Research Update:

Metso Outotec Assigned 'BBB-' Rating; Outlook Negative On Uncertain COVID-19 Fallout And Integration Challenges

August 27, 2020

Rating Action Overview

- Metso Minerals' merger with Outotec took place on June 30, 2020, and the combined group, Metso Outotec Corp., recently reported its first set of pro-forma statements.
- Metso Minerals' showed solid results despite the pandemic, and its management has increased and shortened its cost-synergies target for Metso Outotec to €120 million by end-2021.
- However, the recessionary environment has hit Outotec hard and we therefore expect overall pro-forma weaker results for the combined group in 2020 compared with 2019.
- We continue to see the combined group's adjusted pro-forma funds from operations (FFO)-to-debt ratio declining to about 30% in 2020, but improving to about 35% in 2021.
- We are assigning our 'BBB-' issuer credit rating to Metso Outotec.
- At the same time, we are affirming our 'BBB-' issue rating on the €400 million senior unsecured notes that were transferred from Metso Corp. to the newly formed Metso Outotec on the merger date.
- The negative outlook reflects the potential for a one-notch downgrade if the group's pro-forma adjusted FFO to debt falls below 30% with no prospects for short-term recovery in 2021.

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Rating Action Rationale

The rating on Metso Outotec reflects the company's position as a leading provider of process technology, equipment, and services in the minerals, metals, and aggregates industries. At the same time, it incorporates the company's target to maintain credit metrics commensurate with an investment-grade rating, translating into our expectation Metso Outotec's pro-forma FFO to debt at about 30% for 2020 and consistently improving above 35% from 2021, as well as an S&P Global Ratings-adjusted EBITDA margin above 11% over time. Under our revised base case, which does not materially differ from our last review ("Metso Outotec Outlook Revised To Negative On Increased Leverage Risk Due To COVID And Tie-Up; 'BBB-(Prelim)' Affirmed," March 25, 2020), we now forecast pro-forma FFO to debt will be at about 30% for 2020 when including transaction costs in our EBITDA calculation. Based on that and thanks to the group's accelerated synergies and cost savings, we now expect FFO to debt to improve sustainably above 35% from 2021. Additionally, despite weaker revenue and earnings in 2020, we expect Metso Outotec to generate positive cash flow after capital expenditure (capex) and dividends in 2020 and 2021 of €140 million-€170 million per year. Cash flow in 2020 would be supported by the group's ability to materially release at least €110 million cash from working capital for the consolidated group.

The risks generated by the COVID-19 outbreak and Outotec's disappointing operating and cash flow performance in first-half (H1) 2020 could dent Metso Outotec's sales and profit margin prospects in 2020. The group has increased its cost synergies target, anticipating that the full run-rate synergies will be €120 million (from €100 million expected previously) by end-2021. We think this supports the group's aspirational level of earnings before interest, tax, and amortization (EBITA) margin of 15%. Moreover, Metso's prompt measures to curb costs helped the group maintain margins in H1 2020. Metso Minerals' reported operating profit reached 10.0% in H1 2020, despite a 3.0% year-on-year decline in revenue (excluding McCloskey in constant currencies), and is only slightly down from 10.9% in 2019. At the same time, notwithstanding the unprecedented market circumstances generated by COVID-19, we recognize that the H1 2020 order intake and backlog for the combined group were at about the same levels as one year ago, at €2.1 billion and €2.0 billion, respectively, mostly supported by Metso Minerals and its recent acquisition of McCloskey.

Metso Minerals' solid contribution to the overall group's operating performance was, however, diluted by Outotec's disappointing operating performance. Outotec's stand-alone reported operating margin decreased to 2.4% for H1 2020, from 8.4% for the 2019. Based on that, we forecast the group's consolidated pro-forma S&P Global Ratings-adjusted EBITDA (including transaction cost of about €60 million) will be €460 million-€480 million for 2020, down from €562 million pro forma in 2019.

Metso Outotec's margins will suffer for 2020 and 2021, but we expect full synergies to be visible from 2022. Under our revised base case, we see pro-forma adjusted EBITDA margins decreasing to about 11% in 2020 and improving to about 13% in 2021 from 13.4% in 2019. We continue to believe the tie-up entails execution risks that could add further negative pressure to the group's profitability, if synergies do not materialize as expected, but all else remains the same. We believe that the high share of revenue from services, and a balanced geographic exposure, should offer some margin protection to the group. However, these strengths are somewhat offset by slight customer concentration, and weaker scale and diversity compared with peers such as Sandvik or Danfoss. 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 integration is at a more advanced stage, 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. We expect Metso Outotec would be able to generate annual cash flow after capex and dividends of about €140 million-€170 million in 2020 and 2021 against a negative of pro forma €157 million for 2019. This should be supported mainly by Metso Minerals' improving cash generation and release of working capital. In H1 2020, Metso Minerals recorded a working capital release, boosting its stand-alone cash flow from operating activities to €303 million from €43 million in 2019. Outotec's H1 2020 cash performance was weak, mainly dented by a lack of new orders and advance client payments. This translated into negative cash flow from operations of €75 million compared with positive operating cash flow of €68 million for 2019. For 2020 we expect capex to be at about €80 million for the whole group, lower than the pro-forma €105 million recorded in 2019. Finally, the group's ability to build some financial flexibility will eventually become clearer once it has fully developed its strategy and declared its dividend and financial policies, which we expect will be available by end-2020.

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 pro-forma S&P Global Ratings-adjusted FFO to debt of about 30% at year-end 2020 for the newly combined group and consistently above 30% from 2021.

Downside scenario

We could take a negative action on Metso Outotec if COVID-19 and continued negative performance from Outotec have a significantly negatively effect on group's EBITDA margins and consequently drive down its margins to below 11% with no prospects of improvement in the short term. Under this scenario, FFO to debt would fall below 30% with no prospects for short-term recovery.

Upside scenario

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

Company Description

Metso Outotec is a leading provider of process technology, equipment, and services in the minerals, metals, and aggregates industries. Pro-forma 2019 sales totaled €4.2 billion, adjusted EBITDA €562 million, and adjusted debt about €1.2 billion.

About 55.5% of the 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 require additional maintenance and services.

Our Base-Case Scenario

Assumptions

- Due to COVID-19, S&P Global Ratings now expects global GDP to fall 3.8% this year, and a reasonably strong recovery in 2021 and 2022 with GDP growth of 5.3% in 2021 and 4.0% in 2022, which should support a rebound in industrial demand.

- We therefore see pro-forma revenue for 2020 reaching about €4.1 billion, down by about 0%-5% from 2019. We expect 2021 revenue to increase by 0%-5% to €4.2 billion, driven by recovery in the aggregates segment and in Outotec.
- Given some impact from weaker volumes in the aggregates segment, and acquisition-related costs, we expect the pro-forma EBITDA margin to remain softer at around 11% in 2020, down from 13.4% in 2019. We expect margins to improve to about 13% in 2021, supported by improved topline and synergies kicking in.
- Working capital inflow of about €110 million in 2020 turning negative in 2021 to about €80 million.
- Capex of about €70 million-€80 million per year in 2020-2021.
- Dividend payments of about €180 million in 2020 and €80 million in 2021, assuming a 50% dividend payout in 2021.

Key metrics

Table 1

Metso Outotec Corp.--Key Metrics*

	--Fiscal year ended Dec. 31--			
	2018a§	2019a§	2020f	2021f
Revenue pro-forma (bil. €)	3.8	4.2	4.1	4.2
Revenue growth pro-forma (%)	13.8	10.8	(5) - 0	0 - 5
EBITDA pro-forma¶ (mil. €)	455	562	470-480	540-550
EBITDA margin pro-forma¶ (%)	12.1	13.4	About 11	About 13
Funds from operations (FFO) pro-forma¶ (mil. €)	325	406	About 360	400-410
Free operating cash flow (FOCF)	116	(13)	About 320	About 250
Debt (mil. €)	0.8	1.2	1.2	1.1
FFO to debt pro-forma¶ (%)	40.5	33.2	About 30	Above 35

*All figures adjusted by S&P Global Ratings. a--Actual. f--Forecast. ¶S&P Global Ratings-adjusted EBITDA includes transaction costs in 2020. §Combined Metso Minerals and Outotec.

Liquidity

In our view, Metso Outotec has adequate liquidity because its sources of liquidity cover uses by about 1.8x over the 12 months started July 1, 2020. We believe Metso Outotec, as one of the largest corporations in Finland, has well-established relationships with banks. The group has access to €690 million of revolving credit facilities (RCFs) maturing beyond 12 months, which are unused, and has arranged a bank term loan to refinance Outotec's debt. The Outotec €150 million hybrid notes were already repaid in July 2020 with a bank term loan.

Principal liquidity sources as of July 1, 2020, include:

- Our estimate of about €413 million in cash for the combined group when excluding about €115 million, which we consider not immediately available;

- Full availability under the €600 million RCF maturing 2024, and under the €90 million RCF maturing 2022. The group also arranged €150 million of bank term loan to refinance Outotec's expiring debt maturities. This totals €840 million committed lines with maturity beyond 12 months.
- Cash FFO of €310 million-€330 million after deducting payments for leases under International Financial Reporting Standard 16; and
- A positive working capital cash inflow of about €15 million.

Principal liquidity uses as of the same date include:

- Debt maturities of about €476 million over the next 12 months;
- High seasonal intrayear working capital swings due to COVID-19 effects, as well some potential projects with intrayear working capital up to €300 million;
- Capex of about €80 million; and
- Dividend payments of €80 million-€90 million.

Covenants

As long as Metso Outotec maintains an investment-grade rating ('BBB-' or higher), no financial covenants are applicable.

Issue Ratings - Subordination Risk Analysis

Capital structure

Following the Merger of Metso Mineral with Outotec and the repayment of the hybrid notes in third-quarter 2020, Metso Outotec's capital structure consists of senior unsecured debt issued at the parent company level.

Analytical conclusions

We rate the debt 'BBB-', the same as the issuer credit rating, since no significant elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating:	BBB-/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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012

Related Research

- Metso Outotec Outlook Revised To Negative On Increased Leverage Risk Due To COVID And Tie-Up; 'BBB-(Prelim)' Affirmed, March 25, 2020

Ratings List

New Rating	
Metso Outotec Corp.	
Issuer Credit Rating	BBB-/Negative/--
Ratings Affirmed	
Metso Outotec Corp.	
Senior Unsecured	BBB-