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Research Update:

French Auto Supplier Valeo S.A. Outlook Revised To Negative; 'BBB/A-2' Ratings Affirmed

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Rating Action Overview

- France-based auto supplier Valeo S.A. posted funds from operations (FFO) to debt of about 28% in 2018, which is largely in line with earlier expectations, but down significantly from the 41% reported in 2017.
- We observe a number of increasing risks for the overall automotive sector. This could prevent the group's earnings generation and cash flow from reaching levels in line with the current rating in 2019 and 2020.
- We are revising our outlook on Valeo to negative from stable and affirming our 'BBB/A-2' long- and short-term issuer credit ratings on the group. We are also affirming our 'BBB' issue-level rating on Valeo's unsecured debt.
- The negative outlook reflects increased risks of a further weakening of operating conditions in the global automotive industry.

Rating Action Rationale

The outlook revision reflects the risk that increasingly uncertain industry prospects in the global automotive industry could impede Valeo's ability to improve its cash flow protection ratios from subdued levels in the coming years, contrary to earlier expectations. Valeo's earnings weakened in 2018 due to weak retail sales in China; distortions linked to the delayed certification of vehicles under new Worldwide Harmonized Light-Duty Vehicle Test Procedure; factory disruptions due to a shortage of electronics components; and increasing raw material prices. Overall, this led to a decline in Valeo's S&P Global Ratings adjusted EBITDA margin to about 9.0% in 2018 (from 10.4% in 2017).

Given increasingly challenging market conditions, we now see less room for Valeo to improve its operating performance. We observe a number of key risks, such as continued weak sales in China, further signs of escalating trade conflicts, and an increased likelihood of a hard Brexit, all of which have the potential to significantly curb car production levels. In addition, the group needs to cope with the already announced restructuring plans of some of its key customers in some regions, which could impede growth prospects in the near term.

Following its sizable acquisition of FTE in 2017 for an enterprise value of €819 million, Valeo entered 2018 with increased financial leverage. At year-end 2018, the group's adjusted debt stood at about €4.6 billion (or 2.7x of EBITDA, compared with 2.0x at year-end 2017). Combined with the group's underperformance in 2018 and negative discretionary cash flow (DCF) generated, this also reduced Valeo's financial headroom under the current rating. FFO to debt stood at about 28% at year-end 2018, slightly below the minimum of 30% that we view as commensurate with the current ratings.

Longer-term expansion prospects are solid owing to the group's favorable positioning toward electrification (with its leading position in 48V technology) and intuitive and autonomous driving. However, both of these areas require high research and development costs that will impede near-term profitability. In spite of its focus on innovation, Valeo's adjusted EBITDA margin fell to about 9% in 2018, lagging behind some of its EU peers, such as Schaeffler, Bosch, and Continental--all of which we expect to post adjusted EBITDA margins above 10% for 2018). The group announced that it will sharpen its focus on its overall cost base, and it has some flexibility in its capex and research and development (R&D) budgets, which is supported by the group's very high spending levels in comparison with industry peers. Valeo's R&D expenses to original equipment sales has averaged about 9%-10% in recent years (about 12% when including capitalized development costs).

We note the group's still dynamic order intake in 2018 (with an order intake at 1.7x of original equipment sales in 2018), which should translate into above industry average growth. Overall, the group's global reach, with a diversified product portfolio and leading market positions in its segments, continues to support Valeo's business risk profile. In addition, about 10%-15% of the group's sales stem from the aftermarket, which we see as less cyclical than sales to original equipment manufacturers. This provides some further stability to the group's operations.

We see the group's free operating cash flow (FOCF) generation as a weakness for the rating, with a low reported €161 million (before interest payments of €58 million) generated in 2018. This led the group to report negative DCF generation of more than €200 million. Failure to improve cash flow generation in the coming years could put pressure on the ratings. In addition, we view the group's decision to maintain its dividend per share at €1.25--the same as in 2016 and 2017--as aggressive given the uncertain industry prospects. We note that Valeo's financial policy framework includes the commitment to an investment grade rating, which is why we expect the group to introduce credit preservation measures if we were to see further underperformance. We also observe a weakening of the group's financial flexibility, given the increased amount of short-term debt and lower expected cash earnings.

Outlook

The negative outlook reflects increased risks of a further weakening of operating conditions in the global automotive industry. This is in contrast with our current base-case, which foresees slightly positive sales increases for Valeo in an environment of flat production levels. Evolving risks relate to potential cuts in production levels from a continued weakness in the

Chinese market, escalating trade conflicts, and a disruptive Brexit, all of which could prevent Valeo from stabilizing its operating and financial performance in the second half of 2019, continuing into 2020.

Downside scenario

In our view, a downgrade would primarily stem from a more severe downturn in the automotive industry in the coming years, with original equipment manufacturers significantly cutting production rates and requiring further restructuring of their manufacturing networks, which would add to auto suppliers' earnings pressure in an already competitive market environment. We could lower the rating if Valeo continued its negative DCF generation. Rating pressure could also arise if financial metrics such as FFO to debt declined to significantly less than 30% for a sustained period.

Upside scenario

We could revise the outlook to stable if we saw recovery in Valeo's operating performance, allowing the group to restore its margins and exhibit tight control over capital investments and working capital to generate a meaningfully positive DCF in 2019 and 2020.

Company Description

With about €19.1 billion of sales reported in 2018, Valeo S.A. is a large tier 1 automotive supplier providing major carmakers such as Volkswagen, Ford, Renault-Nissan, Peugeot, BMW, and Daimler with visibility systems, powertrain systems, comfort driving assistance systems, and thermal systems.

The group designs, produces, and sells components, systems, and modules for automobiles, for both the original equipment market (about 87% of revenues) and the after-market and miscellaneous sales (about 13% of revenues).

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 is listed on Euronext Paris.

Our Base-Case Scenario

- Slowdown in GDP growth in the eurozone to 1.6% in 2019 and 2020 (down from a forecasted 1.9% in 2018). We expect GDP to decelerate to about 2.3% in 2019 and 1.8 % in 2020 in the U.S. (from an expected 2.9% in 2018). In Valeo's other key operating region, Asia-Pacific, we forecast GDP growth of 5.3% in 2019 and 2020 (from an expected 5.6% in 2018).

- Sales growth of 2%-5% 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.
- Adjusted EBITDA margin decline in 2019 to about 8.5%-9.0% in 2019 (from about 9.0% for 2018) owing to operating headwinds related to challenging industry conditions, which we expect to lead to competitive pricing pressures. We also anticipate the group to continue to incur high R&D costs that will weigh on core operating performance. Furthermore, the results of its joint venture operations with Siemens and in China could outweigh the group's focus on tight cost management and a potential easing of input prices for electronic components and raw material prices. We assume some improvements in EBITDA margin after 2019.
- Annual capex of about €1.9 billion (compared with €2.1 billion in 2018) over the coming years, including capitalized development costs.
- We assume stable dividends and no share buybacks over the forecast period.

This results in adjusted credit metrics of:

- FFO to debt of about 25% in 2019, recovering to the levels that the group showed in 2018 of about 28%.
- Debt to EBITDA of close to 3x in 2019, falling to about 2.5x in 2020, compared with about 2.7x for 2018.
- Weak adjusted FOCF to debt of about 2.5% in 2019, recovering to comfortably more than 5% in 2020 (compared with a low 4% for 2018).

Liquidity

We now consider Valeo's liquidity adequate, compared with its previous strong assessment, based on a ratio of liquidity sources to uses above 1.4x for the 12 months from Jan. 1, 2019, and remaining above 1.0x in the 12 months from Jan. 1, 2020.

We estimate that Valeo's principal liquidity sources for the 12 months from Jan. 1, 2019 will comprise:

- About €2.0 billion in available cash, excluding about €400 million we view as not immediately available for debt repayment.
- €1.1 billion of available committed credit lines maturing beyond 12 months.
- FFO of about €2.0 billion-€2.2 billion (before adjustments) in 2019 and 2020.

We estimate that Valeo's principal liquidity uses for the same period will comprise:

- €350 million of private placement coming due in November 2019 and €900 million of short-term debt--including outstanding amounts under the commercial paper program.

- Capex of about €1.9 billion.
- Stable dividends in 2019 and 2020, compared to 2018.

Covenants

Valeo is subject to maintenance covenants in some of its bank lines and loans, which limit net debt to EBITDA to 3.25x. Valeo's net debt to EBITDA stood at 0.9x at Dec. 31. 2018. We expect there will be ample headroom under this covenant, even if EBITDA were to decline by 15%.

Issue Ratings - Subordination Risk Analysis

Capital structure

Valeo's capital structure comprises senior unsecured debt issued at the Valeo S.A. level.

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/Negative/A-2

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 rating analysis: Neutral (no impact)

Related Criteria

- 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
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Auto Suppliers Industry, 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Valeo S.A.		
Issuer Credit Rating	BBB/Negative/A-2	BBB/Stable/A-2

Ratings Affirmed

Valeo S.A.		
Senior Unsecured	BBB	BBB

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.