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Research Update:

Sweden-Based Engineering Group Sandvik Upgraded To 'BBB+' On Improving Credit Metrics; Outlook Stable

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Overview

- Sandvik's performance is strengthening on the back of end-market recovery and cost-savings measures.
- Sandvik has also announced it closed the divestment of its Process Systems business, and we understand it will likely use some of the proceeds to reduce debt, thereby further enhancing its credit profile.
- We are therefore raising our long-term ratings on Sandvik and its debt to 'BBB+' from 'BBB' and affirming our 'A-2' short-term ratings.
- In addition, we are raising our Nordic regional scale rating on Sandvik to 'K-1' from 'K-2'.
- The stable outlook reflects our expectation that the company will continue its deleveraging efforts, while maintaining EBITDA margins above 18% and funds from operations to debt at above 45%.

Rating Action

On Dec. 4, 2017, S&P Global Ratings raised its long-term corporate credit ratings on Swedish engineering company Sandvik AB to 'BBB+' from 'BBB'. The outlook is stable. The 'A-2' short-term rating was affirmed.

At the same time, we raised our short-term Nordic regional scale rating on the company to 'K-1' from 'K-2'. We also raised our issue ratings on Sandvik's debt to 'BBB+' from 'BBB'.

Rationale

The upgrade reflects our expectation that Sandvik's credit ratios will continue to improve over 2018, supported by increased revenues and improving profitability. Additionally, the successful closing of Sandvik's divestment of Process Systems further strengthens the company's financial risk profile. Sandvik's profitability and revenues have increased faster than we previously expected, supported by recovery in several end markets, mining in particular, over the past year, which contributes to strong free cash flow generation and debt reduction. The company's adjusted net debt stood at Swedish krona (SEK) 25.9 billion (about €2.59 billion) as of Sept. 30, 2017, down from about SEK29.3 billion on Dec. 31, 2016.

The company has now completed the sale of its Process Systems business unit

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for SEK5 billion, which it announced in 2016. We understand management will use the proceeds to reduce debt, thereby materially strengthening the company's financial risk profile. We estimate that the lower debt, following the divestment, together with the group's improved profitability, will result in funds from operations (FFO) to debt of 62%-67% in 2017 up from about 41.9% at year-end 2016. Sustained increased profitability and the planned sale of Hyperion (also announced last year), if the proceeds are used to pay down debt when completed, would lead to a further strengthening of credit metrics. Following Sandvik's profitability improvements and portfolio optimization, we expect the company will focus on expanding its core business, and we note an increased appetite for acquisitive growth. We believe the company will use its financial flexibility for investments and add-on acquisitions, but that its credit ratios will remain in line with the rating, including FFO to debt above 45%.

In the first nine months of 2017, Sandvik's revenue increased by 9%. Additionally, Sandvik has been able to improve its profitability and credit ratios, which we view as positive. Sandvik's EBITDA margin improved to 22.0% for the 12 months ended Sept. 30, 2017, from 20.3% on Dec. 31, 2016. In our updated base case, we forecast that Sandvik's EBITDA margin will remain at about 20.0% in 2018. We believe management has been able to structurally improve the company's profitability ratios, which in our view has strengthened the company's satisfactory business risk profile. The improvement follows the efficiency program that Sandvik launched in 2015, lower selling and administrative expenses, and a decentralized business model.

We expect Sandvik's business risk profile will continue to benefit from its world-leading market positions, which give it scale advantages over its competitors. Sandvik's operations are fairly diverse and 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 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.

Our main base-case assumptions are:

- Continued positive revenue growth of 1%-5% in 2018 on the back of an improving order book and recovering end markets, although equipment sales in mining and oil and gas are expected to remain subdued.
- GDP growth, which we forecast at 2.2% in Europe and 2.5% in the U.S.
- No further restructuring costs.
- Dividends of about 50% of earnings per share annually over 2018 and 2019, in line with the company's financial policy.
- Capital expenditures of about SEK3.7 billion in 2017, increasing slightly in 2018.
- Disposal of Hyperion during our forecast period 2018-2019, with proceeds used for debt reduction.

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

- A reported EBITDA margin of 20.0%-22.0% in 2017-2018.
- FFO to debt of 62%-67% in 2017, and remaining comfortably above 45% in 2018, despite any potential acquisitions.
- Free operating cash flow (FOCF) to debt of 30%-35% in 2017 and 2018.

Liquidity

We consider Sandvik's liquidity to be 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 SEK8.6 billion as of Sept. 30, 2017.
- An undrawn committed line of credit of SEK9 billion maturing in 2022, with a possible extension until 2023.
- Estimated FFO of SEK13 billion-SEK14 billion in 2018-2019.
- Aftertax cash proceeds of SEK4.2 billion-SEK4.4 billion from the disposal of Process Solutions.

Principal liquidity uses:

- About SEK2.5 billion-SEK3.0 billion in short-term debt repayment in the coming 12 months.
- About SEK4 billion of capital expenditures anually in 2018-2019.
- Some moderate working capital outflows.
- Dividend payment above 50% of net income, in line with the company's financial policy.

Outlook

The stable outlook reflects our expectation that Sandvik's profitability position will stay at current levels, and the company will remain able to withstand weaker market conditions in some sectors. We do not exclude bolt-on acquisitions, but expect that credit ratios will remain in line with the current rating, including FFO to debt above 45% and FOCF to debt of about 25%.

Downside scenario

We could lower our ratings if Sandvik's EBITDA margin fell below 18% or the company adopted a more aggressive financial policy, resulting in FFO to debt deteriorating to below 45%. This could follow larger-than-expected debt-financed acquisitions or more generous shareholder payouts than we anticipate in our base case.

Upside scenario

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

Ratings Score Snapshot

Corporate Credit Rating: BBB+/Stable/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)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- 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 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: Country Risk Assessment Methodology And Assumptions, 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: 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

Upgraded; Ratings Affirmed

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