Research Update:

France-Based Car Component Maker Valeo S.A. Downgraded To 'BBB-'; Outlook Stable

January 13, 2020

Rating Action Overview

- Valeo S.A. had entered a tougher environment for the auto industry with relatively weak free operating cash flow (FOCF) generation and higher leverage than peers.
- Although we believe that it will likely benefit from its leadership position in electric machines and sensors over the next couple of years, prospects for deleveraging are limited by continuing large investments to fund operating losses at its high-voltage joint venture with Siemens.
- We are therefore lowering our long-term issuer credit and issue ratings on Valeo, its unsecured notes, and revolving credit facility to 'BBB-' from 'BBB'; and our short-term issuer credit rating on the company to 'A-3' from 'A-2'.
- The outlook is stable because we expect auto markets to stabilize rather than aggressively decline, with Valeo's favorable product mix providing scope for organic growth, EBITDA margin trending toward 10% from 2020, and FOCF to debt approaching 10% by year-end 2021. The stable outlook also reflects our belief that Valeo would adjust its financial policy in case of operational underperformance.

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Rating Action Rationale

Valeo's 2019 credit metrics will likely fall below levels we consider commensurate with the current rating. We forecast that, in 2019, Valeo's funds from operations (FFO) to debt will fall to about 28% from 30.6% in 2018. Lower production volumes (forecast to fall 5%-7% globally in 2019, compared with 2018) due to weak demand for cars in China, Europe, and North America as well as cost overruns due to operational issues on specific new programs have been the main spurs for the weaker operating results. The group's 2019 performance was also affected by General Motors workers striking in the U.S., which halted production at some auto suppliers, including Valeo. The group estimates the nonrecurring negative effect on 2019 EBIT at about €50 million. Furthermore, the roughly €200 million capital expenditure (capex) reduction in 2019 and savings generated through cost-cutting measures initiated about a year ago are unlikely to allow positive discretionary cash flow (DCF) this year, following negative DCF in 2017 and 2018.

Valeo's product offering is well aligned with its customers' roadmap to electrification and autonomous driving technology. In our view, Valeo should be able to post organic growth despite our expectation of a global standstill in auto production volumes. We believe Valeo should be able to benefit from an increasing content per car trend. We see the group capitalizing on its global market leadership in 48 Volt (48V) technology. Moreover, it is offering high-voltage solutions for plug-in hybrids (PHEVs) and battery-electric vehicles (BEVs) through its joint venture with Siemens (VSeA). Electrification of the powertrain is key to Valeo's customers, which have committed to cut carbon dioxide (CO_2) emissions. All carmakers have announced plans to launch new electrified models (including mild hybrids, PHEVs, and BEVs) from 2020 onward to comply with ever more stringent regulatory emission limits. As of Sept. 30, 2019, Valeo's order intake for electric machines, including products from VSeA, is about €18 billion.

After a weak S&P Global Ratings-adjusted EBITDA margin of 8.5%-9.0% expected for 2019, we forecast a recovery toward 9.5%-10.5% in 2020-2021; which we still consider low for the rating level. A favorable product mix and the turnaround of some loss-making plants should spur expected profitability improvements in 2020. Still, we expect Valeo to remain at the lower end of the average range for the sector. This is because the contribution from new technological platforms will continue to dilute the overall performance of the group until at least 2022. Our main adjustment to Valeo's reported EBITDA relates to the capitalized development costs that we reclassify as operating expenses (€716 million in 2018).

We see slow deleveraging prospects due to investments needed in the VSeA joint venture. We understand that the group's investments in terms of research and development (R&D) and capex have peaked, since it has completed the development of nine standardized technological platforms. However, total R&D costs (including capitalized R&D) should remain high at 9%-10% of sales for 2020-2022, compared with 10.5%-11.0% in 2018-2019. We also expect that Valeo's capex spend will remain at €1.0 billion-€1.1 billion for the same period, compared with €1.3 billion in 2018. Valeo's deleveraging potential will be constrained by the required contribution to its high-voltage joint venture with Siemens, which is not expected to break even before 2022, against earlier expectations of 2020. The group estimates that it will need to provide about €450 million of loans to VSeA between 2020 and 2022 to fund loss-making operations.

We assume that Valeo would adjust its dividend policy to protect its investment-grade rating if needed. In first-half 2019, Valeo paid a stable dividend of €325 million to its shareholders despite weaker operating results since second-half 2018. However, we assume that Valeo would reduce its dividend payments to protect its investment-grade ('BBB-' or above) rating should it face tougher market conditions than expected. An investment-grade rating is a key objective under its public financial policy declarations.

Outlook

The stable outlook reflects our view that auto markets will stabilize rather than decline aggressively. We believe Valeo's favorable product mix provides scope for above-market-average organic growth and expect its EBITDA margin will increase toward 10% in 2020 and FOCF to debt will approach 10% by year-end 2021. The stable outlook also reflects our expectation that Valeo would adjust its financial policy in case of operational underperformance.

Downside scenario

We could downgrade Valeo if tougher market conditions or operational missteps prevent it from restoring its EBITDA margin to about 10% and keeping FFO to debt above 30% for a sustained period, with FOCF to debt failing to approach 10% by year-end 2021.

Upside scenario

Although unlikely in the short term, we could upgrade Valeo if it sustainably increased its S&P Global Ratings-adjusted EBITDA margin toward 15% while maintaining FFO to debt significantly above 35% and FOCF to debt at comfortably more than 10%.

Company Description

With about €19.1 billion of sales reported in 2018, Valeo is a large Tier 1 auto supplier producing visibility, powertrain, comfort and driving assistance, and thermal systems for major carmakers such as Volkswagen, Ford, Renault-Nissan, Peugeot, BMW, and Daimler.

The group designs, produces, and sells components, systems, and modules for automobiles to both the original equipment manufacturer (OEM; about 87% of revenue) and the aftermarket (about 10% of revenue).

Valeo produces a broad range of components, including climate control, engine cooling, wipers, transmission, lighting, and electronic systems. The group also has a 50% stake in a joint venture with Siemens to develop high-voltage components targeted at electrified powertrains for hybrid and battery electric cars.

The group is headquartered in France and listed on Euronext Paris.

Our Base-Case Scenario

Under our base case scenario, we assume:

- A slowdown in eurozone GDP growth to 1.0% in 2020 and 1.2% in 2021 (down from a forecast 1.2% in 2019). We expect GDP growth to decelerate to about 1.9% in 2020 and 1.8% in 2021 in the U.S. (from an expected 2.3% in 2019). In Valeo's other key operating region, Asia-Pacific, we also forecast slowing GDP growth of 4.8% in 2020 and 4.7% in 2021 (from an expected 5.5% in 2019).
- Sales growth of 2%-3% in 2019 and 2020. Thanks to its strong order intake levels in recent years, we anticipate the group will continue moderately outperforming the overall market in sales to OEMs. However, we expect sales to the aftermarket to remain fairly flat.
- An adjusted EBITDA margin decline to 8.5%-9.0% in 2019 (from about 9.2% for 2018). We assume some improvements in EBITDA margin after 2019 to 9.5%-10.5% in 2020 and 2021 thanks to above-market organic growth, improved plant efficiencies, and lower net R&D expenses.
- Annual capex of €1.0 billion-€1.1 billion over the coming years, compared with €1.3 billion in 2018, excluding capitalized development costs.

- No share buybacks over the forecast period.
- Stable annual dividends of €300 million-€350 million.
- About €450 million of investments related to Valeo's contribution to the joint venture with Siemens over 2020-2022.

This results in adjusted credit metrics of:

- FFO to debt of about 28% in 2019, recovering to about 33% in 2020.
- Debt to EBITDA of about 2.8x in 2019, falling to about 2.5x in 2020, compared with about 2.6x for 2018.
- Weak adjusted FOCF to debt of 5%-6% in 2019, recovering to about 6%-7% in 2020 and further improving in 2021, compared with 1.1% for 2018.

Liquidity

Our short-term rating on Valeo is 'A-3'. Our adequate assessment of the group's liquidity primarily reflects its well-established relationships with banks, its prudent risk management, and our belief that its liquidity sources will exceed uses by 1.2x over the 12 months from July 1, 2019.

Principal liquidity sources include:

- Cash and cash equivalents of €2.4 billion, after deducting €60 million that we consider not immediately available to repay debt;
- About €1.1 billion in undrawn committed credit lines maturing in more than 12 months; and
- Our forecast of about €2 billion of cash FFO.

Principal liquidity uses include:

- About €1.0 billion of commercial paper and debt maturing in the next 12 months;
- Approximately €1.9 billion of annual capex including R&D capitalized costs; and
- Annual dividends of €300 million-€350 million.

Covenants

Valeo is subject to maintenance covenants in some of its bank lines and loans, which limit net debt to EBITDA to 3.5x. Valeo's net debt to EBITDA stood at 0.9x at June 30. 2019. We expect there will be ample headroom under this covenant, even if EBITDA were to decline by 15%.

Environmental, Social, And Governance

We view environmental factors as positive for Valeo compared with peers because about 50% of its products are dedicated to reducing CO_2 emissions. Valeo's product portfolio in its powertrain business aims to help OEM customers to reduce CO_2 and nitrogen oxide emissions, largely through electrification. We see Valeo as well placed to address this trend by serving its customers with 48V technology, for which it holds significant market share. In addition, Valeo should see growth opportunities through its joint venture with Siemens on high-voltage components. Valeo's product portfolio serves three types of electrified cars (mild hybrids, PHEVs, and electric cars). The ongoing electrification of cars' powertrains offers growth opportunities to Valeo because the content per car for a low-voltage electric car is about 2x higher than for a standard internal combustion engine powered car, while it can be up to 7x-9x higher for PHEVs (including high-voltage products from its joint venture with Siemens). However, the group's gross R&D investment remains high (at about 10.8% of 2018 sales) constraining its EBITDA margin and FOCF generation in the near term before sales will reach a critical mass. We believe social factors will generally affect Valeo in line with peers. Furthermore, we score Valeo's management and governance as satisfactory, supported by management's expertise and experience.

Issue Ratings - Subordination Risk Analysis

Capital structure

Valeo's capital structure comprises senior unsecured debt issued at the Valeo S.A. level and immaterial amounts at the operating companies.

Analytical conclusions

We rate Valeo's senior unsecured debt 'BBB-', in line with our 'BBB-' long-term issuer credit rating on the group. This reflects the absence of material liabilities that would rank ahead of the group's unsecured debt by way of structural or contractual subordination in a default scenario.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Stable/A-3

Business risk: Satisfactory

- Country risk: Low
- Industry risk: Moderately high
- 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: Adequate (no impact)
- Management and governance: Satisfactory (no impact) Comparable ratings analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Auto Suppliers 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: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

Ratings List

Downgraded; CreditWatch/Outlook Action		
	To	**From**
Valeo S.A.		
Issuer Credit Rating	BBB-/Stable/A-3	BBB/Negative/A-2
Downgraded		
	To	**From**
Valeo S.A.		
Senior Unsecured	BBB-	BBB