14 January 2021

Corporates

Voith GmbH & Co. KGaA
Germany, Capital Goods

NEGATIVE

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, Voith Paper, Voith Turbo and Voith Digital Ventures. Voith has around 21,000 employees. The company reported revenues of EUR 4.2bn for the business year 2019-20.

Key metrics

			Scope estimates	
Scope credit ratios	**2018-19**	**2019-20**	**2020-21F**	**2021-22F**
EBITDA/interest cover (x)	10.0x	11.5x	9.0x	11.9x
Scope-adjusted debt (SaD)/EBITDA	2.4x	5.5x	5.7x	4.4x
Scope-adjusted FFO/SaD	29%	11%	14%	17%
FOCF/SaD	-6%	12%	1%	5%

Rating rationale

Scope Ratings affirms the BBB- issuer rating for Voith GmbH & Co. KGaA but changes the Outlook from Stable to Negative. The S-2 short-term rating remains unchanged.

The rating action reflects our changed expectations regarding revenues and profitability, affecting the pace at which Voith's deteriorated credit metrics can recover after recent M&A transactions. In our last rating review, we anticipated that Voith's more intense than previously communicated M&A activity would have sustained negative impacts on its financial risk profile. As a result, we downgraded the issuer rating from BBB/Stable to BBB-/Stable in January 2020. As anticipated, Voith's credit metrics were clearly weaker in FY 2019-20, with an even stronger than anticipated decline in Scope-adjusted debt (SaD)/EBITDA to 5.5x (2018-19: 2.4x) reflecting an unexpectedly sharp drop in EBITDA. We have adjusted downwards our EBITDA expectation for FY 2020-21 as we expect lower revenues and higher restructuring expenses. We expect SaD/EBITDA to remain above 5.0x at FY-end 2020-21. While we still expect SaD/EBITDA to recover in FY 2021-22 driven by higher revenues, a recovery to around 3.5x (a level commensurate with the current rating) is now less probable, in view of our weaker expectations.

Voith's unchanged BBB rated business risk profile continues to be supported by its market positioning and diversification. The deterioration in profitability is still the main restraining factor. The Scope-adjusted EBITDA margin fell to 5.7% vs. 7.7% in FY 2018-19. We have adjusted downwards our EBITDA margin expectations for FY 2020-21 and 2021-22. We expect a Scope-adjusted EBITDA margin of 5.5% in FY 2020-21 (previously 8.4%) and 6.8% in FY 2021-22 (previously 8.7%).

We expect free operating cash flow (FOCF) to be around zero in FY 2020-21, burdened by higher net working capital as well as payments for the repair of a large-scale customer plant, restructuring and personnel adjustments. We consider Voith's liquidity reserves to be 'adequate' given short-term debt coverage at more than 100%.

Ratings & Outlook

Corporate rating	BBB-/Negative
Short-term rating	S-2

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Related Methodologies

Corporate Rating Methodology, February 2020

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Outlook and rating-change drivers

The change in Outlook from Stable to Negative reflects our revised expectations regarding revenues and profitability, affecting the pace at which Voith's deteriorated credit metrics can recover after recent M&A transactions.

A negative rating action could result if our base case materialises and Voith fails to improve its EBITDA in the near future, with SaD/EBITDA remaining higher than 4.0x on a sustained basis. A negative rating action could also result if Voith continues to carry out aggressive M&A transactions.

In order to return to a Stable Outlook, Voith's SaD/EBITDA would need to improve to around 4.0x in the near future, e.g. driven by a stronger than expected recovery in EBITDA. We may upgrade the rating if Voith improves its SaD/EBITDA to below 3.0x on a sustained basis, although we believe this is a remote possibility.

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 466m at FY-end 2019-20 and around EUR 730m in two undrawn revolving credit facilities	• Relatively low and decreasing profitability over the past few years, due to increasing personnel expenses among other factors • Deterioration in credit metrics after recent M&A transactions • Our changed expectations regarding the pace at which Voith's deteriorated credit metrics will recover • Expected low FOCF

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• To return to a Stable Outlook, improvement in SaD/EBITDA in the near future to around 4.0x, e.g. driven by stronger than expected EBITDA recovery • We may upgrade the rating if Voith improves SaD/EBITDA to below 3.0x on a sustained basis, although this possibility is remote	• Failure to improve EBITDA in near future, with SaD/EBITDA remaining higher than 4.0x on a sustained basis • Continuation of aggressive M&A transactions

Financial overview

			Scope estimates	
Scope credit ratios	**2018-19**	**2019-20**	**2020-21F**	**2021-22F**
EBITDA/interest cover (x)	10.0x	11.5x	9.0x	11.9x
Scope-adjusted debt (SaD)/EBITDA	2.4x	5.5x	5.7x	4.4x
Scope-adjusted funds from operations/SaD	29%	11%	14%	17%
Free operating cash flow/SaD	-6%	12%	1%	5%
Scope-adjusted EBITDA in EUR m	**2018-19**	**2019-20**	**2020-21F**	**2021-22F**
EBITDA	294	229	245	311
Operating lease payments in respective year	52			
Other	-14	8	-10	-10
Scope-adjusted EBITDA	331	237	235	301
Scope-adjusted funds from operations in EUR m	**2018-19**	**2019-20**	**2020-21F**	**2021-22F**
EBITDA	294	229	245	311
less: (net) cash interest as per cash flow statement	-12	-11	-17	-16
less: pension interest	-16	-9	-9	-9
less: cash tax paid as per cash flow statement	-58	-51	-22	-48
add: depreciation component, operating leases	46			
Other items	-22	-12	-8	-8
Scope-adjusted funds from operations	232	146	189	230
Scope-adjusted debt in EUR m	**2018-19**	**2019-20**	**2020-21F**	**2021-22F**
Reported gross financial debt	399	908	806	806
less: cash and cash equivalents	-774	-704	-514	-534
add: cash not accessible	200	238	200	200
add: pension adjustment	868	859	859	859
add: operating lease obligations	105			
Scope-adjusted debt	799	1,300	1,350	1,331

Business risk profile: BBB

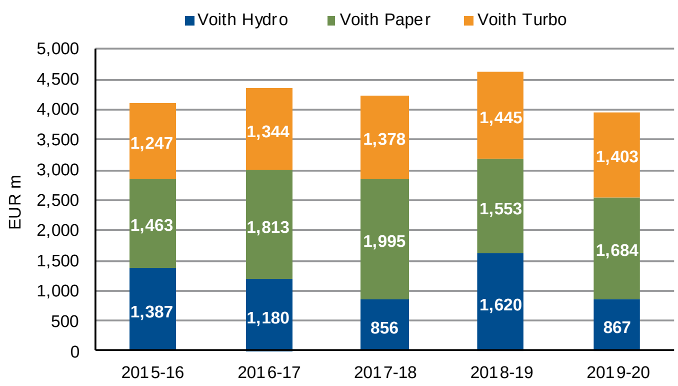
Relatively low profitability still main restraining factor for business risk profile

Voith's unchanged BBB rated business risk profile continues to be supported by its market positioning and diversification. The deterioration in profitability is still the main restraining factor for Voith's business risk profile. EBITDA in FY 2019-20 was negatively impacted by a warranty claim due to technical problems and delivery delays with a hydro power project (total negative impact: EUR 18m). Adjusted for this one-off effect, Scope-adjusted EBITDA still significantly decreased to EUR 237m in FY 2019-20 vs. EUR 331m previously. The Scope-adjusted EBITDA margin fell to 5.7% vs. 7.7% in FY 2018-19. With an EBITDA contribution of EUR 29m, the integration of new subsidiaries had a positive effect on the group's margin (average margin of acquired companies at around 13%). The fact that profitability nevertheless decreased was due to lower revenues and increased restructuring expenses (EUR 59m vs. EUR 42m previously), e.g. in connection with optimising the production network in the turbo division.

Steadily increasing personnel expenses weigh on profitability

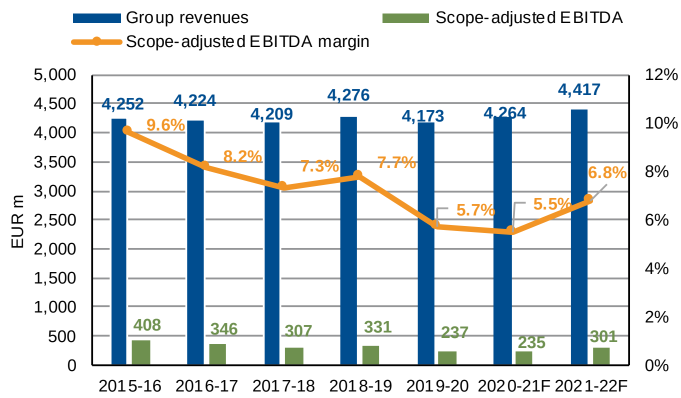
We view negatively the increase in the share of personnel expenses in revenues to 35.8% in FY 2019-20 vs. 34.5% previously. This reflects ongoing rises in personnel expenses due to collectively bargained pay increases as well as acquisitions. We also note that over the past four fiscal years the share of personnel expenses to revenues has grown steadily from 33% in FY 2015-16 to 35.8% in FY 2019-20, weighing on profitability.

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



Source: Voith, Scope

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



Source: Voith, Scope

We have adjusted our margin expectations downward…

We have adjusted downwards our expected EBITDA margin for FY 2020-21 and FY 2021-22. We expect a Scope-adjusted EBITDA margin at 5.5% in FY 2020-21 (previously 8.4%) and 6.8% in FY 2021-22 (previously 8.7%).

…firstly, due to higher than anticipated restructuring expenses,

As part of its plan to increase efficiency, Voith intends to reduce personnel expenses through headcount cuts. However, the settlement payments involved are set to weigh on profitability in FY 2020-21 and 2021-22. In this context, Voith has informed us that its restructuring expenses will be higher than communicated one year ago, close to the level in FY 2019-20 (roughly EUR 59m).

…secondly, due to the downward revision of our revenue expectations

Moreover, we have adjusted downwards our revenue expectation. Revenues proved to be quite resilient and were down by only 3% YoY to EUR 4,173m. The Covid-19 related recession has impacted revenues less than orders received (-14% YoY) due to the long lead times in plant engineering. While revenues in Hydro (-17% YoY) and Turbo (-4% YoY) decreased, Paper achieved an increase in revenues by 9% thanks to good business with China and acquisitions. The decline in Hydro was mainly due to customer uncertainty regarding financing and the extent to which projects could be implemented as planned. The new subsidiaries contributed revenues totalling EUR 227m. Adjusted for acquisitions and negative currency effects of -EUR 63m, revenues decreased by 6%.

Little revenue growth in FY 2020-21, revenue visibility for FY 2021-22 remains low

Voith has announced that FY 2020-21 will be a year of transition with revenues only slightly up on FY 2019-20. We expect revenues in FY 2020-21 of around EUR 4.26bn (around +2% YoY, previous expectation EUR 4.8bn), mainly due to the full year effects of transactions in FY 2019-20. While we expect restructuring expenses to remain high in FY 2021-22, there is low visibility with regard to revenues. In our base case, we anticipate revenues to increase to EUR 4.4bn (+4% YoY) in FY 2021-22. This is below our previous expectation of EUR 4.8bn in revenues.

Environment is positive ESG factor

Environmental considerations are a positive ESG factor. Voith is one of the leading companies in the global hydro equipment sector and benefits from the trend towards renewables. The Hydro division accounted for 23% of Voith's revenues in FY 2019-20. Furthermore, Voith acts as a supplier rather than as a main contractor, which reduces the risk of being sued for violations of environmental requirements.

Financial risk profile: BB-

Financial risk profile has deteriorated following recent acquisitions, as expected

Since FY 2016-17, Voith's financial risk profile has benefited from its relatively high liquidity position, driven by the proceeds from the sale of KUKA shares in 2017. In our last rating review, we anticipated that Voith's more intense than previously communicated M&A activity would have sustained negative impacts on its financial risk profile. As a result, we downgraded the issuer rating from BBB/Stable to BBB-/Stable in January 2020. Our expectation was that after jumping into the 4.0-4.5x range in FY 2019-20 due to the M&A activity, the company's SaD/EBITDA would improve to around 3.5x by FY-end 2021-22 supported by higher EBITDA. As expected, Voith's credit metrics were clearly weaker in FY 2019-20, with an even stronger than anticipated decline in SaD/EBITDA to 5.5x (2018-19: 2.4x), reflecting an unexpectedly sharp drop in EBITDA. Scope-adjusted EBITDA was EUR 237m in FY 2019-20 vs. EUR 331m previously.

Recovery to around 3.5x (level commensurate with current rating) is now less probable

The further development of the SaD/EBITDA ratio will depend on: i) M&A activity; and ii) the strength of the recovery in revenue and EBITDA. Based on our discussions with management, we expect some add-on acquisitions for FY 2020-21. We have factored in M&A related payments of around EUR 70m. We expect no material M&A activity in FY 2021-22. We have adjusted downwards our EBITDA expectation for FY 2020-21 as we expect lower revenues and higher restructuring expenses. We expect SaD/EBITDA to remain above 5.0x at FY-end 2020-21. Full-year effects from the transactions will only have a small impact on SaD/EBITDA in FY 2020-21. While we still expect SaD/EBITDA to recover in FY 2021-22 driven by higher revenues, the recovery to around 3.5x (the level commensurate with the current rating) is now less probable, in view of our weaker EBITDA expectations.

Planned reduction of trapped cash may be rating positive

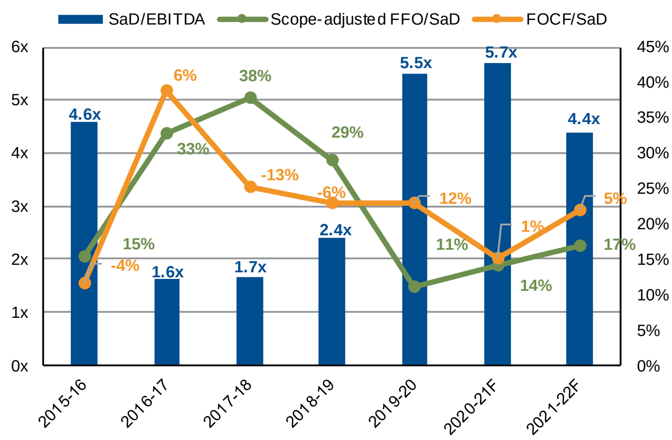
According to Voith, the 'trapped cash' issue has strong management attention. The company plans to reduce trapped cash to around EUR 150m (EUR 238m at FY-end 2019-20) in the medium term through cash transfers to Germany. The planned reduction of trapped cash is likely to be rating positive; however, we lack clarity on the size and timing of the reduction.

Solid cash flow in FY 2019-20 is not expected to be maintained in FY 2020-21

Despite lower EBITDA, Voith had very solid cash flows in FY 2019-20. Operating cash flow increased to EUR 234m (previous year: EUR 46m) thanks to net working capital (NWC) management. Capex of EUR 96m was below the previous fiscal year's level of EUR 113m due to the postponement of some major investments. Voith's FOCF of EUR 152m was at its highest level in the last ten years. We expect FOCF to be around zero in FY 2020-21. We also expect higher net working capital as well as payments for the repair of a large-scale customer plant, restructuring and personnel adjustments to weigh on FOCF in FY 2020-21. We expect FOCF to increase to around EUR 65m in FY 2021-22, supported by higher EBITDA and lower allowance and restructuring payments.

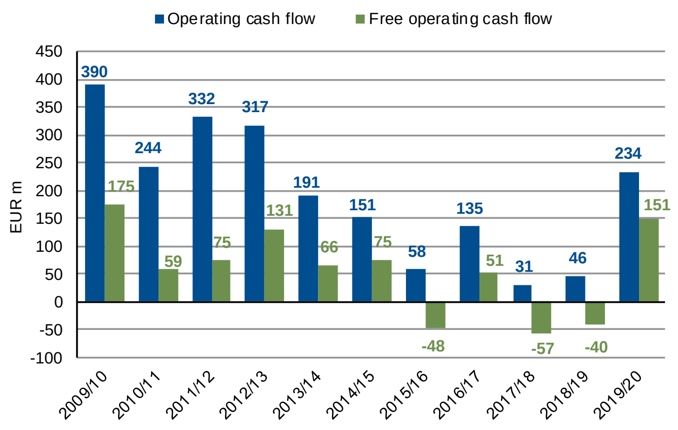
Here, we have factored in net capex of around EUR 95m in FY 2020-21 and around EUR 115m in FY 2021-22.

Figure 3: **Key credit metrics, 2015-16 to 2021-22F**



Source: Voith, Scope

Figure 4: **Trend in cash flow**



Source: Voith, Scope

Significant increase in financial debt in FY 2019-20

Voith's total financial debt at end-September 2020 was EUR 908m, mainly comprising note loans of EUR 561m, lease liabilities of EUR 115.5m and other loans and borrowings of EUR 180m (obligations from the classification of non-controlling interests in limited partnerships). The increase in financial debt compared to EUR 399m at end-September 2019 was due to the issue of a new note loan totalling EUR 400m in February 2020 with terms of five, seven and ten years. The note loan has been used to finance acquisition activities and top up liquidity reserves, particularly in view of maturities of EUR 102m in November 2020. The first-time application of IFRS 16 was another reason for the increase.

We expect no deleveraging in the near future

SaD has increased by EUR 501m to EUR 1.3bn. In order to calculate SaD, we made adjustments for: i) pensions in the amount of EUR 859m, and ii) restricted cash (EUR 238m in total). The increase in restricted cash vs. EUR 200m at FY-end 2019-20 reflects the better liquidity situation in China due to a successful project in the Paper division and the associated advance payments. According to Voith, this high trapped cash position is not sustainable as the liquidity position in China and India will decrease due to planned cash transfers to Germany through dividend payments. Based on our expectations regarding Voith's cash flow, we do not expect SaD to decrease meaningfully in the near future. We see a slight increase in SaD at FY-end 2020-21, due to relatively weak expected FOCF in FY 2020-21.

Two revolving credit facilities unused at FY-end 2019-20

After exercising the second options, Voith extended its existing syndicated euro loan of EUR 550m to April 2025. This loan was undrawn at end-September 2020 and is available as a strategic liquidity reserve. According to Voith, no financial covenants were arranged. In addition, Voith has a syndicated revolving loan of RMB 1,400bn (around EUR 180m) to finance working capital in China. It is available in that country until June 2024 and was not utilised at end-September 2020.

Figure 5: Composition of external financing at end-September 2020

Debt instrument	Currency	Amount (EUR m)	Outstanding (EUR m)	Maturity	Issuer	Leverage
Bilateral committed credit faciliies	EUR	375	0	2-3y	Voith GmbH	0.0x
Syndicated revolving credit facility	EUR	550	0	Apr-25	Voith GmbH	0.0x
Syndicated revolving credit facility	RMB	1,400	0	Jun-24	Various Asian subsidiaries but guaranteed by Voith GmbH	0.0x
SSD 5y	EUR		102	Nov-20	Voith GmbH	0.4x
SSD 7y	EUR		38	Nov-22	Voith GmbH	0.2x
SSD 10y	EUR		21	Nov-25	Voith GmbH	0.1x
SSD new 5y	EUR		200	Feb-25	Voith GmbH	0.8x
SSD new 7y	EUR		160	Feb-27	Voith GmbH	0.7x
SSD new 10y	EUR		40	Feb-30	Voith GmbH	0.2x
MCP			18	<1 year		0.1x
Bank loans	EUR		33	various	Voith GmbH	0.1x
Leases	EUR		116		Voith GmbH	0.5x
Debt at parent level (EUR m)			**728**			**3.1x**
Other debt	EUR		180		Various subsidiaries	0.8x
Senior unsecured debt (EUR m)			**180**			**0.8x**
Total debt (EUR m)			**908**			**3.8x**
Adjustments for:						
Pensions (100% of total amount)*			859			3.6x
Scope-adjusted gross debt (EUR m)			**1,766**			**7.4x**
Unrestricted liquidity			-466			-2.0x
Scope-adjusted debt (EUR m)			**1,300**			**5.5x**

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

'Adequate' liquidity and financial flexibility given short-term debt coverage of over 100%

We consider Voith's liquidity reserves to be 'adequate' given short-term debt coverage at more than 100%. Here we note positively that recent acquisitions have been financed with long-term debt, comprising three tranches of a note loan with terms of five, seven and ten years.

Relatively high cash position and available revolving credit facilities

Principal liquidity sources at end-September 2020 comprised: i) cash on balance of EUR 582m (approx. EUR 238m of which is trapped cash); ii) liquid investments of EUR 123m (mainly time deposits); iii) an unused syndicated revolving credit facility in the amount of EUR 550m due in April 2025; and iv) an unused syndicated revolving credit facility of RMB 1,400bn (around EUR 180m) to finance working capital in China. We expect Voith to have the following cash uses: i) around EUR 70m for some add-on acquisitions in FY 2020-21 (we expect no material M&A activity in FY 2021-22); ii) dividend payments of EUR 30m in FY 2020-21 and FY 2021-22; and iii) debt maturities of around EUR 102m in FY 2020-21 according to Voith's debt maturity profile.

Long-term and short-term debt ratings

Voith currently has no outstanding long- term debt instruments to be rated.

Short-term ratings affirmed

We affirm the S-2 short-term rating in line with the issuer rating and based on our liquidity assessment.

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