Research Update:

Danfoss A/S Outlook Revised To Negative On Increased Debt Burden After Acquisition, Ratings Affirmed

January 23, 2020

Rating Action Overview

- Danfoss has entered into an agreement to acquire from Eaton Corp PLC (A-/Stable/A-2) the vast majority of its hydraulic business for $3.3 billion, using debt.
- We believe Danfoss' market reach and size could benefit from the acquisition, but we see a risk that volatility in earnings could increase and that profit margins could narrow to about 14%-15% in 2020-2021, from the 16% we expect for 2019, due to lower margins in the acquired business and some integration costs.
- After the transaction, Danfoss' credit ratios will be weak for the rating, with funds from operations (FFO) to debt well below 30%. Credit ratios risk not improving as we expect, for example, if industry conditions worsen or the company increases its appetite for further inorganic growth.
- We are therefore revising our outlook to negative from stable and affirming our 'BBB' rating on the company.
- The negative outlook reflects the possibility we could lower our ratings on Danfoss over the 12-18 months if Danfoss' FFO to debt does not improve to 25% or above in 2021, or above 30% after that.

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Rating Action Rationale

Danfoss' material debt-funded acquisition, to complement its Power Solutions Division, is adding more pressure to its credit metrics, leaving the company with no rating leeway. Danfoss has announced its intention to acquire from Eaton a material part of its hydraulic business representing revenues of about $2.2 billion. We view the $3.3 billion acquisition price as a material transaction for Danfoss. Given that it will be fully funded through debt, we expect credit ratios to materially weaken. We understand the deal could close in the second part of 2020.

Based on this, we foresee Danfoss' credit metrics materially departing from its 2018-2019 performance, with FFO to debt of about 60%. We now believe that FFO to debt could decrease to 25% in 2021 and its S&P Global Ratings-adjusted debt could almost to triple to about €4 billion, from €1.3 billion at the end of 2018. We view the financial performance as weak for the current rating, and we see no room for any deviation in performance caused by weaker industry conditions, higher integration costs, or other acquisitions. Our outlook revision to negative reflects this; we see some risks that Danfoss will not be able to restore its financial metrics to align with a 'BBB' rating over the 12 to 18 months after the transaction closes.

Danfoss' acquisition is expected to strengthen company's size and market reach, albeit margins could suffer over the 12 to 18 months from transaction closing. We regard the announced acquisition as broadly neutral for our assessment of Danfoss' business risk. It will increase Danfoss' size such that it will become the largest operator globally within hydraulic systems, which complements well its prominent market share in the cooling, heating, and drives divisions covering other sectors. With the acquired business, we expect revenues at about €8.5 billion-€9.0 billion in 2021 (the first year of full consolidation for the newly acquired business)--comparable to Sandvik or Assa Abloy and double those of Alfa Laval. Moreover, the acquired hydraulic business' exposure to the U.S. brings balance to Danfoss' geographic mix. The increased size of operations will also allow additional resources for investments and research and development, further helping Danfoss investment in megatrends, such as electrification, climate change, and food supply, therefore making growth more sustainable.

However, the acquired business has previously been less profitable, with margins below Danfoss'. We expect Danfoss' reported EBITDA to be about 16% for 2019 compared with 13% for the newly acquired business. We forecast Danfoss' adjusted EBITDA at about 14%-15% in 2021 before improving again to about 16% in 2022. This because we expect some integration costs to play a role in the profit margin contribution over the medium term. For full-year 2019, we expect a slightly higher adjusted EBITDA margin than the 15.4% in 2018.

After the acquisition, about 50% of sales will be derived from the power solutions business. The company's exposure to the short-cycle will increase because that division has some industrial exposure, and we perceive it as more volatile. We therefore expect to see increased volatility in profit margins before full integration is finalized and synergies kick in.

Danfoss' financial policy to maintain a 'BBB' rating and some liquidity pockets could offer some relief. Between 2012 and 2019, Danfoss acquired various businesses and added about €2.6 billion of current top-line in line with its acquisitive growth strategy. Credit metrics, however, remained in line with the rating. While the latest transaction is larger and more transformative, it remains in line with the strategy to growth of 3% via acquisitions and 7% organically through the cycle. That said, we see the latest announcement as a one-off given its size. We expect management will stay committed to restoring credit metrics back to our guidance for the rating within 12-18 months from the deal closing. We understand the shareholders have agreed to lower shareholders' distributions for 2020. We also note previous large acquisitions for which management demonstrated an ability to integrate operations.

Outlook

Due to the debt on Danfoss' balance sheet to fund the $3.3 billion acquisition of its new hydraulic business (about €4.0 billion in adjusted debt at deal closing), we believe ratings headroom has eroded. At year-end 2021, FFO to debt at 25% or above (then exceeding 30% from 2022) would be commensurate with the rating. We could lower our ratings on Danfoss if it does not achieve those levels.

Downside scenario

We would lower the rating to 'BBB-' if the new business integration proved more challenging than we currently foresee, or if adverse market conditions resulted in a softer operating performance than we forecast. We could consider a one-notch downgrade if it seemed unlikely that FFO to debt would reach at least 25% by end-2021, or above 30% from 2022, as well as EBITDA margins staying consistently below 14%. If management undertook any more acquisitions before rating headroom had been restored, this would trigger a downgrade.

Upside scenario

We could revise the outlook to stable if Danfoss' credit metrics 12-18 months after the transaction improved such that FFO to debt was sustainably above 30% and EBITDA trended toward 16%.

Company Description

Danfoss is a leading producer of electrical and mechanical components in several industry segments: power solutions, cooling, drives, and heating. With revenues of about €6.1 billion and adjusted EBITDA of about €1 billion in 2018, Danfoss is a midsize European capital goods company, and its operations are divided into four segments:

- Danfoss Power Solutions: Hydraulic systems and electronic components. Cyclical end-markets include agriculture, construction, and material handling, and specialty equipment. As of year-end 2018, the power solutions division totaled about €2.1 billion, representing 35% of the company's revenues.
- Danfoss Cooling: Components for the air conditioning and refrigeration industry. End-markets include air conditioning and commercial and industrial refrigeration. As of year-end 2018, the cooling division accounted for €1.6 billion, representing 27% of company's revenues.
- Danfoss Drives: Development and production of low-voltage drives and power modules. End-markets are diverse, comprising several industrial sectors, including heating, ventilation, air conditioning, mining, lifts and elevators, food and beverage, automotive, and wind. As of year-end 2018, the drives segment contributed €1.4 billion, representing 23% of the company's revenues.
- Danfoss Heating: Heating components for residential and commercial heating and district energy for cities. End-markets including heating, ventilation, and air-conditioning systems. As of year-end 2018, the heating division totaled about €0.9 billion, representing 15% of the company's revenues.

Danfoss is a privately held company controlled by the Bitten and Mads Clausen Foundation. The foundation and the Clausen family hold 99.8% of the voting shares.

Our Base-Case Scenario

- We expect global real GDP growth of 3.2% in 2020 and 3.4% in 2021, versus 3.1% in 2019 and EU GDP growth of 1.3% in 2020 and 1.6% in 2021 (1.6% in 2019), reflecting higher economic instability among eurozone countries. We expect U.S. growth of about 1.8%-1.9% in 2020-2021 (2.3% in 2019).
- Reflecting the stagnant economic environment, Danfoss' top line will grow by about 3% in 2019 mainly on exchange-rate tailwinds. For 2020, we expect about 1%-2% growth in all its divisions. The new acquisition should support Danfoss' P&L only from the fourth-quarter of 2020, therefore, we see total consolidated growth reaching €6.8 billion (up 8%-9% compared with 2019). For 2021, we anticipate the full contribution of the new acquisition, so we see revenue growth of about 25%, reaching €8.5 billion.
- Adjusted EBITDA in 2019 of about €1.0 billion translating into EBITDA margin of about 16%, improving from 15.4% in 2018. For 2020, we expect EBITDA margin to decrease to about 15.5% and to about 14.5% in 2021. This partly reflects one-off integration costs of more than €100 million but also our assumption that the acquired hydraulic business has somewhat lower profit margins.
- We think the first synergies will start in 2022, when we expect profit margins to improve to about 16%.
- Tax rate of about 25% for 2019-2021.
- We expect working capital outlays to be at about €35 million-€40 million in 2019, then above €110 million in 2020, reflecting expected revenue contraction in the new acquired business (to decrease by 10% in 2020 compared with 2021).
- Capital expenditures (capex) of about €300 million in 2019 (about 5% of annual revenues), reflecting continuous investment in growth initiatives, digitalization, and the new enterprise resource planning system. For 2020, we see capex increasing to €390 million then €430 million in 2021, reflecting the new consolidation perimeter.
- Shareholders distribution including cash dividends and share-buyback of about €220 million in 2019, decreasing to about €130 million-€140 million per year for 2020-2021.
- The fourth quarter of 2020 acquisition of a material part of Eaton's hydraulic division (revenues of $2.2 billion) for $3.3 billion, fully debt-financed, representing a multiple of about 12x. For 2021, we foresee small bolt-on acquisitions of €50 million.

Liquidity

The short-term rating is 'A-2' and we assess Danfoss' liquidity as strong. We expect sources of liquidity to exceed uses by at least 3.0x over the 12 months started Jan. 1, 2020 and 3.1x the following 24 months. Given that the proposed acquisition will be entirely debt-funded, with uses fully covered by sources, we have excluded the transaction from our liquidity analysis. We understand that the majority of the financing package is bridge-to-bond, which would need to be refinanced 12 months after closing. This can been extended at Danfoss' discretion. We foresee a first maturity wall in 2022, which is preventing a higher liquidity score. We would need to see Danfoss proactively extend its debt maturity profile and to refinance the acquisition financing loan.

The company also enjoys a covenant-free capital structure. Given the increased debt on the balance sheet, we believe that it does not have the flexibility to absorb severe macroeconomic shocks without refinancing in the medium term. Moreover, Danfoss has less frequent access to capital markets compared with other rated peers due to its private ownership.

Sources of liquidity include:

- Our assumption of more than €80 million of total unrestricted cash as of Dec. 31, 2019;
- About €990 million available under several long-term committed credit lines as of Dec. 31, 2019. Our conservative assumption is that this will decrease to about €852 million in the following 24 months, but we expect the company will extend the upcoming maturities well in advance;
- Cash FFO generation of €720 million-€740 million in next 12 months; and
- Working capital inflows of about €110 million-€120 million in 2020.

Uses include:

- Manageable debt maturities amounting to €13 million for the following 12 months;
- Intra-year working capital swings up to €100 million;
- Capex of roughly €400 million annually; and
- Shareholders' distribution of about €130 million-€140 million.

Issue Ratings - Subordination Risk Analysis

Capital structure

- Danfoss' consolidated unadjusted debt at Dec. 31, 2018, pro forma the deal, is €4.0 billion, of which about 2% comprises mortgage loans that we see as secured.
- The remainder of the debt includes finance leases of €54 million, which we exclude from our subordination analysis.
- We note that only a residual part of the unsecured debt (about €50 million) is held at subsidiary level.

Analytical conclusions

We rate Danfoss' notes 'BBB', the same as the issuer credit rating, because there are no significant elements of subordination risk present in Danfoss' capital structure.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Negative/A-2

Business risk: Satisfactory

- Country risk: Intermediate

- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/leverage: Intermediate

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

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Capital Goods Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Danfoss A/S		
Issuer Credit Rating	BBB/Negative/A-2	BBB/Stable/A-2
Ratings Affirmed		
Danfoss A/S		
Senior Unsecured	BBB	

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