

# RatingsDirect®

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## Summary:

# Danfoss A/S

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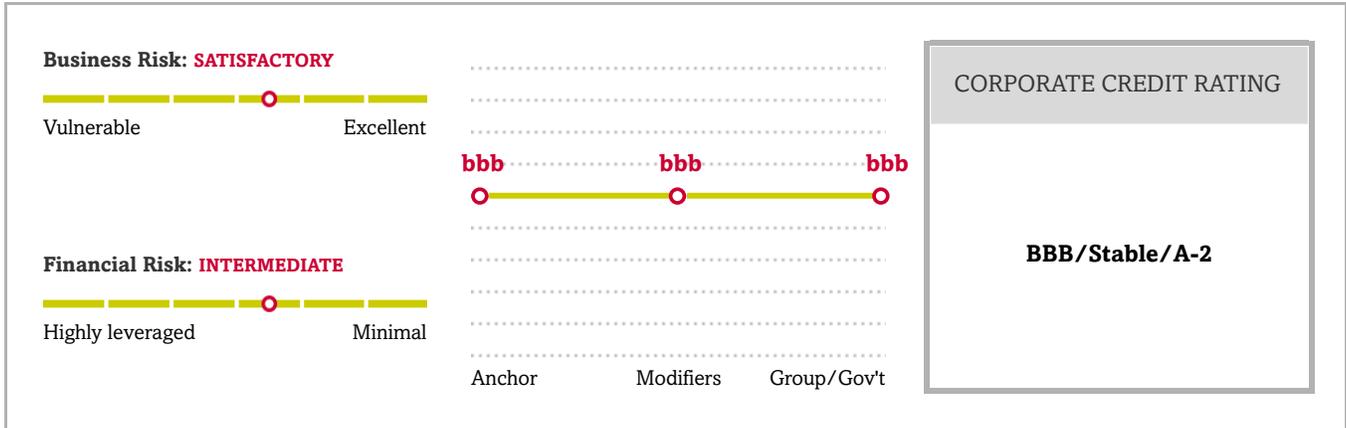
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# Summary:

## Danfoss A/S



### Rationale

Business Risk: Satisfactory	Financial Risk: Intermediate
<ul style="list-style-type: none"> <li>• Leading market positions in electrical and mechanical components in a number of industry segments.</li> <li>• Good degree of customer, end market, and geographic diversity.</li> <li>• Good cost position, resulting in high operating margins, which are at the upper end of the 11%-18% range that we view as "average" in the capital goods sector.</li> <li>• Exposure to cyclical demand.</li> <li>• Competition in pricing and product performance.</li> </ul>	<ul style="list-style-type: none"> <li>• Track record of robust cash flow generation.</li> <li>• "Strong" liquidity and well-spread debt maturity profile.</li> <li>• Growth-oriented strategy, with a number of acquisitions over recent years.</li> <li>• Limited access to equity, owing to status as a privately-held company.</li> </ul>

## Outlook: Stable

The stable outlook on Denmark-headquartered capital goods company Danfoss A/S reflects Standard & Poor's Ratings Services' expectation that the company will maintain credit metrics consistent with an "intermediate" financial risk profile, despite the recent Danish krone (DKK) 7.8 billion acquisition of Finnish company Vacon PLC. We factor in our assumption that Danfoss will continue to report a stable operating performance, leading to solid operating cash flows that we assume the company will apply to reduce debt over the coming years. We expect Standard & Poor's-adjusted funds from operations (FFO) to debt of more than 35%, adjusted debt to EBITDA of less than 2.5x, and positive free operating cash flow (FOCF), in line with the current rating.

We do not expect any further large acquisitions following the Vacon transaction in late 2014. We assume minor bolt-on acquisitions amounting to DKK1.0 billion annually.

### Downside scenario

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% on a sustained basis. We would also consider lowering the rating if Danfoss were to undertake aggressive debt-financed acquisitions that resulted in credit ratios outside our expectations.

### Upside scenario

Given Danfoss' strong cash flow generation, we see some potential for a one-notch upgrade over the medium 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, for an upgrade, we would take into account a more conservative financial policy and leverage tolerance compared with what the company has committed to currently. We would also expect funds from operations to debt exceeding 45% and debt to EBITDA at below 2x.

## Standard & Poor's Base-Case Scenario

Assumptions	Key Metrics			
<ul style="list-style-type: none"> <li>Revenue growth of 5%-10% in 2015, due to currency exchange rate effects and the consolidation of Vacon that Danfoss acquired in late 2014. Organically, we anticipate growth to remain flat in 2015. For 2016 and 2017, we forecast revenue growth of 3%-5%. We see support from recovering industrial activity levels in Danfoss' core Western European market, and continued growth in the U.S. We expect most emerging markets to continue to grow, but at a slower pace than in recent years. In Russia, we expect Danfoss to feel the effect of weakening demand and the significant depreciation of the ruble.</li> <li>An EBITDA margin of about 17%-18%, in line with recent years.</li> <li>Capital expenditure (capex) to sales roughly in line with historical levels at about 3.5% of revenues.</li> <li>Moderate investments in working capital to fund the expansion of the business, amounting to about DKK400 million-DKK500 million per year.</li> <li>Annual dividend payouts of between DKK900 million and DKK1.1 billion for 2015 and 2016.</li> <li>Payouts for bolt-on acquisitions of DKK1.0 billion per year.</li> </ul>				
		<b>2014A§</b>	<b>2015E</b>	<b>2016E</b>
	EBITDA margin (%)*	17.3	17%-18%	17%-18%
	FFO to debt (%)*	32.0	~35%	~40%
	Debt to EBITDA (x)*	2.4x	~2x	~2x
	<p>*Margins and ratios include our debt adjustments for operating leases and postretirement obligations. §2014 metrics are somewhat weakened by the consolidation of Vacon, with related debt fully consolidated, while earnings and cash flows were not yet reflected for the full year. A--Actual. E—Estimate.</p>			

## Business Risk: Satisfactory

Danfoss' "satisfactory" business risk profile is supported by the company's leading market positions for 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. In 2014, Danfoss generated about 60% of its revenues outside the European Union.

Other positive factors are Danfoss' good profitability, with adjusted EBITDA margins that averaged 17.3% over the past three years, thereby positioning Danfoss at the upper end of the 11%-18% range that we view as "average" in the capital goods sector. We believe the business risk profile assessment will be moderately enhanced by the recent acquisition of Vacon, which enabled Danfoss to become the second-largest producer of low-voltage drives for electrical motors. We understand that Vacon's profitability is largely consistent with that of Danfoss.

Those strengths are tempered by Danfoss' exposure to cyclical demand in a number of its segments. The Power Solutions segment showed the most significant decline in the 2008/2009 global financial downturn, with demand being dependent on fairly cyclical end markets. The other segments also showed volatility, but to varying degrees. We

understand that the Cooling and Heating segments are also somewhat dependent on inventory stocking cycles, which exaggerates underlying cyclicity. However, Heating had shown the least cyclicity among Danfoss' businesses in the past. Danfoss is exposed to pricing competition in a number of its segments.

## Financial Risk: Intermediate

We assess Danfoss' financial risk profile as "intermediate," reflecting its robust FOCF generation over the past five years, with consistently positive FOCF that ranged between DKK2.0 billion and DKK3.2 billion per year.

Following strong credit metrics over 2011-2013, with FFO to debt in excess of 45% and debt to EBITDA of clearly below 2x, we forecast FFO to debt between 35% and 40% and debt to EBITDA at about 2x for the coming two years. This follows Danfoss' debt-funded acquisitions of Vacon for a consideration of DKK7.8 billion and a minority stake in SMA Solar for DKK2.25 billion, which led Danfoss to more than double its debt from 2013 levels.

We anticipate, however, that Danfoss will continue to generate solid FOCF, which should help the company to deleverage. We also note Danfoss' commitment to maintain a 'BBB' rating, and we anticipate that the company will consider potential future acquisitions carefully in light of expected earnings and cash flow generation prospects.

The strengths of Danfoss' financial risk profile are somewhat moderated by the company's focus on expansionary growth that led to a number of acquisitions over recent years. We also consider Danfoss's access to equity as limited owing to its status of a privately held company. This is somewhat balanced by shareholder remuneration levels, with dividend payouts of no more than 30% of net income, which is lower than most of Danfoss' public Scandinavian peers.

## Liquidity: Adequate

We assess Danfoss' liquidity as "strong" under our criteria. We expect sources of liquidity to exceed uses by at least 1.5x over the 12 months from March 31, 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	Principal Liquidity Uses
<ul style="list-style-type: none"> <li>About DKK6.9 billion available under a number of long-term committed credit lines on March 31, 2015.</li> <li>Cash FFO generation of more than DKK4 billion per year over 2015-2016.</li> </ul>	<ul style="list-style-type: none"> <li>Seasonal working capital outflows of DKK500 million-DKK1 billion.</li> <li>Capex of roughly DKK1.3 billion-DKK1.5 billion annually.</li> <li>Dividend payouts of between DKK900 million and DKK1.1 billion for 2015 and 2016, given Danfoss' policy of paying out no more than 30% of net income.</li> <li>Payouts of about DKK1 billion on bolt-on acquisitions annually from 2015.</li> </ul>

## Ratings Score Snapshot

### Corporate Credit Rating

BBB/Stable/A-2

### Business risk: Satisfactory

- **Country risk:** Low
- **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
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

## Related Criteria And Research

- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Capital Goods Industry, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Group Rating Methodology, 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
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

<b>Business And Financial Risk Matrix</b>						
<b>Business Risk Profile</b>	<b>Financial Risk Profile</b>					
	Minimal	Modest	<b>Intermediate</b>	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
<b>Satisfactory</b>	a/a-	bbb+	<b>bbb/bbb-</b>	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

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