17 December 2021

Corporates

Elkem ASA
Norway, Integrated Chemicals

SCOPE BBB STABLE

Corporate profile

Elkem ASA is a fully integrated chemicals producer operating in the silicone value chain, from quartz to silicon and downstream silicone specialities as well as speciality ferrosilicon alloys and carbon materials. Elkem has three business divisions: Silicones (fully integrated silicone production); Silicon Products (silicon, ferrosilicon, foundry alloys, micro silica and related speciality products); and Carbon Solutions (electrode paste and speciality products supplied to the ferroalloy, silicon and aluminium industries). The products are sold to a wide range of industries and have various applications. The company has 29 production plants, 6,800 employees, broad sales networks and agents worldwide. In 2018, Elkem was re-listed on the Oslo Stock Exchange but remains majority owned (52.9%) by Bluestar Elkem International Co. Ltd S.A. (Bluestar), which itself is owned by a Chinese state-owned enterprise (a joint company between ChemChina and Sinochem).

Key metrics

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover (x)	12.5x	11.8x	26.7x	19.4x
Scope-adjusted debt (SaD)/EBITDA	2.1x	3.1x	0.9x	1.7x
Scope-adjusted FFO/SaD	34%	25%	92%	50%
Free operating cash flow (FOCF)/SaD	-6%	-2%	21%	-3%

Rating rationale

Scope Ratings GmbH (Scope) has assigned a BBB/Stable issuer rating to Norway-based Elkem ASA. Scope has also assigned a BBB senior unsecured debt rating and a S-2 short-term rating.

Elkem's business risk profile reflects its moderate market position as the fifth largest manufacturer of silicones worldwide and the third largest manufacturer of silicon metal (excluding China and Chinese-based producers). That said, Elkem dominates smaller or niche markets such as electrode paste. We believe Elkem will maintain its strong cost position in the global silicone industry, which is protected by high entry barriers. The company's diversification benefits from a solid footprint with 29 production plants around the globe, and the widespread and diverse application of silicones. Still, diversification is hampered by the moderate contribution of speciality chemicals products to sales, which makes Elkem vulnerable to price declines and limits its ability to exert real price setting power. The historical long-term average profitability (EBITDA) margin of below 15% is a slightly negative factor in relation to our methodology thresholds for profitability and efficiency and compared to key competitors. However, we see potential for the margin to stay above 15% in the next few years based on the high prices in the market in 2021 and the effects of the company's recent investment and cost efficiency programmes.

Elkem's financial risk profile has significantly improved in 2021, following the equity issue in April (NOK 1.9bn) and better operating profitability. As of September 2021, leverage (Scope-adjusted debt [SaD]/EBITDA) is around 1x. We expect Elkem to maintain this leverage ratio within the company's financial policy range of 1-2x going forward despite increased investments.

In recent years, Elkem has been able to fund reinvestment capex through internally generated cash flow with acceptable margins. However, additional strategic growth

Ratings & Outlook

Issuer rating	BBB/Stable
Short-term rating	S-2
Senior unsecured rating	BBB

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Related Methodologies

Corporate Rating Methodology, July 2021

Rating Methodology Chemical Corporates, April 2021

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investments led to negative cash generation in the last couple of years. Thus, the cash flow cover ratio is currently the weakest element in Elkem's financial risk profile. Although the company could see positive free operating cash flow (FOCF) going forward as prices are high, discretionary cash flow (adjusted for strategic M&A and dividend expectation) is likely to be negative.

No rating adjustments have been made for the supplementary rating drivers of financial policy or parent support. We consider Elkem's financial targets to be sound and are confident that management will strive to preserve the capital structure if market conditions weaken or expansionary investments are high. As regards parent support, Elkem is majority-owned by Bluestar, resulting in an indirect ownership by the Chinese government through the ChemChina/Sinochem holding companies. While we acknowledge the proven co-operation between Elkem and its direct parent, this factor does not lead to an explicit rating uplift.

Outlook

Stable Outlook

The Stable Outlook assumes unchanged financial targets by the company, which should result in prudent strategic growth ambitions and keep SaD/EBITDA in the 1-2x range in the medium term.

Ratings upside

A positive rating action could be warranted if Elkem sees higher profitability and fewer strategic growth investments, generating positive and sustained free operating cash flow directed towards strengthening the balance sheet, exemplified by SaD/EBITDA below 1.0x on a sustained basis. Moreover (in the longer term), a positive action could also occur if the overall business risk factors improve by way of increased specialty chemical exposure or a general improved competitive position.

Ratings downside

A negative rating action is possible if SaD/EBITDA reaches above 2.5x on a sustained basis, due to a more aggressive growth strategy or tougher market conditions.

Rating drivers

Positive rating drivers	Negative rating drivers
• Pure player in the global silicone industry with strong cost position; considerable industry entry barriers • Solid global footprint across 29 production plants, with strong niche positions • Showing willingness to issue equity to enable growth within its financial leverage targets • Broad application of silicone in many industries	• Medium-sized player in global silicon metal and silicone • Moderate contribution of speciality-like products to sales • Cyclical end-markets account for more than 50% of sales

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Higher profitability and fewer strategic growth investments, generating positive and sustained free operating cash flow • SaD/EBITDA of below 1x on a sustained basis • Overall business risk factors improve by way of increased specialty chemical exposure or a general improved competitive position	• More aggressive growth strategy or tougher market conditions • SaD/EBITDA of above 2.5x on a sustained basis

Financial overview, numbers in NOK m

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover	12.5x	11.8x	26.7x	19.4x
Scope-adjusted debt (SaD)/EBITDA	2.1x	3.1x	0.9x	1.7x
Scope-adjusted FFO/SaD	34%	25%	92%	50%
Free operating cash flow (FOCF)/SaD	-6%	-2%	21%	-3%
Scope-adjusted EBITDA	**2019**	**2020**	**2021E**	**2022E**
EBITDA	2,626	2,491	5,951	4,515
Operating lease payments in respective year	-	-	-	-
Other items	-	-	-	-
Scope-adjusted EBITDA	**2,626**	**2,491**	**5,951**	**4,515**
Scope-adjusted funds from operations (FFO)	**2019**	**2020**	**2021E**	**2022E**
EBITDA	2,626	2,491	5,951	4,515
less: (net) cash interest as per cash flow statement	-210	-211	-223	-232
less: cash tax paid as per cash flow statement	-559	-192	-834	-455
add: depreciation component, operating leases	-	-	-	-
Other items affecting cash flow (net)	4	-140	20	20
Scope-adjusted funds from operations	**1,861**	**1,948**	**4,913**	**3,847**
Scope-adjusted debt (SaD)	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt	9,602	10,481	9,689	11,789
less: unrestricted cash and cash equivalents	-4,496	-3,154	-4,704	-4,476
add: pension adjustment	237	277	277	277
add: operating lease obligations	-	-	-	-
Contingent liabilities	101	100	100	100
Other items	-	-	-	-
Scope-adjusted debt	**5,444**	**7,704**	**5,362**	**7,690**

Business risk profile

Industry risk profile: BBB

We consider companies acting as integrated players in the chemicals industry to face high revenue and earnings cyclicality. In particular, base chemicals and petrochemicals are very sensitive to economic developments. However, portfolio cyclicality is partly balanced by less cyclical speciality chemicals. In addition, producers acting as integrated chemical companies are protected by high entry barriers and medium substitution risk. Base chemicals are also the backbone of many aftermarkets.

No dominance of big markets; favourable cost position

Elkem's business risk profile is supported by its strong market position despite a lack of dominance in the global silicone and silicon metal markets. This market position is mainly due to: i) Elkem's integrated business model, with two quartz mines in Norway and four in Spain securing the company's raw material demand for the next 30 years; ii) the acquisition of Elkem by China's Bluestar in 2011, in tandem with the country's low production costs due to the presence of the world's largest reserves of cost-efficient silicon metal; and iii) the aim to keep capacity utilisation high by extracting value at different stages in the value chain. For instance, the ability to boost sales of silicone intermediates in the case of soft demand for specialty silicones provides flexibility. In parts of the silicone industry, a strong cost position is required to ensure that imports are successful, due to the commodity-like features of silicones.

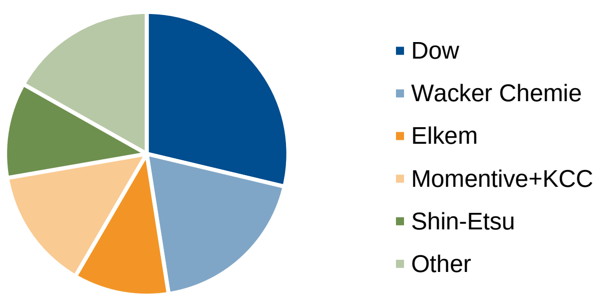
Leading position in various small or niche markets

Elkem is within the top-five largest manufacturer of silicones worldwide (figure 1) and top-three of the largest manufacturer of silicon metal (excluding China and Chinese-based producers, figure 2). The company is more dominant in smaller or niche markets such as the production of electrode paste (Carbon Solutions division) used for steel (ferroalloys), among others. Here, the company offers branded products including ELSEP® and Elkem Søderberg electrode paste. Prices are negotiated with each individual customer.

Substantial entry barriers

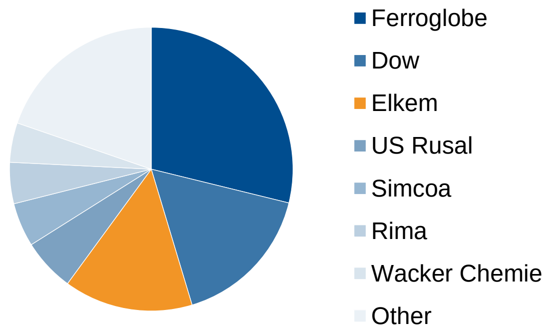
Elkem's market position is further bolstered by the likely stable sector landscape, given the consolidated market and high entry barriers, in contrast to the processing of many oil-based materials. It also benefits from a low likelihood of being affected by tighter anti-dumping regulation, as China's silicon metal production comprises a limited share of exports to North America.

Figure 1: Estimated global silicones market positions by producers



Source: Elkem, Wacker, Scope

Figure 2: Global production[1] breakdown for silicon metal (excluding China and Chinse-based producers)



Source: Elkem, CRU, Scope

[1] *Please note this includes also captive production, e,g. Dow and Wacker*

Elkem's diversification is moderate. The company is a fully integrated silicone producer, and its portfolio has a moderate proportion of speciality-like products.

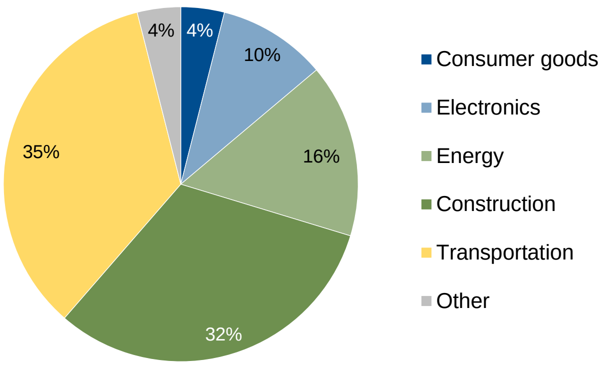
High share of cyclical end-markets

These two aspects make Elkem sensitive to a fall in commodity prices. Moreover, Elkem's portfolio is exposed to highly cyclical end-markets such as automotive and construction markets. The wide application of Elkem's products in many industries, in different quantities and degrees of purity, mitigates these risks, but is ultimately insufficient to offset the overall industry's cyclicality.

Solid global footprint

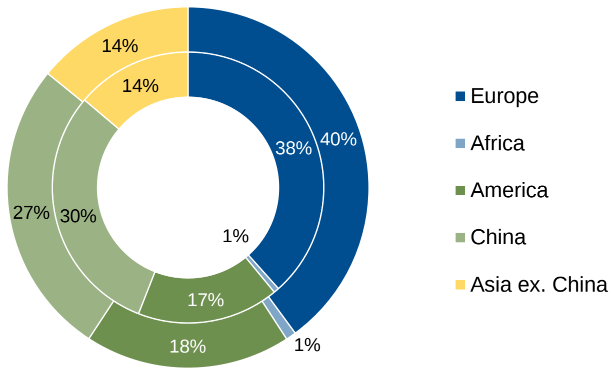
Geographical diversification is satisfactory. Elkem has a solid global footprint, with plants in about 30 countries. Moreover, the high concentration on China (around 25%-30% of sales) is reasonable as the country is the world's largest market and fastest growing market for silicones and offers low-cost production.

Figure 3: Elkem's end-markets



Source: Scope, Elkem

Figure 4: Geographical diversification 2019 and 2020

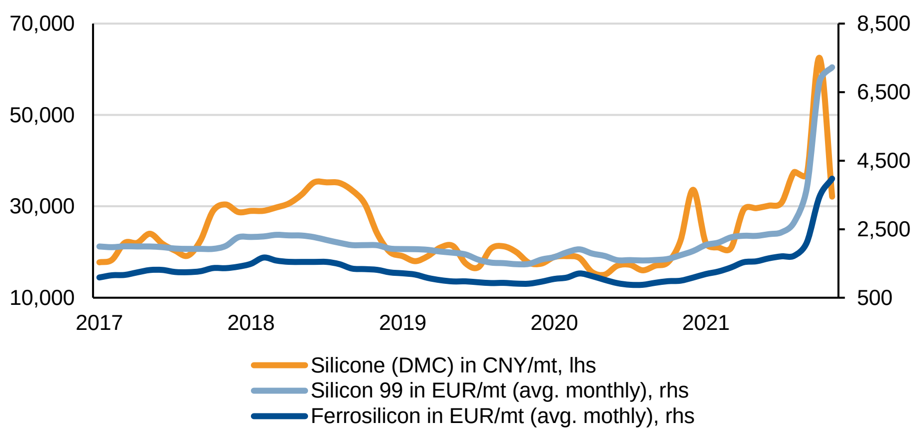


Source: Scope, Elkem

Very strong profitability (EBITDA) margins in 2021 are not sustainable…

In accordance with our rating methodology on chemical corporates, we focus on the through-the-cycle EBITDA margin when assessing profitability and operating efficiency. The company's EBITDA margin averaged slightly below 15% between 2013 and 2020. Historically, Elkem's EBITDA margin has been lower than that of major competitors. This is mainly due to: i) the lower EBITDA contribution of speciality products; ii) the simpler production processes and weaker cost structures of products such as ferrosilicon; and iii) the generally higher costs in Norway.

Figure 5: Development of key market prices



Source: Scope, Bloomberg, Elkem

…but we still expect margins in 2022 to be higher than historical levels

Going forward, we believe the EBITDA gap will be closing, as Elkem's investment programme should strengthen the company's position in the silicones market and further support its specialisation strategy, which also will improve its overall cost position. Moreover, Elkem's integrated structure makes its profitability less sensitive to raw material prices than other oil-based chemicals production companies. Our rating case anticipates an EBITDA margin above 15% for 2022 (and moving towards 17%-18% in the longer term), despite significantly lower silicone reference prices next year as the spike in 2021 is not expected to be sustainable.

Financial risk profile

Financial risk profile: BBB+

Elkem's financial risk profile has significantly improved during 2021, following the equity issue in April (NOK 1.9bn) and better operating profitability. The latter has been helped by higher sales prices and an improved product mix, while the equity issue was completed to increase Elkem's capacity to invest in growth initiatives and simultaneously comply with its financial policy targets.

Leverage currently within the target range of 1-2x

As of June 2021, leverage (SaD/EBITDA) is back within the company's financial policy range of 1-2x, which it was outside of last year. The weaker result last year was due to price declines and weaker demand for speciality products, particularly in the EU and the US. Today, the situation is very different, with good market conditions in all of Elkem's main markets, strong demand and much higher prices, resulting in record operating income.

High prices and tight market balance provide very high EBITDA margins in 2021

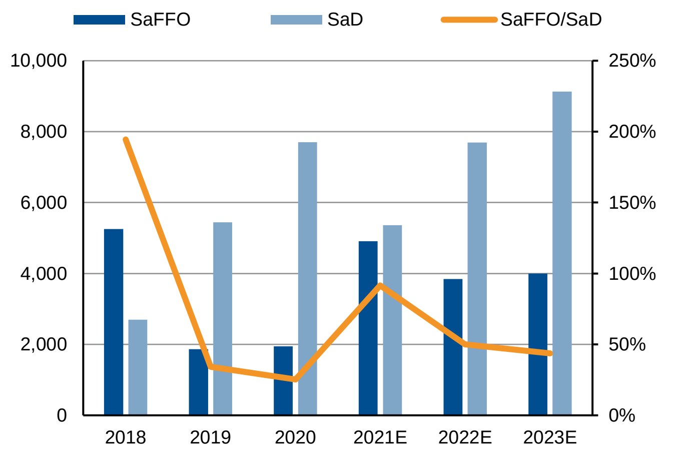
We do not expect the positive EBITDA margin spike in 2021 to be fully sustainable in the long term. However, we do foresee higher margins in the medium term compared to Elkem's results in 2019 and 2020. This will be helped by the improved mix of silicone products and higher volumes from upstream and downstream silicone projects. Further, the company's productivity improvement programme, which targets NOK 350m in annual cost savings by year-end 2021 has already seen effects and is on schedule (NOK 304m achieved as of Q3 2021).

High capex spending expected, but some of it is discretionary

Elkem also has an ambitious growth strategy, which will involve large investments in the next few years. As an example, the company announced in April 2021 that the Board had approved a NOK 3.8bn strategic expansion of the Xinghuo Silicones plant in China to strengthen Elkem's position in the silicones market and further support its specialisation strategy. The project is also expected to improve Elkem's overall cost position and environmental profile.

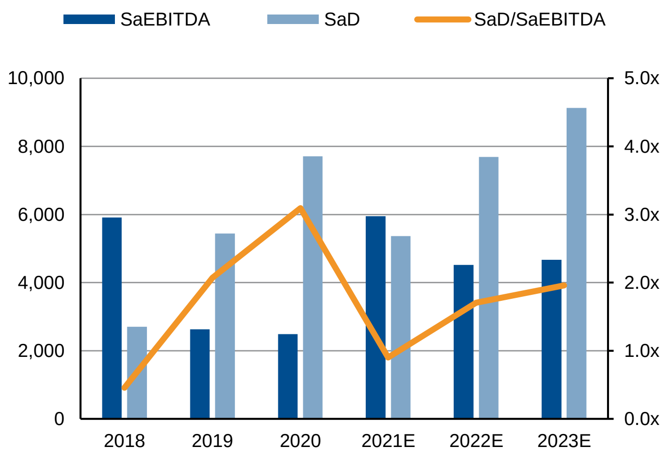
Combining the above project with ordinary maintenance capex and other strategic growth projects, we anticipate that net capex outflow could be around 50% higher p.a. in the medium term than it was last year. In addition to these high capex growth expectations, we assume that the dividend will be maintained in the mid-range of its target, i.e. 40% of net income. We also note that most capex going forward will be strategic growth-related, which has a discretionary element to it.

Figure 6: Funds from operations and SaD in NOK m (LHS), and Scope-adjusted FFO/SaD (RHS)



Source: Scope estimates

Figure 7: Leverage development (RHS), Scope-adjusted EBITDA and SaD in NOK m (LHS)



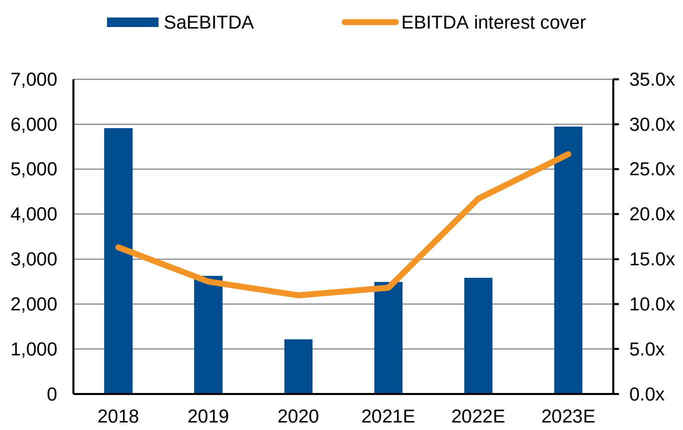
Source: Scope estimates

Based on the above assumptions, we expect leverage to stay within the 1-2x area in the medium term. The improved profitability and the equity issue this year will help the company to manage its higher capex without jeopardising its balance sheet too much.

Negative discretionary cash flow expectations

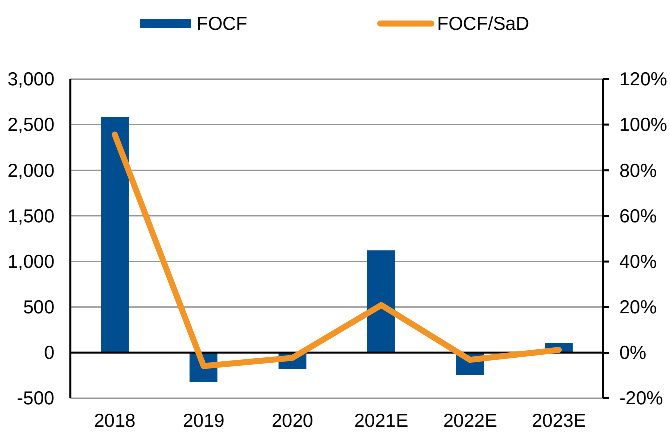
In recent years, Elkem has been able to fund reinvestment capex through internally generated cash flow with acceptable margins. However, the addition of strategic investments led to negative FOCF in the last couple of years. This is likely to continue going forward, making cash flow cover the weakest element in Elkem’s financial risk profile at present. Although the company may achieve positive FOCF, we believe that discretionary cash flow (adjusted for strategic M&A and our dividend expectation) is likely to be in negative territory in the currently favourable market environment.

Figure 8: Scope adjusted EBITDA (SaEBITDA) interest cover, NOK m (LHS)



Source: Scope estimates

Figure 9: Free operating cash flow (FOCF), in NOK m (LHS) and FOCF/Scope-adjusted debt (RHS)



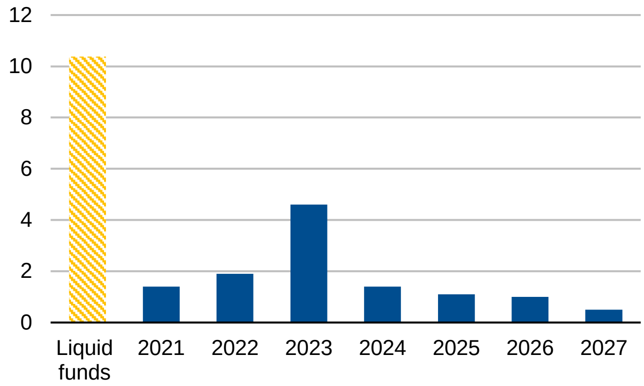
Source: Scope estimates

Diversified funding structure

In terms of key debt financing sources, Elkem has increased the usage of NOK bond financing recently, with two separate bond issuances this year (four bonds in total). The company also has bank financing and Schuldshein loans in place. In addition, Elkem's Chinese entities use acceptance bills with a duration normally below six months. These bills payable are documents with which the buyer formally agrees to pay for purchased goods or services at the maturity date. They are normally guaranteed by a financial institution. Elkem is also recognising lease liabilities on the balance sheet, included in interest bearing debt. They are measured at the net present value in accordance with IFRS.

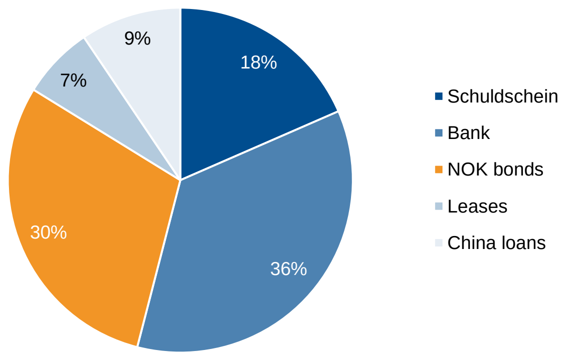
Please note that Scope-adjusted debt is adjusted by: i) 80% of provisions for site restoration and environmental measures (contingent liabilities); and ii) pension liabilities (50% of unfunded obligations); while iii) the net amount of bills payable (NOK 0.9bn) used in the Chinese operations are not included[2].

Figure 10: Liquid funds* and debt maturity profile (in NOK bn), as of Q3 2021



Source: Company, Scope estimates. *Cash and undrawn credit lines

Figure 11: Funding sources, based on data as of Q3 2021



Source: Elkem, Scope estimates

Liquidity: adequate

Liquidity (NOK 10.4bn in cash, cash equivalents and undrawn credit lines) is more than adequate to cover the debt maturing over the next 12 months.

[2] *We consider these to be more like working capital financing with similar terms as other payables. Including them in SaD would increase leverage 0.1x-0.2x on average, and thus would not change our overall financial risk profile assessment.*

Supplementary rating drivers

Financial policy

Financial policy is sound but does not lead to a rating adjustment

Around the date of its IPO, Elkem announced new financial targets: i) the maintenance of an investment grade profile; ii) leverage at 1-2x; iii) keeping the liquidity reserve at 10% or more of the company's annual turnover; and iv) the refinancing of any significant debt obligations well in advance of their final maturity date.

We consider these financial targets to be sound and are confident that management will strive to improve the capital structure if market conditions weaken or expansionary investments are high. This was recently proved by the equity issue, which will enable expansionary projects like the Xinghuo Silicones plant in China, following a period last year when Elkem was outside its optimum leverage target range.

Ownership and parent support

Strong and supportive majority owner, but no explicit uplift for parent support

Elkem's majority owner, Bluestar, owns 52.9% (down from 58.2% prior to the recent equity issue). The remaining owners consist largely of institutional investors holding less than 5%.

Bluestar is part of the ChemChina group (and the newly established joint company between ChemChina and Sinochem), which is fully owned by the Chinese government. Although we recognise the indirect state ownership of Elkem, we have made no rating uplift for parent support, as the ChemChina/Sinochem holding company's standalone credit assessment is weaker than Elkem's. Further, the majority owner did not participate in the recent equity issue in Elkem. Still, we believe Bluestar would support Elkem as much as possible if really needed, and do not expect the ownership to go below 50%.

Long-term and short-term debt ratings

Senior unsecured debt rating: BBB

Short-term debt rating: S-2

The senior unsecured rating is in line with the issuer rating, with Elkem ASA also being the bond-issuing entity. The S-2 short-term rating reflects the company's sufficient short-term debt coverage and good access to banks and debt markets. Elkem has five outstanding NOK bonds as well as several senior unsecured Schuldschein loans issued at fixed and floating rates.

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