S&P Global Ratings

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Research Update:

Thyssenkrupp Outlook Revised To Negative On Continued Cash Burn; 'BB-' Rating Affirmed

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Rating Action Overview

- S&P Global Ratings expects improving demand from the automotive industry and better pricing and demand for German diversified industrial conglomerate thyssenkrupp AG's (tk's) steel products will spark a recovery of tk's revenues in fiscal (FY) 2021-2022, after a 15% drop in FY2020 on a like-for-like basis, which should help the group reduce its still high cash burn rate in FY2021-2022.
- However, in the absence of major disposals of loss-making units or a further materially improving economic environment, the restructuring needs within the group remain high and we expect free operating cash flow (FOCF) to remain materially negative over the next 24 months, with a cumulative outflow of about €1.3 billion to €1.5 billion.
- We are affirming the ratings on tk and its issues at 'BB-' but revising the outlook to negative from stable.
- The negative outlook reflects the risk of a downgrade in the next 12 months if the group is not able to materially improve its underlying FOCF generation towards break-even levels over the next 24 months.

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Rating Action Rationale

Material FOCF and profitability improvements are keys to sustain the rating. Recovery in demand for steel and improving prices while input costs remain flattish as well as the improving sentiment in the automotive industry will support the recovery of the operating performance of the group in FY2021. We expect now revenues to increase by about 11% year-on-year and EBITDA margins to recover to about 2%, compared to our previous expectation of about 6% revenue growth and 1%-2% for EBITDA margins. For FY2022 we estimate a further revenue increase of about 3%-4% supported by GDP growth and EBITDA margin recovery to about 4%-5% supported by the unfolding benefits of its implemented restructuring but also higher volumes.

Nevertheless, we believe FOCF will remain significantly negative partly because of higher capital expenditures and restructuring costs, and we continue to view tk's inability to generate positive

FOCF as a key rating constraint. For FY2021, we expect FOCF to reach negative €800 million-negative €900 million and for FY2022 around negative €600 million, following a cash burn of €5.3 billion in FY2020. However, to become FOCF positive we estimate the company needs an EBITDA margin level of more than 6%.

The cyclical recovery in the steel market supports reduction of cash burn in the group. Over the next 12 months the recovery in free cash flow generation depends largely on the cyclical recovery in steel and automotive demand. Compared to our previous base case, the cash outflow for the group will be about €500 million less over the next 24 months, mainly caused by the cycle rebound in the steel market. The lower cash burn should support the recovery in credit metrics and provide more funds to reposition the group to return to growth, higher profitability, and address its cost base. For FY2021 we now expect funds from operations (FFO) to debt of about 20%, improving to comfortably above 30% in FY2022, while debt to EBITDA stands at 3x to 4x in FY2021 and about 2x in FY2022. The strong balance sheet following the sale of the elevator business continues to support the rating. As of Sept. 30, 2020, tk reported a net financial cash position of €5.1 billion, which corresponds to S&P Global Ratings-adjusted debt of €2.6 billion (the difference primarily represents our adjustment for unfunded pension obligations of €7.0 billion).

The future shape, scope, and balance sheet of the group is still quite uncertain. Tk has a wide range of strategic options on the table. In particular, the final strategy for its challenged and capital expenditures (capex)-intense steel operations would have an material impact on the group's profile, given the steel operations' weight within the group, high restructuring needs, high fixed cost base, high pension obligations, and high sensitivity to the economy, translating into volatile cash flows and profitability for the group. We note that tk has held talks with various steel peers and with the local and federal government on industrial consolidation, and even a spin-off could be an option. We expect to get more clarity in spring 2021 when management plans to provide an update on its steel strategy. For now, we use a going-concern approach in our analysis and have not included any material sale of operations. However, we would expect material progress on the execution of its non-core assets (its "multi tracks" portfolio) over the upcoming 24 months, which in turn could result in more structural improvements in profitability.

Cash balance of more than €10 billion is providing ample liquid resources. We estimate the group will have more than €10 billion in cash and cash equivalence available after redemption in December 2020 of a €850 million 2.75% note originally due in March 2021. Given the ample liquidity sources and manageable debt maturities upcoming, liquidity remains strong.

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 the majority of the proceeds to pay back its financial debt at maturity and to fund a contractual trust agreement (CTA) to cover its pension obligations. We therefore assume management will not take any shareholder-friendly measures such as paying out an extraordinary dividend or initiating a share buyback program. We also expect management will not reinitiate a regular dividend before FOCF generation capacity is structurally positive.

Outlook

The negative outlook reflects the execution risk on its prolonged restructuring plan to improve the cost structure and free cash flow generation on a structural basis over the next 24 months.

Downside scenario

We could lower the ratings in the next 12 months if the group is not able to materially improve its underlying FOCF generation towards break-even levels over the next 24 months as well as its EBITDA margins to at least 4.5% in FY2022. This scenario could unfold if

- The cost cutting is less effective then currently envisaged;
- The group is unable to dispose its non-core assets; or
- Its end-markets--in particular automotive or steel operations--would become depressed again.

Upside scenario

We could revise the outlook to stable if the group's operating performance materially recovers, helped by favorable demand trends in key end markets, coupled with the benefits from its restructuring efforts. In particular, EBITDA margins of about 6% (based on the group's current scope) coupled with break-even FOCF prospects as well as adjusted FFO to debt of at least 20%, could support such an outlook revision.

Company Description

Tk is a Germany-based diversified industrial conglomerate with active operations in about 60 countries. In July 2020 it sold off its elevator technology division for €17.2 billion. The new group structure comprises five operating segments and a portfolio of companies, which it will either restructure, sell, partner, or close, called "multi tracks":

- 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: Among other things, production of stabilizer and springs, and construction of plants for the chemical, mining, and cement industry.

With the deconsolidation of the elevator technology business, tk generated about €29 billion in revenues in FY2020.

Our Base-Case Scenario

- Global GDP shrinkage of 2.5% in 2020 and growth of 5.6% in 2021; in the U.S., shrinkage of 5.0% in 2020 and growth of 5.2% in 2021; in the eurozone, shrinkage of 7.8% in 2020 and growth of 5.5% in 2021; and in Asia-Pacific, shrinkage of 1.3% in 2020 and growth of 6.9% in 2021.

- We forecast revenue growth of about 11% in 2021 and about 3%-4% in FY2022, as market conditions improve on the back of the global economic recovery, improving sentiment in the automotive industry, and better pricing in steel.
- Adjusted EBITDA margins to improve to about 2% in FY2021, and 4%-5% in FY2022, as volumes recover and first efficiencies from cost measures start materializing. However, restructuring charges continue to depress profitability and cash flows at least over 2021 and 2022.
- Start of pension funding when a decision on steel operations is taken and full effects of the pandemic are visible (we assume the stake in the elevator business to be included).
- Capex of around €1.5 billion per year.
- Some working capital inflows of about €300 million in 2021, reverting to about the same amount in 2022.
- No material acquisitions expected in 2021-2022.
- No dividend payments expected in 2021-2022.

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

- FFO to debt of about 20% in fiscal FY2021, improving to above 30% in FY2022.
- Negative free cash flow of less than €900 million for fiscal 2021, improving to around negative €600 million in fiscal 2022.
- Debt to EBITDA in 2021 of 3.2x-3.7x in FY2021, improving to about 2x in FY2022.

Liquidity

We view tk's liquidity as strong, based on our projection that sources will exceed potential uses by more than 1.8x over the 12 months starting from Sept. 30, 2020, and remain above 2.0x for 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.

Our short-term rating on tk is 'B', reflecting the long-term issuer credit rating and our assessment of the group's liquidity.

The company paid back its drawn committed lines with sale proceeds in July, and made an early redemption in September 2020 of a €750 million 1.75% note originally due in November 2020, as well as a redemption in December 2020 of a €850 million 2.75% note originally due in March 2021.

The company terminated the €2 billion facility originally maturing in March 2021 early in September 2020, leaving about €1.6 billion in various committed lines available.

Principal liquidity sources from the end of Sept. 30, 2020:

- Cash balances of €11.5 billion;
- Full availability under the undrawn €1.6 billion committed lines.
- Some positive working capital inflow

Principal liquidity over the same period:

- €1.1 billion of short-term debt in next 12 months, and €1.5 billion in the following 12 months;

- Annual capex of about €1.5 billion-€1.6 billion per year;
- No dividend payments; and
- About €1 billion intrayear working capital outflows swings.

Covenants

There is no covenant for the remaining committed credit lines of about €1.6 billion.

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 lower half of the 50%-70% range (rounded estimate: 55%).
- 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 €2 billion in maturing senior debt in FY2021 and 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: 2025
- 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: €6.6 billion
- Net recovery value for waterfall after administrative expenses (5%) and pension consideration (€3.5 billion): €3.2 billion
- First priority claims: €0.3 billion
- Value available for senior unsecured claims: €2.7 billion

- Senior unsecured claims: €4.8 billion
- --Recovery range: 50%-70% (rounded estimate: 55%)

All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating: BB-/Negative/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)

Related Criteria

- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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

Ratings List

Ratings Affirmed; Outlook Action

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