13 January 2020 Corporates

Voith GmbH & Co. KGaA
Germany, Capital Goods

STABLE
BBB-

Corporate profile

Founded in 1867, Voith GmbH & Co. KGaA is a 100% family-owned company in the mechanical engineering sector, headquartered in Heidenheim/Brenz, Germany. Voith's operating business is split into four group divisions. Voith Hydro (a fully consolidated joint venture of Voith and Siemens, which was founded in April 2000, and in which Voith holds a majority 65% of all shares and voting rights) covers the entire life cycle and all components of large and small hydropower plants. Voith Paper serves the paper market for all types of paper – newspaper, board and packaging paper, tissue paper as well as specialty papers such as bank notes – with new machines, rebuilds of entire production facilities, partial rebuilds, services and spare parts as well as fabric and roll-cover products. Voith Turbo can be divided 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 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. The recently established Voith Digital Ventures focusses on the development of new digital business solutions. Voith has around 19,500 employees. For the business year 2018-19, the company reported revenues of EUR 4.3bn and EBITDA of EUR 293m.

Key metrics

			Scope estimates	
Scope credit ratios	**2017-18**	**2018-19**	**2019-20F**	**2020-21F**
EBITDA/interest cover (x)	11.2x	9.8x	8.4x	10.1x
Scope-adjusted debt (SaD)/EBITDA	1.7x	2.4x	4.3x	3.4x
Scope-adjusted FFO/SaD	38%	29%	17%	21%
FOCF/SaD	-13%	-6%	2%	3%

Rating rationale

In its annual review Scope Ratings downgrades its BBB issuer rating for Voith GmbH & Co. KGaA by one notch to BBB- with a Stable Outlook. The S-2 short-term rating remains unchanged.

The downgrade is triggered by the expected deterioration in Voith's credit metrics as a result of its M&A activity, which has been more aggressive than previously communicated. Voith's business risk profile remains unchanged.

A sharp rise in orders in the Voith Hydro division (+89% YoY to EUR 1,620m) has increased Voith's order intake by 9% to EUR 4,691m. This was due to a major contract with a volume in the mid-three-digit million euro range. In contrast, Voith Paper reported 22% lower incoming orders YoY due to weaker project business (new machines and major rebuilds) in China. We believe that the fall in Voith Paper division's incoming orders represents a return to normal after two years of exceptional growth. Orders in Voith Turbo were slightly higher, driven by sound performance in the Mobility division (which focuses on commercial vehicles, in particular the trucks and buses, railway and marine end-markets).

Ratings & Outlook

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

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Related Methodology

Corporate Rating Methodology

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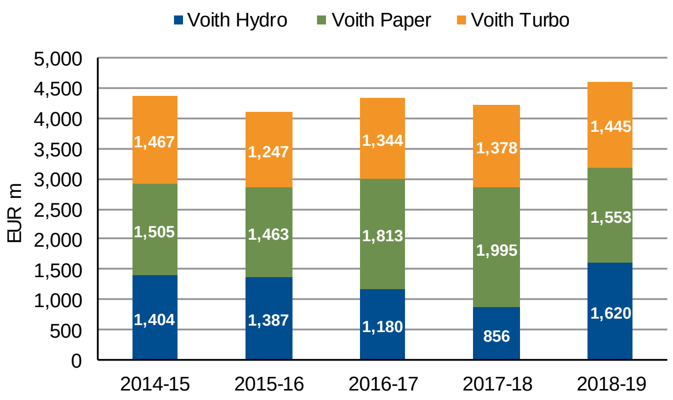
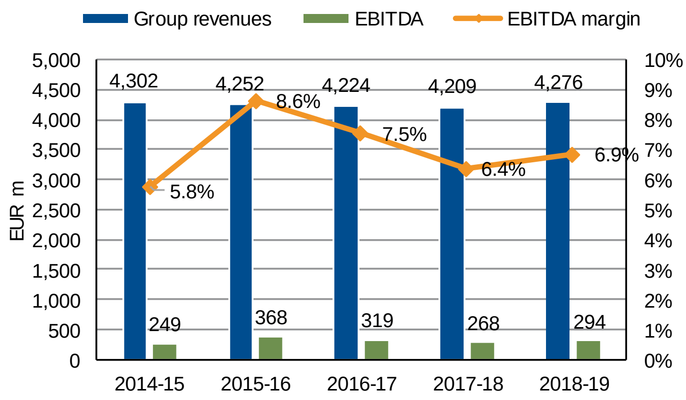
As a result of strong incoming orders in the Voith Hydro division, the company's order backlog of EUR 5,630m at end-September 2019 was around EUR 460m or 9% higher than the EUR 5,172m reported a year ago. Voith's total revenues of EUR 4,276m were 1.6% higher YoY. Higher revenues in Voith Hydro (+4.0% YoY), Voith Turbo (+7.4% YoY) as well as Voith Digital Ventures (+EUR 22m) compensated for lower revenues in Voith Paper (minus 4.9% YoY). The revenue decline in Voith Paper was caused by weaker project business in China. The Voith Turbo division benefited from strong demand for the Mobility division in Europe, the Middle East, Africa and the Asia-Pacific region.

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



Source: Voith, Scope

Figure 2: **Voith's revenue and EBITDA**



Source: Voith, Scope

Voith has presented its growth strategy, which is a combination of organic growth, M&A and growth in the digital field. The main strategic goals are: i) strengthening Voith's full-line supplier position in its core business; ii) growth in adjacent markets (in particular in electric drives, water treatment and recycling) through internal developments and M&A; and iii) evaluating opportunities, in particular in energy storage and the digitization of assets and services. Voith's target is to grow its revenues to EUR 5.5-6.0bn by 2025.

As part of this strategy, Voith closed the acquisition of BTG in December 2019. The strategic reason for this acquisition is to strengthen Voith Paper's position as a full-line supplier, given BTG's complementary product portfolio. We expect BTG to contribute around EUR 120m in revenues in FY 2019-20F. At the end of 2019, Voith announced two additional acquisitions: i) 70% of the shares in ELIN Motoren GmbH, an Austrian manufacturer of electric motors and generators for industrial applications with revenues of approx. EUR 120m; and ii) 90% of the shares in Toscotec S.p.A. A, an Italian manufacturer of machines for the tissue and paper industry with revenues of approx. EUR 100m. Voith expects the acquisition of the shares in both companies to be completed in the first six months of the 2020 calendar year. These three acquisitions will add approx. EUR 370m to Voith's total revenues. Moreover, Voith has formed two joint ventures with the China Railway Rolling Stock Corporation. The activities of the two joint ventures will focus on a wide range of products for the rail industry (research and development, manufacturing, sales and maintenance). Voith expects these joint ventures to strengthen its position in the important Chinese rail market.

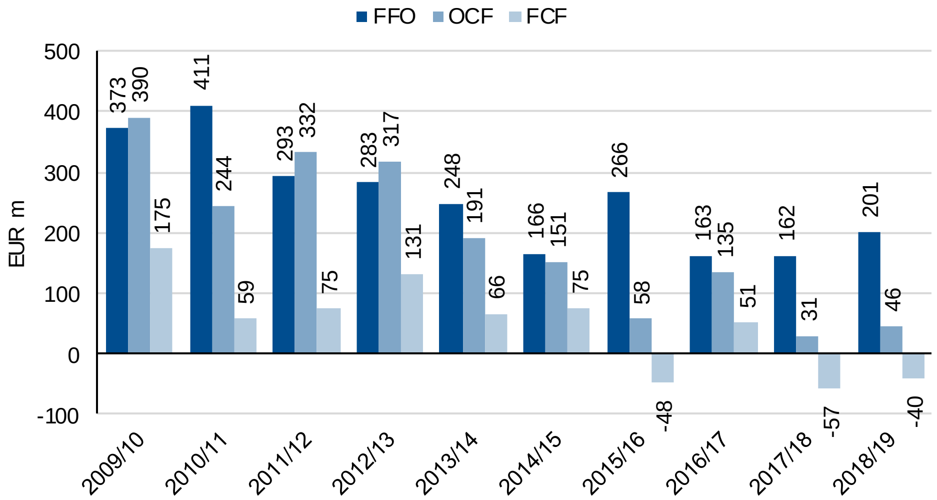
We expect revenues to increase to around EUR 4.5bn in FY 2019-20F. The increase will be mainly driven by the consolidation of three companies acquired in 2019. For FY 2020-21F, we expect another increase in revenues to around EUR 4.75bn, mainly due to full-year consolidation effects and the order backlog execution in Voith Hydro.

Profitability continues to be the main restraining factor for company's business risk profile. Voith's EBITDA margin of 6.9% was at the high end of our expected margin corridor of 6%-7%. The increase compared to 6.4% in FY 2017-18 is mainly attributable to other expenses being lower. This positive effect was counteracted by a continuing rise in personnel expenses driven by increased headcount and collectively bargained pay rises. Voith's divisions present a mixed picture: Voith Paper reported higher profitability due to fewer revenues from low-margin project business. In addition, Voith Digital Ventures reported a reduced loss (minus EUR 22m vs. minus EUR 35m previously). On the other hand, profitability in Voith Hydro and Voith Turbo has declined as both divisions increasingly faced competitive and margin pressure.

In order to improve profitability, Voith has announced the closure of three production locations in its Voith Turbo division and the transfer of existing production capacities to other locations. We expect the associated restructuring costs to weigh on profitability in FY 2019-20F. Costs for the integration of the acquired businesses are likely to be another negative factor in FY 2019-20F. We expect a continued increase in personnel expenses, further depressing profitability. At the same time, we expect positive impacts from the IFRS 16 adjustment (around EUR 30m) and a slightly higher gross profit margin. Voith should also benefit from the consolidation of the higher-margin business of recently acquired BTG. All in all, we expect a roughly unchanged EBITDA margin for FY 2019-20F. Going forward, we expect Voith's EBITDA margin to increase, mainly due to synergies.

Fund from operations (FFO) in FY 2018-19 were around EUR 40m above the previous fiscal year's level, due to higher EBITDA and lower cash taxes. Operating cash flow (OCF) was EUR 15m up on the previous year's figure. The increased level of cash outflow from the change in net working capital was counterbalanced by a lower outflow of cash and cash equivalents from the utilisation of provisions. Capex increased to minus EUR 113m compared to minus EUR 94m. However, due to higher proceeds from asset disposals, net capex was around EUR 2m below the previous fiscal year's level. Free cash flow (FCF) remained negative at minus EUR 40m (FY 2017-18: minus EUR 57m). We expect lower cash outflow for working capital. This is based on our discussion with Voith's management, from which we understand that part of the increase in net working capital in FY 2018-19 was due to pre-financing effects. We expect this positive effect to be offset by increased capex as a result of large planned projects. We expect FCF to come in slightly positive in FY 2019-20F.

Figure 3: 10-year trend in cash flow



Source: Voith, Scope

We have downgraded our rating for Voith's financial risk profile due to its M&A activity. This has been more aggressive than previously communicated, and we expect it to result in a deterioration of credit metrics. Scope-adjusted debt (SaD) has increased by EUR 194m to EUR 799m. This increase was mainly driven by higher pensions (+ EUR 122m YoY) due to the fall in discount rates in Germany and the US. Due to higher SaD, Voith's net leverage has increased to 2.4x at FY-end 2018-19 (FY-end 2017-18: 1.7x).

Figure 4: Composition of external financing at end-September 2019

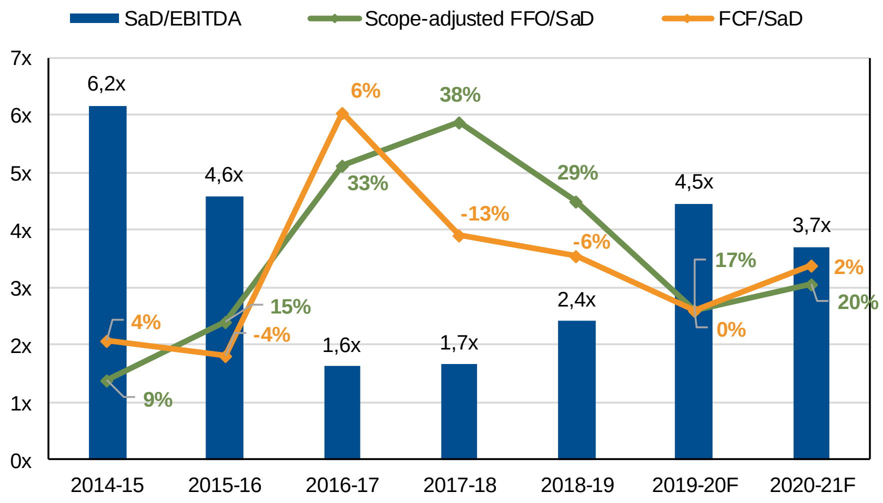
Debt instrument	Currency	Amount (millions)	Outstanding (EUR m)	Coupon	Maturity	Issuer	Leverage
Syndicated revolving credit facility	EUR	550	0		Apr-24	Voith GmbH	0.0x
SSD 5y	EUR		102		Nov-20	Voith GmbH	0.3x
SSD 7y	EUR		38		Nov-22	Voith GmbH	0.1x
SSD 10y	EUR		21		Nov-25	Voith GmbH	0.1x
Term loan in China	RMB	255	33		May-20	Various Asian subsidiaries but guaranteed by Voith GmbH	0.1x
Bank loans	EUR		34		<1 year	Voith GmbH	0.1x
Revolving credit facility	RMB	1,400	0		Jun-24	Various Asian subsidiaries but guaranteed by Voith GmbH	0.0x
Finance lease	EUR		0			Voith GmbH	0.0x
Debt on parent level (EUR m)			**228**				**0.7x**
Other debt	EUR		171			Various subsidiaries	0.5x
Senior unsecured debt (EUR m)			**171**				**0.5x**
Total debt (EUR m)			**399**				**1.2x**
Adjustments for:							
Pensions (100% of total amount)*			868				2.6x
Operating leases*			105				0.3x
Scope-adjusted gross debt (EUR m)			**1,372**				**4.1x**
Unrestricted liquidity			-574				-1.7x
Scope-adjusted debt (EUR m)			**798**				**2.4x**

*In accordance with Scope's methodology; Source: Voith, Scope

We expect SaD to increase to around EUR 1.3bn at end-September 2020F as a result of recent M&A activity and the planned capex increase. Here, we have factored in around EUR 500m in M&A-related payouts. Furthermore, we expect net capex to increase to around EUR 140m and remain elevated in the next two fiscal years due to planned projects.

As a result of the recent M&A activity, we expect net leverage to increase into the 4.0-4.5x range at end-September 2020F. While we subsequently expect Voith's net leverage to come down, driven by higher EBITDA, we expect it to remain at around 3.5x, at least until end-September 2022F.

Figure 5: **Key credit metrics 2014 to 2020F**



Source: Voith, Scope

Liquidity

Voith's liquid funds have decreased by EUR 186m to EUR 774m at end-September 2019 (EUR 960m at end-September 2018). We still consider Voith's liquidity reserves to be adequate.

Principal cash sources at end-September 2019 comprised:

- Cash on balance of EUR 418m. According to Voith, approx. EUR 200m of its liquidity (mainly liquidity at the level of its affiliated companies) is trapped and has been deducted from liquidity.
- Liquid investments of EUR 356m (mainly time deposits);
- Syndicated revolving credit facility in the amount of EUR 550m due in 2024 at parent company level, which was undrawn at FY-end 2019. We expect the revolving credit facility to remain mostly undrawn;
- We expect OCF of around EUR 160m in 2019-20F and around EUR 200m in 2020-21F.

Our liquidity analysis has not considered Voith's revolving credit facility in China in the amount of RMB 1,400bn (around EUR 180m) to finance working capital as well as unconfirmed credit lines. Furthermore, we expect Voith to raise additional debt in early 2020.

We expect the following cash uses:

- Capex of EUR 150m in FY 2019-20F and EUR 160m in FY 2020-21F;
- Acquisition-related cash payouts of around EUR 500m in FY 2019-20F; EUR 10m in FY 2020-21F;
- Dividend payment of EUR 35m in FY 2019-20F and FY 2020-21F;
- Debt maturities according to Voith's debt maturity profile: around EUR 52m in FY 2019-20F and EUR 102m in 2020-21F.

While we expect Voith's liquidity position to decrease as result of payments for acquisitions, it still amply covers upcoming maturities. We therefore affirm Voith's S-2 short-term rating.

Outlook

The Outlook is Stable. This is based on our expectation that, after the integration of the acquired businesses, Voith's SaD-to-EBITDA ratio will improve to around 3.5x.

We may upgrade the rating if Voith's SaD-to-EBITDA ratio improves to below 3.0x on a sustained basis. A negative rating action could result if the SaD-to-EBITDA ratio remains around 4.0x on a sustained basis, e.g. due to weaker than projected profitability.

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 group-and segmentwise • Still sound liquidity position with accessible cash on the balance sheet of EUR 574m at FY-end 2018-19 and undrawn credit lines • Solid order backlog with EUR 5,630m at end-September 2019	• Relatively low and decreasing profitability over the past years due to increasing personnel expenses and higher material costs • More aggressive than previously communicated M&A activity, which we expect to result in a deterioration of credit metrics • Expected low FCF

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/EBITDA and FCF/SaD below 3x on a sustained basis	• SaD/EBITDA remaining around 4.0x on a sustained basis, e.g. because of weaker than projected profitability

Financial overview

			Scope estimates	
Scope credit ratios	**2017-18**	**2018-19**	**2019-20F**	**2020-21F**
EBITDA/interest cover (x)	11.2x	9.8x	8.4x	10.1x
Scope-adjusted debt (SaD)/EBITDA	1.7x	2.4x	4.3x	3.4x
Scope-adjusted funds from operations/SaD	38%	29%	17%	21%
Free operating cash flow/SaD	-13%	-6%	2%	3%
Scope-adjusted EBITDA in EUR m	**2017-18**	**2018-19**	**2019-20F**	**2020-21F**
EBITDA	268	294	315	399
Operating lease payments in respective year	51	52		
Other	-13	-14	-14	-14
Scope-adjusted EBITDA	307	331	301	385
Scope-adjusted funds from operations in EUR m	**2017-18**	**2018-19**	**2019-20F**	**2020-21F**
EBITDA	268	294	315	399
less: (net) cash interest as per cash flow statement	-6	-12	-20	-22
less: pension interest	-16	-16	-16	-16
less: cash tax paid as per cash flow statement	-70	-58	-57	-86
add: depreciation component, operating leases	46	46		
Other items	-30	-22	2	2
Scope-adjusted funds from operations	193	231	224	277
Scope-adjusted debt in EUR m	**2017-18**	**2018-19**	**2019-20F**	**2020-21F**
Reported gross financial debt	451	399	699	719
less: cash and cash equivalents	-960	-774	-463	-475
add: cash not accessible	168	200	200	200
add: pension adjustment	744	868	868	868
add: operating lease obligations	107	105		
Scope-adjusted debt	510	799	1,303	1,311

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