costs will continue to weigh on cash flow

Cash flow will probably continue to be depressed by the start-up costs for the Voith Digital Solutions division, as Voith has announced an additional EUR 100m in start-up costs over the next two fiscal years. Furthermore, Voith does not expect the division to break even before FY 2021-22. On the other hand, lower interest payments due to the repayment of EUR 600m in corporate notes in 2017 will support cash flows.

Very strong liquidity situation

Scope considers Voith's liquidity and financial flexibility as 'more than adequate' in accordance with its methodology to determine the liquidity of corporates. Scope's liquidity assessment is driven by:

- Voith's very strong available liquidity position. Voith's total cash assets amounted to EUR 1,184m at end-September 2017 (EUR 683m at end-September 2016), comprising EUR 582m accounted for as cash and cash equivalents and liquid investments of EUR 602m (mainly time deposits). As mentioned above, the increase in liquidity compared to FY-end 2016 is mainly due to EUR 1.15bn in cash proceeds from the sale of shares in KUKA AG (less approx. EUR 700m used for debt repayment). In addition, Voith has access to a syndicated revolving credit facility to the amount of EUR 770m due in 2021 at the level of the parent company which was undrawn at FY-end 2017. Scope expects the revolving credit facility to remain mostly undrawn. According to Voith, approx. EUR 230m of its liquidity (mainly liquidity at the level of the affiliated companies) is trapped and has been deducted from liquidity.
- The absence of larger maturities until 2020, when a Schuldschein loan of EUR 152m is due for repayment. The CNY syndicated loan will largely be repaid in FY 2017-18.
- The company's sustained positive FCF development over the past 10 fiscal years (except for FY 2015-16).

Conservative liquidity policy

In addition, Scope acknowledges Voith's conservative liquidity policy reflected in: i) a high amount of available cash on the balance sheet over the last financial year (cash accounted for 9-16% of total assets); and ii) its restrained dividend policy with limited dividend payments over the past years as well as a negligible extraordinary payment following the sale of KUKA AG shares.

S-2 short-term rating

Scope has assigned a short-term rating of S-2 based on our positive assessment of liquidity as well as Voith's investment grade rating.

Outlook

The Stable Outlook reflects Scope's expectation that the company's SaD-to-EBITDA ratio will not exceed 2.5x (a level commensurate with a BBB rating category) and that its FCF-to-net-debt ratio will remain below 10%.

Scope may upgrade the rating if Voith's SaD-to-EBITDA remains below 2.0x and its FCF-to-net-debt ratio improves to above 10% on a sustainable basis. A negative rating action could result if the company's SaD-to-EBITDA increased towards 3.0x on a sustainable basis, e.g. due to a potential future acquisition for significantly more than EUR 600m.

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