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Research Update:

Metso Outotec Outlook Revised To Negative On Increased Leverage Risk Due To COVID And Tie-Up; 'BBB-(Prelim)' Affirmed

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Rating Action Overview

- In our view, the COVID-19 outbreak and lower demand for commodities could dent Metso Outotec's sales and profit margin prospects in 2020.
- As a result, Metso Outotec may not be able to reach a level of adjusted funds from operations (FFO) to debt of at least 30% in 2020 unless management takes extraordinary measures or lowers shareholder returns to preserve its balance sheet.
- We are therefore revising our outlook on Metso Outotec to negative from stable and affirming the preliminary 'BBB-' rating.
- The outlook is negative because we believe we would downgrade Metso Outotec by one notch if its adjusted FFO to debt does not reach at least 30% by the end of 2020.

Rating Action Rationale

We revised the outlook to negative because of the risk that the COVID-19 outbreak, as well as lower commodity prices, could dent Metso Outotec's sales and profit margin prospects in 2020. Metso Outotec may not be able to reach a level of adjusted FFO to debt of at least 30% in 2020 absent management taking extraordinary measures or lowering shareholder returns to preserve its balance sheet. We regard adjusted FFO to debt of 30% as the minimum leverage threshold for maintaining an investment-grade rating ('BBB-' or higher) on the Metso Outotec Group. Although we understand Metso Outotec's order intake for the first two months of 2020 has been largely unchanged against last year, we see emerging risks in the short- to medium-term, mainly owing to the severity and breadth of the spread of COVID-19, coupled with lower commodity prices that could affect demand for Metso Outotec's products. This comes on top of the risks that the merger of Metso Minerals and Outotec to form Metso Outotec already entails, including execution risks, the reliance on material synergies, aggressive dividend distributions, and Outotec's exposure to loss-making turnkey projects.

We understand the merger could be accomplished by mid-year 2020; therefore, we continue to expect some one-off costs to weigh on the operating performance this year and limit profit margin preservation. Under our revised base case we see margins decreasing to about 10% in 2020 from 13.4% in 2019. However at this stage we have limited visibility on what type of countermeasures management is undertaking to preserve profitability. We continue to believe that the tie-up entails execution risks that could further add negative pressure to the group's profitability, if synergies do not materialize as expected, all else being equal. In addition, Metso Outotec's 2019 profitability is weaker than that of many of its investment-grade peers in the capital goods sector. Therefore, lack of clear margin improvement once the merger is complete, or continued material risks from its turnkey project activities, could lead us to revise down our current business risk assessment, which we already assess at the lower end of the range.

Metso Outotec's ability to deleverage will depend on its portfolio, dividend policy, and working capital management. In 2019, the combined Metso Outotec group recorded negative free operating cash flow (FOCF), driven by working capital buildup at Metso Minerals. Metso Minerals' high working capital outlays, peaking at €224 million in 2019 and increasing from €111 million in 2018, owed partly to its recent McCloskey acquisition (October 2019), as well as some stocking issues. As a result, we estimate that Metso Outotec's combined pro forma FFO to debt remained at about 33% for 2019, which does not provide ample flexibility to face the challenges that COVID-19 and lower commodities prices are now posing. For 2020, we expect a potential working capital inflow of up to €80 million after the material buildup in 2019, which would sustain cash generation, lifting the FOCF to about €200 million from negative €15 million in 2019. Additionally Metso's dividend proposal on 2019 profits, which for Metso Group as a whole amounts to about €220 million, would put further pressure on credit metrics, if paid out as currently proposed.

We maintain the preliminary rating on Metso Outotec until the transaction closes. We expect to finalize our rating on Metso Outotec once the transaction is complete. Therefore we expect to maintain the preliminary rating until that date. The final rating will depend on the company's successful transfer of €400 million notes to Metso Outotec, and the capital structure at closing (net debt, transfers from Neles to Metso Minerals, and debt refinancing). The final rating will also depend on our receipt and satisfactory review of all final transaction documentation. Accordingly, the preliminary rating should not be construed as evidence of the final rating. If S&P Global Ratings does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, we reserve the right to withdraw or revise our ratings.

Outlook

The outlook on Metso Outotec is negative because of the possibility we could downgrade the company over the following few months if the management's actions to address the COVID-19 pandemic and the expected lower demand are not enough to ensure adjusted FFO to debt of more than 30% at year-end 2020 for the newly combine group.

Downside scenario

We could take a negative action on Metso Outotec if COVID-19 and lower expected commodities prices have a significantly negatively effect on its order book and sales, and consequently drive down its margins to below 11% with no prospects of improvement in the short term. Additionally, if the integration of Metso Minerals with Outotec proves more challenging than anticipated, it could negatively affect margins. Under this scenario FFO to debt would fall below 30%.

Upside scenario

We could revise the outlook to stable if Metso Outotec proves able to maintain adjusted FFO to debt well above 30% and EBITDA margin consistently above 11%.

Company Description

After the merger closes, Metso Outotec will be a leading provider of process technology, equipment, and services in the minerals, metals, and aggregates industries. On a combined basis for 2019, sales totaled €4.2 billion, adjusted EBITDA €562 million, and adjusted debt totaled about €1.2 billion.

About 55.5% of group's sales stemmed from minerals processing, 28.4% aggregates, 12.6% metals, energy, and water, and 3.5% recycling. About 55% of sales came from services and from the aftermarket, where we expect the group will expand slightly over the coming years, thanks to increased production at brownfield mines, which would require additional maintenance and services.

Our Base-Case Scenario

- Very unstable market momentum driven by COVID-19 and the prospects of a sharp decline in global growth for 2020, coupled with commodities prices trending down and lower demand from important sectors such as automotive and construction.
- We therefore foresee revenue decreasing as much as 5% in 2020 to €4.1 billion versus €4.2 billion in 2019 for the combined entity. We assume organic growth for the group will decline by 5%-10%, while McCloskey will support sales, given its first full consolidation year. For 2021 we see sales growing by up to 5%.
- Given the recent COVID-19 outbreak, and additional costs to integrate the two companies, we see margins dropping by about 300 basis points to about 10%, from 13.4% at the end of 2019%, absent management countermeasures to safeguard profitability. We expect a margin stabilization at around 12% from 2021.
- Working capital inflow of about €80 million in 2020 turning negative in 2021. This compares with negative working capital outlays well in excess of €200 million in 2019.
- Capital expenditure (capex) of about €80 million in 2020-2021, slightly below €105 million in 2019.
- Dividends in 2020 of €200 million (of which €180 million referred to Metso Minerals) decreasing to about €80 million in 2021 when assuming a 50% dividend payout. This compares with €180 million distributed in 2019.
- We assume intercompany transactions between Metso Minerals and Neles will result in a cash inflow for Metso Minerals of €50 million-€100 million over 2020.

Based on these assumptions we arrive at the following:

- S&P Global Ratings-adjusted pro forma FFO to debt of about 25%-30% in 2020, and about 35%

in 2021;

- Adjusted debt to EBITDA of about 2.5x in 2020, and of about 2.0x in 2021; and
- Slightly positive discretionary cash flow in 2020 and 2021.

Liquidity

In our view, Metso Outotec has an adequate liquidity position because its sources cover uses by about 1.4x over the 12 months started Jan. 1, 2020. We believe Metso Outotec has well-established relationships with banks, as one of the largest corporations in Finland. We understand that Metso has recently signed a new revolving credit facility (RCF) of €600 million to support the merger, which at closing will be transferred to the new entity Metso Outotec. As long as Metso Outotec maintains an investment-grade rating ('BBB-' or higher) no financial covenants are applicable.

Principal liquidity sources on Jan. 1, 2020, include:

- Our estimate of about €370 million in cash for the combined group;
- The €600 million RCF at Metso, will be available to the new entity;
- Cash FFO of €170 million-€180 million after deducting payments for leases under International Financial Reporting Standard 16; and
- A positive working capital cash inflow of about €80 million.

Principal liquidity uses as of Jan. 1, 2020, include:

- Debt maturities of about €270 million;
- High seasonal working capital swing requirement due to COVID-19 effects of up to €300 million;
- Capex of about €80 million; and
- Dividends of €200 million.

Ratings Score Snapshot

Issuer Credit Rating:	BBB-(prelim)/Negative/--
Business risk:	Satisfactory
Country risk:	Intermediate
Industry risk:	Intermediate
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)
Stand-alone credit profile:	bbb-

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
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Capital Goods Industry, 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

Ratings List

CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Metso Outotec		
Issuer Credit Rating	BBB-/Negative/--	BBB-/Stable/--