

LANXESS AG

Germany, Specialty Chemicals


BBB STABLE

Corporate profile

LANXESS AG, based in Cologne, Germany, is a leading producer of specialty chemicals. The company was founded through a spin-off from Bayer AG in 2004. An IPO was also carried out in 2005. LANXESS operates in 25 countries, has 75 production sites and employs about 19,200 staff. In 2004, most revenues were generated through the production of synthetic rubber and basic chemicals. However, in 2012/2013 synthetic rubber prices decreased significantly due to large investment by market participants into production expansion. The resulting overcapacity in synthetic rubber production prompted LANXESS to adjust and restructure its portfolio. The company founded ARLANXEO as a joint venture in 2016, to which it transferred its synthetic rubber activities. Then in 2017, it acquired Chemtura and the 'Clean and Disinfect' business of Chemours (2016), two US-based companies. The two acquisitions strengthened LANXESS's position as a mid-sized producer of specialty chemicals, expanding its mix of end-markets. Before this, the company was active mainly in automotive, tires, agricultural, consumer goods, construction, and food and beverages; now it operates over four divisions: Advanced Intermediates, Performance Chemicals, Engineering Materials, Specialty Additives, and ARLANXEO (synthetic rubber).

Key metrics

Scope credit ratios	2016	Scope estimates		
		2017F	2018F	2019F
EBITDA/interest cover (x)	5.8x	6.9x	8.5x	7.2x
Scope-adjusted debt (SaD) /EBITDA	0.8x	2.2x	1.7x	1.6x
Scope-adjusted FFO/SaD	89%	35%	47%	46%
Free cash flow/SaD	21%	6%	23%	19%

Rating rationale

Scope Ratings assigns a BBB issuer rating to Germany-based LANXESS AG. The short-term rating is S-2. The rating Outlook is Stable.

The corporate credit rating mainly reflects Scope's perception of LANXESS's protected position in specialty chemicals, its market positions in various niche markets, which are mostly concentrated in its supply structure, and the credit-supportive financial risk profile, which includes management's commitment to a cautious financial policy. In addition, Scope views positively the company's segment diversification in terms of revenues and EBITDA generation.

In Scope's opinion, business risk profiles for specialty chemicals companies generally exhibit medium sensitivity to GDP changes as well as medium entry barriers. The industry contains a wide range of different-sized companies, and factors such as production expertise and customer relationships in end-markets provide de facto entry barriers. Scope also considers substitution risk to be low, as specialty chemicals are often critical inputs for a wide range of markets, with few or no substitutes.

Ratings & Outlook

Corporate rating	BBB/Stable
Short-term rating	S-2

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Related methodology

Corporate Rating Methodology, January 2017

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In 2012/2013 synthetic rubber prices decreased significantly due to large investment by market participants into production expansion. The resulting overcapacity in synthetic rubber production prompted LANXESS to adjust and restructure its portfolio. To this end, the company formed a joint venture (ARLANXEO) with Saudi Aramco in 2016, to which it transferred its synthetic rubber activities. From 1 April 2019, the company will account for this joint venture using the equity method – in Scope's view, this implies a high likelihood to exit the synthetic rubber segment. This would also decrease its presence in the more cyclical automobile and tire segments (major end-markets for synthetic rubbers), which currently comprise around a quarter of total revenues.

The diversification of LANXESS mirrors that of a specialty chemicals company, even including its present large exposure to synthetic rubbers. In 2017, the company improved its diversification by acquiring two US-based businesses: Chemtura, a specialty chemicals producer whose products dominate their respective markets (transaction closed on 21 April 2017); and the 'Clean and Disinfect' business of Chemours (transaction closed on 31 August 2016).

While credit metrics deteriorated during 2013-15 due to the organisational changes and intense competition in synthetic rubbers, they improved substantially in 2016. The improvement in 2016 was driven by cash inflows from foundation of ARLANXEO followed by the Chemtura acquisition in 2017. Credit metrics are thus likely to deteriorate in 2017 in a year-on-year comparison, due to the acquisition while LANXESS had a strong year operationally.

For 2018 and 2019, Scope expects overall credit metrics to improve: SaD/EBITDA should fall below 2x; FFO/SaD to increase to about 46%. There is also the potential to increase product prices thanks to the two acquisitions and continued growth in end-markets. After integration of the Chemtura and Chemours businesses, Scope expects better profitability as well as lower cyclicity for EBITDA from 2018 onwards. Moreover, the financial risk profile is supported by company's better-than-adequate liquidity management over the last few years, with internal and external liquidity sources covering short-term debt by well over 100%.

Scope considers LANXESS's financial policy to have a balanced approach towards shareholders and debtholders, which the agency does not expect to change in the foreseeable future. In 2014, LANXESS's liquidity was strengthened through an increase in capital by about EUR 400m. In 2016, a share buyback was cancelled to finance the Chemtura acquisition. Management's strong commitment to maintaining the investment grade rating is also a positive factor.

Rating drivers

Positive rating drivers

- Strong position in niche and medium-sized markets
- Well diversified by end-markets
- Geographically diversified revenue structure
- Moderate dividend payout policy
- Cautious financial policy (i.e. selective M&A strategy, management tools for maintaining credit rating)

Negative rating drivers

- Weak profitability and free cash flow compared to specialty chemicals sector for several years
- Cyclical nature of specialty chemicals sector is medium

Rating-change drivers

Positive rating-change drivers

- EBITDA margins sustained at 15%
- More balanced end-market mix
- Potential ARLANXEO proceeds can be used to reduce debt

Negative rating-change drivers

- Declining economic activity affecting revenue from automotive or construction segments
- Inability to pass on significant price increases for commodity chemicals and electricity, leading to single-digit EBITDA margins
- Large inorganic growth projects financed with debt



Financial overview

		Scope estimates		
Scope credit ratios	2016	2017F	2018F	2019F
EBITDA/interest cover (x)	5.8x	6.9x	8.5x	7.2x
Scope-adjusted debt (SaD)/EBITDA	0.8x	2.2x	1.7x	1.6x
Scope-adjusted FFO/SaD	89%	35%	47%	46%
FOCF/SaD	21%	6%	23%	19%
Scope-adjusted EBITDA in EUR m				
EBITDA	995	1,273	1,480	1,236
Operating lease payments in respective year	61	70	70	46
Other				
Scope-adjusted EBITDA	1,056	1,343	1,550	1,282
Scope-adjusted funds from operations (FFO) in EUR m				
EBITDA	995	1,273	1,480	1,236
less: (net) cash interest as per cash flow statement	-63	-86	-75	-75
less: cash tax paid as per cash flow statement	-184	-192	-253	-259
add: depreciation component operating leases	48	54	54	35
Scope-adjusted funds from operations	796	1,048	1,206	937
Scope-adjusted debt in EUR m				
Reported gross financial debt	2,312	2,312	2,312	2,312
Hybrid bond	250	250	250	250
less: cash, cash equivalents	-2,543	-779	-1,182	-1,492
Cash not accessible	0	0	0	0
add: pension adjustment	479	753	753	628
add: operating lease obligation	270	328	328	224
Other	128	128	128	128
Scope-adjusted debt	895	2,991	2,589	2,050

Business risk profile

Overall cyclicality of specialty chemical industry is medium

LANXESS's industry risk profile is supported by our view of the low substitution risk and medium market entry barriers in its segments. About 66% of revenues (end-2017) come from specialty chemicals and additives, which are often major inputs for a wide variety of markets such as construction, automotive, agricultural, consumer goods or pharmaceuticals. The resulting sensitivity to these markets is a drawback, in our view, and we judge the overall industry cyclicality of specialty chemicals to be medium.

More diversified end-market mix

In accordance with our corporate ratings methodology, we assess the business risk profile by considering the company's different operating divisions. For LANXESS this consists mainly of specialty chemicals, with a smaller presence in synthetic rubbers. The latter is characterised by commodity chemicals, mass production, and high capital requirements. In 2015 the company agreed a joint venture with Saudi Aramco, and transferred its synthetic rubber business to the newly formed entity, ARLANXEO; LANXESS received about EUR 1.2bn of proceeds in return. The improved structure and operating competitiveness, combined with the Chemtura and Chemours acquisitions, led to a more diversified mix of revenue and earnings (see figure 1).

The Chemtura acquisition not only broaden the mix of end-markets but also enhanced overall diversification, evidenced by increases in both the number of end-markets and their respective share in total revenue (see figure 2). Nevertheless, we consider LANXESS to exhibit high exposures to the automobile sector at consolidated level (including ARLANXEO), and we believe a greater share of less cyclical end-markets, such as pharmaceuticals or consumer products, would benefit profitability during economic downturns.

Strong position in medium-sized markets

Most of LANXESS's products compete in medium-sized markets, which are concentrated and dominated by few players. LANXESS in our view mostly holds strong market position in an overall broad product portfolio. The company is also a leading producer of organic pigments and flame-retardant chemicals. Its position in synthetic rubbers is somewhat weaker (this segment is much less concentrated than specialty chemicals), though ARLANXEO still ranks well as measured by total production capacity.

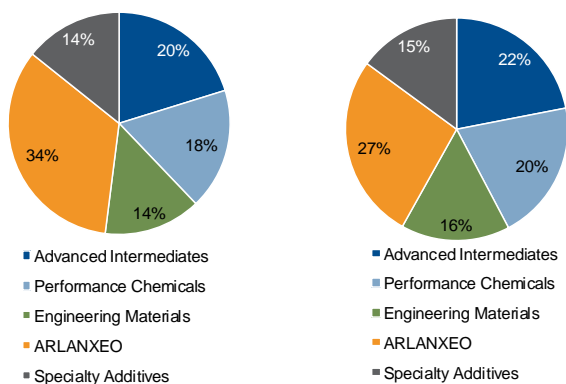
Positive effects of ARLANXEO's equity consolidation

From 1 April 2019, LANXESS will account for the ARLANXEO joint venture using the equity method. As such Scope considers it highly likely that the company will exit synthetic rubbers in the medium to long term. The new accounting method would have several benefits for LANXESS, notably a broader revenue mix (see figure 2), having 100% of EBITDA generated in specialty chemicals, and a lower sensitivity to commodities (butadiene) and their price volatility.

Increasing and less volatile profitability expected

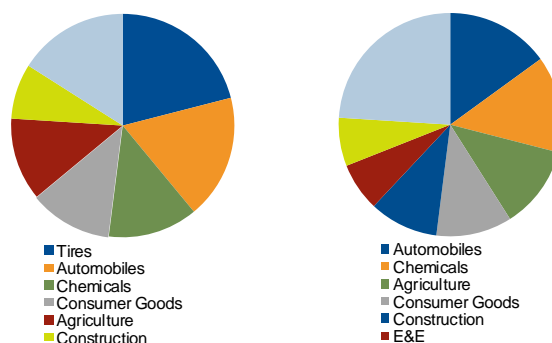
The medium earnings cyclicality of specialty chemicals companies is a slightly negative rating factor in general. Added to this, LANXESS's profitability was affected negatively by its organisational realignment (EUR 50m in 2016; EUR 160m in 2017), which was necessary for restructuring and for integrating the acquired companies. For the next two years, we forecast profitability to increase and be less volatile. This is based on anticipated results from portfolio adjustments and the potential for selective inorganic growth in the next years. Scope sees room for increased product prices in several end-markets as well.

Figure 1: Revenue and EBITDA breakdown by divisions, 2017E



Source: Scope estimates

Figure 2: End market mix 2015 and 2017F (excl. ARLANXEO)



Source: LANXESS

LANXESS credit metrics in last years have been affected by organisational realignment and modification of portfolio

High likelihood for continuing growth in markets

ARLANXEO's equity consolidation with limited effect on credit metrics

Financial risk profile

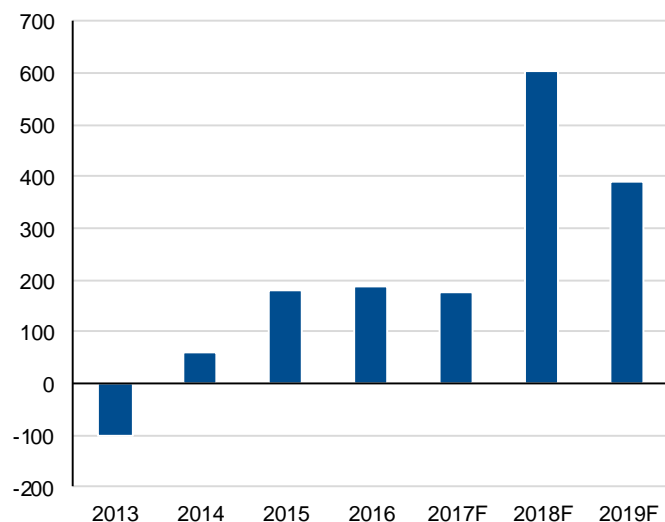
The organisational realignment and the integration of acquired companies affected LANXESS's credit metrics negatively between 2013 and 2015. Metrics improved in 2016, boosted by proceeds received in connection with the ARLANXEO joint venture. Operationally, 2017 was a good year for LANXESS, reflecting ongoing market demand and rising selling prices for many of the company's products. Consolidated EBITDA is thus very likely to improve in 2017 by about 26% from the previous year (+27% in first nine months of 2017), which will include the additional revenue from consolidating Chemtura from 21 April 2017. However, the Chemtura acquisition and related one-off costs of about EUR 160m will again depress credit metrics and free cash flow to about EUR 200m in 2017.

Scope expects the overall financial risk profile to improve significantly in 2018 as well, a result of continuing positive volume and pricing trends for most of LANXESS's specialty chemicals products as well as significantly lower one-off costs in that year. Moreover, Scope expects positive effects of synergies up to EUR 60m until 2020. Bolstered by LANXESS's strong rating commitment, we expect free cash flow generation to recover significantly, which will result in a speedy deleveraging in 2018 and 2019.

In general, Scope considers the chemical sector to be in a late phase in the cycle, implying the risk of a potential downturn in medium term. To address this, Scope performed a stress scenario reflecting 2008/2009 characteristics. Despite the significant changes in LANXESS's structure since 2009, Scope believes that the corporate structure is much more resilient today (see figure 2). Scope views positively that the company's financial risk profile is likely to remain at BB even in the modelled stress scenario. So, it is unlikely in our view that LANXESS's corporate rating of BBB will come under pressure significantly in such a stress scenario.

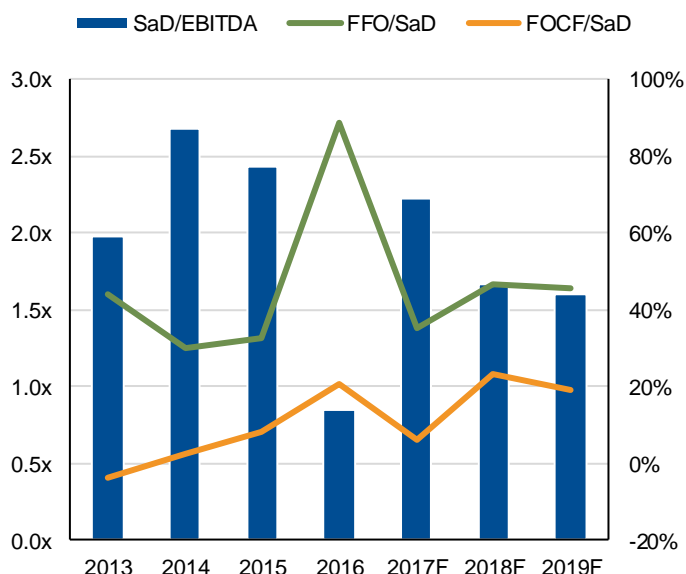
In 2019, credit metrics will be affected by the new accounting method for ARLANXEO, by lowering both EBITDA and free cash flow. On the other hand, Scope expects an increase of consolidated EBITDA margin, as ARLANXEO's profitability – lower than that of LANXESS's other divisions and consolidated EBITDA margin (2017F: ARLANXEO; 12%; LANXESS 13%) – will be stripped out of the consolidated result. Scope expects the new accounting treatment to have a limited impact on LANXESS's credit metrics.

Figure 3: Free cash flow, 2013-2019F



Source: Scope

Figure 4: Key credit metrics, 2013-2019F



Source: Scope

Overall, we view the company's liquidity management as better than adequate (as per our methodology). Internal and external sources of liquidity exceeded short-term debt by about 4x in 2016, despite funds from operations being mostly flat during 2014-16, because the company is actively transforming its debt maturity profile, including its mix of financial instruments.

Better-than-adequate liquidity management

Financial policy: equal treatment for share- and debtholders

Supplementary rating drivers

Scope views positively that past acquisitions and operational realignments were financed through a range of sources. LANXESS increased capital, issued a hybrid bond and various corporate bonds, and received proceeds for the joint venture while maintaining dividend levels. We also view positively management's commitment to maintain its credit rating. For instance, 50% of the EUR 500m hybrid bond issued to finance the Chemtura acquisition is considered equity, lessening the impact on debt. Furthermore, in 2016 the announced buyback was suspended because of Chemtura acquisition.

Short-term rating

S-2 short-term rating

Scope has assigned a short-term issuer rating of S-2, based on our assessment of LANXESS's liquidity and long-term issuer credit rating. Alongside an undrawn revolving credit facility of about EUR 1,250m, liquidity is supported by a conservative approach to liquidity and maturity transformation. Liquidity to short-term debt was about 4x in 2016 including internal and external sources.



Outlook

The Stable Outlook reflects Scope's expectation of ongoing growth in the company's revenue and EBITDA, based on positive acquisition-related effects and a solid economic environment. In 2018, we expect SaD/EBITDA to improve to around 1.7x and a OFCF/SaD to about 23%. These levels accord with our rating outlook and a BBB financial risk profile.

A higher rating may be triggered if EBITDA margin is sustained above 15%, combined with a SaD/EBITDA of less than 1.5x and an FFO/SaD of above 50%. We currently view the probability of a positive rating action as remote.

A negative rating action could result from worsened trading conditions, such as increased feedstock prices, that lead to a single-digit EBITDA margin; or from the initiation of large, debt-funded M&A. An increase of SaD/EBITDA to above 3.0x or a decrease in FFO/SaD to below 30%, both on a sustained basis, may also prompt downgrades.



Stress testing & cash flow analysis

No stress testing was performed. Scope performed its standard cash flow forecasting for the company.

Methodology

The methodology used for this rating(s) and/or rating outlook(s) Corporate Rating Methodology 2017 is available on www.scooperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on <https://www.scooperatings.com/#governance-and-policies/regulatory-ESMA> Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): <http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml>.

A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies on www.scooperatings.com. The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The rated entity and/or its agents participated in the rating process.

The following substantially material sources of information were used to prepare the credit rating: public domain, the rated entity, third parties and Scope internal sources.

Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds on which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

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Lead analyst Olaf Tölke, Managing Director

Person responsible for approval of the rating: Werner Stäblein, Executive Director

The ratings/outlooks were first released by Scope on 30.01.2018.

Potential conflicts

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