

Research Update:

Finnish Engineering Company Outotec Rated Prelim 'BBB-' On Proposed Merger To Create Metso Outotec; Outlook Stable

October 8, 2019

Rating Action Overview

- We expect Outotec's proposed merger with Metso Minerals will strengthen its presence in minerals processing and its product offering, but its exposure to volatile, loss-making turnkey projects in its Metals, Energy, and Water business will dilute margins in the short term.
- Including Metso's recent aggregates acquisition (McCloskey) and dividend payment of about €180 million this year (€150 million by Metso Minerals), we forecast the combined entity's adjusted debt at about €1.2 billion at year-end 2019, translating into S&P Global Ratings-adjusted funds from operations (FFO) to debt of about 35% pro forma McCloskey.
- We are assigning our 'BBB-' preliminary long-term issuer credit rating to Outotec Oyj (to be renamed Metso Outotec).
- The outlook is stable because we expect the combined group will extract meaningful cost and revenue synergies from the merger and adopt a conservative financial policy, resulting in adjusted FFO to debt of about 35% at year-end 2020 and an adjusted EBITDA margin of close to 13% within 12 months after the transaction closes.

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Rating Action Rationale

Once the merger between Outotec and Metso Minerals closes, the new enlarged company--to be named Metso Outotec--will have a stronger market presence in the minerals processing industry. Approval will be sought at the companies' extraordinary general meetings in October 2019, and closing is expected in the second quarter of 2020. We anticipate the business combination will be a paper deal. We also expect the combined entity's margins and credit metrics would improve significantly within 12-24 months from closing, thanks to meaningful cost and revenue synergies, cost optimization, the complementary nature of the two businesses, and market tailwinds.

Costs to combine the two companies, alongside certain less profitable noncore loss-making businesses within Outotec's Metals, Energy, and Water division (ME&W), would temporally weigh

on profitability and potentially add volatility to profit margins. ME&W accounted for about 12.6% of combined sales in 2018, or about 60% of sales for Outotec alone. We forecast our adjusted EBITDA margin for Metso Outotec at around 12% in 2019, before decreasing at closing in 2020 due to one-off costs.

Given Metso's €300 million debt-funded acquisition of McCloskey in October 2019, to widen its aggregates business, and its generous shareholder distribution of about €180 million this year (about €150 million for Metso Minerals), we expect Metso Outotec's adjusted debt to reach around €1.2 billion by year-end 2019. The total debt would translate into FFO to debt for the combined entity of slightly above 30% at year-end 2019, or around 35% including McCloskey's pro forma EBITDA.

The company's ability to deleverage over the next 12 to 24 months will depend on its dividend policy and working capital improvements. The combined working capital for 2018 was negative by about €110 million, and we expect this will widen to between €160 million and €180 million in 2019.

The merger offers opportunities to increase the group's market relevance, without adding material geographic concentration.

On a pro forma basis, the group's sales totaled €4.2 billion (including McCloskey) in 2018, of which about 55.5% stemmed from minerals processing, 28.4% aggregates, 12.6% ME&W, 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. We also understand the group would benefit from a prominent market share in the mid-minerals processing value chain. We expect the enlarged company's product offering and ability to cross sell will increase after the merger.

The company's management expects run-rate revenue synergies of at least €150 million. Metso Minerals contributed about 70% of sales and Outotec 30% in 2018, (or about 78% for Metso Minerals pro forma McCloskey and 22% for Outotec). Metso Outotec's top line is well diversified geographically, with 42% of sales from Europe, the Middle East, and Africa, 35% from the Americas, and 23% from Asia-Pacific. Its client base is also varied, with the top 20 clients representing 20% of the top line.

During first-half 2019, both Metso Minerals and Outotec saw good business development, translating into combined orders increasing by 9.6% to €2.3 billion compared with the same period last year. For the full year of 2019, we expect combined EBITDA margins to reach about 12%.

Weaker margins at closing of the merger will likely improve within the ensuing 12 months toward 13%.

The Metso Outotec merger will initially dilute margins because of transaction costs of about €48 million in 2019-2020, integration expenses we estimate at about €100 million in 2020-2021, and Outotec's lower margins. In 2018, Outotec's S&P Global Ratings-adjusted EBITDA margins was 8.2% (excluding a €110 million provision recorded by Outotec in 2018) versus Metso Minerals' 13%.

Over the past few years, Outotec's ME&W division has posted losses. This division accounts for about 12.6% of Metso Outotec's pro forma 2018 sales and about 60% of the top line for Outotec

alone. In 2018, Outotec posted a €110 million provision for the ilmenite smelter Cristal, which has a project value €350 million, to cover penalties and cost overruns. Assuming management focuses on adding only profitable projects in the future, we expect that Outotec alone can generate EBITDA margins of 9%-10%. We perceive the company's exposure to turnkey project activities as a key risk that could weigh on our perception of business risk.

That said, we understand the group could refocus its portfolio with selected divestments to achieve EBITA (earnings before interest, taxes, and amortization) margins of about 15% in the medium term. Expected cost synergies of about €100 million should help it achieve this target.

Metso Outotec's 2018 profitability is weaker than that of peers in the capital goods sector, considering its current business risk profile. Therefore, lack of clear margin improvement after the merger is completed, or continued material risks from its turnkey project activities, could lead us to revise downward our business risk assessment.

Metso Outotec's ability to deleverage will depend on its portfolio, dividend policy, and working capital management.

In 2019, we expect cash flow after capex and shareholders' distributions to be negative by about €80 million after negative €15 million in 2018. The decline will be partly due to working capital outlays of €160 million-€180 million (negative by about €110 million in 2018) and high dividends. We note that, in 2019, Metso Corp. will distribute about 110% of its 2018 profits, while Outotec won't pay any dividends. Although the new entity's dividend policy has not yet been approved, we assumed it will mirror that of Metso, equaling a 50% payout. We also assume it will maintain a financial policy commensurate with an investment grade company.

Nevertheless, before the merger closes, both Metso Corp. and Outotec could distribute dividends that we estimate at up to €200 million (€180 from Metso Minerals and €20 million from Outotec). If this were to materialize, it would leave the company with little or no rating leeway, in our view.

In our view, high working capital outlays constrain Metso Outotec's deleveraging prospects. In 2018 and first-half 2019, Metso Minerals, unlike Outotec, recorded material working capital outlays, due to increasing sales and stocking issues that its management is addressing. Free operating cash flow for the combined entity reached 3% of sales at year-end 2018, we expect it to decrease in 2019 to 1%-2%, since we forecast negative working capital outflow of €160 million-€180 million.

We estimate FFO to debt at about 31% in 2019 (or about 35% pro forma McCloskey) and around 35% in 2020, assuming the company achieves some of its foreseen revenue and cost synergies quickly, or pre-closing dividends are in line with a 50% distribution policy.

Assuming the merger concludes as proposed, there are no additional liabilities related to shareholders' right to redeem shares in cash at fair value, and intercompany activities between Metso Minerals and Neles close with a positive inflow for Metso Minerals of €50 million-€100 million, we expect Metso Outotec's debt to reach about €1.2 billion.

We expect to finalize our rating on Metso Outotec once the transaction takes place. Therefore we expect to maintain the preliminary ratings for longer than the typical 90 days.

The final rating will depend on the company's successful transfer of €400 million notes to Metso Outotec, shareholders' approval, 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 stable outlook reflects our view that, once the merger between Metso Minerals and Outotec takes place, likely in the second quarter of 2020, the combined group will post an EBITDA margin of almost 13% in 12 months afterward, as a result of synergies and divestment of less profitable divisions.

We foresee the adjusted FFO to debt ratio approaching 35% by year-end 2020, and adjusted debt to EBITDA improving to about 2.0x, supported in the medium term by what we consider a rigorous financial policy and positive cash flow after capex and shareholder distributions. We also assume the company will not incur additional liabilities for payments to shareholders that could object to the merger.

Downside scenario

We could lower our rating on Metso Outotec (currently Outotec) if the business combination proves more difficult than we currently expect. This could materialize if, for example, exceptional one-off cash costs for integrating the two business were higher than expected, if market conditions were much less supportive than today, or if there are increased project risks. Under these scenarios, the group's EBITDA margin may fail to improve or even decline from about 11%.

Moreover, negative rating pressure could develop if FFO to debt were to fall below 30%, for example after higher-than-expected dividend distributions.

Upside scenario

Given that the proposed business combination is subject to execution risks and we already assume margin and credit metric improvements after closing, we see no rating upside over the next 24 months. That said, we could see potential for an upgrade if the group's EBITDA margin sustainably improved to well above 15% and FFO to debt improving toward 45%.

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 pro forma consolidated basis for 2018, sales totaled €4.2 billion, combined adjusted EBITDA €468 million, and adjusted debt totaled about €800 million. We estimate that, in 2018:

- Metso Minerals posted €2.6 billion in revenue and €335 million of adjusted EBITDA;
- Outotec reported €1.3 billion revenue, with adjusted EBITDA of €105 million; and
- McCloskey, whose acquisition by Metso was concluded in October 2019, reported €302 million in revenue and EBITDA of €28 million.

At year-end 2018, the combined entity's reported debt reached €793 million. We then added €123 million of lease obligations, €97 million of pension obligations, €150 million of hybrid instruments

we treat as debt, and €130 million in provisions related to Outotec, while deducting €490 million of accessible cash.

Our Base-Case Scenario

- Good market developments in 2019, supported by services. In first-half 2019, the combined group's share of services contributed 57% of sales, increasing by 100 bps from 2018.
- Over first-half 2019 the order book increased to €2.3 billion or by about 10% for the combined entity, after an increase of 17% to €4.2 billion in 2018. That said, we note a decrease in orders at Outotec's MEW division to 11%, indicating that the company is now more conscious about margins and selects only profitable orders.
- We therefore foresee revenue increasing by about 10% in 2019 to €4.3 billion versus €3.9 billion in 2018 for the combined entity. For 2020, we see revenue growth of 10%-15% to €4.8 billion. We assume somewhat milder organic growth for 2020, therefore the majority of the sale increase will be led by McCloskey.
- Given the proposed merger, we see additional costs diluting the company's EBITDA in 2019 and 2020. We project adjusted EBITDA margins at around 12% in 2019, slightly lower in 2020, and trending toward 13% in 2021. This includes a material realization of the envisaged merger synergies.
- Interest expenses are forecast at about €50 million in 2019 (including interest paid on the hybrid) broadly line with 2018 for the combined group. From 2020, we anticipate a sharp decrease in this expense to about €30 million, thanks to better interest rates and comprehensive refinancing. We assume the hybrid will be refinanced with unsecured debt.
- Working capital outlays of €160 million-€180 million for 2019 decreasing to €50 million-€70 million in 2020. This compares with negative working capital outlays of about €110 million in 2018.
- Capex of about €100 million in 2019, slightly above €80 million in 2018, before decreasing to €90 million in 2020.
- Dividends in 2019 of €140 million-€150 million, which is the portion of Metso group's dividend Metso Minerals would pay. For 2020, we anticipate dividends of €125 million-€200 million, depending on management's distribution decisions before closing.
- We assume intercompany transactions between Metso Minerals and Neles will result in a cash inflow for Metso Minerals of €50 million-€100 million.
- We also include the debt-funded acquisition of McCloskey for €300 million, plus about €50 million in one-off cash expenses over 2019 and 2020 for the Cristal project.
- We do not incorporate any incremental debt stemming from shareholders' right to request cash redemption, assuming the transaction will not generate any additional liability.

Based on these assumptions we arrive at the following:

- S&P Global Ratings-adjusted FFO to debt of about 35% in 2019, pro forma the McCloskey acquisition (or about 30% on a combined basis), and about 35% in 2020;
- Adjusted debt to EBITDA of about 2.0x in 2019, pro forma the McCloskey acquisition, and 2.0x-2.5x in 2020; and
- Negative discretionary cash flow in 2019, turning positive from 2020.

Liquidity

In our view, Metso Outotec has an adequate liquidity position because its sources cover uses by about 1.6x over the 12 months started July 1, 2019. We believe Metso Outotec has well-established relationships with banks, as one of the largest corporations in Finland. We understand that Metso has just signed a new revolving credit facility (RCF) of €600 million to support the merger. As long as Metso Outotec maintains an investment-grade rating ('BBB-' or higher) no financial covenants are applicable.

Principal liquidity sources on July 1, 2019, include:

- Our estimate of about €400 million in cash for the combined group;
- The €600 million RCF at Metso, will be available to the new entity;
- An undrawn €40 million European Investment Bank facility;
- Cash FFO of €310 million-€330 million after deducting payments for leases under IFRS 16; and
- A neutral impact of financial receivables, payables, and cash pooling between Metso Minerals and Metso Corp., since such amounts are not committed.

Principal liquidity uses as of July 1, 2019, include:

- Debt maturities of about €270 million;
- Negative changes in working capital of €110 million-€120 million on average;
- Potential intrayear working capital swings of up to €150 million;
- Capex of about €100 million; and
- Dividends of €125 million-€200 million.

Issue Ratings--Subordination Risk Analysis

Capital structure

At closing, Metso Outotec's reported debt would amount to about €1.1 billion. We expect debt to be booked at the parent level and be unsecured.

Analytical conclusions

Assuming the transaction goes ahead as planned, we would rate Metso Outotec's notes 'BBB-', the same as the issuer credit rating, since there are no significant elements of subordination risk present in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating: BBB-(prelim)/Stable/--

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)
- Liquidity: Adequate (No impact)
- Financial policy: Neutral (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

New Rating

Outotec Oyj

Issuer Credit Rating BBB-(prelim)/Stable/--

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. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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