FitchRatings

Fitch Downgrades thyssenkrupp to 'BB-'; Outlook Stable

Fitch Ratings - Warsaw - 04 March 2020:

Fitch Ratings has downgraded thyssenkrupp AG's (TK) Long-Term Issuer Default Rating (IDR) to 'BB-' from 'BB+' and removed it from Rating Watch Negative (RWN). The Outlook is Stable. Fitch has simultaneously downgraded the senior unsecured notes' rating to 'BB-' from 'BB+'.

The rating actions reflect the weakening of TK's business profile as a result of the announced disposal of the profitable Elevator Technology (ET) business (expected to be closed by the end of the 2020 fiscal year) coupled with the expectation that following the disposal, the company's underlying cash generation is likely to be weak in the short to medium term.

The ratings are supported by the company's strong liquidity profile, which will receive a material boost from the EUR17.2 billion sale proceeds of the ET business, and will allow TK to reduce its financial liabilities and provide adequate time to restructure its underperforming businesses and return them to adequate and sustainable profitability levels. The strong liquidity position mitigates the execution risk related to the restructuring plans and underpins the Stable Outlook.

Fitch expects that over the medium term, the company is likely to successfully implement its efficiency improvement measures, which should support sustainable cash flow generation. Together with the short-term structural reduction in financing and pension-related costs stemming from the ET disposal, this could lead to cash-flow based profitability measures being restored to levels commensurate with the 'BB' category over the coming three to four years.

Key Rating Drivers

Weaker Business Profile: Disposing of its ET unit significantly weakens the group's business profile as it leaves TK exposed to the lower margin and more cyclical materials and automotive businesses. ET is the largest contributor of operating cash flows to the group, with EBIT margins consistently above 11%. The remainder of the company will see weak cash flow generation and likely weak margins, at least in the near term, until there is a successful turnaround amid restructuring initiatives.

ET Divestment to Reduce Debt: We understand that management's priority is to use a significant portion of the ET division EUR17.2 billion sale proceeds to repay debt, strengthening the group's weak balance sheet. We expect TK to reduce short-term debt immediately and the remaining debt as it matures. We also expect TK to fund a material share of its pension liability, significantly alleviating the sizeable related annual cash outflow. The remaining proceeds will provide sufficient cash to restructure and turnaround the rest of the businesses.

Negative FCF: TK's free cash flow (FCF) generation has been subdued over the past several years, as evidenced by accumulated negative FCF of around EUR3 billion over 2016-2019. We expect the negative FCF trend to continue over the short to medium term, with a gradual reduction in cash burn as macroeconomic conditions improve and TK successfully implements its restructuring plans.

Execution Risk Over Restructuring: The group's management has announced a restructuring programme, aiming to cut around 4% of the global workforce, equating to around 6,000 jobs (500 already cut in 1Q20), adopt leaner corporate headquarters and focusing on improving the remaining businesses and particularly the underperforming Springs & Stabilizers, Heavy Plates and System Engineering units.

We believe that these measures could support a sustainable improvement in operating cash flow generation, but this will be only achieved through sizeable cash costs to cover the restructuring programme. Although we view TK's liquidity as adequate to cover any restructuring expenses, we note the related execution risks.

Further Strategic Reviews: We understand that TK is reviewing its investment needs across the remaining business units. Steel Europe and Material Services may seek consolidation options on a smaller scale, while TK may pursue a different ownership structure for its Automotive Technology, Industrial Components or Marine Systems (MS) units. We understand that strategic alternatives could entail partnerships or the sale of stakes.

More recently, management announced that it is in the process of signing NDAs seeking to divest part or the whole Plant Technology unit. Partial divestiture of the segments, divestiture with subsequent debt reduction, or strategic restructuring efforts could have a positive impact on the company's leverage and overall credit profile. However, we note that these alternatives are only at the early stages. We would assess the impact of any transaction as it occurred.

Weakened Capital Goods Performance: TK has been significantly affected by unfavourable macroeconomic factors over recent years. Softer demand for auto components, concerns over international trade conflicts, loss-making projects in the Plant Technology and MS Units weigh on the group's thin cash flow generation. Fitch projects weaker operating cash flows this year amid weakening business environment and increasingly limited visibility following the Covid-19 outbreak.

Materials Businesses Underperforming: Lower volumes, sluggish demand, depressed steel prices and higher raw material costs have affected the group's operating cash flows. Fitch expects global iron ore supply to recover in 2H20, which should reduce TK Materials Services costs. However, Fitch expects that weak demand and the continued spread of Covid-19 will provide limited headroom for steel prices to grow.

Derivation Summary

TK's rating reflects its relatively good business profile with a more diversified business profile than steel-focused peers, in particular closest peer ArcelorMittal S.A. (BBB-/Negative), stemming from its capital goods businesses, which provide more earnings stability. This compares with ArcelorMittal's greater scale, more geographic diversification, vertical integration into raw materials (iron ore) and stronger credit metrics, notably a more resilient FCF margin and lower funds from operations (FFO) adjusted gross leverage.

Conversely, TK has greater exposure to volatile steel earnings, a greater fixed cost base and lower production flexibility than capital goods peers, including KION GROUP AG (BBB-/Stable) and Atlas Copco AB (A+/Stable). These peers also have a greater proportion of total group sales derived from stable servicing and maintenance.

Key Assumptions

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- EBITDA declining to about 60% in pro-forma 2020, reflecting deconsolidation of ET and weakening operating performance from the rest of the businesses; around 65% EBITDA increase in 2021 from the prior year's trough supported mainly by restructuring efforts and marginal markets improvements

- EUR17.2 billion of ET divestment proceeds in 2020

- Significant funding of the company's pension liabilities in 2020

- Debt reduction throughout the rating horizon, in line with debt maturity schedule

- Resumption of dividends payments in 2021

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- Improvement and stabilisation of cash generation leading to FFO and FCF margins above 6% and 1%, respectively, on a sustainable basis

- FFO adjusted gross leverage below 4.5x on a sustained basis

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO margin below 3% on a sustainable basis

- Lack of tangible progress in improving the FCF generation capacity resulting in negative FCF on a regular basis

- Material deterioration in the company's liquidity position

- Failed restructuring measures resulting in FFO adjusted gross leverage above 5.5x after FY21 on a sustained basis

Liquidity and Debt Structure

Strong Liquidity: As of 31 December 2019, TK had about EUR5.1 billion of liquidity, consisting of EUR2.1 billion of readily available cash and EUR3 million of undrawn committed credit lines, of which EUR2 billion matures in March 2021. Liquidity is also supported by the company's EUR3 billion commercial paper programme (EUR1 billion used at end-December 2019) and the group's strong history of tapping the capital markets on a regular basis, most recently in September 2019 when it issued a EUR1 billion bond with a term of 3.5 years and a coupon of 1.875%.

Available liquidity sources provide ample headroom to cover short-term financial debt, capex and working capital requirements. EUR17.2 billion of ET divestment cash will significantly bolster liquidity once the company receives the proceeds by the end of this fiscal year. However, expected negative FCF over the rating horizon will continue to burden TK's liquidity.

Summary of Financial Adjustments

Summary of Financial Adjustments

Fitch has adjusted balance-sheet debt at end-September 2019 by including the utilised amount of the factoring programme of around EUR2 billion.

Fitch has adjusted cash in the amount of EUR500 million which we treat as not readily available for debt repayment because of seasonal working-capital swings.

Fitch adjusted debt as at end-September 2019 by capitalising the annual operating lease expense of EUR218 million using a multiple 8x.

ESG Considerations

ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
thyssenkrupp AG	LT IDR BB- Downgrade		BB+
	ST IDR B Affirmed		B
senior unsecured	LT BB- Downgrade		BB+
senior unsecured	ST B Affirmed		B

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Applicable Criteria

Corporate Rating Criteria (pub. 19 Feb 2019)
Short-Term Ratings Criteria (pub. 02 May 2019)
Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
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