Research Update:

Danfoss A/S Outlook Revised To Stable From Negative; 'BBB/A-2' Ratings Affirmed; €2.5 Billion EMTN Program Rated 'BBB'

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Rating Action Overview

- Operating performance at Danfoss A/S, a leading European producer of electrical and mechanical components, was better than we anticipated in 2020, with S&P Global Ratings-adjusted EBITDA margin stable at 16.4% despite a revenue decline of 7.3% year on year.
- This, combined with higher-than-expected free operating cash flow (FOCF) resulted in funds from operations (FFO) to debt of about 93% compared with about 75% in our previous base case.
- Although the planned $3.3 billion acquisition of Eaton hydraulics business will significantly weigh on credit metrics, we now believe that Danfoss has enough financial flexibility to maintain pro-forma FFO to debt of about 30% in 2021, and sustainably above this level from 2022 onward.
- We are therefore revising our outlook to stable from negative and affirming our 'BBB/A-2' long- and short-term issuer credit ratings on Danfoss, and assigning our 'BBB' issue rating to the company's new senior unsecured €2.5 billion euro medium-term note (EMTN) program.
- The stable outlook reflects our view that FFO to debt will remain comfortably above 30% and adjusted EBITDA margin will increase to about 16% in the 12-18 months after the planned acquisition of Eaton's hydraulics business.

Rating Action Rationale

Danfoss proved more resilient to the COVID-19 pandemic than we expected in 2020 and is likely to maintain adjusted FFO to debt of about 30% pro forma the acquisition from Eaton. Danfoss quickly prepared to meet unprecedented harsh market conditions. Over 2020, its adjusted EBITDA margins were not affected by the pandemic while revenue decreased by 7.3%. This resulted in a healthy S&P Global Ratings-adjusted EBITDA margin of about 16.4%, against 16.2% reached in

2019 and higher than our previous expectation of about 15%-16% (see: "Danfoss A/S Affirmed At 'BBB/A-2' On Expected Resilience; Off CreditWatch; Outlook Negative," published Sept. 14, 2020, on RatingsDirect for more details). Our adjusted EBITDA for 2020 includes about €50 million of one-off costs related to the Eaton acquisition and €24 million related to Danfoss' factory footprint program. Additionally, Danfoss' FOCF reached an all-time high of €555 million in 2020, owing to working capital releases and comparatively lower capital expenditure (capex), up from €479 million in 2019. This translates to FFO to debt of 93% in 2020, which is higher than our previous estimate of about 75% and up from 66.8% in 2019. Thanks to a gradual improvement of market conditions in 2021, which should sustain organic sales momentum, we now believe that Danfoss has enough financial flexibility to quickly absorb the planned $3.3 billion acquisition of Eaton hydraulics business. This would result in pro-forma FFO to debt at about 30% in 2021, before markedly improving above those levels from 2022 onward.

Eaton's hydraulics business is inherently more volatile than that of Danfoss as a whole. The acquisition of Eaton hydraulics business is now set to close toward the end of second-quarter 2021, once Danfoss receives clearance from antitrust authorities linked to the disposal of the White Drive Motors & Steering business. Eaton's hydraulics business is inherently more cyclical than that of Danfoss, and therefore was not immune to the pandemic, with sales down about 16.4% in 2020. We note that Danfoss Power Solutions sales decreased by 11% over the same period. This reflects Eaton's comparatively higher exposure to the U.S. than Danfoss Power Solutions. For 2021, owing to integration costs estimated at about €80 million-€90 million, we expect Danfoss' pro-forma EBITDA will decrease to about 15%, before improving to about 16% from 2022 onward.

We view the $3.3 billion acquisition from Eaton as materially increasing group's leverage, leaving Danfoss with no rating leeway for other acquisitions or more generous than anticipated shareholder remuneration. Danfoss' financial policy is to retain enough flexibility to ensure a 'BBB' rating over the cycle. With the Eaton hydraulics business acquisition, we believe that the group has no buffer to fund other acquisitions or to increase shareholder distributions above what we currently estimate under our revised base case. Over 2020, Danfoss distributed dividends of €38 million to minority shareholders. We anticipate that over 2021 the group will maintain the same approach. For 2022 we now estimate dividends of €200 million-€250 million.

To permanently fund the acquisition, Danfoss has established a new €2.5 billion EMTN program. We rate Danfoss' senior unsecured debt 'BBB'. The EMTN program is expected under the following issuers:

- Danfoss A/S;
- New subsidiary Danfoss Finance I B.V., with a guarantee offered by Danfoss A/S; and Danfoss Power Solutions Inc. or alternatively;
- New subsidiary Danfoss Finance II B.V., with a guarantee from Danfoss A/S.

The notes constitute senior unsecured and unsubordinated obligations of the respective issuer, ranking pari passu among themselves and with all other present or future unsecured and unsubordinated obligations unless such obligations are accorded priority under mandatory provisions of statutory law. The base prospectus contains customary negative pledge clauses as well as a change of control clause with a put option for lenders. There are no financial covenants. The net proceeds from each issue of notes under the program will be used either to finance, or refinance, the Eaton hydraulics business acquisition; or for general corporate purposes; or to finance green projects. To offset the risk of subordination in the structure, Danfoss Power Solutions Inc. is providing an upstream guarantee with a third-party legal opinion, which is a sufficient mitigant to overcome potential subordination in the capital structure of the group, in our view.

S&P Global Ratings believes there remains high, albeit moderating, uncertainty about the evolution of the coronavirus pandemic and its economic effects. Vaccine production is ramping up and rollouts are gathering pace around the world. Widespread immunization, which will help pave the way for a return to more normal social and economic activity, looks to be achievable by most developed economies by the end of the third quarter. However, some emerging markets may only achieve widespread immunization by year-end or later. We use these assumptions about vaccine timing in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Outlook

The stable outlook reflects our view that Danfoss will quickly absorb the planned acquisition of Eaton hydraulics business, showing FFO to debt comfortably above 30% and increasing its adjusted EBITDA margin to about 16% in the 12-18 months after the acquisition.

Downside scenario

We would lower the rating if the new business integration proves more challenging than we currently forecast, or if adverse market conditions result in softer operating performance than anticipated--resulting in FFO to debt below 30% for a prolonged period without prospects for a short-term recovery. Higher-than-envisaged shareholder distributions or material additional debt-funded acquisitions could also result in a lower rating.

Upside scenario

We could raise the rating if adjusted FFO to debt is above 45% through the cycle, supported by a financial policy commitment to maintain this leverage.

Company Description

Danfoss is a leading producer of electrical and mechanical components in several industry segments including: power solutions, climate solutions, and drives. With revenue of about €5.8 billion and S&P Global Ratings-adjusted EBITDA of €958 billion in 2020, Danfoss is a midsize European capital goods company with operations in three segments:

- Danfoss Power Solutions: Hydraulic systems and electronic components. Cyclical end markets include agriculture, construction, and material handling, and specialty equipment. At year-end 2020, this segment's revenue was about €2.0 billion, representing 34% of total revenue.
- Danfoss Climate Solutions: Components for the air conditioning and refrigeration industry as well as heating components for residential and nonresidential heating and district energy for cities. End markets include heating, ventilation, and air-conditioning systems, and commercial and industrial refrigeration. As of year-end 2020, revenue was €2.5 billion, representing 43% 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, wind, and solar. As of year-end 2020, segment revenue was €1.3 billion, representing 23% 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 hydraulics business. This business provides products for customers in markets such as agriculture, construction, and industrial segments. The business will be transferred into Danfoss Power Solutions, adding approximately 10,000 employees and 2020 sales of €1.6 billion, which will double the group's hydraulics business.

Our Base-Case Scenario

Assumptions

- A rebound in global GDP to 4.9% growth in 2021 from a 3.7% contraction in 2020.
- U.S. (where Danfoss generates about 23% of its revenue in 2020) and eurozone (accounting for about 37% in 2020) GDP reduced by 3.9% and 7.2% respectively in 2020. For 2021, we expect modest growth of 4.2% in the U.S. and 4.8% in the eurozone. Asia-Pacific GDP will reduce by 1.7% in 2020, followed by 6.1% growth in 2021 (accounting for about 24% of Danfoss' revenue in 2020).
- Organic growth of about 5%-6% for the group in 2021, slightly better than our global GDP forecasts. However, the Eaton hydraulics business acquisition, which we assume will happen toward the end of second-quarter 2021, will spur a revenue increase of about 35% over 2020 on a pro-forma basis. In 2022, we expect sales for the combined group will increase by about 5%-8%. This compares with Danfoss' sales decline of 7.3% in 2020 to €5.8 billion.
- Notwithstanding the sales drop in 2020, Danfoss' EBITDA margin was resilient to the pandemic, reaching 16.4% from 16.2% in 2019. For 2021, we forecast that pro-forma EBITDA margin will decline to about 15%, mainly driven by the acquisition and attached one-off costs. We expect margins to normalize at about 15.5%-16.0% in 2022.
- No material swings in working capital over 2020-2021. This compares with a €52 million working capital release in 2020.
- Capex of about €250 million in 2020, increasing to €350 million-€400 million on average in 2021-2022 per year.
- No acquisitions in 2021, with the $3.3 billion Eaton hydraulics acquisition assumed to take place by the end of second-quarter 2021.
- Dividends to minorities of about €40 million in 2021. For 2022, we expect Danfoss to restart shareholder distributions of about €200 million.
- Some cash proceeds from the disposal of the White Drive Motors & Steering business.

Key metrics

Danfoss A/S--Key Metrics*

	--Fiscal year ended Dec. 31--				
Mil. €	2018a	2019a	2020a	2021f - pro-forma Eaton hydraulics business	2022f
Revenue	6,098	6,285	5,828	7,500-8,000	8,000-8,500
Revenue growth (%)	4.7	3.1	(7.3)	About 35	5-8
EBITDA	939	1,017	958	1,100-1,200	1,250-1,350
EBITDA margin (%)	15.4	16.2	16.4	About 15	15.5-16.0
Funds from operations (FFO)	737	848	755	900-1,000	1,000-1,100
Capital expenditure	310	310	245	300-350	350-400
Free operating cash flow (FOCF)	398	479	555	About 500	500-600
Dividends	113	161	38	About 40	About 200
Debt	1,283	1,269	813	About 3,300	About 3,000
Debt to EBITDA (x)	1.4	1.2	0.8	2.5-3.0	2.0-2.5
FFO to debt (%)	57.4	66.8	92.9	About 30	33-38
FOCF to debt (%)	31.0	37.7	68.3	13-18	17-22

*All figures adjusted by S&P Global Ratings. a--Actual. f--Forecast.

Liquidity

The short-term rating is 'A-2' and we assess Danfoss' liquidity as strong. We expect sources of liquidity will exceed uses by at least 4.2x over the 12 months started Jan. 1, 2021, and 1.5x the following 24 months. We believe that Danfoss will fund the hydraulics business acquisition through unsecured bonds, along with a material portion using cash at the parent. For this reason, we consider available cash of only €60 million as of Jan. 1, 2021. In assessing Danfoss' liquidity we also value the company's prudent risk-management, sound relationship with banks, and covenant-free capital structure.

Sources of liquidity as of Jan. 1, 2021, include:

- Our assumption of about €60 million of total unrestricted cash;
- About €1.4 billion available under several long-term committed credit lines. Our conservative assumption is that this will decrease to about €800 million in the following 24 months, but we expect the company will extend the upcoming maturities well in advance; and
- Cash FFO of €750 million-€760 million in the next 12 months; increasing to about €900 million-€950 million over the following 24 months.

Uses of liquidity for the same period include:

- Manageable debt maturities amounting to €63 million for the coming 12 months, increasing by about €700 million over the coming 24 months because the €500 million euro notes come due in February 2022;

- Intrayear working capital swings of up to €100 million, with working capital absorption neutral in 2021 and negative by about €30 million-€40 million in 2022;
- Capex of roughly €300 million-€320 million for the coming 12 months, increasing to €370 million-€380 million for the coming 24 months; and
- Minority shareholder distributions of about €40 million for the coming 12 months, with distributions in 2022 of €200 million.

Issue Ratings - Subordination Risk Analysis

Capital structure

- Danfoss' consolidated unadjusted debt at Dec. 31, 2020, amounts to €952 million, of which about €69 million is represented by a mortgage loan that we consider secured.
- We note that currently only a residual part of the unsecured debt is held at subsidiaries, which we assess to be about €19 million.
- In light of the EMTN program, we expect Danfoss to leverage its new issuing platform, expected under three different issuers--Danfoss Finance II B.V., a fully owned subsidiary of Danfoss A/S; Danfoss Finance I B.V., a fully owned subsidiary of Danfoss Power Solutions Inc.; and Danfoss A/S.
- Danfoss A/S and Danfoss Power Solutions Inc. have irrevocably and unconditionally agreed to guarantee, on a joint and several basis, the obligations of Danfoss Finance I B.V. under and in relation to notes issued by Danfoss Finance I B.V.
- Danfoss A/S has irrevocably and unconditionally agreed to guarantee the obligations of Danfoss Finance II B.V. under and in relation to notes issued by Danfoss Finance II B.V.
- To overcome the structural subordination issue that might arise if Danfoss Finance I raises a material amount of debt to fund either the hydraulics business acquisition or Danfoss A/S, Danfoss Power Solutions has provided an upstream guarantee to Danfoss A/S. We regard the guarantee as valid because we received a legal opinion from an outside counsel.

Analytical conclusions

- Danfoss' notes and its new EMTN program are rated 'BBB', the same as the long-term issuer credit rating, as there are no currently significant elements of subordination risk present in the capital structure. Moreover, going forward we expect Danfoss Power Solutions' upstream guarantee to mitigate the structural subordination elements that could arise under the new set up.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/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

Related Research

- Danfoss A/S Affirmed At 'BBB/A-2' On Expected Resilience; Off CreditWatch; Outlook Negative, Sept. 14, 2020

Ratings List

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Ratings Affirmed; Outlook Action		
	To	**From**
Danfoss A/S		
Issuer Credit Rating	BBB/Stable/A-2	BBB/Negative/A-2
Senior Unsecured	BBB	BBB
New Rating		
Danfoss Finance I B.V.		
Danfoss Finance II B.V.		
Senior Unsecured	BBB	

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.