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## Research Update:

# Danish Capital Goods Company Danfoss A/S Assigned 'BBB/A-2' Ratings; Outlook Stable

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## Research Update:

# Danish Capital Goods Company Danfoss A/S Assigned 'BBB/A-2' Ratings; Outlook Stable

## Overview

- Danfoss A/S (Danfoss) is a Denmark-headquartered electrical and mechanical solutions provider serving a wide range of customer end markets.
- We are assigning our 'BBB/A-2' ratings to Danfoss.
- On Sept. 12, 2014, Danfoss announced its intention to open a tender offer to acquire Finnish company Vacon PLC for about €1.0 billion. The transaction is pending shareholder and regulatory approval, but we assume it will be executed in line with the proposed terms.
- The stable outlook reflects our expectation that the group will maintain credit metrics in line with an intermediate financial risk profile, including FFO to debt of more than 35% and debt to EBITDA of less than 2.5x, despite the planned debt-funded acquisition of Vacon.

## Rating Action

On Nov. 10, 2014, Standard & Poor's Ratings Services assigned its 'BBB/A-2' long- and short-term corporate credit ratings to Denmark-headquartered capital goods company Danfoss A/S. The outlook is stable.

## Rationale

The rating reflects Danfoss' "satisfactory" business risk profile. With revenues of close to Danish krone (DKK)34 billion (€4.5 billion), Danfoss is a leading producer of electrical and mechanical components in a number of industry segments. We also view positively the company's good degree of customer end market diversification and its fairly good geographic diversification.

Our business risk profile assessment is also supported by Danfoss' profitability, with margins that we consider to be at the upper end of the 11%-17% range that we view as "average" in the capital goods sector. We believe the business risk profile assessment would be moderately enhanced by the acquisition of Vacon, which would enable Danfoss to become the second-largest producer of low voltage drives for electrical motors. We understand the profitability of the targeted company is largely consistent with that of Danfoss.

Danfoss is split into two segments. Danfoss Climate & Energy's key expertise lies in food refrigeration, air-conditioning systems, controls for electric

motors, heating systems for buildings, and components for renewable energy, including solar and wind energy. Danfoss Power Solutions' key expertise is in hydraulic systems and components for powering mobile machinery used in agriculture, construction, materials handling, and specialty equipment.

Our assessment of Danfoss' financial risk profile as "intermediate" rests on the assumption that the company will acquire Vacon for about €1.038 billion (DKK7.7 billion). However, the transaction is still subject to shareholder and regulatory approval. Under our base case, we therefore anticipate a significant increase in the company's debt compared with prior years (adjusted debt levels at year-end 2013 amounted to DKK6.7 billion, including our adjustment for operating lease commitments of about DKK1.1 billion and close to DKK0.7 billion for postretirement obligations). However, we expect Danfoss' ratio of funds from operations (FFO) to debt to return to more than 35% in 2015, which is in line with the current rating.

We believe the Vacon transaction demonstrates a shift toward a more growth-oriented strategy, following the group's focus on cost efficiency improvements and margin expansion in recent years. As a result, a failure to conclude the proposed Vacon transaction is unlikely to lead to an upgrade in the near term, although we believe that the group's metrics would be more in line with a "modest" financial risk profile assessment, including FFO to debt of more than 45% and debt to EBITDA of less than 2x. If the Vacon transaction is completed as expected, we anticipate Danfoss will focus on deleveraging before undertaking any larger transactions, consistent with its financial policy targets.

In our base case assume, we assume:

- Flat organic growth for 2014, followed by low-single-digit revenue growth for 2015, on the back of recovering industrial activity in Danfoss' core Western European market, and continued growth in emerging markets and the U.S.
- A continued focus on efficiency improvements, coupled with moderate volume growth and disciplined pricing policies, which should allow Danfoss to slightly improve its adjusted EBITDA margins over 2015-2016.
- Capital expenditures to sales of about 3.5%, roughly in line with historical levels.
- Moderate investments in working capital to fund the expansion of the business, amounting to about DKK400 million-DKK500 million.
- Annual dividend payouts of DKK800 million for 2014 and 2015.
- Acquisition payouts of about DKK10 billion in 2014 in our base case. About DKK7.7 billion relates to the acquisition of Vacon. Some DKK2.25 billion relates to the group's transaction with SMA, in which Danfoss took a 20% minority stake while contributing its solar inverter business to SMA. We do not expect this to result in meaningful contribution to earnings and cash flows since the stake in SMA will only be equity consolidated and we do not assume significant dividends will be received. We assume additional payouts for bolt-on acquisitions of DKK1.0 billion from 2015.

Based on these assumptions, and when including related revenues, earnings, and cash flow generation potential from Vacon, we arrive at the following credit measures:

- Pro forma FFO to debt of between 30% and 35% in 2014, improving to slightly more than 35% in 2015.
- Pro forma debt to EBITDA of about 2.5x in 2014, improving to about 2.0x in 2015.
- Discretionary cash flows of about DKK1.5 billion in 2014, improving to about DKK2.0 billion in 2015.

## **Liquidity**

We assess Danfoss' liquidity as "strong." We expect sources of liquidity to exceed uses by at least 1.5x over the 12 months starting Sept. 30, 2014. We also expect that liquidity sources would exceed uses even if EBITDA declined by 30%. We view Danfoss' bank relationships as well-established, its credit market standing as high, and its risk management as very prudent. The company does not have any financial covenants.

Principal liquidity sources on Sept. 30, 2014, include:

- About DKK5.9 billion available under a number of long-term committed credit lines, with no maturities in 2015.
- A €900 million (DKK6.7 billion) bridge facility to fund the Vacon transaction. We expect this to almost cover the acquisition payouts of about DKK7.8 billion related to Vacon.
- Cash FFO generation of more than DKK4 billion per year over 2015-2016.

Principal liquidity uses as of the same date include:

- Working capital outflows of about DKK400 million-DKK500 million.
- Capital expenditures of roughly DKK1.3 billion-DKK1.4 billion annually.
- Dividend payouts of between DKK800 million and DKK900 million for 2014 and 2015, given the group's policy of paying out no more than 30% of net income.
- From 2015, we anticipate the group will pay out about DKK1 billion annually in bolt-on acquisitions.

We note that failure to refinance the bridge facility more than 12 months before its final maturity date in September 2016 could put pressure on the group's liquidity profile. However, we anticipate that management will proactively manage liquidity over the coming months.

## **Outlook**

The stable outlook reflects our expectation that the group will maintain credit metrics consistent with an "intermediate" financial risk profile, despite the planned DKK7.8 billion Vacon acquisition. We factor in our assumption that Danfoss will continue to report a solid operating performance, leading to solid operating cash flows that we assume the group will apply to reduce debt over the coming years.

We expect adjusted FFO to debt of more than 35%, adjusted debt to EBITDA of less than 2.5x, and positive FOCF, in line with the current rating. If the group undertakes the Vacon transaction as planned, we wouldn't expect any further large acquisitions. However, from 2015, we assume minor bolt-on acquisitions amounting to DKK1.0 billion annually.

### **Upside scenario**

Given Danfoss' strong cash flow generation, we see some potential for a one-notch upgrade over the longer term. However, a positive rating action would likely depend on Danfoss' ability to sustain a strong financial performance that exceeds the requirements for the current rating. At the same time, we would need to observe clear guidance regarding the group's financial policy and leverage tolerance, and its credit ratios would need to reach levels such as FFO to debt exceeding 45% and debt to EBITDA below 2x.

### **Downside scenario**

Downgrade pressure could arise. We could consider a negative rating action if we were to see a significant deterioration in Danfoss' credit metrics as a result of weakening operating performance that could, when coupled with large additional acquisition payouts, result in credit metrics no longer commensurate with an "intermediate" financial risk profile. We could consider a downgrade if FFO to debt were to fall below 35%. We would also consider lowering the rating if Danfoss were to undertake aggressive debt-financed acquisitions that resulted in credit ratios outside our expectations.

## **Ratings Score Snapshot**

Corporate Credit Rating: BBB/Stable/A-2

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk:

- Cash flow/Leverage: Intermediate

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Neutral (no impact)

## Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios and Adjustments, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Key Credit Factors For The Capital Goods Industry, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

## Ratings List

New Rating

Danfoss A/S

Corporate Credit Rating

BBB/Stable/A-2

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