Research Update:

Danfoss A/S Affirmed At 'BBB/A-2' On Expected Resilience; Off CreditWatch; Outlook Negative

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Rating Action Overview

- Operating performance at Danfoss, a leading European producer of electrical and mechanical components, has shown resilience over first-half 2020, with the EBITDA margin at about the same level as last year.
- Although the planned $3.3 billion acquisition from Eaton will significantly weigh on credit metrics, we view positively Danfoss' actions to strengthen the balance sheet and expect further measures in the coming quarters.
- We are therefore affirming our 'BBB/A-2' ratings on Danfoss and removing the ratings from CreditWatch negative where we placed them on March 25, 2020.
- The negative outlook reflects that we could downgrade Danfoss if, at closing of the acquisition, we expected that the group was unlikely to achieve adjusted FFO to debt above 25% by end-2021 on a pro forma basis, and sustainably above 30% from 2022.

Rating Action Rationale

Over second-quarter 2020, Danfoss has proven able to withstand the pandemic. Contrary to what we had expected when we placed the ratings on CreditWatch, Danfoss has quickly prepared the group to accommodate unprecedented harsh market conditions. Over second-quarter 2020, its adjusted EBITDA margins were not affected by the pandemic while revenue decreased by 13.6%. This results in healthy first-half 2020 S&P Global Ratings-adjusted EBITDA at about 14.8%, against 16.2% reached in 2019. Our adjusted EBITDA for first-half 2020 includes about €35 million of one-off costs related to the Eaton acquisition and Danfoss' factoring footprint program. For 2020, we therefore expect sales to decrease by 7%-8% and EBITDA margins to range between 15% and 16%. Our base case is rooted in a gradual improvement of market conditions in the second half of 2020. We also expect healthy cash generation for the group thanks to lower capital expenditure (capex), no dividends to shareholders, and cost rationalization. We now see cash and cash equivalents for the group in excess of €450 million at the end of 2020, up from €203 million at the end of June 2020, surprisingly high for the group, which has maintained a historically very low level of cash at about €100 million maximum. This would translate into FFO to debt of about 75% in 2020 up from 66.8% in 2019.

However, we view the $3.3 billion acquisition from Eaton as risky for the group. The acquisition of Eaton's hydraulic business is now set to close toward the end of first-quarter 2021. It entails execution risk and will leave the company with no rating leeway, under the current capital structure. We continue to see the acquisition as risky for the group, given the uncertainties over an economic uptick in 2021, and significantly negative for Danfoss' credit metrics. Eaton's hydraulic business has been affected by the pandemic, with an organic sales contraction by 30% in the second quarter of 2020. We note that Danfoss Power Solutions was down by 23% over the same period, reflecting Eaton's comparatively higher exposure to the U.S. than Danfoss' Power Solution business. In the absence of a material equity or equity-like infusion or materially improving market fundamentals above our current base-case assumptions, we expect the group's credit metrics will remain somewhat below our rating thresholds in 2021 and 2022. For the moment, we see adjusted debt reaching about €3.6 billion, up from our expectation of €930 million at year-end 2020 and €1.3 billion recorded in 2019. For 2021 on a pro forma basis, assuming the transaction is fully and permanently debt-funded, we now see FFO to debt of 20%-25%, and debt to EBITDA of 3.0x-3.5x, which we would no longer consider as commensurate with our 'BBB' rating.

The group has time to take measures to strengthen its capital structure before the transaction occurs. We view positively the group's cut in dividends and sale of treasury shares for about €70 million in 2020. We believe the group is committed to maintaining the current rating and hence, expect further measures from the group to strengthen its balance sheet in the coming quarters.

We assess liquidity as strong, since there is no imminent refinancing risk. We note that Danfoss has €1.5 billion of undrawn committed lines with maturity beyond 12 months on July 1, 2020. We believe these lines will be enough to face the first maturity wall at the beginning of 2022 when the €500 million euro notes come due. We understand that Danfoss has pre-funded in full the $3.3 billion acquisition with a syndicated loan. The loan is in two tranches, 70% under the form of a bridge to bond with a bullet repayment after 12 months from closing and extendible by an additional 6+6 months at Danfoss' sole discretion. The remaining 30% is an amortizing term loan due 2024. Although not contemplated under our base case, we expect the group will continue to actively manage its balance sheet, refinancing the loan at closing to ensure strong liquidity over time.

Outlook

The negative outlook reflects the expected material deterioration in Danfoss' balance sheet following the planned acquisition of Eaton's hydraulic business, which will result in credit metrics somewhat below our thresholds for the rating. We could lower our ratings on Danfoss if it is unlikely to achieve credit metrics in line with the rating at closing of the transaction.

Downside scenario

We would lower the rating to 'BBB-' if the new business integration proved more challenging than we currently foresee, if adverse market conditions resulted in a softer operating performance than we forecast, or if Danfoss proves to be unable to strengthen its balance sheet further in the coming quarters to offset the negative impact from the planned acquisition. We could consider a one-notch downgrade if we deemed unlikely that, at closing of the transaction, FFO to debt would reach at least 25% by end-2021 on a pro forma basis, and above 30% from 2022. At the same time, EBITDA margins staying consistently below 14% could trigger a downgrade.

Upside scenario

We could revise the outlook to stable if Danfoss' credit metrics after the transaction closing improved such that FFO to debt was sustainably above 30% and EBITDA margins trended at about 16%.

Company Description

Danfoss is a leading producer of electrical and mechanical components in several industry segments including: power solutions, cooling, drives, and heating. With revenue of about €6.3 billion and S&P Global Ratings-adjusted EBITDA of about €1 billion in 2019, Danfoss is a midsize European capital goods company with operations in four segments:

- Danfoss Power Solutions: Hydraulic systems and electronic components. Cyclical end markets include agriculture, construction, and material handling, and specialty equipment. At year-end 2019, this division's revenue was about €2.2 billion, representing 35% of total revenue.
- Danfoss Cooling: Components for the air conditioning and refrigeration industry. End markets include air conditioning and commercial and industrial refrigeration. As of year-end 2019, revenue was €1.7 billion, representing 27% of total revenue.
- 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, auto, and wind. As of year-end 2019, segment revenue was €1.5 billion, representing 23% of total revenue.
- 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 2019, heating division revenue was about €0.9 billion, representing 15% of total revenue.

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.

In January 2020, Danfoss announced it had entered into a binding agreement to buy Eaton's hydraulics business. This business provides products for customers in markets such as agriculture, construction, and in industrial market segments. The business will be transferred into the existing Danfoss business segment, Danfoss Power Solutions, adding approximately 11,000 employees and 2019 sales of US$2.2 billion (€2.0 billion) to the business segment, which will double the hydraulics business.

Our Base-Case Scenario

- Due to the COVID-19 pandemic, we have revised our global GDP growth projections and we now expect a 3.7% contraction in 2020, followed by rebound of 5.4% growth in 2021.
- The U.S. and eurozone to contract 5.0% and 7.8%, respectively, in 2020 and China to have modest growth of 1.2%.
- The weaker economic backdrop underpins our forecast of a 7%-8% revenue decline for Danfoss

in 2020, followed by sharp revenue growth of about 35% in 2021, spurred by the acquisition of Eaton's hydraulics business and slightly positive organic demand on a pro forma basis. This compares with a year-on-year sales drop of 10% in first-half 2020.

- Notwithstanding the sales drop in 2020, Danfoss' EBITDA margin has shown resilience to the pandemic, reaching 15%-16% for 2020, slightly lower than 16.2% recorded for 2019. For 2021, we forecast the pro forma EBITDA margin will decline to 14.0%-14.5%, mainly driven by acquisition of Eaton's hydraulic business and attached one-off costs.
- No material swings in working capital over 2020-2021.
- Capex of about €250 million in 2020, increasing to €350 million in 2021.
- No acquisitions in 2020, with the $3.3 billion acquisition of Eaton's hydraulics business assumed to take place in first-quarter 2021.
- Dividends to minorities of €35 million for both 2020 and 2021; no dividends to shareholders over 2020 and 2021.
- Some treasury share repurchases from shareholders amounting to €70 million in 2020.

Key metrics

Table 1

Danfoss A/S -- Key Metrics*

	--Fiscal year ended Dec. 31--				
	2018a	2019a	2020f§	2021f	2022f
(Mil. €)					
Revenue	6,098	6,285	About 5,800	About 7,800	About 8,000
Revenue growth (%)	4.7	3.1	(8)-(7)	32-35	2-4
EBITDA	939	1,017	About 900	About 1,100	1,250-1,350
EBITDA margin (%)	15.4	16.2	15-16	13.5-14.5	15.5-16.5
Funds from operations (FFO)	737	848	About 700	800-850	900-1,000
Capital expenditure	310	310	About 250	About 350	400-450
Free operating cash flow (FOCF)	398	479	About 400	About 500	About 500
Dividends	113	161	About 35	About 35	About 100
Debt	1,283	1,269	About 900	About 3,600	About 3,300
Debt to EBITDA (x)	1.4	1.2	0.9-1.1	3.0-3.5	2.5-3.0
FFO to debt (%)	57.4	66.8	About 75	20-25	25-30
FOCF to debt (%)	31.0	37.7	About 45	10-15	10-15

*All figures adjusted by S&P Global Ratings. §Pro forma Eaton's hydraulic business acquistion. a--Actual. f--Forecast.

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 4.8x over the 12 months started July 1, 2020, and 1.8x the following 24 months. Given that the hydraulics business acquisition from Eaton has been entirely pre-funded with a bridge financing, 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+6+6 months after closing at the sole discretion of the company. In assessing liquidity we also value the company's prudent risk-management, its sound relationship with banks, and its covenant-free capital structure.

Sources of liquidity as of July 1, 2020, include:

- Our assumption of more than €190 million of total unrestricted cash;
- About €1.5 billion available under several long-term committed credit lines. Our conservative assumption is that this will decrease to about €720 million in the following 24 months, but we expect the company will extend the upcoming maturities well in advance;
- Cash FFO of €700 million in next 12 months; increasing to about €830 million over the following 24 months.

Uses of liquidity for the same period include:

- Manageable debt maturities amounting to €37 million for the coming 12 months, increasing by about €560 million over the coming 24 months because the €500 million euro notes come due in February 2022;
- Intrayear working capital swings up to €100 million; and working capital absorption of about €20 million-€30 million per year
- Capex of roughly €300 million for the coming 12 months, increasing to more than €390 million for the coming 24 months; and
- Minority shareholders' distribution of about €35 million for the coming 12 months, increasing to about €100 million for the coming 24 months.

Issue Ratings - Subordination Risk Analysis

Capital structure

Danfoss' consolidated unadjusted debt at Dec. 31, 2019, amounts to €975 million, of which about 7% comprises mortgages. The committed facility for the acquisition is unsecured and fully undrawn, and the borrower will be Danfoss A/S.

Analytical conclusions

The rating on the €500 million euro notes coming due in February 2020 is 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 Ratings 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 | 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: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Danfoss A/S		
Issuer Credit Rating	BBB/Negative/A-2	BBB/Watch Neg/A-2

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Senior Unsecured	BBB	BBB/Watch Neg

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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.