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Research Update:

Sweden-Based Sandvik AB Outlook Revised To Positive On Strong Credit Ratios; 'BBB+/A-2' And 'K-1' Ratings Affirmed

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Research Update:

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Overview

- We think Sweden-based capital goods group Sandvik's credit protection measures will continue to improve over 2018 on the back of continued strong operating performance and disposal proceeds used for continued debt reduction.
- We consequently believe Sandvik is well positioned to sustain its strong credit ratios over the near to medium term.
- We are therefore revising our outlook on Sandvik to positive from stable, and affirming our 'BBB+/A-2' and 'K-1' ratings.
- The positive outlook indicates that we could raise the ratings if Sandvik sustained its strong credit ratios over the next two years, with funds from operations to debt above 60% and discretionary cash flow to debt above 25%, assuming other factors are unchanged.

Rating Action

On April 18, 2018, S&P Global Ratings revised its outlook on Sweden-based capital goods group Sandvik AB to positive from stable. At the same time, we affirmed our 'BBB+/A-2' long- and short-term issuer credit ratings.

We affirmed our 'K-1' short-term Nordic regional scale rating on Sandvik.

We also affirmed our 'BBB+' ratings on Sandvik's debt.

Rationale

The outlook revision reflects our expectation that Sandvik's credit ratios will continue to gradually improve over 2018, supported by continued revenue growth from its core operations and our expectation of sustained profitability and continued debt reduction.

Sandvik's management has focused on reducing the group's debt, and we understand that proceeds from the completed sale of Process System were used to repay debt, materially strengthening the group's balance sheet. The group's adjusted net debt stood at Swedish krona (SEK) 16.8 billion (about €1.7 billion) as of Dec. 31, 2017, down from about SEK29.3 billion on Dec. 31,

2016. The lower debt and strong operating performance resulted in funds from operations (FFO) to debt improving to about 87.8% in 2017, up from 41.7% at year-end 2016. Sandvik also announced the sale of Hyperion in December 2017 for SEK4.0 billion. We forecast that the divestment will further strengthen the group's balance sheet, as we expect that most of the proceeds will be used for further debt reduction, resulting in a leverage decline of about 0.2x.

Following Sandvik's recent profitability improvements and portfolio optimization, we expect the group will focus on expanding its core businesses, and we don't exclude some midsize bolt-on acquisitions. However, we see management as focused on sustaining its strong balance sheet. Although Sandvik is set for growth and will likely use part of its financial flexibility for investments and bolt-on acquisitions, we believe the group will do so while sustaining strong credit ratios, including FFO to debt of about 85%-110%.

Sandvik's profitability and revenues reached record levels in 2017, after it took measures to improve operating efficiency over the prior two years. The operating result was further supported by recovery in several end markets in 2017, mining in particular (31% of revenues in 2017), which contributed to strong free cash flow generation, which Sandvik used to lower debt. The group's revenues increased by 11.5% in 2017 and its EBITDA margin continued to improve to 21.7% from 20.3% in 2016.

The improvement has been supported by market tailwinds, but we also believe that management has been able to structurally improve the group's profitability ratios, and we forecast that it will be able to sustain its EBITDA margin at about 20.0%-22.0% in 2018-2019, from an average of about 16.2% in 2013-2015.

Improved profitability over the past couple of years comes on the heels of Sandvik's efficiency program, launched in 2015, which included lowering selling and administrative expenses, reducing the number of manufacturing sites, and increasingly outsourcing noncore production, along with its decentralized business model introduced in 2016. Overall, the measures the group took have resulted in a more flexible business model, and we believe margins should now be more resilient also during market downturns.

Sandvik also divested noncore, lower-margin business units, reducing its exposure to the more volatile equipment sales segment. Although Sandvik remains exposed to volatile end markets, especially mining, the group should benefit from a higher share of consumable sales also within its mining operations. We also see as positive the expected continued growth in mining output over the coming years.

We expect Sandvik's business risk profile will continue to benefit from its world-leading market positions, typically holding the position as No.1 or No.2 globally in its markets, which give it scale advantages over its competitors. Sandvik's operations are fairly diverse and the group is exposed to about six different industries. Sandvik Machining Solutions is the clear global market leader in metalworking industry tools, with a large amount of consumable sales and high degree of exposure to the aerospace and defense, automotive, electronics, and medical industries. Sandvik Mining and Rock Technology's leading position in drilling tools and equipment for rock and mineral mining is underpinned by its strong position in underground and safe mining. We believe that the group is well positioned to capture growth opportunities coming from the shift to digitalization and automation in the wider manufacturing and mining industries, creating new business opportunities.

In our base case for Sandvik, we assume:

- Broadly neutral revenue growth in 2018, eroded by recent disposals, but mitigated by solid growth in the remaining business areas on the back of a strong order book and our expectations of continued strengthening of end markets, although equipment sales will remain subdued in mining and oil and gas.
- EBITDA margin to remain at about 20%-22% over 2018-2019.
- Dividends of about SEK4.4 billion in 2018 and about 50% of earnings per share in 2019 and thereafter, in line with the group's financial policy.
- Capital expenditures of about SEK4 billion in 2018, increasing slightly in 2019.
- Moderate working capital outflows driven by sales growth.
- Disposal of Hyperion to close in 2018, with proceeds used for debt reduction.
- We do not fully exclude that management, given its current strategy, could dispose of some further noncore operations. We do not however include any such disposals in our forecast.
- Small to midsize bolt-on acquisitions of about SEK3 billion–SEK5 billion per year.

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

- FFO to debt of about 90%-110% in 2018, and remaining comfortably above 60% in 2019, despite any potential acquisitions.
- Free operating cash flow to debt of 50%-60% in 2018 and 2019.

Liquidity

We consider Sandvik's liquidity as strong, based on our projections that the group's ratio of potential sources of liquidity to uses will be about 3.5x in 2018 and 3.0x in 2019. Other supporting factors include Sandvik's high standing in the credit markets, and well-established banking relationships with leading Nordic and European banks. Lastly, we believe Sandvik would be able to absorb a high-impact, low-probability event without refinancing, because its scale, product, and geographic diversity should enable it to weather any operational difficulties in individual business segments or geographic regions. In such a situation, Sandvik's well-managed debt maturity profile and strong cash flow generation is a further positive factor.

Principal liquidity sources as of Jan. 1, 2018, include:

- Cash and liquid assets of about SEK12.7 billion.
- An undrawn committed line of credit of SEK9 billion maturing in 2022, with a possible extension until 2023.
- Estimated cash FFO of SEK14 billion-SEK15 billion in 2018-2019.
- After-tax cash proceeds of SEK3 billion-SEK3.8 billion from the disposal of Hyperion.

Principal liquidity uses as of the same date include:

- About SEK1 billion in short-term debt repayment in the coming 12 months and SEK2.0 billion-SEK 2.5 billion in 2019.
- About SEK4 billion of capital expenditures in 2018, slightly increasing in 2019.
- Some moderate working capital outflows.
- Dividend payment of about SEK4.4 billion in 2018 and about 50% of net income in 2019, in line with the group's financial policy.

Loan documents are not subject to financial covenants.

Outlook

The positive outlook on Sandvik reflects the possibility of an upgrade over the coming two years if we believe the group is able and willing to sustain its strong financial position over the longer term, while continuing to show a solid operating performance and free cash flow generation over the cycle. We do not exclude bolt-on acquisitions, but expect that credit ratios will remain strong for the rating, including FFO to debt at about 85%-110%.

Upside scenario

We could consider raising the ratings if Sandvik demonstrated a sustained strong financial performance, and management committed to what we consider to be a conservative financial policy. Besides FFO to debt sustainably above 60%, discretionary cash flow to debt would need to exceed 25% for an upgrade. We could also raise the ratings if Sandvik sustainably posted EBITDA margins in excess of 20% and sustained its improved profitability even in adverse market conditions.

Downside scenario

We could revise the outlook to stable if Sandvik's EBITDA margin fell below 18% or the group adopted a more aggressive financial policy, resulting in FFO to debt deteriorating to below 60%. This could follow larger-than-expected debt-financed acquisitions or more generous shareholder distributions than we anticipate.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Positive/A-2

Business risk: Satisfactory
- Country risk: Intermediate
- 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 rating analysis: Neutral (no impact)

Issue Ratings--Subordination Risk Analysis

Capital structure

Sandvik's capital structure consists of senior unsecured debt issued at the parent company level.

Analytical conclusions

The debt is rated 'BBB+', the same as the issuer credit rating, since no significant elements of subordination risk are present in the capital structure. This is also supported by the group's low leverage, and our modest financial risk assessment.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping

Tables, Aug. 14, 2017

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology: The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers, Dec. 14, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Capital Goods Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Sandvik AB		
Issuer Credit Rating	BBB+/Positive/A-2	BBB+/Stable/A-2
Nordic Regional Scale	K-1	K-1
Senior Unsecured	BBB+	BBB+
Commercial Paper	A-2	A-2
Sandvik Treasury AB		
Senior Unsecured	BBB+	BBB+
Commercial Paper	A-2	A-2
Commercial Paper	K-1	K-1

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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 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 the 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.