Fitch Ratings

Fitch Affirms MTU Aero Engines at 'BBB'; Stable Outlook

Fitch Ratings - Warsaw - 25 February 2020:

Fitch Ratings has affirmed MTU's Long-Term Issuer Default Rating (IDR) at 'BBB' with a Stable Outlook.

The ratings reflect the group's stable aftermarket-driven earnings performance, alongside its improving profitability and capital structure. Fitch believes that the company's substantial investment phase peaked in 2019, which along with the continued ramp up of its new GTF engines, should lead to a material improvement in free cash flow (FCF) generation in the near term.

We believe that over the next five years, MTU should be able to achieve and maintain its increase in its earnings and cash flow generation ability, which was already evident from a stronger than expected 2019 performance. Following the strong and consistent financial performance, we believe that MTU is set to deliver sustainable FCF, which was not the case historically. The company has displayed a marked improvement in leverage, with gross leverage standing at around 1.1x at end-2019, compared with 1.4x at year-end 2017. Likewise FFO margins have improved significantly to around 20% in 2019 versus 16% at year-end 2017.

Key Rating Drivers

Improving Financial Profile: The ratings reflect MTU's improving financial profile, as evident from end-2019 gross leverage of around 1.1x, and adequate liquidity. We estimate that MTU's FFO margin will remain at around at least 17.3 % over 2020-2022, a significant improvement on the last four years' historical average of 14.6%. This demonstrates consistent cash generation improvement, primarily as a result of strong aftermarket and maintenance business and key engine programme maturity.

MTU's FCF has been on a positive trajectory since 2017, as a result of consistent investment in capacity and production ramp-up. However, given the sector's expected continued strong health, the maturity of certain large engine programmes and MTU's volume improvement will support stronger FCF generation. We expect FCF margins to remain positive throughout the medium term, albeit in the low to mid-single digit range.

Refinancing of 2023 Convertible Bond: In September 2019, MTU issued a senior, unsecured convertible bond for a total nominal amount of EUR500 million with a maturity until 2027 to partially refinance outstanding convertible bonds due 2023 with a total nominal value of EUR275 million. The net impact of the transactions was an increase in gross debt of roughly EUR100 million from 2018 levels and the extension of MTU's maturity profile till 2027.

Robust Operational Performance to Continue: We expect MTU's revenue and operating profit to continue to improve over the short to medium term, as increased maintenance, repair and overhaul (MRO) work offsets any downward pressure from increased geared-turbofan engine production volumes. The pressure on original equipment manufacturing (OEM) margins should be offset by more profitable V2500 spare parts, since airlines are flying older aircrafts amid the Boeing Max grounding. More Eurofighter, A400M and CH53-K deliveries should help sustain revenues in the military engine business.

Cash Deployment to Stay Balanced: We expect MTU's profitability and cash generating ability to follow an upward trajectory throughout our forecast period, as a result of the phasing of engine programmes. We
believe that the cash flow boost will materialise from a number of factors, primarily the maturity of certain series programmes, like the V2500 and solid growth in the MRO business. Additionally, we expect FCF to maintain its positive trajectory through the combined effect of only a moderate decline in working capital and a declining capex/sales ratio.

The stability of the group’s cash deployment strategy is key to its rating. Fitch believes that MTU is likely to continue to balance the needs of its business and shareholders while maintaining a conservative capital structure in the short to medium term. As we expect FCF generation to continue to improve in line with higher operating cash flows, the company may increase the amount of cash returned to its shareholders. However, Fitch believes that key credit metrics such as gross or net leverage are unlikely to materially change from their present levels.

Business Profile Constrains Ratings: The ratings are constrained by limited business diversification, restrained pricing power due to the company's position in the production chain, and exposure to the cyclical commercial aerospace sector. MTU's main business customer is Airbus, which accounts for roughly 60% of its OEM engine series sales.

Strong Market Position: MTU benefits from its position as a key component manufacturer for aircraft engines, exposure to a diverse range of aircraft platforms in both the commercial and defence aerospace sectors, and long-term relationships with the world's largest engine manufacturers. Fitch believes that MTU is positively exposed to aircrafts for which production rates are on the rise, including the A320neo, A220, Embraer E2, B777X, and new business jets.

Sector Fundamentals Remain Stable: Fitch expects sector fundamentals to remain stable in the short to medium term, despite the issues related to the Boeing's 737 MAX's grounding that are negatively impacting the aviation industry at present. The combined order books at Airbus and Boeing totalled a little over 12,870 aircraft at the end-2019, equivalent to over eight years of production at 2019 rates.

Limited Brexit impact: MTU has no manufacturing facilities and very few suppliers based in the UK, therefore Fitch does not anticipate any significant direct impact from Brexit. Nevertheless, Brexit may have a material impact on its customers that have key operations in the UK, indirectly affecting MTU's business.

Derivation Summary

Alongside TransDigm (B/Stable), Fitch considers MTU a tier 2 aerospace supplier. MTU is a manufacturer of the key components for aircraft engines and holds a solid market share in its niche and is highly diversified by supplying parts to a sizable portfolio of aircraft engines in both commercial and defense sectors. The company has long-term relationships with the world's largest engine manufacturers. By contrast, TransDigm is outside of the top 10 in terms of market position for aerospace suppliers, and provides a relatively diverse portfolio of small aircraft parts. The business profile is considered weaker than tier 1 suppliers: Rolls-Royce (BBB+/Stable) is the world's second-largest maker of aircraft engines while General Electric (BBB+/Negative) is the global leader. MTU has a strong financial structure compared with other tier 2 peers due to its consistent financial performance and conservative capital structure.

Key Assumptions

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Revenue growth of around 4% in 2019 and 14% in 2020, driven by both OEM and strong maintenance shop visits.
- No significant acquisitions or disposals.
- Average capital expenditure of around 6% of sales throughout our forecast period.
- Gradual improvement in dividend payout ratio towards 40%.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
- An improvement in the company's business profile, in particular via diversification into new sectors
- FFO-adjusted gross leverage sustainably below 1x
- Net cash FFO-adjusted net leverage
- FCF margin above 5% on a sustained basis

Developments That May, Individually or Collectively, Lead to Negative Rating Action
- FFO-adjusted gross leverage above 2x
- FCF margin below 3% on a sustained basis
- FFO margin below 9% on a sustained basis

Liquidity and Debt Structure

Strong Liquidity: At 1H19 the company had EUR115 million of readily available cash/cash equivalents (adjusted for EUR20 million of intra-year cash needs) and EUR586 million of available long-term committed bank lines. This compares with short-term debt of EUR42 million (excluding the financial liability programme participation liabilities, which Fitch does not treat as debt).

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Summary of Financial Adjustments

- Operating lease expenses pertaining to the real estate of the industrial operations are capitalised using a multiple of 8x
- EUR20 million is deducted from reported cash levels and treated as non-available for intra-year operating needs
- Purchase price liability adjustment: liability not considered debt; 60% of settlement cash flow considered operating, 40% investing
ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3. ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

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<th>ENTITY/DEBT</th>
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<td>MTU Aero Engines AG</td>
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RATING ACTIONS

Additional information is available on www.fitchratings.com

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