Research Update:

German Truck Manufacturer TRATON SE Affirmed At 'BBB' Despite Weaker Margin Prospects In 2022; Outlook Stable

July 22, 2022

Rating Action Overview

- We anticipate that TRATON's deleveraging will be somewhat slower than we expected due to weaker top-line and margin prospects in 2022, so we forecast its S&P Global Ratings-adjusted funds from operations (FFO) to debt at 15%-20% rather than about 30% in 2022, compared with 12.3% in 2021.
- We expect further improvement in 2023 since the company will likely continue actively working to improve its capital structure, but its credit metrics are likely to remain below those in our previous base case.
- Nevertheless, we consider TRATON a highly strategic subsidiary of Volkswagen AG (VW; BBB+/Stable/A-2), which has a stake of close to 90%, owing to its continued strong operational and financial ties with its parent; as such our rating is primarily based on VW's likely support for TRATON.
- We have therefore affirmed our 'BBB' long-term rating on TRATON.
- The stable outlook mirrors that on VW, as long as VW owns more than 75% of TRATON.

PRIMARY CREDIT ANALYST

Marta Bevilacqua
Milan
+ (39)0272111298
marta.bevilacqua
@spglobal.com

SECONDARY CONTACT

Vittoria Ferraris
Milan
+ 390272111207
vittoria.ferraris
@spglobal.com

ADDITIONAL CONTACT

Corporate and IFR EMEA
RatingsCorpIFREMEA
@spglobal.com

Rating Action Rationale

TRATON's operating performance will be soft in 2022 and its management targets a reported return on sales on a consolidated basis of 9% by 2024. In its capital market day in May 2022, TRATON's management outlined a target of achieving a healthy consolidated reported return on sales of about 9% by the end of 2024. We believe that this strategic goal, which we note is unchanged compared with that of the last few years, will lift the company's profitability and potentially its resilience to external shocks over 2023-2024. At the same time, we anticipate that prolonged supply chain issues affecting its brands and rising input costs will still affect TRATON's 2022 operating performance. Under our revised base case, we now anticipate that TRATON's industrial business will deliver 295,000 units–305,000 units in 2022 (up from 271,608 units in

2021) supported by the full consolidation of Navistar. This will translate into our adjusted EBITDA margin ranging between 6.0% and 7.0%, similar to 6.3% in 2021.

We anticipate 2022-2023 credit metrics will be weaker than expected. TRATON's credit metrics will remain soft over the coming two years. For 2022, we now expect FFO to debt of 15%-20% (reflecting S&P Global Ratings-adjusted debt of €9.0 billion-€10 billion slightly above 2021 levels) improving to 30%-35% in 2023. This marks a moderate improvement against 12.3% in 2021 but is still below our previous base case when we expected steeper deleveraging, with FFO to debt at 30%-40% over 2021-2022 on average. We understand that the company will actively work on improving its capital structure. We also note that its management plans to set up an independent financial services function, whose details haven't been disclosed. At the same time, we believe that TRATON's operating performance, together with an assumed €1.4 billion-€1.5 billion one-off outflow for potential Navistar settlements and Scania's fine, makes deleveraging more challenging, resulting in our expectation of negative adjusted free operating cash flow (FOCF) for the industrial business of €300 million-€400 million in 2022. Consequently, we revised our assessment of TRATON's stand-alone credit profile (SACP) to 'bb+' from 'bbb-'. We would consider revising our SACP assessment if adjusted FFO to debt rises sustainably to about 45% and FOCF to debt strengthens, staying above 15%.

TRATON continues to have strong ties with its parent, VW, and our rating on TRATON reflects this. We consider TRATON a highly strategic subsidiary of VW, reflecting its strong ties with the parent and our expectation that VW's stake in the company will not decrease below 75% for the foreseeable future. We believe that VW regards TRATON as a very important strategic asset and there are close operational links between TRATON and VW. In 2021, TRATON contributed about 12% of VW's consolidated top line. Moreover, TRATON has access to VW's purchasing platforms and both MAN and VWTB (Volkswagen Truck & Bus)'s financial services are offered through VW's captive operations. In addition, VW has granted TRATON an acquisition facility to support the purchase of Navistar and an uncommitted line of €4 billion. So, as long as we view TRATON as highly strategic to the VW group, we will rate it up to one notch below our rating on VW, all else being equal. Should VW's stake in TRATON decrease below 75%, we could reconsider TRATON's group status and the implications for our long-term rating.

TRATON's Global Champion Strategy is now complete but requires integration. With its recent acquisition of Navistar and direct foothold in China through Scania, TRATON has now concluded its geographic expansion; therefore, we assess its country risk as low rather than intermediate. TRATON's increased geographic penetration sustains its business positioning albeit synergies are yet to materialize, thereby affecting margins in 2022-2023. At the same time, we continue to believe that the industrial modularization of TRATON's brands could take several years and entails execution risks. As such, we anticipate that TRATON's cost structure will remain relatively more rigid than that of benchmark peers and could be less optimal in downturns. We believe this represents a risk in the currently less supportive macroeconomic conditions. In addition, the race toward electrification requires high research and development costs, alongside capex, thus limiting the group's ability to deleverage. Under our updated base case, we expect our adjusted capex figure for TRATON to be €1,100 million-€1,400 million per year over 2022-2023.

The company's captive operations for its brands are not yet integrated. TRATON does not have fully centralized captive finance operations. MAN and VWTB rely on captive services offered by VW Financial Services, and Scania offers it through its own financial services business. Only a very small portion of Navistar's financial services operation is consolidated in TRATON's accounts, and the majority is handled by third-party providers. As of year-end 2021, TRATON's captive operations had a leverage ratio of 6.0x as a result of the first consolidation of Navistar (with Scania alone about 8.0x in 2021). We expect that TRATON's future strategy will be outlined once its management decides how it intends to run the financing arm of the group. We therefore believe that financial services operations are, for the time being, neutral to TRATON's creditworthiness. Any changes to the company's captive business could change the treatment of captive business, which we do not currently consider in our analysis of TRATON.

Outlook

The stable outlook on TRATON mirrors that on VW.

Downside scenario

Although it is unlikely, given VW's solid headroom under the 'BBB+' rating, we could lower our rating on TRATON following a similar action on VW.

Upside scenario

We could take a positive rating action on TRATON following a positive rating action on VW.

Company Description

TRATON was founded in 2015 as the commercial vehicle arm of VW. It sells trucks and buses under the Scania, MAN, Navistar, and VWTB brands. TRATON is a leader in both Europe and South America for heavy duty trucks (class 8) with a market share of about 26.5% and 31.8%, respectively. The company is mainly active in Germany, the U.S., North America, and South America, with Brazil counting in its international footprint in 16 countries, operating 31 production and assembly sites. Through its July 2021 acquisition of Navistar, TRATON gained material exposure to the North American heavy duty vehicle market. The Navistar acquisition gave TRATON the No. 4 position in the U.S. heavy duty truck market.

In 2021, TRATON recorded S&P Global Ratings-adjusted revenue of €29.7 billion (€22.2 billion in 2020) and adjusted EBITDA margin of 6.3% (4.1%) under its industrial business. Currently, the company sells its new vehicles supported by either Scania's financial business operations (for the Scania brand) or by VW's financial services (for MAN and VWTB). Navistar manages a small portion of its financial services internally, with the majority dealt with by third-party providers.

TRATON is controlled by VW, which today owns about 90% of its share capital after an IPO in June 2019. TRATON is listed on the Frankfurt stock exchange and the Nasdaq Stockholm. As of July 21, 2022, the company's market capitalization was about €7.1 billion.

Our Base-Case Scenario

Assumptions

- Real GDP growth for the U.S. of 2.4% in 2022 and 1.6% in 2023, for the Eurozone 2.6% in 2022 and by 1.9% in 2023, and for Brazil 1.2% in 2022 and 1.4% in 2023. GDP growth is one of the key variables influencing demand for trucks. Other considerations include the aging and mileage of the fleet, regulatory requirements on emissions leading to pre-buying effects, and truck manufacturers' ability to navigate currently challenging supply chain issues.

- A fall in global unit sales of heavy duty trucks by 17.5%-22.5% in 2022 to about 2.0 million units, with a steeper drop in Asia-Pacific; declines of 27.5%-32.5% in Asia and 7.5%-12.5% in Europe, but a still-moderate increase of 2.5%-7.5% in the U.S. (see "Global Heavy Truck Sales Forecast: COVID, War, And Supply Chain Woes Are Taking Their Toll In 2022," published June 24, 2022, on RatingsDirect).
- Supply chain gaps to continue in 2022, with production constraints potentially extending to 2023, affecting companies' ability to deliver on their still-healthy order books.
- At the group level, total volumes of 295,000 units-305,000 units, staying 10.0%-12.0% above the 2021 levels (due to the effect of Navistar's consolidation and growth). This will translate into revenue at the industrial business of €32.0 billion-€37 billion, 16%-18% higher than in 2021.
- Adjusted EBITDA margin remaining at around 2021 levels at 6.0%-7.0% in 2022 before increasing to 9.0%-10.0% in 2023 considering a positive impact from Scania's sales of its new CBE, a somewhat better contribution from MAN, and a gradual alignment of Navistar.
- Working capital outflow for the industrial business in 2022 of €800 million-€900 million, and around €1.5 billion negative in 2023.
- Payment of the fine by Scania of €950 million in 2022, and about €490 million of settlement expenditure for Navistar against profit-sharing plan disputes.
- Capex in the industrial business (including capitalized development costs) of about €1.6 billion in 2022 and €1.8 billion in 2023, in line with pre-pandemic levels.
- Dividend payments of €250 million in 2022, and from 2023 about 30% of prior-year profits, in line with TRATON's dividend policy.
- Nonmaterial disposals or acquisitions.

Key metrics

TRATON SE--Key Metrics*

	--Fiscal year ended Dec. 31--			
Mil. €	**2020a**	**2021a**	**2022e**	**2023f**
Units sold	190,180	271,608	295,000-305,000	305,000-330,000
Revenue	22,156	29,656	32,000-37,000	35,000-45,000
EBITDA	899	1,865	2,000-2,500	3,000-4,000
Capital expenditure	1,029	1,128	About 1,150	About 1,350
Free operating cash flow	669	716	(400)-(300)	800-1,000
Dividends	501	135	250	200-300
Debt	2,087	9,111	9,000-10,000	7,500-8,500
Annual revenue growth (%)	(16.2)	33.9	16.0-18.0	5.0-10.0
EBITDA margin (%)	4.1	6.3	6.0-7.0	9.0-10.0

TRATON SE--Key Metrics* (cont.)

	--Fiscal year ended Dec. 31--			
Mil. €	2020a	2021a	2022e	2023f
Debt/EBITDA (x)	2.3	4.9	4.0-4.5	2.0-2.5
Funds from operations/debt (%)	19.4	12.3	15.0-20.0	30.0-35.0

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess TRATON's liquidity as adequate. We estimate that the company's ratio of sources to uses will be 1.3x over the 12 months started April 1, 2022.

Principal liquidity sources for the 12 months from April 1, 2022, include:

- Cash and equivalents of about €1.5 billion as of March 31, 2022, excluding cash and cash equivalents at the financial service business, and our estimate of inaccessible cash of about €230 million.
- €3.5 billion of undrawn committed lines maturing beyond 12 months, excluding our expectation of peak commercial paper use of up to about €1.0 billion. TRATON's syndicated RCF amounts to €4.5 billion.
- Industrial's reported cash FFO of €3.6 billion-€3.8 billion over the next 12 months.

Principal liquidity uses for the same period include:

- Debt maturities at TRATON's industrial business of about €965 million over the next 12 months.
- Our assumption of working capital outflow including working capital intrayear swings of about €2.0 billion (including the change in lease assets).
- Capex of about €1.7 billion.
- Dividend payments of about €250 million.
- Cash outflow for Scania's fine payment and Navistar's settlement of about €1.4 billion - €1.5 billion.

Issue Ratings--Subordination Risk Analysis

As of March 31, 2022, TRATON's consolidated financial debt totaled about €18 billion. We continue to rate TRATON's senior unsecured debt and the €12 billion Euro medium-term notes program 'BBB'. The priority debt ratio is about 50.5% and sensitive to some swings in issuances, however we still believe the amount of priority debt will decrease over time, with new issuances at the parent level.

Environmental, Social, And Governance

ESG credit indicators: E-3, S-2, G-3

Governance factors are a moderately negative consideration in our credit rating analysis of TRATON after the revision of our management and governance score to fair from satisfactory. This primarily reflects our assessment of its parent governance, the slower-than-anticipated integration of brands under the previous management team, and higher-than-average management turnover, which somewhat affected the speed of execution. We note that TRATON faces higher-than-average execution risks, for example regarding the integration of its brands, the creation of a common financial services framework, and increasing its market shares in the U.S. while defending its market position in Europe amid worsening market conditions.

Environmental factors are a moderately negative consideration in our credit rating analysis of TRATON. The German truck maker is exposed to the challenges of managing the transition of its product portfolio toward zero-emission vehicles in light of more stringent global carbon dioxide emission regulation. Tightening emission regulation kicks in from 2025 in Europe where the group sold about 55% of its trucks in 2020. Battery electric vehicle (BEV) technology is already available for trucks, but we expect conventional engines to largely dominate the market in 2021-2025. At this stage, higher total cost of ownership for transport companies, lack of charging infrastructure, and the limited maximum range that trucks can cover with the current battery technology will constrain the scalability of these technologies, in our view. Additionally, there is still meaningful uncertainty on the evolution of carbon dioxide regulation and the margin contribution for zero-emission vehicles against conventional combustion engines in the longer term. For the first three months of 2022, TRATON sold 417 battery vehicles, about 50% of which were vans; and its BEV orders totaled 554 units.

Ratings Score Snapshot

Issuer Credit Rating	BBB/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)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Neutral (no impact)
Captive finance	Neutral (no impact)
Stand-alone credit profile:	bb+

Issuer Credit Rating	BBB/Stable/--
Group credit profile	bbb+
Entity status within group	Highly strategic (-1 notch from group credit profile)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers, Dec. 14, 2015
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Industry Top Trends Update: Autos EMEA, July 14, 2022
- Scania AB (publ.), June 30, 2022
- Bulletin: Sweden-Based Truck Maker AB Volvo Is Preparing To Embrace Electrification, June 28, 2022
- Bulletin: Daimler Truck On Track To Deliver On Its 2022 Guidance With Small Improvements Over Last Year’s Performance, June 27, 2022
- Global Heavy Truck Sales Forecast: COVID, War, And Supply Chain Woes Are Taking Their Toll In 2022, June 24, 2022
- Bulletin: TRATON's Deleveraging Prospects Affected By The €880.5 Million Antitrust Fine Imposed On Scania, Feb. 9, 2022
- TRATON SE, Dec. 14, 2021

Ratings List

Ratings Affirmed	
TRATON SE	
Issuer Credit Rating	BBB/Stable/--
TRATON Finance Luxembourg S.A.	
Senior Unsecured	BBB