

Research Update:

German Autoparts Supplier MAHLE GmbH Rated 'BB'; Outlook Stable

April 19, 2024

Rating Action Overview

- Germany-based MAHLE is a global tier-one auto supplier with leading market positions in engine components, filtration systems, and thermal modules, with a diversified customer base and strong liquidity.
- MAHLE is adapting its business model to address the transition to e-mobility and the commoditization of conventional products by shifting its investments toward the development of new electric vehicle (EV)-related components and by optimizing its cost base.
- MAHLE's strategy relies on the successful transfer of its production and research and development (R&D) personnel to best-cost countries, the turnaround of underperforming plants, and on its ability to launch profitable products in a highly competitive market.
- We assigned our 'BB' long-term issuer credit rating to MAHLE. The stable outlook indicates our expectations that the company's S&P Global Ratings-adjusted EBITDA margin will improve toward at least 8%-9% over 2024-2025, from 6.8% in 2023, and that MAHLE will reduce its debt further through free operating cash flow (FOCF) generation and asset disposals. We therefore expect a substantial improvement in credit metrics in 2024, with adjusted funds from operations (FFO) to debt of about 25% and FOCF to debt of about 5% in 2024, with incremental improvements thereafter.

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Rating Action Rationale

Our analysis of MAHLE balances the company's top market position as a supplier of engine components, filtration systems, and thermal modules against several key constraints. With reported revenues of about €12.8 billion in 2023, MAHLE is a leading provider of pistons, oil filter modules, and thermal modules. It also exhibits a moderately diversified customer base, with the top three customers accounting for 24% and the top 10 customers for 47%. On the other hand, about 40% of MAHLE's sales rely on conventional internal combustion engines (ICEs) for light vehicles (LVs), while its adjusted EBITDA margin of about 6%-8% in the past five years was below the sector average of 9%-15%. In our base case, we expect the company's cost optimization efforts and the reduction in ramp-up losses for new EV-related products will improve margins to

8%-9% over 2024-2025.

The gradual transfer of MAHLE's production to best-cost countries will mitigate the commoditization trend some of its products are exposed to. As part of its restructuring program, MAHLE is cutting production capacity in higher-cost countries, such as Western Europe, North America, and Japan. Instead, it is building new production capacity and R&D centers in best-cost countries in Eastern Europe, Asia, and Mexico. MAHLE plans that most of its direct personnel and indirect employees will operate in best-cost countries by 2025. Our base case assumes that MAHLE will execute the plan successfully. This will help the company mitigate pricing pressure from automakers on products that are at risk of commoditization, especially engine components and filtration systems, whose current contribution to EBITDA (about 68% in 2023) and cash flows is significant.

High competition in e-mobility could challenge MAHLE's plans to reduce its sales dependency on ICEs for LVs from about 40%. MAHLE can advance e-mobility, thanks to its in-house core technical competencies, its global footprint--with plants in Europe, North America, and Asia, including several low-cost manufacturing sites--and its long-term relationships with automakers. The company's product offering in e-mobility includes traction drives and electric compressors, as well as conductive and inductive charging solutions. Nevertheless, we note that it will likely take time for MAHLE to build a profitable portfolio in e-mobility. This is because of fierce competition from other suppliers, including Valeo, BorgWarner, and Bosch, and because of still low volumes as battery electric vehicles (BEV) penetration ramps up gradually. The current volatility in BEV demand in certain European markets will make it difficult for MAHLE to cover its fixed costs in 2024, but original equipment manufacturers' (OEMs') compliance with stricter CO2 emission levels in Europe from 2025 could improve profitability. However, absent a substantial improvement in demand for BEVs, MAHLE could struggle to make its electronics and mechatronics division profitable, in our view.

After a very weak operating performance in the first half 2022, MAHLE improved its earnings and cash flows in 2023. This reflects management's success in offsetting input cost inflation through price recovery and cost discipline. MAHLE renegotiated with OEMs the pricing of certain loss-making contracts it inherited from the acquisition of Delphi's thermal assets in 2015. Besides, the company implemented new processes in its best performing plants to improve the contribution of loss-making production sites. This increased the reported EBITDA margin in the thermal management division to about 3% in 2023, from breakeven levels in 2022. Over the next couple of years, management will further improve the earnings contribution of the thermal management division by optimizing manufacturing and purchasing, tightening control on launch costs, and standardizing components. At the group level, MAHLE's adjusted EBITDA margin increased to 6.8% in 2023, from 5.9% in 2022. FOCF benefited significantly from a working capital reduction in 2022 and increased markedly to about €220 million in 2023, from negative €440 million in 2022. We anticipate solid FOCF of €100 million-€200 million over 2024-2025, mainly because of higher earnings. Working capital movements will be insignificant.

We think MAHLE will focus on deleveraging, in line with its conservative financial policy.

MAHLE's shareholders, consisting of non-profit entities MAHLE Stiftung and MAHLE Beteiligungen GmbH (MABEG), will continue to support prudent dividend distributions. We therefore expect dividends of €30 million over 2024-2025. Additionally, we believe the company will only consider small bolt-on acquisitions. Management targets a reported net debt to EBITDA ratio of 1.0x, compared with 2.5x at the end of 2023. In our base case, we expect adjusted debt to

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EBITDA of 2.5x-3.0x in 2024 and 2.0x-2.5x in 2025, down from 3.6x in 2023. Apart from higher earnings, the deleveraging in 2024 is also supported by disposals, for example MAHLE's sale of its stake in Behr-Hella Thermocontrol GmbH (BHTC) for about €200 million in April 2024. The 1.1x difference between MAHLE's reported leverage and the adjusted leverage mainly stems from our adjustments related to operating lease and pension obligations, as well as outstanding receivable financing. We also exclude some cash balances that we consider are not immediately available for debt repayment.

Outlook

The stable outlook indicates our expectations that the profitability of MAHLE's thermal management business will gradually improve, which--together with steady profits from its established products and cost optimizing efforts--will more than offset ramp-up losses in the electronics and mechatronics segment, which is suffering from still low and volatile EV production volumes. We expect this will support an improvement in its overall earnings and FOCF, leading to FFO to debt above 25% and FOCF to debt above 5% by 2025.

Downside scenario

We could lower our rating on MAHLE if operating setbacks or higher-than-expected losses in the electronics and mechatronics segment, coupled with weaker auto production volumes, led to:

- Adjusted FFO to debt increasing to only about 20%-25%;
- Adjusted debt to EBITDA remaining at 3.5x-4.0x; and
- Adjusted FOCF to debt decreasing below 5%.

Upside scenario

We could raise our rating on MAHLE if the company:

- Improved its credit metrics such that its FOCF to debt improved to about 10%, while maintaining debt to EBITDA below 2.5 and FFO to debt well above 30%; or
- Demonstrated a track record of increasing profitability--reflected in the EBITDA margin increasing toward 12% and evidencing the successful and profitable growth of non-ICE-related products--the the capacity to mitigate material operating issues, and the ability to offset price pressure from OEMs.

Company Description

MAHLE is a global auto parts manufacturer for LVs, commercial vehicles, and the aftermarket. It reported sales of about €12.8 billion, including the contribution of joint ventures, in 2023. 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%)

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- Electronics and mechatronics (10.6%)
- Aftermarket (9.8%)
- Profit penters (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 shares, while MABEG owns all voting rights.

Our Base-Case Scenario

Assumptions

- Global real GDP growth of 2.9% in 2024 and 3.4% in 2025, after an estimated growth of 3.2% in 2023. GDP remains a key driver for LV and trucks demand, in our view.
- LV production to increase modestly by up to 2% in 2024 and 1%-3% in 2025, from about 10% in 2023.
- Flat sales in 2024 due to volatile BEV demand leading to limited growth in the electronics and mechatronics division and sales growth of about 2%-3% in 2025, in line with the market trend.
- EBITDA margin to increase to about 8% in 2024 and about 8.5% in 2025, on the back of an operating improvement in the thermal management division and operating efficiencies throughout the company.
- MAHLE's restructuring plan to transfer the cost base to best-cost countries will translate into elevated cash restructuring costs of €300 million-€350 million over 2024-2025.
- Working capital outflows of up to €50 million over 2024-2025, reflecting management's focus on cash.
- Capital expenditure (capex) accounting for about 4.0%-4.5% of sales, covering the depreciation of assets.
- Dividends paid to shareholders remain modest at about €30 million over 2024-2025.
- Limited outflows for acquisitions of about €50 million over 2024-2025, after the purchase of shares in the MAHLE/BHTC joint venture.
- No call exercised in 2023 to preserve cash.
- Net proceeds of about €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 the MAHLE/BHTC joint venture, and accessible cash.

Key metrics

MAHLE GmbH--Key metrics*

(Mil. €)	--Fiscal year ended Dec. 31--						
	2019a	2020a	2021a	2022a	2023a	2024f	2025f
Revenue (excluding JVs)	11,394	9,237	10,382	11,830	12,205	12,000-12,500	12,500-13,000
Revenue Growth (%)	-9.4	-18.9	12.4	13.9	3.2	(-1)-1	2.0-4.0
EBITDA Margin (%)	6.0	5.9	8.1	5.9	6.8	8.0-8.5	8.5-9.0
Capex	536	427	400	443	455	500-550	500-550
Free Operating Cash Flow	75.8	342.0	-10.0	-439.0	220.0	100.0-200.0	100.0-200.0
Debt/EBITDA (x)	4	4.5	3	4.7	3.6	2.5-3.0	2.0-2.5
FFO/Debt (%)	16.3	14.3	23.8	12.4	18.2	24.0-26.0	26.0-28.0
FOCF/Debt (%)	2.8	14.0	-0.4	Negative	7.4	5.0-7.0	5.0-7.0

*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 twelve months. We also consider the company's solid relationships with banks and its well-spread debt maturities.

Principal liquidity sources for the 24 months from Jan. 1, 2024, include:

- Adjusted cash and cash equivalents of about €584 million, excluding cash of about €129 million held at joint ventures and inaccessible cash;
- About €1.2 billion in available committed credit facilities (RCFs) maturing in 2029 (including extension options) and €400 million in an undrawn term loan due in 2026;
- About €200 million in net proceeds related to the BHTC sale; and
- About €600 million-€700 million in reported funds from operations annually.

Principal liquidity uses over the same period include:

- About €529 million in debt repayment in 2024 and €360 million in 2025;
- About €500 million-€550 million in capex per year;
- Up to €300 million in intra-year working capital needs; and
- Dividends of about €20 million-€30 million per year.

Covenants

The RCF documentation includes two financial maintenance covenants, namely debt to EBITDA of 3.5x and an interest coverage 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 ICEs 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 and the slow adoption of the company's technology still represents a meaningful downside risk at this stage, despite the company's efforts to expand and improve the profitability of its EV-related product portfolio. We positively note that the company has the technological capability to support the increased electrification of vehicle powertrains at a competitive cost. However, we expect high R&D costs of about 5%-6% of sales over the next two to three years will likely constrain an EBITDA margin expansion.

Ratings Score Snapshot

Issuer credit rating	BB/Stable/--
Business risk:	Fair
Country risk	Intermediate
Industry risk	Moderately high
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

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- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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

New Rating

Mahle GmbH

Issuer Credit Rating BB/Stable/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at <https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceid/504352>. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.

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