Research Update:

thyssenkrupp Outlook Revised To Stable From Negative On Stronger-Than-Expected Operating Performance; Affirmed At 'BB-'

December 13, 2021

Rating Action Overview

- Because of thyssenkrupp's (tk's) stronger-than-expected operating performance during fiscal (FY) 2021 (ended September 30) and our expectation of further improvement in FY2022 thanks to better price realization in its steel operations as well as progress on its restructuring efforts, the company is likely to perform in line with our expectations for the current rating over the next 12-18 months.
- We now anticipate an EBITDA margin of more than 7%, yielding neutral free operating cash flow (FOCF) for FY2022, versus our previous estimate of negative €600 million.
- Therefore, we revised our outlook on tk to stable from negative and affirmed our 'BB-/B' ratings on the company and the 'BB-' ratings on its debt.
- The stable outlook reflects our view that the operating performance, including EBITDA margins of more than 7% in FY2022 and about neutral cash flow, will continue to strengthen over the next 12-18 months.

PRIMARY CREDIT ANALYST

Tobias Buechler, CFA
Frankfurt
+ 49 693 399 9136
tobias.buechler
@spglobal.com

SECONDARY CONTACT

Pierre-Henri Giraud
Paris
+ 33(0)140752566
Pierre-Henri.Giraud
@spglobal.com

ADDITIONAL CONTACT

Industrial Ratings Europe
Corporate_Admin_London
@spglobal.com

Rating Action Rationale

Although tk's FOCF fell short due to higher inventories, its significantly improved operating performance quells downside risks. tk's credit metrics have made a stronger-than-expected comeback in FY2021 from the COVID-19-related setbacks of 2020. The company reported an S&P Global Ratings-adjusted EBITDA margin of 4.4 %. This is a pronounced improvement from the 2.0%-2.5 % we anticipated in our previous review (see "Thyssenkrupp Outlook Revised To Negative On Continued Cash Burn; 'BB-' Rating Affirmed, published Jan. 20, 2021, on RatingsDirect). At the same time, revenue increased by 17.5%, versus an expected 10.5%-11.5% growth range. The solid recovery was mainly driven by the dynamic macroeconomic environment. Market conditions for all segments were better than expected, with higher steel prices, increased demand for truck components, and a thriving wind energy sector, particularly in China. However, we also note that operating cash flow stood at a weaker-than-anticipated €100 million, versus about €650 million estimated. This was primarily driven by working capital outflow of €800 million--versus an expected €350 million inflow--caused by increasing inventory reflecting higher material prices. This translated into negative €1.3 billion FOCF compared to our estimate of negative €900 million.

Prevailing favorable conditions in the steel market continue should support the group's cash flow over the next 12 months. We expect Steel Europe to be the dominant driver of further revenue and margin expansion in FY2022, based on ongoing favorable market conditions, first tangible results from restructuring efforts, and the benefits of higher steel prices thanks to newly negotiated contracts. Thanks to the cyclical recovery in steel we estimate the adjusted EBITDA margin will exceed 7.0 % in FY2022, though growth will be partially offset by lower margins in the other segments, owing to less demand on supply chain shortages of semiconductors, among other components. Higher freight costs may also cast a shadow on margins. We anticipate the improved earnings position to support cash flow, with tk reporting about breakeven FOCF in FY2022 compared to our previous estimate of negative €600 million.

We note tk's progress in restructuring and successful disposal of various activities under its multi tracks segment. We estimate that the introduced restructuring measures are progressing according to plan, with more than 65% of headcount reductions already achieved and about €900 million expenses booked over the past two years. However, we note that the release of the provisions will weigh on cash flow in FY2022 and FY2023, while we estimate full benefits will start to unveil from FY2023 and after. At the same time, the group has sold or closed five out of its 10 non-core assets (multi-tracks). This should reduce losses in its multi-tracks activities and support profitability improvements.

Although the future shape and scope of tk's portfolio remain unclear, the group's streamlining efforts have gained momentum. tk continues to have a wide range of strategic options on the table. In particular, the final strategy for its challenged and capital expenditure (capex)-intense steel operations would materially affect the group's profile, given the steel operations' weight within the group, elevated restructuring needs, high fixed cost base, sizable pension obligations, and pronounced sensitivity to the economy. This suggests volatile cash flow and profitability. That said, we note that tk recently announced plans to prepare Steel Europe to operate on a stand-alone basis, and we expect to gain more clarity on this development during 2022. Additionally, given the favorable market valuations, the group is considering an initial public offering (IPO) of its UCE (hydrogen electrolysis business). Even though we expect TK to retain a significant stake in the company, the transaction would strengthen the company's already sound balance sheet. At this time, we use a going-concern approach in our analysis and have not included any material sale of operations, expect for the announced disposals.

The €9 billion in cash and cash equivalents available at end-FY2021 provides ample liquidity resources. After the redemption in December 2021 of a €1,250 million bond originally due in March 2022, liquidity sources will remain comfortable and upcoming debt maturities will still be manageable (about €1.3 billion until the end of FY2023).

Management remains committed to reducing debt on the balance sheet, restructuring the business, and improving the credit rating. We continue to believe the group will use its cash held at balance sheet to pay back its financial debt at maturity and to cover its pension obligations, likely by funding a contractual trust agreement (CTA). Therefore, we do not expect management to pay a regular dividend until FOCF generation capacity is structurally positive, even though the resumption of a reliable dividend is stated as a clear objective for the future.

Outlook

The stable outlook reflects our view that tk's operating performance has improved markedly over the past 12 months and will further improve over the next 12 months including about neutral cash flow in FY2022 and FY2023 thanks to the first benefits of cost-saving measures alongside the favorable economic environment, particularly for its steel operations in FY2022. We estimate the group will post EBITDA margins of more than 7% in FY2022 and above 6% in FY2023, while FFO to debt stays comfortably above 60% over the next 24 months.

Downside scenario

We could lower the ratings if the group:

- Is unable to further improve its FOCF toward at least breakeven over the next 12-18 months;
- Fails to post EBITDA margins of about 6% (in the current scope).
- Cannot sustain FFO to debt above 20% during a cyclical downturn; or
- Faces depressed end markets, in particular automotive, or weaker-than-expected outcomes from its restructuring efforts.

Upside scenario

We could raise our ratings if the group further strengthened its profitability with continuously improving EBITDA margins to above 7% through the cycle, which should enable the group to generate and sustain meaningful FOCF. Such a development could occur if the group successfully completes its restructuring program, including the sale or closure of all its non-core activities. We could also raise the rating if we believe its cash flow becomes less volatile.

Company Description

tk is a Germany-based diversified industrial conglomerate with active operations in 56 countries. The group structure comprises six operating segments:

- Automotive Technology: Development and production of high-tech components and systems for the auto industry, and development of automated production systems for the auto industry.
- Industrial Components: Production of crankshafts, slewing bearings and seamless rings, and undercarriage components.
- Marine Systems: System supplier for submarines and surface vessels, as well as for maritime electronics and security technology.
- Materials Services: Stainless steel production and global materials distribution.
- Steel Europe: Production of flat-rolled carbon steel for the auto industry and other sectors.
- Multi Tracks: A portfolio of companies, which tk will either sell, partner, or close. Among others, the portfolio includes production of stabilizer and springs, and construction of plants for the

chemical, mining, and cement industry.

Tk generated about €34 billion in revenue and about €1.5 billion in EBITDA in FY2021.

Our Base-Case Scenario

Assumptions

- Global GDP growth of 5.6% in 2021 and 4.3% in 2022. Specifically, in the U.S., 5.5% in 2021 and 3.9% in 2022; in Eurozone, 5.1% in 2021 and 4.4% in 2022; in Asia-Pacific, 6.3% in 2020 and 4.9% in 2021.
- Flat to slightly increasing revenue in FY2022, supported by the positive momentum in the steel operations. This, however, is nearly entirely offset by declines in most of its other segments due to ongoing supply chain issues, lower demand in China and sales or closing of five multi-tracks portfolio companies.
- Revenue to rise 2%-4% in 2023 due to improved supply chain conditions in its automotive segment and economic growth.
- S&P Global Ratings-adjusted EBITDA margin should surpass 7% in FY2022 from 4.4% in FY2021, supported by upcoming higher spreads in its steel operations, lower restructuring cost and reduced losses from its multi-tracks segment.
- EBITDA margin to moderate to about 6.5% in FY2023 since we assume the steel environment will normalize, while margins in its remaining segments to expand on the back of restructuring benefits and normalization of supply chains.
- Annual capex of around €1.5 billion in FY2022-FY2023.
- Working capital outflow of about €300 million in FY2022, then turning neutral in FY2023.
- Bolt-on acquisitions of around €50 million per year over 2022-2023.
- No dividend payments expected in 2022-2023.

Key metrics

Based on the above, we arrive at the following key credit metrics:

- FFO to debt of more than 60% in FY2022 and FY2023.
- Around neutral FOCF for FY2022 and FY2023.
- Debt to EBITDA of less than 1.5x in FY2022-FY2023.

Liquidity

Our short-term rating on tk is 'B', reflecting the long-term issuer credit rating and our assessment of the group's liquidity as strong. We base this on our projection that sources will exceed potential uses by more than 3.0x over the 12 months starting from Sept. 30, 2021, and remain above 3.0x the 12 months thereafter. We also believe tk's net sources will remain positive even if forecast EBITDA declines more than 30%. Also supporting our liquidity score is tk's prudent financial risk management and well-established relationship with banks.

Principal liquidity sources for the 12 months started Sept 30, 2021:

- Cash balances of about €9 billion;
- Undrawn bank lines (RCF) of about €1.5 billion; and
- About €1.4 billion operating cash flow, followed by €1.4 billion-€1.6 billion over the following 12 months.

Principal liquidity uses over the same period:

- Working capital outflow of about €300 million;
- About €1 billion intra-year working capital swings;
- Annual capex of about €1.5 billion;
- No dividends;
- Short-term debt maturities of €1.5 billion, then €1.0 billion in following 12 months.

We note that, at the beginning of December 2021, the group repaid early its €1.25 billion bond originally maturing in March 2022.

Covenants

There is no covenant for the committed credit lines of about €1.5 billion or bonds outstanding.

Environmental, Social, And Governance

E-4 S-2 G-3

Environmental factors are a negative consideration in our credit rating analysis of tk. As a steel producer (more than 25% of group sales in FY2021, it is exposed to a high risk of changing environmental regulation and more stringent requirements for CO2 emissions, which could force the group to make high investments to produce green steel and potentially erode its cost position compared to less regulated producers. Despite ongoing measures to improve its energy efficiency gains (215 gigawatt hours in FY2020), the group still consumed about 69 terawatt hours. We recognize tk's strong technological capabilities in providing hydrogen technologies. A potential partial sale via an IPO in 2022 would support the balance sheet further. Governance factors are a moderately negative consideration. The company adheres to high standards of disclosure, in line with international publicly listed groups. However, we view as a negative the lengthy and significant restructuring of the group to restore its profitability, which has been pending for multiple years, as well as multiple unexpected changes in senior management.

Issue Ratings - Recovery Analysis

Key analytical factors

- We rate tk's various senior unsecured notes 'BB-'; the recovery rating on these debt instruments is '3'.

- Our recovery expectations are in the 50%-70% range (rounded estimate: 65%).
- Under our hypothetical scenario, a default would follow the persistent weakness in the industries in which tk operates. We would also expect operating setbacks to lead to deteriorating financial performance, permanent negative free cash flow, and an inability to refinance key obligations. We further included a retirement of about €1.5 billion in maturing senior debt in FY2022 using its high cash balance.
- We value tk as a going concern, given the solid market positions of several of its core divisions.
- Nevertheless, we believe many parts of the group could be broken up, sold separately, and provide significant value to creditors in a default scenario.

Simulated default assumptions

- Year of default: 2026
- EBITDA at emergence: €1.3 billion (we assume maintenance capex at 2.5% of revenue; cyclical adjustment of 5% and operational adjustment of 10%, which is standard for the sector and €150 million annual pension amortization)
- Implied enterprise value multiple: 5.0x
- Jurisdiction: Germany

Simplified waterfall

- Gross recovery value: €6.9 billion
- Net recovery value for waterfall after administrative expenses (5%) and pension consideration (€3.5 billion): €3.2 billion
- First priority claims: €0.1 billion
- Value available for senior unsecured claims: €3.1 billion
- Senior unsecured claims: €4.7 billion
- --Recovery range: 50%-70% (rounded estimate: 65%)

All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating: BB-/Stable/B

Business risk: Fair

- Country risk: Low
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

ESG Credit Indicators: E-4 S-2 G-3

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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

- Thyssenkrupp Outlook Revised To Negative On Continued Cash Burn; 'BB-' Rating Affirmed, Jan. 20, 2021

Ratings List

Ratings Affirmed; Outlook Action

	To	From
thyssenkrupp AG		
Issuer Credit Rating	BB-/Stable/B	BB-/Negative/B
Issue-Level Ratings Affirmed; Recovery Expectations Revised		
thyssenkrupp AG		
Senior Unsecured	BB-	BB-
Recovery Rating	3(65%)	3(55%)
Commercial Paper	B	B