Rating Action: Moody's affirms MTU's LT Issuer rating at Baa3, outlook negative

17 Apr 2020

Frankfurt am Main, April 17, 2020 -- Moody's Investors Service, ("Moody's") has today affirmed MTU Aero Engines AG's (MTU) long term issuer rating at Baa3. The outlook has been changed to negative from stable.

RATINGS RATIONALE

The rapid and widening spread of the coronavirus outbreak, deteriorating global economic outlook, falling oil prices, and asset price declines are creating a severe and extensive credit shock across many sectors, regions and markets. The combined credit effects of these developments are unprecedented. The commercial aviation sector has been one of the sectors most significantly affected by the shock given its exposure to declining passenger traffic, travel restrictions and sensitivity to consumer demand and sentiment. More specifically, the weaknesses in MTU's credit profile, including its exposure to most airline customers across the world have left it vulnerable to shifts in market sentiment in these unprecedented operating conditions and MTU remains vulnerable to the outbreak continuing to spread. We regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety. Today's action reflects the impact on MTU of the breadth and severity of the shock, and the broad deterioration in credit quality it has triggered.

The rating affirmation considers MTU's strong balance sheet position prior to the coronavirus outbreak as a strong mitigant to the severity of the demand shock from the outbreak combined with the expectation of a performance turnaround in 2021. Furthermore, the affirmation reflects the company's proactive operational and financial measures implemented to mitigate the impact of the current market disruptions.

MTU closed year-end 2019 with a strong balance sheet position and significant headroom under its current rating category. Supported by strong demand for its engine original equipment business across most of its engine platforms as well as its MRO activities, MTU's gross leverage as measured by Moody's adjusted Debt/EBITDA stood at 2.0 at year-end 2019 (2.0x in 2018). RCF/Net debt was also robust with 52% in 2019 (56% in 2018). This provides good cushion against the current market shock.

Moody's base case assumptions are that the coronavirus pandemic will lead to a period of severe cuts in passenger traffic and deliveries of aircraft over at least the next three months with all regions affected globally. Our base case assumes there is a gradual recovery in deliveries starting in the third quarter. However there are high risks of more challenging downside scenarios and the severity and duration of the pandemic and travel restrictions is uncertain. Moody's analysis assumes an around 40% reduction in MTU's engine sales and MRO activities in 2020. Longer term we do not envisage a return to 2019 revenues before mid-2023 at the earliest (2022 revenues still expected to be 5% below 2019 levels). Under this scenario we expect MTU's leverage as measured by Moody's adjusted Debt/EBITDA to significantly exceed our downgrade trigger at year-end 2020 before reverting back to the lower end of our tolerance level for the current rating by year-end 2022.

More broadly MTU's Baa3 issuer rating remains supported by (1) the company's established position as a global supplier of engine components and subsystems, and the largest independent provider of aircraft engine maintenance, repair and overhaul (MRO) services worldwide; (2) strong order backlog (equivalent to around four years of production based on 2019 sales); (3) strong demand from airlines for narrow body aircrafts, especially A320 family equipped also with GTF engines prior to the coronavirus outbreak; (4) improvement in profitability over the past few years despite dilution from GTF ramp up.

RATIONALE FOR THE NEGATIVE OUTLOOK

The negative outlook to the current rating reflects the uncertainties related to the length of the current outbreak and the recovery pattern of demand for aircrafts and MRO services post outbreak.

Moody's base case assumes a very sharp drop in deliveries and MRO activity in Q2 2020 with a gradual recovery starting from Q3 2020 but full year 2020 deliveries and MRO activities to be 40% below 2019 levels. For 2021 and 2022, Moody's expects a gradual rebound in activity but with revenue still slightly below 2019 levels at year-end 2022. These assumptions are subject to material uncertainties notwithstanding that MTU's sizeable order backlog and good engine platform diversification (both in original equipment and MRO activities) should act as a buffer if underlying demand for aircrafts picks up more slowly than we currently expect. The supportive stance of governments around the world to protect their airlines as an important element of their transportation infrastructure also offers some comfort on recovery prospects for the industry. Lastly, an ageing fleet should support some level of aircraft demand post outbreak.

LIQUIDITY

MTU's liquidity position is deemed adequate. The company had €140 million of cash and marketable securities on balance sheet at 31st December 2019 and €564 million availability under a €600 million revolving credit facility with comfortable covenant headroom at year-end 2019. MTU has a well spread maturity profile with only €30 million maturing in 2021 and €90 million maturing in 2023. The largest maturity is not until 2027 when a €500 million convertible bond matures. We understand that MTU is currently in the process of taping the German private placement market to beef up its liquidity resources. In addition the issuer is in negotiations with its RCF lenders to add a €100 million so called corona tranche to its €600 million undrawn RCF.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATING

Positive rating pressure is unlikely in the short term. Longer term a gross leverage as measured by Moody's-adjusted debt/EBITDA below 2.5x and retained cash flow (RCF)/net debt above 35% as well as sustained positive FCF generation, with FCF/debt in the high-single digits in percentage terms could lead to positive rating pressure.

Negative rating pressure would build if leverage (Moody's-adjusted debt/EBITDA) would increase sustainably above 3.0x. A drop in RCF/Net debt below 25% on a sustainable basis and materially negative FCF generation could lead to negative pressure on the current rating. A deterioration in the group's liquidity profile would also exert negative pressure on the rating. Given the current market shock from the coronavirus outbreak we do not expect MTU's leverage to drop back to below 3.0x before 2022.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was Aerospace and Defense Industry published in March 2018 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1108840 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569 .

At least one ESG consideration was material to the credit rating action(s) announced and described above.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

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