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Research Update:

Sweden-Based Sandvik AB Outlook Revised To Positive On Improving Credit Ratios; 'BBB/A-2' Ratings Affirmed

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Overview

- We expect the credit protection measures of Sweden-based capital goods company Sandvik AB to continue to improve over 2017.
- We are therefore revising our outlook on Sandvik to positive from negative, and affirming our 'BBB/A-2' global scale ratings and our 'K-2' short-term Nordic regional scale rating on the company.
- The positive outlook indicates that we could raise the ratings if Sandvik's credit metrics improve sustainably, with funds from operations (FFO) to debt above 45% and free operating cash flow (FOCF) to debt above 25%, assuming other factors are unchanged.

Rating Action

On Feb. 16, 2017, S&P Global Ratings revised its outlook on Sweden-based capital goods company Sandvik AB to positive from negative. At the same time, we affirmed our 'BBB/A-2' long- and short-term corporate credit ratings and 'K-2' short-term Nordic regional scale rating on the company. We also affirmed our ratings on Sandvik's debt.

Rationale

The outlook revision and rating affirmation reflect our expectation that Sandvik's credit ratios will continue to improve over 2017, supported by strengthened profitability as well as management's plans to dispose of noncore assets and use the proceeds to lower debt. We also note that the company improved its profitability in 2016 beyond our previous expectations, despite a period of softer demand.

In 2016, although revenue decreased by 4%, Sandvik improved its profitability and credit ratios, which we view as positive. In our updated forecast, we now assume that Sandvik's EBITDA margin will remain between 19.5% and 20.5% in 2017. We believe that management has structurally enhanced profitability ratios, which in our view has improved the group's business risk profile within the satisfactory level. The improved profitability ratios follow the efficiency program that Sandvik launched in 2015, lower selling and administrative expenses, and a more decentralized business model.

Partly due to the improved profitability, Sandvik's cash flow generation was strong in 2016, leading to a rebound of credit measures. FOCF to debt stood at around 25%, and the company lowered its adjusted debt by about Swedish krona (SEK)5 billion ($560 million), to SEK32 billion, based on preliminary numbers. In 2017 and 2018, we expect the company to be able to continue to deliver healthy free cash flow in excess of SEK5 billion.

The outlook change is further based on our expectation that management will continue to focus on debt reduction. The company announced in 2016 its ambitions to dispose of two business units, Sandvik Process Systems and Sandvik Hyperion. We understand the process has now been initiated, and in our base case we therefore assume that Sandvik will dispose of at least one of these units, and use the proceeds to lower debt. We think this could result in a stronger credit profile over 2017 and 2018. We now assume this will lead to FFO to debt improving to about 43%-47% on a fully adjusted basis by year-end 2017, with continued but more moderate improvements in 2018, which could warrant a one-notch upgrade at that time. At year-end 2016, FFO to debt stood at about 36%, based on preliminary results. At the same time, we recognize that if Sandvik is unable to dispose of any of the businesses units, FFO to debt would likely remain in the 39%-44% range in 2017. Conversely, if management is able to dispose of both units, we forecast FFO to debt would be around 55%-60%.

We expect Sandvik's business risk profile to continue to benefit from the company's world-leading market positions, which give it advantages of scale over its competitors. Operations are fairly diversified and exposed to about six different industries in total. Sandvik Machining Solutions is the clear global market leader in metalworking industry tools, with a high level of consumable sales and high degree of exposure to aerospace/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. It is supported by the higher-value-added content of its products compared with those of peer steel companies, although competition varies from one product segment to another.

In our base case, we assume:

- A moderate revenue increase of 1%-3% in 2017 and 2018 on the back of continued low investments in the mining and oil and gas sectors. However, we recognize the improvement in the order book during the second half of 2016.
- We also take into account our forecast GDP growth of 3.5% globally for 2017, 1.5% in Western Europe, and 2.4% in the U.S.
- No further restructuring costs.
- Dividends of about SEK3.4 billion in 2017 and no extraordinary shareholder returns.
- Capital expenditures of about SEK4 billion.
- No or very limited acquisitions.
- Disposal of Sandvik Process Systems or Sandvik Hyperion, with the proceeds used for debt reduction.

Based on these assumptions, we arrive at the following credit measures for 2017:

- A reported EBITDA margin around 19.5%-20.5%.
- FFO to debt of about 43%-47%.
- FOCF to debt of about 20%-25%.

Liquidity

We consider that Sandvik's liquidity is strong, which reflects our view that the company's sources of cash cover its uses by at least 1.5x for the next 12 months. Other supporting factors include well-established bank relationships, a high standing in credit markets, and the likely ability to absorb high-impact, low-probability events without refinancing. Loan documents are not subject to financial covenants.

Principal liquidity sources:

- Cash and liquid assets of about SEK8.8 billion as of Dec. 31, 2016.
- An undrawn committed line of credit of SEK9 billion maturing in 2021.
- Estimated FFO of SEK11.5 billion-SEK12.5 billion annually over 2017-2018.

Principal liquidity uses:

- About SEK4.5 billion-SEK5.0 billion in short-term borrowing repayment in the coming 12 months.
- About SEK4 billion of capital expenditure annually in 2017-2018.
- Potentially some small working capital outflows, as well as intrayear working capital swings.
- A dividend payment of SEK3.4 billion in 2017.

Outlook

Our positive outlook on Sandvik indicates the possibility of an upgrade over the next 12-24 months if, as we expect, Sandvik's profitability remains at least at current levels, the company continues to withstand the softer market conditions, and at the same time the financial risk profile improves. We expect this could happen if at least one of Sandvik's two planned disposals goes ahead, and at the same time the company continues to use a relatively large share of FOCF to reduce debt.

Upside scenario

We could raise the ratings if Sandvik's credit metrics sustainably improve, despite the soft demand situation. A track record of FFO to debt above 45% and FOCF to debt at about 25% could lead to a one-notch upgrade. We would also expect the EBITDA margin to remain above 19%.

Downside scenario

We could revise the outlook to stable if Sandvik's EBITDA margin falls below 18% over 2017 and 2018, or if adjusted FFO to debt doesn't reach above 45% on a sustainable basis. Moreover, we would consider a downgrade in the event of more generous shareholder payouts than we anticipate in our base case.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Positive/A-2

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

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

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: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, June 01, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- 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: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 07, 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
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each

Issue, April 15, 2008

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Sandvik AB		
Corporate Credit Rating	BBB/Positive/A-2	BBB/Negative/A-2

Ratings Affirmed

Sandvik AB	
Nordic Regional Scale	K-2
Senior Unsecured	BBB
Commercial Paper	A-2
Sandvik Treasury AB	
Senior Unsecured*	BBB
Commercial Paper*	A-2
Commercial Paper*	K-2

*Guaranteed by Sandvik AB.

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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.globalcreditportal.com and at spcapitaliq.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.