Research Update:

French Auto Supplier Valeo Downgraded To 'BB+' On Weak Deleveraging Post-COVID-19; Stable Outlook

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Rating Action Overview

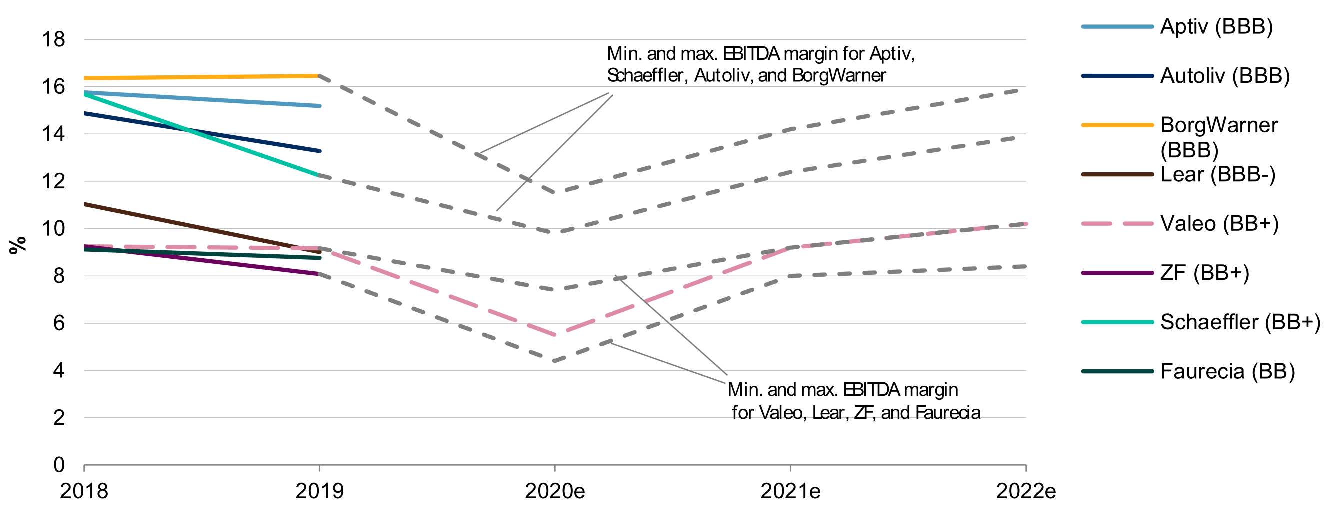
- Valeo SA's earnings, cash flows, and leverage will be severely hit by the impact of the COVID-19 pandemic on global auto production volumes in 2020.
- We foresee a significant cash burn for Valeo this year, and given the slow pace of market recovery, we expect Valeo's free cash flow to remain subdued in the next two years and that cash contributions to its joint-venture Valeo Siemens eAutomotive (VSeA) will further limit its ability to reduce debt.
- We are therefore lowering our long-term issuer credit rating and unsecured issue-level rating on Valeo and its debt to 'BB+'. We are also lowering our short-term rating to 'B'.
- The stable outlook reflects our expectation that Valeo's revenue will recover faster than its industry from the trough in 2020, supporting an improvement in free operating cash flow (FOCF) to debt toward 10% and funds from operations (FFO) to debt well above 20% in 2021.

Rating Action Rationale

Valeo's earnings, cash flows, and leverage will deteriorate materially in 2020 from already weak levels in 2019. The demand for cars has plummeted in the first half of 2020 due to the extensive lockdowns imposed by governments to combat the spread of the COVID-19 pandemic. Overall, for the full year 2020, we project auto unit sales will decrease by about 20%-25% in Europe, by about 21% in the U.S., and by about 10% in China. We assume auto production volumes will follow similar trends. For Valeo, we think this will lead to a drop in sales of 17%-18% in 2020, reflecting its large exposure to Europe and North America, which accounted for 67% of 2019 sales. We estimate the sales decline will cause a drop in S&P Global Ratings-adjusted EBITDA margin to 5%-6%, down from 9.2% in 2019, resulting from the company's high level of fixed costs. In our view, this will translate into negative FOCF of €450 million-€550 million in 2020, also taking into account an outflow in working capital of about €250 million for the full year. In the first half 2020, Valeo's working capital increased by €574 million due to the sharp decrease in sales. Our FOCF estimate for the full year assumes a reversal in working capital of about €320 million in the second half, supported by our expectation of sales recovery. The company's intention to reduce capital expenditures (capex) will not prevent FOCF from turning negative in 2020. The steep downturn will further cause our adjusted FFO to debt to fall well below 15% in 2020 and remain below the level of about 31% observed in 2019 in 2021.

Valeo's EBITDA margin and FOCF will recover in 2021, but it will likely remain lower than peers. We see mild recovery prospects for the auto sector in 2021, especially in Europe, where we expect real GDP to grow by only 5.2%, after a contraction of 6.7% in 2020. In our base case scenario, we assume Valeo will outpace market growth thanks to its product portfolio, which should benefit from the electrification of car models and from the increasing interest in connected and automated cars. For instance, the company's comfort and driving assistance products (such as cameras and radars) are becoming mainstream on new car models; driving a higher content per car for Valeo. In addition, the company is well-placed to support carmakers' needs to meet the more stringent CO2 emissions limit from 2020, for example, with products like 48V systems (e-motors and DC/DC converters) used for mild hybrid cars. In 2021, we assume these factors will help Valeo increase sales by more than 15%, and restore its EBITDA margin to 9%-10%, supported by higher volumes and efficiency gains. We also assume limited ramp-up costs because the start of production for new contracts will mostly be related to the second generation of parts that Valeo already manufactures. That said, at this level, Valeo will still lag peers such as Aptiv, Autoliv, and Borgwarner in terms of profitability, and its EBITDA margins will be more comparable with Faurecia, Lear Corp., and ZF Friedrichshafen. Moreover, despite a rebound in Valeo's cash flows next year, our forecast for its FOCF to debt of 8%-10% in 2021 is weaker than what we project for peers such as Lear and Aptiv.

EBITDA Adjusted Margin Peer Comparison



e--Estimate. Source: S&P Global Ratings, company data.

Valeo's dividend cut is creditor-friendly, but the magnitude of the cash savings is too small to significantly speed up debt reduction. In response to the pandemic, Valeo's board of directors slashed the dividend per share to €0.20, corresponding to a payment of about €50 million in 2020, down from about €297 million (€1.25 per share) in 2019. We believe this measure will not be enough to prevent a build-up of debt in the near-term. This is also because of an expected cash contribution of about €200 million-€250 million to VSeA, Valeo's joint-venture with Siemens in the area of high voltage components for electrified cars, which will continue to delay leverage reduction. At year-end 2020, we expect that Valeo's debt will increase to about €5.1 billion-€5.3 billion compared with €4.5 billion in 2019.

Environmental, social, and governance (ESG) factors relevant to the rating action:

- Health and safety

Outlook

The stable outlook reflects our expectation that Valeo will outperform its industry during the expected market recovery thanks to its focus on innovative products. This should enable Valeo to increase revenue by at least 15% and increase EBITDA margins back toward 10% in 2021. We think this will translate into FFO to debt above 25% and FOCF to debt strengthening toward 10% next year. In addition, we think Valeo will proactively refinance upcoming debt maturities so as to ensure continued adequate liquidity.

Downside scenario

We could lower our ratings on Valeo if we expected its FOCF to debt to remain materially below 10% in the next 12–18 months, in addition to FFO to debt not recovering to above 20%.

Upside scenario

We could raise the rating if Valeo continued to show significantly faster topline growth than its industry, combined with EBITDA margins above our base case and FOCF to debt improving sustainably above 10%. In addition, this would require FFO to debt of more than 30%, supported by a conservative financial policy. Alternatively, we could raise our rating on Valeo if its FFO to debt sustainably exceeded 30% and its FOCF to debt increased toward 15%.

Company Description

With about €19.5 billion of sales reported in 2019, 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 and 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 86% of revenues) and the after-market and miscellaneous sales (about 14% 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 is listed on Euronext Paris.

Our Base-Case Scenario

Assumptions

- Sharp decline in revenue in 2020 due to the COVID-19 pandemic, followed by a recovery exceeding market rate in 2021 thanks to an increase in content per car.
- S&P Global Ratings-adjusted EBITDA margin dropping to about 5%-6% in 2020 reflecting the company's high operating leverage, and recovering to about 9%-10% in 2021 (close to the 2019 level) from volume growth and efficiency gains.
- Capex to sales of about 5% in 2020 and 2021, compared with 6% in 2019.
- Working capital-related cash outflows of about €250 million in 2020, reflecting our expectation of a reversal of working capital needs in the second half of 2020 as production ramps up and €100 million-€200 million in 2021.
- Dividend of about €50 million in 2020 and 2021.
- Cash contribution to VSeA of about €450 million for 2020-2021.
- No acquisitions.

Key metrics

Valeo S.A. Key Metrics*

	--Fiscal year ended Dec. 31--				
(Bil. €)	2018a	2019a	2020e	2021f	2022f
Revenue	19.1	19.5	15.5-16.5	18.0-19.0	20.0-21.0
EBITDA margin (%)	9.2	9.2	5.0-6.0	9.0-10.0	10.0-10.5
Funds from operations	1.4	1.4	0.5-0.7	1.3-1.5	1.6-1.8
Capex (excluding capitalized research and development costs)	1.4	1.2	About 0.9	About 0.8	About 1.0
Free operating cash flow	0.1	0.5	(0.4)-(0.6)	0.4-0.5	0.5-0.6
Debt§	4.6	4.5	5.1-5.3	4.9-5.1	4.5-4.7
FFO to debt (%)	30.6	30.8	10.0-12.0	27.0-29.0	34.0-36.0
FOCF to debt (%)	1.1	11.1	<0	8.0-10 .0	10.0-12.0

*All figures adjusted by S&P Global Ratings. §2019 year-end debt consists of net financial debt of €3.17 bil. with key adjustments being €290 mil. in receivables sold, €981 mil. in pension. a--Actual. e--Estimate. f--Forecast.

Liquidity

Our short-term rating on Valeo is 'B'. Our assessment of the group's liquidity as adequate primarily reflects the company's reliance on short-term financing with about €1.9 billion of commercial paper outstanding at the end of June 2020. It also reflects our belief that its liquidity sources will exceed uses by 1.2x over the 12 months from July 1, 2020.

Principal liquidity sources include:

- Cash and cash equivalents of €2.0 billion, after deducting €60 million that we consider not immediately available to repay debt;
- About €2.3 billion in undrawn committed credit lines maturing in more than 12 months; and
- Our forecast of about €1.6 billion of cash FFO after lease payments.

Principal liquidity uses include:

- About €1.9 billion of commercial paper and about €700 million of other debt maturing in the next 12 months;
- Working capital inflows of more than €250 million, mainly reflecting a reversal of adverse working capital dynamics in the first half of 2020;
- Approximately €1.2 billion of non-discretionary capex, including research and development capitalized costs; and
- Annual dividends of €50 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. We expect there will be adequate headroom under this covenant, even if EBITDA were to decline by 15%.

Issue Ratings--Recovery Analysis

Key analytical factors

- The senior unsecured notes--issued by Valeo SA--have an issue rating of 'BB+' and a recovery rating of '3', reflecting the pari passu ranking of the notes and credit facilities.
- In our hypothetical default scenario for Valeo, a cyclical downturn in the industry, combined with intensified competition, would lower production volumes and prices and would cause Valeo's operating performance to deteriorate markedly and EBITDA and cash flow generation to decline sharply.
- We value Valeo as a going concern based on its strong market position in the automotive supply industry and its diverse base of customers.

Simulated default assumptions

- Year of default: 2025
- Jurisdiction: France

Simplified waterfall

- Emergence EBITDA: €1.03 billion (maintenance capex is assumed to be 4% of revenue; cyclical adjustment of 10%, standard for the sector)
- Multiple: 5.5x
- Gross recovery value: €5.66 billion
- Net recovery value for waterfall after administrative expenses (5%) and pension deficit: €4.93 million
- Priority claims*: €490 million
- Value available for senior unsecured claims: €4.44 billion
- Senior unsecured claims: €6.08 billion§
- --Recovery expectations: 50%-70% (rounded estimate: 65%)

*Including bilateral lines at operating companies and receivables sold. §All debt amounts include six months' prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating: BB+/Stable/--

Business risk: Satisfactory

- Country risk: Low
- Industry risk: Moderately high
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating 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: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Auto Suppliers Industry, 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

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Valeo S.A.		
Issuer Credit Rating	BB+/Stable/B	BBB-/Watch Neg/A-3
Senior Unsecured	BB+	BBB-/Watch Neg
Recovery Rating	3(65%)	

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.