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Research Update:

German Truck Manufacturer TRATON SE Assigned 'BBB' Rating; Outlook Stable

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Rating Action Overview

- TRATON SE is the leading truckmaker in Europe and South America, with market shares of about 30% in both regions. The key brands include Scania, MAN and VWCO.
- The company has started an extensive program to use similar powertrain components across the brands, where it is targeting long-term synergies of up to €700 million and over-the-cycle return on sales of about 9%, up from about 7% in 2019.
- For 2020, given the COVID-19-related recession, we expect break-even or even slightly negative reported operating profit for the industrial business, down from €1.7 billion in 2020 (6.6% margin) and a decline in adjusted funds from operations (FFO) to debt to about 30% from about 200% in 2019.
- We view the company as a highly strategic subsidiary for its 89.7% owner Volkswagen AG (VW).
- We are assigning our 'BBB' long-term issuer credit rating to TRATON.
- The stable outlook reflects our expectation that the company will successfully execute its margin and cash flow preservation measures and pursue a conservative financial policy, ensuring adjusted funds from operations (FFO) to debt of about 30% at year-end 2020 and above 60% at year-end 2021.

Rating Action Rationale

TRATON has a strong market position in Europe and Brazil, although execution risks from integrating its brands and COVID-19-related fallout will stress financial performance intensely in 2020 before improving in 2021. The rating also reflects our view of the company's solid combined market shares of its Scania premium brand, MAN, and VWCO brands. TRATON is leading the heavy duty market with a 33% share in Europe. It is also the leading operator in Brazil with about 38% market share. In addition, it holds the no. 1 position in South America overall with a 30% market share. We believe that the company's strong market position in its core markets is a competitive advantage against peers that are pursuing a follower strategy, once further integration will be accomplished. Moreover, we believe that the recent truck launches in its portfolio should support order intake once COVID-19 has been contained.

TRATON's industrial business credit metrics will weaken materially in 2020 but recover in 2021. We expect adjusted EBITDA margin will fall to about 3% from 9% in 2019, causing adjusted FFO to debt to fall to about 30% in 2020 from 200% in 2019, provided that capital expenditure (capex) for 2020 is at about €1 billion. We believe that TRATON's operating performance will be particularly affected by lower demand owing to the global recession from the pandemic. In addition, MAN is still in a parallel production phase of deploying new trucks, which is holding back margins, and the company has disbursed €1.4 billion of cash to terminate the domination and profit and loss transfer agreement (DPLTA) with its parent Volkswagen. Based on that, in our base-case scenario, we expect only break-even or even slightly negative reported operating profit for the industrial business, down from €1.7 billion in 2019. This implies that the loss reported by MAN will be balanced by Scania's operating performance, assuming some recovery in the second half from first-half 2020 lows. For 2021, we expect a marked increase in units sold, supporting a recovery of operating profit margins back to 2019 levels of 6.6% under its industrial business. Under our base-case scenario for the industrial operations, we forecast the company's FFO to debt at about 30% in 2020 from about 200% in 2019. At the same time, we expect that TRATON's industrial FFO to debt ratio will increase above 60% by 2021, sustained by improving profit margins.

We think TRATON's stand-alone credit profile (SACP) has very limited headroom in 2020 due to the very weak and currently hard to predict market. The company follows a conservative financial policy that aims to run its industrial business in a net cash position under normal circumstances. At the end of first-quarter 2020, TRATON's gross reported industrial debt, including lease liabilities, stood at €3.5 billion. Its gross cash stood at €3.4 billion. We anticipate intense credit pressure in second-quarter before cash absorption normalizes in the second half of 2020, provided that COVID-19 will be contained. On March 23, the company announced that the executive board had proposed a €1 dividend per share for 2019, subject to approval by the annual shareholder meeting, which has been postponed to a later date. Consequently, we included in our base-case €500 million cash for dividends in 2020, although shareholders haven't approved this yet. If the dividends were cancelled, we calculate that the company's adjusted FFO to debt would increase to about 40% for 2020 (all else being equal) in our base-case scenario, providing some cushion to our downgrade trigger of 30% in 2020.

TRATON's diverging brand performance and cash flow generation weighs on leverage metrics. In 2019, the company's sold 242,219 units, up 4% from 2018, about equally split between Scania and MAN. In first-quarter 2020, orders were down 16% year on year to 54,000 units, and units sold were down 20% to 46,000. Although TRATON's market reach and brand positioning are solid for both its main brands, we understand that about 80% of operating profits came from Scania in 2019. In first-quarter 2020, the company's reported industrial operating profit margin declined to 2.4% from 7.3% in first-quarter 2019. The uneven margin contribution of Scania and MAN will eventually become even more prominent in full-year 2020, since we expect operating losses at MAN and operating margins of about 4% at Scania. To face the unprecedented COVID-pandemic, with most countries in which it operates having been under lockdown and facing supply shortages, TRATON halted its production for about five weeks in March-April 2020. Therefore first-quarter operating profit was partially affected by COVID-19 and partially by MAN's parallel production. We expect units sold to decrease by 65% year on year in second-quarter to about 22,000 and by about 25% in the third quarter to about 40,000. However, in the fourth quarter, we expect units sold to be similar to 2019 at about 60,000. This would imply units sold will decrease by about 30% in 2020, before improving by about 20% in 2021 from 2020 levels.

TRATON safeguards its liquidity and cash flow generation. In 2019, the company undertook cost-cutting measures in light of gloomier truck market prospects in 2020 to gain operating flexibility. Apart from curbing costs, we anticipate that capex and some research and development spending will be contained in 2020. In addition, over the past few weeks, TRATON and its subsidiaries have closed multiple bilateral credit lines, which are on top of the permanent €3 billion undrawn lines the company has from VW. As a result, TRATON had €5.6 billion of undrawn committed lines available at March 31, 2020.

Mergers and acquisitions could materially alter the group's leverage beyond COVID-19, while the integration of its brands still entails execution risk. TRATON has several strategic projects that could increase leverage in 2020-2021. The group focuses primarily on integrating the Scania, MAN, and VWCO brands for extracting synergies. Although we continue to see the successful integration as pivotal for the rating we have assigned today, it still entails some execution risk that could result in delays to synergies and cash flow generation. Earlier this year, TRATON announced its proposition to squeeze-out MAN's minority shareholders. It holds 94.36% of MAN's share capital, while the remainder is free float. MAN's annual general meeting has been postponed, which creates uncertainty of the decision and timing. In our base-case scenario, the transaction occurs in 2021, resulting in a cash out of about €450 million. The company also holds 16.7% of NAVISTAR's share capital and has made a nonbinding tender offer to acquire the shares outstanding for $35 per share, or about $2.9 billion. Although we see the transaction increasing TRATON's market reach in North America, where it is currently not present, we acknowledge NAVISTAR's leverage (about $5 billion of S&P Global Ratings-adjusted industrial debt at Oct. 31, 2019) would put further significant negative pressure on TRATON's credit metrics. Given the offer's nonbinding nature and the uncertainty regarding the timing and price, we excluded it from our base-case scenario, so have not considered the potential transaction in our rating and outlook on the company.

We consider TRATON a highly strategic subsidiary within VW (BBB+/Negative/A-2), reflecting its strong ties with the parent company 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 strategic asset. In 2019, it contributed about 17% of VW's consolidated top line. Moreover, TRATON has access to VW's purchasing platforms and both MAN and VWCO's financial services are offered through VW's captive operations. Furthermore, VW has granted TRATON a permanent €3 billion revolving credit facility. As long as we view TRATON as a highly strategic subsidiary for VW, the long-term rating on it will remain one notch below that on VW. This would remain the case even if we revise our SACP on TRATON to 'bbb-' or below, provided VW retains a 'BBB+' long-term issuer credit rating. Our rating on TRATON could equal, but not exceed, the rating on VW if its SACP is at least equal to the rating on VW, although this is currently not the case.

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Outlook

The stable outlook reflects our expectation that TRATON will successfully execute its margin and cash flow preservation measures and pursue a conservative financial policy, ensuring adjusted FFO to debt of about 30% at year-end 2020 and above 60% at year-end 2021.

Downside scenario

We could lower the rating if we were to downgrade VW while revising downward our SACP on TRATON. The latter could follow a drop in adjusted FFO to debt well below 60% with no prospect of near-term recovery.

Upside scenario

Ratings upside could arise if the company's operating performance improves. This would be on the back of meaningful progress under its integration plans translating to a strengthening of industrial adjusted EBITDA margin to at least 10% and free operating cash flow to debt of about 25%.

Company Description

TRATON was founded in 2015 as the commercial vehicle arm of VW. The company sells trucks and buses under the Scania, MAN, and VWCO brands and is market leader in Europe and Brazil in the heavy duty truck segment (over 15 tons) with about 33% and 38% market share, respectively. It is mainly active in Europe and South America, with a footprint in 17 countries and 29 production and assembly sites. TRATON recorded revenue of more than €26 billion and adjusted EBITDA margin of 9% under its industrial business in 2019. The company sells its new vehicles supported by either Scania's financial business operations (for the Scania brand) or VW's financial services (for MAN and VWCO).

TRATON is controlled by VW group, which owns 89.7% of its share capital after a June 2019 IPO. It is listed on the Frankfurt stock exchange and the Nasdaq Stockholm. As of June 17, 2020, its market capitalization was about €9.0 billion.

Our Base-Case Scenario

Assumptions

- Real GDP growth in the eurozone will contract 7.3% in 2020 before 6.2% growth in 2021, from 1.2% growth in 2019. Brazil's real GDP will contract 4.3% in 2020, before 3.3% growth in 2021, from 1.1% growth in 2019. Despite evidence of a recovery in China, under our revised macroeconomic assumptions, we think that real GDP in Asia-Pacific will likely see just 0.7% growth in 2020 and then 6.3% in 2021, after 4.8% for 2019.
- Based on this, heavy-duty truck sales in Europe are likely to decline 30%-40% this year, depending on the speed of recovery in second-half 2020. For 2021, we expect pronounced growth of 15%-25%, but not enough to fully cover 2020 volume losses. For South America, we

expect heavy-duty trucks unit sold to fall by 10%-20% from about 18% growth in 2019, while for 2021 we see growth consolidating by 20%-30%. For Asia-Pacific, we expect a decline in commercial vehicle sales by 10%-20% this year. In addition, we still forecast another sales contraction for heavy-duty trucks in Asia-Pacific in 2021 of up to 10%, mainly because of the recent fleet expansion after regulation changes and the scheduled implementation of higher emission standards in 2021 (for more information, see "COVID-19 Will Further Slow Demand For Heavy Trucks," published May 5, 2020, on RatingsDirect).

- Our expectations for the global commercial vehicle market will likely evolve throughout the second and third quarters of 2020 as more information becomes available.
- We expect industrial reported operating profit for 2020 to be break-even or slightly negative after €1.7 billion for 2019. For 2021 we expect industrial reported operating profit of about €1.1 billion.
- We assume corporate tax rate of about 30% for 2020 and 2021 after about 24% in 2019.
- Trade working capital changes of about positive €1 billion for 2020, offset by changes in leasing and rentals of the same amount, resulting in neutral working capital. For 2021, we expect working capital of negative €1.1 billion-€1.2 billion.
- Capex in the industrial business, including capitalized development costs, will be €1.1 billion-€1.2 billion for 2020, lower than €1.5 billion for 2019. For 2021, we expect capex at 2019 levels.
- In February 2020, TRATON paid €1.4 billion to VW for the termination of the DPLTA.
- Notwithstanding COVID-19 effects, TRATON's dividend proposal hasn't been withdrawn. Therefore, we still retain about €500 million for 2020, while for 2021 we assume no dividends due to a net loss for fiscal 2020.
- TRATON will exercise the option to squeeze-out MAN minority shareholders. Although we assume that the transaction would have a positive effect on the structure of the group there could be delays in the execution, leading to a potential cash-out in 2021 of about €450 million.
- Our base-case scenario excludes any potential NAVISTAR takeover.

Key metrics

TRATON SE--Key Metrics*

	--Fiscal year ended Dec. 31--			
	2018a	**2019a**	**2020e**	**2021f**
(Mil. €)				
Truck units sold	232,994	242,219	170,000	205,000
Revenue	24,963	26,444	About 20,000	About 22,000
Revenue growth (%)	5.6	5.9	(25)	10-12
EBITDA	1,958	2,379	650-700	About 2,000
EBITDA margin (%)	7.8	9.0	About 3.0	Slighlty above 9
Free operating cash flow (FOCF)	319.9	564.0	600-700	200-250
Debt	5,418	933	About 2,100	2,000-2,500
Debt/EBITDA (x)	2.8	0.4	3.0-3.5	1.0-1.5

TRATON SE--Key Metrics* (cont.)

	--Fiscal year ended Dec. 31--			
	2018a	2019a	2020e	2021f
Funds from operations/debt (%)	26.1	196.4	25-30	Above 60
FOCF/debt (%)	5.9	60.4	30-35	About 10

*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 of liquidity will be 1.4x over the 12 months started April. 1, 2020. Our assessment primarily considers TRATON's concentrated debt maturity profile at the industrial level, with a weighted-average maturity of about 2 years as of March 31, 2020. Although we recognize that VW Group can extend part of the short-term repayments at any time, the somewhat short-term nature of the capital structure constrains our liquidity assessment.

We recognize that most of TRATON's cash is from deposits via Scania. We understand the company could use this cash if needed and, therefore, we do include cash upstreamed by Scania from our ratios and liquidity analysis. The group enjoys a covenant debt-free structure.

We expect principal liquidity sources for the 12 months from April 1, 2020, will include the following:

- Cash and equivalents of about €3.0 billion when excluding our assessment of €250 million of cash not immediately available and €100 million of cash we estimate at captive
- €4.3 billion of undrawn committed lines maturing beyond 12 months, to which we have added about €800 million lines signed in the course of the second quarter. We assess lines available in the amount of €3.9 billion after deducting our estimation of peak-commercial paper use
- Industrial unadjusted cash FFO of about €2.0 billion, including the payment of operating leases over the next 12 months.

We expect principal liquidity uses for the same period will include:

- Debt maturities under TRATON's industrial business of about €2.2 billion over the next 12 months, of which the €1 billion MAN facility from VW can be extended at any time
- Our assumption of working capital outflow including working capital intrayear swings of up to about €2.6 billion (including the change in lease assets)
- Capex of €1.2 billion-€1.3 billion
- Dividends of €500 million

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/--

Business risk: Satisfactory

- Country risk: Intermediate

- Industry risk: Moderately high
- Competitive position: Satisfactory

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers

- Diversification and 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 ratings analysis: Negative (-1 notch)
- Captive finance: Neutral (no impact)

Stand-alone credit profile: bbb

- Group credit profile: bbb+
- Entity status within group: Highly strategic (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Auto And Commercial Vehicle Manufacturing 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: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Swedish Truckmaker Scania Downgraded To 'BBB' On Expected Gradual Integration With TRATON; Outlook Stable, May 14, 2020
- Heavy Truck Manufacturer Volvo Affirmed At 'A-/A-2' In Weaker Operating Environment; Outlook Stable, May 14, 2020
- COVID-19 Will Further Slow Demand For Heavy Trucks, May 5, 2020
- Navistar International Corp. CreditWatch Implications Revised To Negative Due To Coronavirus Impact, April 15, 2020

Ratings List

New Rating	
Traton SE	
Issuer Credit Rating	BBB/Stable/--