S&P Global Ratings

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Research Update:

Sweden-Based Capital Goods Company Epiroc AB Assigned Preliminary 'BBB+' Rating; Outlook Stable

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Overview

- Epiroc AB, which was spun off from Atlas Copco earlier this year, enjoys a leading global position as a provider of mining equipment for rock drilling and excavation, expected resilience against cyclicality in equipment demands thanks to its high-share of aftermarket sales revenues, as well as industry-leading EBITDA margins of around 23%-24%.
- We expect Epiroc to have a strong balance sheet, with adjusted debt to EBITDA below 0.5x, coupled with strongly positive free operating cash flow (FOCF) around Swedish krona (SEK) 4.0 billion-SEK4.5 billion annually.
- Our expectations of limited discretionary cash flow generation due to large dividends is only a minor deterrent for Epiroc's FOCF, given the strong balance sheet.
- We are assigning our preliminary 'BBB+' long-term issuer credit rating to Epiroc.
- The stable outlook reflects our view that, thanks to a flexible and efficient production system and low adjusted debt, the group should continue to be fairly resilient to potential volatile industry demand, with funds from operations to debt above 45% during the full industry cycle, complemented by positive FOCF.

Rating Action

On Nov. 21, 2018, S&P Global Ratings assigned its preliminary 'BBB+' long-term issuer credit rating to Sweden-based capital goods company Epiroc AB. The outlook is stable.

Rationale

The preliminary 'BBB+' rating on Epiroc reflects our view of the company's leading global position as a provider of equipment for rock drilling and excavation, its ability to mitigate cyclicality in equipment demand thanks to its high share of aftermarket sales revenues, and our expectations that its industry-leading EBITDA margins will remain sustainable at around 23%-24%, or higher, during stronger periods of the cycle. We also factor into our analysis our projections of healthy revenue growth, a strong balance sheet complemented by strong FOCFs, somewhat offset by sizable dividends, and occasional strategic acquisitions.

Epiroc typically holds the No. 1 or 2 position in its markets globally, with equipment for rock drilling and excavation representing 70% of revenues and infrastructure equipment representing 30%. We expect that the group's strong geographical spread, diversified customer base, and high-share after-market sales should continue to offset cyclicality in demand. Roughly 20%-25% of sales stem from Europe, North America, and Asia/Australia each, and both South America and Africa/Middle East generate 13%-14% each. We see no major customer concentration since the top 10 customers represent about 16% of total sales. We believe that, if the industry enters a downturn similar to 2012-2016, driven by lower investments, the company's operating margin and FOCF will show resilience, while there will likely be some volatility in revenue because the sales of new products are adversely affected. Despite a downward trend in capital expenditures (capex) for the larger miners during that downturn, Epiroc's EBITDA margin remained around 20%, which we view as high, notably during the softer period of the cycle (we use Atlas Copco's previous Mining and Rock Excavation division as a proxy for longer periods). The proven stability in earnings and margins is an important rating factor, particularly as the mining sector to which Epiroc is exposed to carries significant volatility, especially in mining capital capex. From the peak level in 2012, the total mining capex decreased from about USD80 billion to USD49 billion in 2016.

We believe there are several explanations for the earnings stability:

- First, there are few players that offer the same products globally. Sandvik is a main competitor, followed to a lesser extent by Caterpillar and Furukawa in some segments. Although competition can be stiff, prices are unlikely distinguishing factors in this part of the capital goods industry.
- Secondly, the majority of Epiroc's revenues are linked to the mining aftermarket, i.e. production, and included in customer's operational expenditure, not its capex, which typically is reduced to bare minimums under downturns. As long as the miners can produce above break-even prices, they typically do so even if prices are volatile, meaning the need to continue to acquire and serve its products. A large portion (about two-thirds) of Epiroc's sales are also aftermarket service, which usually caries high margins. With a substantial installed base of equipment that requires frequent maintenance, Epiroc continuously generates stable and profitable cash flows throughout the cycle, thanks to its aftermarket operations.
- Lastly, Epiroc outsources a big share of the production of components used in its end-products, typically non-critical components that stand for around 75% of total components. This means that Epiroc quickly could scale down production during periods of softer demand, supporting resilience in operating margins.

When it comes to size and diversification, however, we believe Epiroc is less diversified than some of its peers in the broader capital goods industry that we rate in our 'BBB' category. For example, Sandvik has four large divisions, with various end-market exposure. Alfa Laval is somewhat similar in size to Epiroc, but is exposed to several end markets that are not as volatile. Also, Danfoss has four business segments. Nevertheless, in our opinion, Epiroc's business risk profile is stronger than that of Metso and Weir Group, whose sales and profitability took big hits from the softer demand in their end markets over 2015-2017.

We believe that Epiroc will be able to deliver EBITDA margins in the 22%-24% range over the coming two to three years (24% in third-quarter 2018), supported by a balanced global supply demand situation for most metals and mining commodities over the next two years. Over the medium to longer term, we also believe Epiroc should benefit from the positive industry trends, including growth in resource demand, which can be challenging as resources deplete at the same time. There is also an ongoing trend to increase underground mines that should support Epiroc's products. Growing use of digital products, including electrified and connected machineries, which heightens production and safety, should also benefit the technical leaders in the industry, which we believe Epiroc belongs to.

We expect Epiroc to continue to maintain prudent capitalization, meaning a strong balance sheet, supporting strong coverage ratios. We have forecasted funds from operations (FFO) to debt and debt to EBITDA of about 200% and below 0.5x, respectively, for 2019 and 2020. The strong and stable FOCF is a major credit strength for Epiroc, and is the result of good FFO and low capex. FFO usually covers capex by about 6x-7x, a level we expect the group will sustain in the coming years. This is partly offset by our expectations of occasional heavy working capital outflow and limited discretionary cash flow due to sizable dividends. In its financial policy, Epiroc management states that it is committed to an investment-grade rating, as well as annual revenue growth of 8% over a business cycle. We therefore assume that management will undertake bolt-on to midsize acquisitions, which during shorter periods could imply weaker credit ratios. We assume the company will pay dividends corresponding to 50% of net income over the cycle. This means we could see higher payouts when the cycle is stronger, as we expect to observe at least over 2019-2020. We expect that this will hold back discretionary cash flow, which we forecast below SEK1 billion in 2019 when the first dividend will be paid. Similarly, we expect management to reduce dividends when industry conditions are tougher.

As of Sept. 30, 2018, Epiroc reported financial gross debt of about SEK6.8 billion, predominantly in form of a one-year bridge facility that was drawn upon when Epiroc was spun off from Atlas Copco on June 18, 2018. The bridge facility has two six-month extensions. Our preliminary rating assumes that Epiroc will extend the average length of its capital structure. Epiroc has approximately SEK3.9 billion cash in hand. We adjust the reported debt with its captive finance operations (SEK2.6 billion as of Dec. 31, 2017) as we have concluded that the captive finance operations does not weigh on the financial risk profile nor carry any significant risk, as its well diversified. Furthermore, less than 30% of the portfolio constitutes finance lease receivables, so we believe potential residual value losses could be handled without major impact. Lastly, we notice the low historical loss ratio, typically below 1% even during periods with softer industry conditions. Other significant adjustments include operating lease adjustments (SEK888 million) and unfunded pension obligations (SEK148 million).

In our base case, we assume:

- Global economy growth of 3.8% in 2018, which we expect will bolster Epiroc's top line growth, as we believe there is link between the demand of mining products and economic growth, at least over the cycle. We assume furthermore that, at least in the short term, there will be improvement in investment levels from the global mining companies compared with recent years and expect a gradual but firm, recovery in investment 2018-2019, resulting in increased sales of new equipment. All in all, we expect this will lead to revenue growth of around 3%-8% over 2018-2019.
- Aftermarket sales will continue to be around two-thirds of sales over the cycle.
- EBITDA margin of 22%-24% in 2018.
- Working capital outflow of SEK1.0 billion-SEK1.5 billion in 2018 and 2019 annually.
- Capex of about SEK700 million-SEK900 million annually in 2018-2019.
- Dividends in line with the company's financial policy of 50% of net income over the cycle.
- The possibility of acquisitions of up to SEK1.5 billion, but occasionally even larger.

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

- Adjusted debt to EBITDA below 1.0x.
- FFO to debt of about 200%.
- Discretionary cash flow around SEK0.5 billion–SEK1.0 billion annually.

Liquidity

We consider Epiroc's liquidity to be strong. Its liquidity is supported by sizable cash reserves, low debt maturities, and a solid liquidity sources-to-uses ratio of 2.2x in the next 12 months. Moreover, we believe the company has good and well-defined liquidity polices in place that stipulate minimum liquidity reserves, including five-year SEK4 billion committed credit facilities, and the maximum amount of debt due within one year. We believe Epiroc has good relationships with its core banks.

We also believe Epiroc's access to market is supported by the 22.7% ownership by the Swedish investment holding company Investor AB (AA-/Stable/A-1+) and Epiroc's solid investment-grade rating. As a stand-alone company, however, Epiroc lacks a track record of access to the international bond markets.

We estimate that principal liquidity sources as of Sept. 30, 2018, and for the ensuing 12 months to be about SEK13 billion-SEK14 billion and include:

- Cash and short-term investments of about SEK3.9 billion;
- Cash FFO of about SEK5.6 billion-SEK6.1 billion in 2019; and
- An undrawn multicurrency revolving credit facility of SEK4 billion maturing in June 2023. The facility carries two one-year extension options.

We estimate that principal liquidity uses include:

- Post the expected re-financing, we expect no material debt maturities over the coming 12 months;
- Capex of about SEK700 million-SEK900 million annually in 2018-2019;
- Working capital outflow during 2018 and 2019 of SEK1.0 billion-SEK1.5 billion annually; and
- Annual dividends of about SEK3.0 billion-SEK3.5 billion, with first payment in 2019.

We expect no financial covenants after the refinancing.

Outlook

The stable outlook reflects our view that, thanks to a flexible and highly profitable production system, and low debt, the group should continue to be fairly resilient to industry volatility, with FFO to debt significantly above 45% also at the bottom of the cycle, complemented by positive FOCF. We expect Epiroc to continue to withstand the volatility in its end markets, and the EBITDA margin at all times will remain above 18%, even though sales are likely to show some volatility over the cycle.

Downside scenario

We could downgrade Epiroc if its FFO to debt fell below 45% more than temporarily. This could follow significant debt-financed acquisitions or shareholder returns, which we consider unlikely at this stage. Would the industry conditions weaken, we expect management to lower its dividend payment, in line with policy to pay 50% of net income over the cycle.

We could also lower the preliminary rating if Epiroc's profitability materially deteriorates from historical levels, specifically if its EBITDA margins dropped below 18% without near-term prospects for recovery. This could stem from substantial restructuring expenses as a result of a substantial weakening of market demand, resulting in declining sales volumes, and order intake.

Upside scenario

We see no upside potential in the near term, given Epiroc's lower business diversification compared with companies in our 'A' rating category, as well as the company's financial policy, which we think will lead to acquisitions from time to time. An upgrade could be supported by a clearer commitment from management toward its financial policy leverage targets, but given that the financial policy was recently communicated, at the creation of the company, we believe this is unlikely in the near term.

Ratings Score Snapshot

Issuer Credit Rating: BBB+(prelim)/Stable/--

Business risk: Satisfactory
- Country risk: Low
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Modest
- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Satisfactory (no impact)

Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Capital Goods Industry, 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: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, 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

Ratings List

New Rating

Epiroc AB	
Issuer Credit Rating	BBB+(prelim)/Stable/--

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com

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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at 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.