Research Update:

German Autoparts Supplier MAHLE Outlook Revised To Negative On Slower Profitability Improvement; 'BB' Rating Affirmed

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Rating Action Overview

- MAHLE GmbH (Mahle) revised down its sales and profit expectations for 2024, and now expects an EBITDA margin of 7.5%-8.5% compared with more than 8.5% previously, since it cannot fully mitigate lower auto production volumes through price adjustments and productivity gains.
- As a result, we now estimate that our adjusted funds from operations (FFO) to debt ratio for Mahle will increase to about 19% in 2024, compared with our earlier estimate of 20%-25%, and believe Mahle will find it difficult to meet our leverage threshold of 25% by 2025 if challenging market conditions prevail next year.
- We have therefore revised our outlook on Mahle to negative from stable and affirmed our 'BB' long-term issuer credit rating.
- The negative outlook reflects the potential for a downgrade if Mahle's fails to increase its FFO to debt to more than 25% and restore its free operating cash flow (FOCF) to debt to more than 5% by 2025.

Rating Action Rationale

Mahle's operating profitability is improving at a slower pace than expected amid tough market conditions. We revised down our adjusted 2024 EBITDA margin projection to 7%-8% from 8%-9% previously for Mahle. Mahle's reported EBITDA increased to €489 million (including one-off gains of €144 million from divestments) in first-half 2024 from €400 million in first-half 2023. This corresponds to a reported EBITDA margin of 8.1% (5.7% excluding divestment gains) versus 6.1% the previous year. We understand that productivity increases and positive price adjustments were fully offset by negative volume effects and increased labor costs. The company's sales decreased by 4.2% organically (or 8.8% including foreign exchange and scope effects) in first-half 2024 due to flattish global light vehicle production, with even more negative trends in Europe where Mahle generates about 45%-50% of its sales. In addition, demand for commercial vehicles was also down in first-half 2024 with the production of medium- and heavy-duty trucks declining by 0.8%. In our base case for 2024, we incorporate higher cost compensation from customers in the second half of 2024 versus the first half, following a similar pattern seen in 2023, as well as continued discipline on costs and further productivity enhancements. We have also revised our projections for adjusted FOCF for Mahle in 2024 to zero or up to €50 million from €100 million-€200 million previously. This is close to management's guidance of free cash flow of about €400 million for 2024, since our adjusted FOCF figure excludes gains and losses from disposals and includes cash interest paid. This should lead to an FOCF-to-debt ratio of 0.0%-2.0% in 2024, which we consider weak for the rating.

The forecast improvement in our adjusted EBITDA margin for Mahle to 8%-9% in 2025 hinges mainly on further productivity gains. By 2025, Mahle plans to operate with most of its direct personnel and indirect employees in best-cost countries. The company has been cutting production capacity in higher-cost countries such as Western Europe, North America, and Japan and building new production capacity and research and development (R&D) centers in Eastern Europe, Asia, and Mexico. In our base case, we assume the plan will be executed successfully, which should help Mahle mitigate pricing pressure from automakers on products and risks of commoditization over time, especially of its engine components and filtration systems, which are currently contributing significantly to the group's EBITDA (about 72% in 2023) and cash flows. In addition, the contribution from Mahle's Thermal Management division should improve following the company's price renegotiation with customers last year. The current volatility in BEV demand in certain European markets will make it difficult for Mahle to cover its fixed costs on its e-mobility offering in 2024. However, we assume a pickup in BEV demand in 2025, when automakers will have to comply with stricter carbon dioxide (CO_2) emissions regulations in Europe, could also support an improvement in profitability. Nevertheless, we are mindful that automakers may choose to buy CO_2 credits instead of using discounts to push BEVs to the market if demand remains weak. While Mahle's dual strategy offers some protection against volatile BEV demand, upfront costs for the development of new e-mobility products remain inevitable and represent a drag on profits in the short term. In 2025, we forecast FOCF of €150 million-€200 million (corresponding to FOCF to debt of 5.5%-7.5%) in line with our assumption of a higher EBITDA margin of 8%-9% and flat capital expenditure (capex) to sales of about 4%.

We think that Mahle will continue to favor deleveraging through a conservative financial policy. Mahle's shareholders, which are non-profit entities MAHLE Stiftung and MABEG, should continue to support a prudent dividend policy. This leads us to estimate cash dividends of €30 million-€50 million over 2024-2025. Along the same lines, we believe the company will only consider small bolt-on acquisitions. Management targets a reported net debt-to-EBITDA ratio of 1.0x, which compares to 1.3x on June 30, 2024. In our base case, we expect an S&P Global Ratings-adjusted debt-to-EBITDA ratio of 3.0x-3.5x in 2024 and 2.5x-3.0x in 2025, down from 3.6x in 2023. Apart from higher earnings, deleveraging in 2024 is also supported by disposals. This year, Mahle sold its stake in BHTC for about €200 million. The difference between Mahle's reported leverage and our adjusted leverage metric mainly stems from our adjustments related to operating leases, pension obligations, outstanding receivable financing, and reclassification of income from asset disposals as exceptional items. We also exclude some cash balances that we consider not immediately available for debt repayment.

Outlook

The negative outlook reflects the risk that weak auto production volumes, including volatile BEV production, will not support an improvement in Mahle's overall earnings and FOCF. We expect this could lead to FFO to debt lower than 25% and FOCF to debt lower than 5% by 2025.

Downside scenario

We could lower our rating on Mahle if operating setbacks or higher-than-expected losses in electronics and mechatronics, coupled with weaker auto production volumes, caused:

- S&P Global Ratings-adjusted FFO to debt to recover to only about 20%-25%; and
- S&P Global Ratings-adjusted FOCF to debt remains below 5%.

Upside scenario

We could revise our outlook to stable if we see prospects for Mahle's FFO to debt and FOCF to debt to sustainably exceed 25% and 5%, respectively.

Company Description

Mahle is a global auto parts manufacturer for light vehicles, commercial vehicles, and the aftermarket, and in 2023, it reported sales of about €12.8 billion (including joint ventures). It operates under five business units and four profit centers:

- Thermal Management (35.8% of 2023 sales).
- Engine Systems and Components (20.6%).
- Filtration and Engine Peripherals (16.7%).
- Electronics and Mechatronics (10.6%).
- Aftermarket (9.8%).
- Profit Centers (6.6%).

Mahle is headquartered in Germany and operates about 148 production plants across 31 countries. At the end of 2023, it had about 72,000 employees. MAHLE Stiftung, a non-profit foundation based in Stuttgart, owns all the shares, and MABEG owns all the voting rights.

Our Base-Case Scenario

Assumptions

- Global real GDP growth of 3.3% in 2024 and 3.2% in 2025, after growth of 3.4% in 2023. GDP remains a key driver of demand for light vehicles and trucks, in our view.
- Global light vehicle production increasing modestly by up to 1% in 2024 and 0%-2% in 2025, after about 10% in 2023, though we expect slightly weaker production volumes in Europe in the

next two years.

- Declining sales in 2024 due to volatile demand for BEVs, leading to limited growth in the Electronics and Mechatronics division, and sales growth of 2%-4% in 2025, in line with the market.
- EBITDA margins to increase to about 7.5% in 2024 and about 8.5% in 2025 on the back of operating improvement in the Thermal Management division and operating efficiencies throughout the group.
- Mahle's restructuring plan to transfer the cost base to best-cost countries, which should translate into elevated cash restructuring costs of €300 million-€350 million spread over 2024 and 2025.
- Working capital inflow of about €100 million in 2024 and only modest outflow of zero or up to €50 million in 2025, reflecting management's focus on improving working capital efficiencies.
- Capex representing about 4.0% of sales, roughly in line with the depreciation of assets.
- Modest dividends to shareholders of €30 million-€50 million annually in 2024 and 2025.
- No acquisitions in 2024-2025 even in relation to the purchase of shares in the Mahle Behr joint venture through a call option to preserve cash; and net proceeds of €250 million-€300 million from asset disposals in 2024.

Our main adjustments to Mahle's reported debt include operating leases, receivables securitization, pension liabilities, a put option related to Mahle Behr, and accessible cash.

Key metrics

MAHLE GmbH--Key metrics*

	--Fiscal year ended Dec. 31--						
(Mil. €)	2019a	2020a	2021a	2022a	2023a	2024f	2025f
Revenue (excluding joint ventures)	11,394	9,237	10,382	11,830	12,205	11,500-12,000	12,000-12,500
Revenue growth (%)	(9.4)	(18.9)	12.4	13.9	3.2	(-5)-(-2)	2.0-4.0
EBITDA margin (%)	6.0	5.9	8.1	5.9	6.8	7.0-8.0	8.0-9.0
Capex	536.0	427.0	400.0	443.0	455.0	450-500	475-525
Free operating cash flow	75.8	342.0	(10.0)	(439.0)	220.0	0-50	100-200
Debt/EBITDA (x)	4.0	4.5	3.0	4.7	3.6	3.0-3.5	2.5-3.0
FFO/debt (%)	16.3	14.3	23.8	12.4	18.2	18.0-20.0	25.0-27.0
FOCF/debt (%)	2.8	14.0	(0.4)	Negative	7.4	0-2.0	5.5-7.5

*All figures adjusted by S&P Global Ratings. Figures for 2024f and 2025f are based on assumptions made by S&P Global Ratings. a--Actual. f--Forecast.

Liquidity

We assess Mahle's liquidity as strong, reflecting that sources will exceed uses by more than 1.5x over the next 12 months. We also consider the company's solid relationships with banks, and its well-spread debt maturities.

Principal liquidity sources:

- For the 24 months started July 1, 2024, adjusted cash and cash equivalents of about €986 million, excluding about €66 million of cash held at joint ventures and inaccessible cash.
- About €1.2 billion of available committed credit facilities maturing in 2029 (including extension options.
- About €450 million-€600 million of reported FFO annually.

Principal liquidity uses:

- For the same period, about €358 million of debt repayment in 2024 and €124 million in 2025.
- About €475 million-€525 million of capex per year.
- Up to €300 million of intrayear working capital needs.
- Dividends of about €30 million-€50 million per year.

Covenants

The documentation for Mahle's revolving credit facility (RCF) includes two financial maintenance covenants: debt to EBITDA ratio of 3.5x and interest cover ratio of 3x. We expect headroom of more than 30% under both covenants over the next two years.

Environmental, Social, And Governance

Environmental factors are a negative consideration in our credit rating analysis of Mahle because the company relies on conventional internal combustion engines for about 40% of its sales. The company faces substitution risks from electrification, and its ability to offset potential losses in its combustion engine-related businesses largely depends on higher content per vehicle in its electronics and mechatronics business.

A faster-than-expected transition to BEVs, coupled with slow adoption of the company's technology, still represents a meaningful risk, despite the company's efforts to expand and improve the profitability of its EV-related product portfolio. We note as positive, however, that Mahle has the technological capability to support the increased electrification of vehicle powertrains at a competitive cost. However, we expect high R&D costs of 5.0%-6.0% of sales over the next two to three years will likely constrain EBITDA margin expansion.

Ratings Score Snapshot

Issuer Credit Rating	BB/Negative/--
Business risk:	Fair
Country risk	Intermediate
Industry risk	Moderately high

Issuer Credit Rating	**BB/Negative/--**
Competitive position	Fair
Financial risk:	Significant
Cash flow/leverage	Significant
Anchor	bb
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Strong (no impact)
Management and governance	Moderately negative (no impact)
Comparable rating analysis	Neutral (no impact)

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Outlook Action; Ratings Affirmed

	To	**From**
Mahle GmbH		
Issuer Credit Rating	BB/Negative/--	BB/Stable/--

Senior Unsecured	**BB**	**BB**
Recovery Rating	3(55%)	3(55%)