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**Research Update:**

## German Automotive Parts Supplier ZF Friedrichshafen AG Outlook To Negative; 'BBB-' Rating Affirmed

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## Research Update:

# German Automotive Parts Supplier ZF Friedrichshafen AG Outlook To Negative; 'BBB-' Rating Affirmed

## Rating Action Overview

- German automotive parts supplier ZF Friedrichshafen AG has signed a definitive agreement to buy commercial vehicle brake manufacturer WABCO Inc. for about \$8.5 billion (€7.4 billion). ZF plans to fund the acquisition through new debt.
- On a pro forma basis, we expect the acquisition to increase ZF's S&P Global Ratings-adjusted debt-to-EBITDA ratio to about 3.5x, from a forecast 2.0x at year-end 2018.
- In our view, the acquisition of WABCO nicely complements ZF's product portfolio and we expect ZF to reduce leverage back toward 3x during the 24 months after closing.
- As a result, we are affirming our 'BBB-' long-term ratings on ZF and its senior unsecured debt. At the same time, we are revising our outlook to negative from stable.
- The negative outlook reflects the risk of a downgrade if increasingly difficult conditions in the automotive industry cause a further decline in ZF's operating margins and subsequently impair its ability to reduce leverage following the WABCO acquisition.

## Rating Action Rationale

The outlook revision follows the announcement that ZF is making an offer to acquire commercial vehicle braking manufacturer WABCO Inc. for a total consideration of €7.4 billion, consisting of \$7 billion equity value and about \$1.5 billion in WABCO debt and debt-like liabilities. ZF plans to fund the acquisition through debt. This would significantly increase its financial debt compared with the end of the first half of 2018, when it had an adjusted debt position of €8.2 billion. That said, the acquisition of WABCO will add an important product group to its portfolio. The addition of braking systems to the portfolio will allow ZF to strengthen its competitive position in autonomous driving technology. In addition, WABCO will strengthen ZF's margin profile.

Even before the acquisition, ZF was the fourth-largest auto supplier company globally and we regard it as having a widely diversified product range. ZF also supplies to industrial end-markets (7% of revenues in first half of 2018) and supplies its products to commercial vehicles (9% of first-half revenues in

2018). We understand the company will integrate WABCO into its commercial vehicle segment.

WABCO is one of the leading braking systems producers for commercial vehicles globally, holding a very significant market share together with its peer German Knorr-Bremse AG (which generated close to €3.2 billion revenues in its commercial vehicle business in 2018). WABCO also generated revenues of about €3.2 billion in 2018. Its reported stand-alone EBIT margin of about 12.5% in 2018 was considerably stronger than that of ZF (adjusted EBIT margin of 5.7% in H1 2018). As a result, we expect the acquisition to slightly improve the group's margin.

Despite these benefits, this acquisition indicates that ZF is pursuing an aggressive acquisition policy. It is entirely debt-financed and the timing is tricky. ZF's passenger vehicle business is currently exposed to increasingly difficult market conditions in China and to subdued near-term production rates in Europe. In our opinion, the industry as a whole also faces increased geopolitical risks, including a potential no-deal Brexit and U.S. tariffs that, if imposed, would weigh on original equipment manufacturers and their suppliers (see "Trump's Tariffs Could Hurt EU Carmakers--Not The Economy," March 26, 2019). In addition, we expect the commercial vehicle cycle to turn after 2019. Demand for WABCO's products had already fallen in the past quarter, after years of solid growth.

ZF had achieved a strong reduction in leverage over recent years after it acquired U.S. competitor TRW in a fully debt-funded acquisition in 2014. The company successfully integrated TRW and reported solid operating performance over recent years, with relatively stable adjusted EBITDA margins of 10.0%-11.5%, despite significantly increased research and development expenses in recent years. Given WABCO's smaller size and ZF's sizable investment plan, we expect reducing debt after this acquisition to take longer than it did after the TRW acquisition.

## **Outlook**

The negative outlook indicates that we could lower the ratings if a significant reduction in volumes put a strain on operating margins in a challenging environment, or if the truck market saw a downturn after a solid 2019. In addition, we expect ZF to focus on reducing leverage over the coming years, with only minor bolt-on acquisitions and a continuation of its conservative dividend policy.

### **Downside scenario**

We could lower the rating if, in our view, ZF is unlikely to reduce its adjusted debt to EBITDA to about 3x and improve its adjusted FFO to debt to about 30% in the 24 months after the WABCO acquisition closes. We could also lower the ratings if we saw additional sizable acquisitions, which would delay the deleveraging.

## Upside scenario

We could revise the outlook to stable if steady industry conditions enable ZF's operating performance to be relatively flat in 2019 and 2020 and the group is able to smoothly integrate WABCO in 2020. We would also revise the outlook to stable if ZF achieves continued solid free operating cash flows and applies them largely to reducing debt.

## Company Description

ZF is headquartered in Friedrichshafen, Germany and is a global leader in driveline and chassis technology, as well as in active and passive safety technology, after acquiring TRW in 2015. With €36.4 billion in revenues, ZF is currently the fourth-largest automotive supplier worldwide, behind Robert Bosch GmbH, Denso Corp., and Continental AG.

Its operations are organized into seven main divisions:

- Active and passive safety technology (36% of 2017 sales);
- Car powertrain technology, which provides automatic/manual transmissions, axle drives, and powertrain modules (22%);
- Car chassis technology (17%);
- Commercial vehicle technology (8%);
- ZF services (8%);
- Industrial technology (6%);
- E-mobility (2%); and
- Corporate research and development, corporate headquarters, and service companies (1%).

The ZF group is 93.8% owned by the Zeppelin Foundation and 6.2% owned by the Dr. Jürgen and Irmgard Ulderup Foundation.

The company operates globally, being present in 230 locations in 40 countries at the end of 2017. At the same time, it had 120 service locations worldwide, and was developing 20 further locations in eight countries. WABCO will add 230 factories in 40 countries.

## Our Base-Case Scenario

- Group revenues to remain broadly flat in 2018 following the sale of BCS (which generated approximately \$1 billion). We expect organic growth to be flat or slightly negative in 2019 and 2020, after rising by about 6% in 2017. Revenue growth will be closely tied to the global light vehicle production schedules of various auto manufacturers, and we anticipate

that ZF's revenue growth will exceed market rates because of its expanded customer base and improved geographic outreach.

- Slowing group sales growth in 2019 and 2020 of 1%-3%, given that the industry outlook is uncertain because of the weakening macroeconomic trend, trade conflicts between the U.S. and China, and the potential continued softening of demand from China, where recent retail sales were weak. We see some more dynamic growth from the e-mobility segment in 2019 and 2020, supported by higher interest on future-oriented technologies, but this will likely be offset by slower growth in product groups that are more closely tied to production volumes.
- Sales growth of 1%-3% in 2019 across later cyclical industrial technology and services, supported by intelligent mechanics and the spread of autonomous driving, moderating to 0%-1% in 2020.
- Sales growth of 1%-3% in 2019 for its commercial vehicle operations and WABCO, a significant moderation following strong growth in the past two years. We attribute this to strong backlogs at major customers. We forecast moderate declines for 2020 if economic conditions do not improve.
- High annual capital expenditure of about €2.2 billion-€2.5 billion in 2019-2020 due to the expansion of existing capacity, investment requirements for new product launches, and electrification investments to facilitate emission reductions, as outlined in the group's €12 billion investment program.
- Small-to-midsize acquisitions leading to a cash-out of about €100 million-€150 million per year in 2019 and 2020.
- Relatively flat working capital in 2019 and 2020.
- Dividend payouts of about €200 million-€210 million for 2018-2020 (compared with €122 million in 2017), based on a low payout ratio of 18% of the previous year's net income after tax.
- Closing of the WABCO transaction at proposed terms.

Based on these assumptions, we arrive at the following credit measures:

- FFO to debt dropping to the higher end of the 20%-25% range in 2019 (pro forma for the WABCO acquisition) improving to clearly above 25% in 2020, from about 40% forecasted for year-end 2018.
- Debt to EBITDA at about 3.4x at the end of 2019 (pro forma the WABCO acquisition), declining toward 3x in 2020, compared with about 2.0x expected for year-end 2018.

## Liquidity

We expect ZF will maintain strong liquidity and that sources of liquidity will exceed uses by more than 1.5x over the 12 months from June 30, 2018 and by more than 1.0x in the following 12 months. We also expect liquidity sources to exceed uses, even if EBITDA unexpectedly fell 30% below our base-case

forecast.

ZF maintains well-established bank relationships and access to debt capital markets, as demonstrated by its frequent refinancing activities over recent years. These have left the company with a fairly long-dated maturity profile. The company also demonstrates generally prudent risk management and financial covenant headroom, which we expect will continue. It has debt maturities in 2019 that are well covered by existing, unused committed credit lines and on-balance-sheet cash.

We anticipate the company will have the following principal liquidity sources over the next 12 months:

- Cash and liquid assets of about €1.2 billion, less about €300 million in cash that is not readily available.
- Undrawn committed line of credit of about €3.0 billion maturing in July 2023.
- Estimated FFO of about €3.0 billion in the forecast years.

We anticipate the company will have the following principal liquidity uses over the same period:

- About €1.2 billion to repay short-term borrowings in the coming 12 months.
- About €2.0 billion of capex.
- Seasonal and year-on-year working capital requirement of about €400 million.
- Dividend payout of about €220 million.

We do not include the acquisition payout in our liquidity coverage calculation, since we understand that the company has arranged a fully underwritten facility to cover for the cash-out.

## Related Criteria

- 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
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013

- Criteria - Corporates - Industrials: Key Credit Factors For The Auto Suppliers Industry, 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Related Research

- Trump's Tariffs Could Hurt EU Carmakers--Not The Economy, March 26, 2019

## Ratings List

Ratings Affirmed; Outlook Action

	To	From
ZF Friedrichshafen AG Issuer Credit Rating	BBB-/Negative/--	BBB-/Stable/--

Ratings Affirmed

ZF Friedrichshafen AG TRW Automotive Inc. ZF North America Capital Inc. Senior Unsecured	BBB-
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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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://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.

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