Research Update:

German Auto Systems Maker ZF Friedrichshafen Downgraded To 'BB+' On COVID-19 Impact; Outlook Negative

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Rating Action Overview

- We project the impact of the COVID-19 pandemic will lead to a global auto sales decline of almost 15% in 2020, and even more severe declines in the commercial vehicle markets, well as weaker global demand and GDP growth, followed by a mild recovery in sales volumes of 6%-8% in 2021.
- Automakers' plant closures in response to the pandemic, and the drop in global industrial production, will pressure ZF's earnings and free cash flow generation through 2021.
- As a result, we don't expect ZF's credit metrics to recover in 2021-2022 to levels consistent with the 'BBB-' rating after its $8.5 billion debt-funded acquisition of WABCO in the second quarter of this year.
- We are therefore lowering our ratings on ZF and its unsecured debt to 'BB+' from 'BBB-', and assigning a recovery rating of '3' to the senior unsecured debt, indicating our expectation of meaningful recovery prospects (rounded estimate 55%) in a hypothetical default scenario.
- The negative outlook reflects our view that ZF's credit metrics could be eroded further by continuation of the COVID-19 pandemic in its key regions and prolonged containment measures by governments.

Rating Action Rationale

ZF's operating performance will remain subdued in 2020 due to the expected drop in global light-vehicle production volumes and demand for commercial vehicles. ZF announced a substantial cutback of its German and European automotive production operations in response to the production cuts automakers have announced across Europe. Because of the COVID-19 pandemic and resulting economic pressure, we now project that auto sales will decline by 15%-20% in the U.S. and Europe, and by 8%-10% in China, in 2020. We expect production rates to decline in a similar pattern, which will have a significant impact on ZF'S automotive operations through which the company generated more than 80% of revenues in 2019. We also expect the group's industrial operations to see a significant impact from the pandemic, although to a lower degree than its automotive operations. We expect the most severe revenue decline will occur in its commercial vehicle segment, which already experienced cyclical weakening in the second half of 2019 and could see a drop of more than 25%. In our view, ZF's debt-funded acquisition of WABCO ($7 billion in equity value and $1.5 billion in WABCO debt) will strengthen its portfolio by adding braking systems, thereby improving its competitive position in autonomous driving technology. However, we think this transaction will also lead to greater volatility of revenue and earnings, given the more pronounced cyclicality of commercial vehicle markets. Based on our revised base case scenario, we assume ZF's consolidated revenues will decline by 8%-12% this year, assuming WABCO would be added in May this year, with the adjusted EBITDA margin showing a further decline of 50 basis points (bps) to 150bps, from an already weak 8.1% estimated in 2019. This is despite the addition of WABCO, which has historically posted higher margins than ZF.

Free operating cash flow will benefit from lower capex and working capital investments. We would expect ZF to take decisive measures to contain costs, for example, through part-time work schemes, reduction of temporary workers, and reducing purchasing volumes. Nonetheless, we expect the decline in earnings and increase in debt from the WABCO acquisition would be only partly mitigated by the group's increased cash generation focus. We would expect an increased focus on working capital discipline following a cash outflow of about €550 million in 2018 and 2019 that allows room for moderate inflow in 2020. We would also expect ZF to rein in capital expenditure (capex), which could allow it to improve its free operating cash flow (FOCF) to €0.5 billion-€0.7 billion in 2020 from €452 million in 2019. The expected deleveraging following the WABCO acquisition is now further delayed, and we forecast weak funds from operations (FFO) to debt of 10%-15% in 2020 assuming eight months' contribution from WABCO, before approaching 20% in 2021. S&P Global Ratings' adjusted ratio of debt (including all our adjustments, such as significant postretirement obligations) to EBITDA will likely exceed 5.0x in 2020, assuming the eight months' contribution from WABCO, before returning to below 4.5x in 2021 if the group's operations recover in 2021.

ZF's liquidity will likely weaken and have tight covenant headroom throughout the year. We assume the group's financial flexibility will weaken due to the significant decline in earnings, since the group would need to absorb high fixed cash costs during a production shutdown at a large number of its operating facilities. We forecast the group will have €12.0 billion-€12.5 billion of liquidity sources for 2020 that would need to cover close to €10 billion in uses, including near-term debt maturities, capex, working capital fluctuations, payment related to the WABCO transaction, and dividends. Under our current base case, covenant headroom under financial covenants will become very tight, but we expect ZF would proactively manage its liquidity situation. We also expect the group to look for additional funding sources to ensure adequate liquidity and financial flexibility to navigate through the downturn.

Outlook

The negative outlook reflects our view that ZF's credit metrics could be eroded further by the COVID-19 pandemic in its key regions and prolonged containment measures by governments.

Downside scenario

We could lower the rating if we conclude that our forecast adjusted FFO to debt for ZF is unlikely to recover, owing to prolonged weakness in global automotive markets or a more significant decline in its commercial vehicles operations. At the current rating level we would expect our adjusted FFO to debt metric for ZF to approach 20% in 2021 and FOCF to debt to improve to almost 10% in 2021, with FFO to debt comfortably above 20% in 2022.

Upside scenario

We could revise the outlook to stable if production patterns returned to normal in the second half of 2020, both in Europe and the U.S., and China's economy continues to recover.

Issue Ratings - Recovery Analysis

Key analytical factors

- Our recovery and issue ratings are '3' and 'BB+' respectively on ZF's senior unsecured debt, based on recovery prospects of 50%-70% (rounded estimate: 55%).
- The recovery rating reflects the company's fairly strong business position, but is constrained by a large amount of unsecured debt.
- In our hypothetical default scenario, we envision a downturn in the industry that will be further exacerbated by intense competition. This would lead to drop in volumes, along with a fall in prices, which would cause the sales of the company to decline as well.
- We value the company as a going concern, based on its strong market position in the automotive supply industry, specifically in the manufacture of transmission and chassis, and its diverse base of customers.

Simulated default and valuation assumptions

- Year of default: 2025
- Jurisdiction: Germany (Jurisdiction Ranking A)

Simplified waterfall

- Emergence EBITDA: €1,925 million
- --Capex is assumed to be 3% of revenues
- --10% cyclicality adjustment, standard for the sector
- --10% operational adjustment
- Multiple: 5.5x
- Gross recovery value: €9,120 million (including an adjustment for pension liabilities)

- Net recovery value for waterfall after admin. expenses (5%): €8,664 million
- Total senior unsecured debt claims: €14,621 million
- Recovery range: 50%-70%; rounded recovery of 55%
- Recovery rating: 3

*All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating: BB+/Negative/--

Business risk: Satisfactory

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

Financial risk: Significant

- Cash flow/Leverage: Significant

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

- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Auto Suppliers Industry, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded

	To	From
ZF Friedrichshafen AG		
Issuer Credit Rating	BB+/Negative/--	BBB-/Negative/--
ZF Friedrichshafen AG		
ZF Europe Finance B.V.		
ZF North America Capital Inc.		
TRW Automotive Inc.		
Senior Unsecured	BB+	BBB-