

Research Update:

Swedish Steelmaker SSAB Upgraded To 'BB+' On Improved Business And Resilient Operational Performance; Outlook Stable

May 27, 2019

Rating Action Overview

- In the first quarter of 2019, the Swedish steelmaker SSAB reported strong results, driven by its North American division, positioning the company for another good year.
- The progress the company has made in the past two years, improving its product mix and operating costs, and reducing its absolute debt, is likely to make it more resilient in the next downturn.
- We are therefore raising our long-term issuer credit rating on SSAB to 'BB+' from 'BB'.
- The stable outlook reflects our expectations of continued deleveraging in 2019 and 2020, supported by still healthy steel industry conditions and further improvements in the business model.

Rating Action Rationale

The upgrade is mainly driven by the company's progress on its business model, namely improving its product mix toward specialty steel and reducing its operating costs. We believe that further yields will be harvested over the medium term. This positive trajectory led us to reassess the business risk profile of the company as fair. The upgrade was also supported by SSAB's further reduction in its absolute debt and very supportive credit metrics.

We understand the company will continue to focus on strengthening its balance sheet and the majority of the free cash flow will be allocated to reducing its reported debt. We now expect SSAB to have adjusted EBITDA of Swedish krona (SEK)9 billion-SEK10 billion (€830 million-€930 million) in 2019, translating into S&P Global Ratings-adjusted funds from operations (FFO) to debt of about 65% and adjusted debt falling below SEK12 billion by end-2019.

Our decision to reassess SSAB's business risk profile as fair (lower part of the range), compared with weak previously, stems from the company's average or above-average profitability compared with industry peers'. After a history of weak probability (about 5%-7% during the last downturn in

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2013 and 2015), the company posted EBITDA margins of 12% and above in 2018 and in the first quarter of 2019. We attribute this improvement to the following:

- Improved market conditions. The prevailing market conditions in 2018, propelled by strong demand for steel especially in the U.S., together with short-term windfalls from the implementation of Section 232, led to improved results for most of the steel industry. For example, in 2018 SSAB Americas strengthened its margins to 15% from 6% in 2017 (compared with an improvement to 12% from 9% in ArcelorMittal's division), and in Europe it saw a decline to 13% from 14% (compared with EBITDA margins of about 9.5% in ArcelorMittal's corresponding division).
- Internal measures. SSAB has reduced fixed costs by over SEK3 billion in the past four years, including reducing its workforce by 2,500 (initial target 900) and closing some capacity, leading also to much better utilization rates of the remaining blast furnaces (about 90%).
- Enhanced product mix. Premium products have reached 37% of total sales, close to the company's target of 40%, and up from 32% in 2016. These products are characterized by lower volatility and higher margins through the cycle (12%-15%). We understand that SSAB is investing in order to allocate more capacity to its quenched and tempered (Q&T) steel product line in the Americas, which will further support value-added product growth in its mix.
- Maintenance of a strong market position in special-grade steel products (40% market share in Q&T steel), as well as in heavy plates in North America (about 28%; target of 30% by 2020) and 40% share of the flat carbon and tube market in the Nordic region.

Outlook

The stable outlook reflects our expectations of continued deleveraging in 2019 and 2020, supported by still healthy steel industry conditions. In our view, deleveraging, alongside further improvements in the business model, will better position the company ahead of a future downturn of the industry.

Under our base case, with an adjusted EBITDA of SEK9.0 billion-SEK10.5 billion in 2019 and in 2020, we assume adjusted FFO to debt to be about 60%-70% in 2019 and over 100% in 2020, well above the adjusted FFO to debt of 60% that we consider to be commensurate with the current rating in the current favorable market conditions (or an adjusted FFO to debt of more than 45% in a downturn).

Downside scenario

We view pressure on the rating to be remote in the coming 12-18 months. Nevertheless, we could lower the rating if the company's performance showed less resilience than expected to a potential downturn or operational challenges, such that EBITDA dropped materially, translating into adjusted FFO to debt falling well below 45%, without signs of an obvious recovery.

Other scenarios leading to a lower rating would include a deviation from the current financial policy, including embarking on an aggressive growth strategy or very sizable dividends, prompting much higher debt.

Upside scenario

We would consider raising the rating to 'BBB-' subject to the following:

- A reduction of adjusted debt to about SEK8 billion (equivalent to reported net debt of about SEK4 billion) or below. In our view, this would allow the company to maintain a robust balance sheet through the cycle, notably during severe downturns.
- A track record of a prudent financial policy, including low debt (which is well below the company's official public gearing objective of maximum 35% at most times), no changes in shareholder returns, and disciplined capital expenditure (capex).
- Further enhancement of the business model, including a better product offering and a reduction in operating costs. This should be supported by consistently high or improving EBITDA margins (12% or above) through the cycle.

Other conditions include the company's ability to maintain adjusted FFO to debt above 60% in the current favorable market conditions with positive discretionary cash flow.

Company Description

SSAB produces high-strength steels, Q&T steels, as well as strip, plate, and tube products, and provides construction solutions. It had sales of SEK75 billion and annual production capacity of 8.8 million tons in Sweden, Finland, and the U.S. in 2018.

The company serves a number of end markets, such as industrial applications, automotive, heavy transport, construction building and energy.

The company operates through five divisions:

- Special Steels (21% of EBITDA).
- Europe (46% of EBITDA).
- Americas (27% of EBITDA).
- Tibnor (3% of EBITDA).
- Ruukki Construction (3% of EBITDA)

SSAB is headquartered in Stockholm, while its shares are traded on NASDAQ Stockholm and Helsinki, with 21.8% of the shares held by Industrivarden (11.8%) and Solidium (10%), which are long-term strategic investors. The remaining shares are free-float.

Notable rated peers include Aperam, US Steel, Bluescope, Arcelor Mittal, and Evraz.

Our Base-Case Scenario

SSAB posted EBITDA of SEK9.3 billion in 2018, up from SEK7.7 in 2017. The strong performance was mainly attributable to the Americas division, on the back of high plate prices (supported by the steel tariffs), as Europe experienced some softening and Special Steels in particular was affected by a prolonged maintenance outage, resulting in EBITDA of about SEK9.3 billion (compared with our projection of SEK9.5 billion-SEK10 billion).

The Americas division continued to fuel results for the group in 2018 (EBITDA of SEK2.5 billion), followed by the Special Steels division (EBITDA of SEK1.9 billion), while the European division (EBITDA of SEK4.1 billion) continued to reflect the recent softness in the European economy. The company's EBITDA margin crossed the 12% mark in 2018, which we view as a strong indicator for business robustness.

In the first quarter of 2019, SSAB reported record adjusted EBITDA of SEK2.8 billion (up from SEK1.9 billion year on year). In the first quarter we saw two diverging trends, with the U.S. division reporting very strong results (EBITDA of SEK1.1 billion) and the European division reporting weak results (EBITDA of SEK0.7 billion). We believe this is likely to be the case in the second quarter, too, with the gap closing in the second half of the year (some recovery in the results in Europe and decline from record high profitability in the U.S.).

Among its strategic targets for 2020, the company has signaled it would like to expand Special Steels volume to 1.35 million tons (mton) from 1.30 mton in 2018, increase the automotive premium product volumes to 750 mton from 562 mton currently and achieve a 40% share of premium products within the European division from the current 37%. While the company has shown a good track record of achieving its strategic targets, the current softness in Europe may delay potential contributions.

Under our base-case scenario, we expect adjusted EBITDA of SEK9 billion-SEK10 billion for 2019, with an improvement of SEK0.5 billion in 2020 (SEK9.5 billion-SEK10.5 billion). Our projection factors in continued good demand on all end-markets, with some reversal of the strong Americas and weak European performance. We expect premium products and Special Steels will continue to support margins.

On the debt side we expect the company to use a substantial portion of its discretionary cash flows (free cash flow after dividend payments) to reduce its debt by about SEK5.7 billion-SEK6.0 billion by end-2020, reaching adjusted debt of SEK8 billion (equivalent to net debt of SEK3.8 billion), and potentially leading to a virtually net debt free status by 2021.

The following assumptions underpin our projections:

- GDP growth expectation of 1.3% and 1.9% for Europe and 2.2% and 1.7% for the U.S. in 2019 and 2020, respectively. In general we expect that the demand for steel would be in line or above GDP growth in both markets. That said, we believe that the demand in Europe in 2019 could contract by about 1%, before showing some recovery in 2020.
- Further supportive protective measures by different countries, including Section 232 in the U.S. (implemented in 2018), as well as the recent safeguard measures by the EU Commission.
- Iron ore prices of \$75/dry metric ton (dmt) in 2019 and \$70/dmt in 2020. Raw material price movements may offset some of the upside we are currently expecting, especially in the European division. This is also due to the time lag with which the company can pass on higher costs to customers.
- Shipment growth of about 4% in 2019 and 2020, mainly driven by the Special Steels and Europe divisions. We expect demand growth in the Americas to slow down this year.
- EBITDA margin of around 12.5%-13.0%, improving somewhat from 12.3% in 2018. We expect the Special Steels division to slightly improve to 11%-12% margins and Europe to maintain its 13% margin, while the Americas division should experience a slight weakening to about 14%. Planned outages in 2019 are expected to lead to SEK1 billion of maintenance costs and cost of lower capacity utilization.
- Capex of SEK2.5 billion annually, of which SEK1.8 billion is maintenance and the remaining SEK700 million strategic capex to enhance automotive high-strength steels business and service expansion.
- Slightly negative or neutral change in working capital, depending on the evolution of raw material prices in the coming quarters.
- Following the April 2019 acquisition of the steel distribution division of Sanistal, with a cash

payment of DKK450 million (about SEK650 million), future acquisitions will be limited to bolt-on transactions, according to SSAB.

- About SEK1.4 billion in dividends in 2019 and SEK1.5 billion-SEK2.0 billion in 2020, corresponding to 40% of previous year's net income--in line with the company's dividend policy.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures in 2019 and 2020:

- FFO to debt exceeding 60% in both 2019 and 2020.
- Debt to EBITDA of around 1.0x-1.5x in 2019 and below 1.0x in 2020.
- Discretionary cash flow of about SEK3.5 billion-SEK4.2 billion in each of the coming two years.
- Debt of SEK12 billion, equivalent to reported net debt of SEK8 billion in 2019, and SEK8 billion and SEK3.8 billion, respectively, in 2020.

In our view, the reduction in absolute debt should protect SSAB's credit metrics from declining severely at the bottom of the cycle. When extrapolating the current projection beyond 2020, we envisage SSAB having virtually no financial debt by 2021. We continue to see adjusted debt of SEK8 billion (equivalent to a reported net debt of SEK4 billion) as an important trigger before reassessing SSAB's financial risk profile. We note that under our base case, leverage will remain well below the company's official public gearing objective of maximum 35% at most times.

In our view, with this debt level the company's EBITDA could drop by 40% from current levels before its adjusted FFO to debt declined below 45%. Moreover, under such a scenario the company's FOCF would be about SEK1.5billion-SEK2.0 billion (or neutral discretionary cash flow after maintaining the same level of dividends).

Liquidity

We assess SSAB's liquidity as strong, as we forecast the company's liquidity sources will cover its uses by more than 1.5x over the next 24 months. Our assessment is underscored by the company's sizable cash balance and its fully available €600 million revolving credit facility with a five-year tenor.

As of March 31, 2019, SSAB's average loan duration was 6.3 years.

We understand the company has about SEK6.0 billion of debt maturing in the coming three years, mostly falling due in 2019. The company has built a long track record of a prudent risk management.

Principal liquidity sources for the 12 months from March 31, 2019, are:

- Cash and cash equivalents of SEK6.2 billion (including short-term bank deposits in escrow).
- Availability under the revolving credit facility of about SEK6.5 billion (equivalent to €600 million) due 2023.
- Our estimate of FFO of about SEK7.2 billion-SEK7.8 billion over the coming 12 months.

Principal liquidity uses for the same period are:

- Short-term debt maturities of about SEK5.0 billion (including SEK1.5 billion of commercial papers, SEK2.5 billion of long-term bonds, and the rest is loans).
- About SEK1.4 billion of off-balance-sheet receivable securitization, although the company has

a good track record of extending these.

- Capex of SEK2.5 billion, most of which is maintenance capex.
- Intra-year working capital swings of several hundred krona, reflecting changes in prices and seasonality. We understand that the company aims to optimize its working capital management further, which would likely lead to lower swings in the future.
- About SEK650 million of cash payment for the Sanistal steel division acquisition, completed in April 2019.
- Dividend payment of 40% of profit before tax, about SEK1.5 billion, in line with the company's dividend policy.

Covenants

We understand that SSAB is subject to a gearing financial covenant under its loans of 60% maximum. As of March 31, 2019, the company had ample headroom under the financial covenant, which is expected to further improve with the reduction in its absolute debt.

Issue Ratings--Recovery Analysis

After the repayment of the €350 million senior unsecured notes, we do not rate any debt.

Ratings Score Snapshot

Issuer Credit Rating: BB+/Stable/B

Business risk: Fair

- Country risk: Very low
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Metals And Mining Downstream Industry, Dec. 20, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Upgraded; Ratings Affirmed

| | To | From |
|----------------------|--------------|---------------|
| SSAB AB | | |
| Issuer Credit Rating | BB+/Stable/B | BB/Positive/B |

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