11 May 2020 | Rating Changed Outlook to Negative

Fitch Revises MTU Aero Engines' Outlook to Negative; Affirms at 'BBB'

Fitch Ratings-Warsaw-11 May 2020:

Fitch Ratings has revised MTU Aero Engines AG's (MTU) Outlook to Negative from Stable, while affirming the aerospace group's Long-Term Issuer Default Rating (IDR) at 'BBB'. A full list of rating actions is detailed below.

The rating action is driven by our expectation of the impact on the commercial OEM (original equipment manufacturing) and MRO (maintenance, repair and overhaul) businesses for civil aviation from the rapid escalation of the coronavirus pandemic.

Fitch's rating case includes expectations for a significant global economic downturn through 2Q20, followed by a gradual recovery towards end-2020 and into 2021. Fitch expects profitability in the commercial OEM and MRO businesses will suffer in the short- to medium-term, due largely to the current grounding of most fleets and the continued limited visibility on air traffic development.

The Negative Outlook reflects the potential for a more extended coronavirus pandemic, which may result in worsening financial performance and a longer-term impact arising from reduction or cancellations in engine deliveries, further fleet grounding and significantly fewer shop visits.

We expect that free cash flow (FCF) will come under immense pressure and leverage metrics to breach our negative sensitivity by end-2020. Fitch believes that MTU may be challenged to return its credit metrics to levels consistent with a 'BBB' rating by end-2021, which would result in a downgrade.

Key Rating Drivers

Material Risk from COVID-19: The coronavirus pandemic presents a material risk to MTU's operations in the short- to medium-term and may result in significantly weaker financial performance in 2020 and 2021. MTU has taken actions in response to a sharp drop in global air traffic, including the suspension of a large proportion of its operations across Germany and Poland for three weeks, and a return to normal activities based on developments of the coronavirus infection, customer demand and supply chain reliability.

Sharp Demand Cuts: With global aircraft carriers announcing major production cuts for 2020, we expect aircraft engine orders will experience significant deferrals and or, to a lower extent, cancellations. Given continued limited visibility on air traffic development and current grounding of most fleets, Fitch expects the OEM and aftermarket business to see sharp demand reduction. We expect MRO will also see a large reduction in commercial operator shop visits, in turn significantly impacting profitability. Positively Fitch believes that military OEM will remain largely unaffected. MTU has stated that the freighter business, which albeit a much smaller profit contributor, has witnessed some positive momentum.

Cash Conservation Efforts: MTU has taken a number of measures to cut operating costs to help conserve cash, including reducing payroll costs through fewer working hours, significant cutbacks on general expenses and reduction in R&D expenses. MTU will also cut down and defer capex plans for 2020 and 2021 and postpone dividends distribution in 2020. It has also stated its intention to focus on working capital management, which includes adjusting the supply chain to lower output demand, and closely monitoring accounts receivables.

Liquidity Headroom Improvement: MTU has taken various actions to improve liquidity in recent weeks, including the increase of its existing EUR600 million revolving credit facility (RCF), which was unutilised at the start of the year, by an additional EUR100 million 'corona tranche'. The new tranche is committed for 12 months with two extension options at six months. Additionally MTU has issued EUR100 million promissory notes (Schuldschein) with a tenor of 400 days.

Resilient Capital Structure: MTU has a strong and stable capital structure. Funds from operations (FFO) leverage has been improving since 2016, at an average of less than 1x in recent years, and debt levels are expected to remain broadly stable in the near future. FFO margins were also historically solid at an average of more than 16% in the last four years, while FCF margins were less resilient. In light of the pandemic, we expect that FCF will come under immense pressure and leverage metrics to breach our negative sensitivity by end-2020. However, given the several measures MTU is undertaking to reduce and manage costs, Fitch believes that, albeit challenging, the negative trend could be reversed by end- 2021.

Good 1Q20 Results: MTU delivered solid 1Q20 results, which were largely in line with our pre-COVID-19 expectations. Revenue increased 13% to almost EUR1.3 billion, driven by a strong MRO business. Group adjusted EBIT was down 3% at EUR182 million, resulting in an EBIT adjusted margin of 14.3%. Total OEM revenues were stable at around EUR500 million. OEM military revenues were down slightly to EUR98 million, while OEM commercial increased by an annual 4% to EUR400 million, while revenues from spare parts were roughly stable. This business mix led to a decrease in adjusted OEM EBIT to EUR116 million with a margin of 23%. MRO revenues increased 21% to EUR795 million and adjusted EBIT rose 16% to EUR66 million, resulting in an adjusted EBIT margin of 8.3%.

Derivation Summary

Fitch considers MTU a tier 2 aerospace supplier. It 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. It has long-term relationships with the world's largest engine manufacturers.

Its business profile is considered weaker than that of tier 1 suppliers such as Rolls-Royce plc (BBB+/Negative), which is the world's second-largest maker of aircraft engines while General Electric Company (BBB/Stable) 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

- A 27% yoy decline in consolidated revenues for 2020 at an EBITDA margin of 10% compared with 2019 EBITDA margin 18%

- No dividends distribution in 2020 with a gradual resumption in 2021

- A 20% reduction in capex versus previous guidance for 2020 and 2021 and a return to normal levels in 2022

- Repayment of the Schuldschein by 2021

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- An improvement in the business profile, in particular via diversification into new sectors

- FFO leverage sustainably below 1x

- Net cash position

- FCF margin above 5% on a sustained basis

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- FFO leverage above 2x

- FCF margin below 3% on a sustained basis

- FFO margin below 9% on a sustained basis

Best/Worst Case Rating Scenario

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

Liquidity and Debt Structure

Strong Liquidity: At end-1Q20 MTU had EUR136 million (net of our EUR20 million adjustment for intra-year operational cash requirements) and EUR600 million of available long-term committed bank lines. This compares with short-term debt of EUR12 million (excluding the financial liability programme participation liabilities, which Fitch does not treat as debt).

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING
The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations
The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

MTU Aero Engines AG; Long Term Issuer Default Rating; Affirmed; BBB; RO:Neg
; Short Term Issuer Default Rating; Affirmed; F2
----senior unsecured; Long Term Rating; Affirmed; BBB

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Additional information is available on www.fitchratings.com

Applicable Criteria
Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)
Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)
Short-Term Ratings Criteria (pub. 06 Mar 2020)

Applicable Model
Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

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