Research Update:

French Auto Supplier Valeo 'BBB-/A-3' Ratings Placed On CreditWatch Negative On COVID-19 Impact

April 3, 2020

Rating Action Overview

- We project the impact of the COVID-19 pandemic will lead to a global auto sales decline of almost 15% in 2020, as well as weaker global demand and GDP growth, followed by a mild recovery in sales volumes of 6%-8% in 2021.

- Automakers’ plant closures in response to the pandemic will likely materially hurt Valeo’s earnings and cash flow in 2020, likely leading to a decline in the EBITDA margin to 6%-8% versus 9.2% in 2019.

- We are therefore placing our ‘BBB-’ ratings on Valeo and its unsecured debt, as well as our ‘A-3’ short-term rating on CreditWatch with negative implications.

- We expect to resolve the CreditWatch during the second quarter of 2020 once we have additional information about the potential impact of the COVID-19 pandemic on the group’s earnings and cash flows in 2020, as well as the effectiveness of the group’s countermeasures to preserve margins and cash flow generation.

Rating Action Rationale

The global spread of COVID-19 has worsened an already difficult business environment for the global auto industry. With about 70% of its sales stemming from Europe and North America, we expect that Valeo’s 2020 operating performance will suffer, due to the production cuts major automakers have announced in these regions as a result of likely weaker sales volumes. Because of the COVID-19 pandemic and resulting economic pressure, we now project that auto sales will decline by 15%-20% in the U.S. and Europe, and by 8%-10% in China, in 2020. We expect production rates to decline in a similar pattern. Based on our revised scenario, we assume Valeo’s group revenues will decline by 8%-10% this year, with the adjusted EBITDA margin dropping to 6%-8% from 9.2% in 2019. In our view, Valeo is likely to outperform market growth in 2020 thanks to its strong order intake in recent years.
Free operating cash flow will likely decline substantially in 2020 due to the high fixed-cost base. We would expect Valeo to take the necessary measures to contain costs through, for example, partial unemployment schemes, reduction of temporary workers, and reducing purchasing volumes. However, we also expect the decline in earnings will not be fully compensated by a reduction in nondiscretionary capital expenditure (capex) and a potential working capital inflow, which we do not include in our base case at the moment, given the volatile market conditions and possible need to support struggling suppliers. We would therefore expect adjusted free operating cash flows to fall significantly to about breakeven levels in 2020 from €503 million in 2019. As a result, Valeo's credit metrics would be weak for the current rating in 2020, including funds from operations (FFO) to debt of between 20% and 25%, and debt to EBITDA of 3x-4x. We also forecast a recovery of the group's operations next year, which could allow FFO to debt to return to about 30%, and debt to EBITDA to be lower than 3x by the end of 2021.

Valeo's financial policy is a key lever to support the investment-grade rating. Given the limited flexibility in cutting investments such as capex, and Valeo's contribution to its joint venture with Siemens, we view the company's financial policy as an important internal tool to partly mitigate the expected increase in adjusted net debt.

We continue to assess Valeo's liquidity as adequate. Valeo ended 2019 with about €1.8 billion of cash on the balance sheet and about €1.1 billion of available credit lines maturing in December 2022. With limited debt maturing in 2020 and assuming a normalization of production from May 2020, we believe that Valeo's liquidity sources will cover its capex needs, potential working capital outflows and contributions to its joint-venture with Siemens. Valeo credit facilities contain a financial maintenance covenant stipulating reported net debt to EBITDA of less than 3.5x. At the end of December 2019, the company's net leverage ratio stood at 1.13x, providing comfortable headroom under the covenant. Under our current base case, we consider that the headroom will decrease but remain comfortably above 15%.

Environmental, social, and governance (ESG) factors relevant to the rating action:
- Health and safety.

CreditWatch

We expect to resolve the CreditWatch during the second quarter of 2020 once we have additional information about the impact of the COVID-19 pandemic on the group's earnings and cash flows in 2020, as well as the effectiveness of the group's countermeasures to preserve margins and cash flow generation.

Downside scenario

We could lower the rating if the group's production facilities remain shut down for longer or auto production volumes are likely to be even lower in 2020-2021 than we currently expect, causing Valeo's credit metrics to deteriorate more significantly than currently forecast, with no prospects of FFO to debt returning to above 30% and free operating cash flow to debt approaching 10% by the end of 2021.
Upside scenario

We could affirm the rating if the likely impact from COVID-19 is less severe than expected or if the company’s countermeasures are more effective than we have currently factored into our base case.

Company Description

With about €19.5 billion of sales reported in 2019, Valeo is a large automotive supplier providing major carmakers such as Volkswagen, Ford, Renault-Nissan, Peugeot, BMW, and Daimler with visibility systems, powertrain systems, comfort and driving assistance systems, and thermal systems. The group designs, produces, and sells components, systems, and modules for automobiles, both for the original equipment market (about 85% of revenues) and the after-market (about 10% 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.

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: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
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<th>CreditWatch/Outlook Action</th>
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<td>Issuer Credit Rating</td>
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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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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.