

Research Update:

Atlas Copco Ratings Raised To 'A/A-1' On Strong And Resilient Financial Performance; Outlook Stable

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Table Of Contents

- Overview
- Rating Action
- Rationale
- Outlook
- Related Criteria And Research
- Ratings List

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Overview

- In our view, Sweden-based industrial machinery manufacturer Atlas Copco AB has shown stronger-than-expected and resilient operating and financial performance relative to peers.
- Due to a very strong and stable cash flow generation, Atlas Copco's financial risk profile has proven stronger than we had previously anticipated, allowing for sizable shareholder distributions and midsize acquisitions.
- We are therefore raising our ratings on Atlas Copco to 'A/A-1' from 'A-/A-2'.
- The stable outlook reflects our expectation of continued strong credit metrics, despite recently increased shareholder remunerations, and potential cash- or debt-funded midsize acquisitions.

Rating Action

On Feb. 24, 2011, Standard & Poor's Ratings Services raised its long- and short-term corporate credit ratings on Sweden-based industrial machinery manufacturer Atlas Copco AB and its related entities to 'A/A-1' from 'A-/A-2'. The Nordic scale rating remained unchanged at 'K-1'. The outlook is stable.

Rationale

The upgrade reflects the resilience of Atlas Copco's operating performance and strong credit metrics during the market downturn relative to its rated peers. We anticipate that the company will maintain its solid cash flow performance and financial policy, balancing potential acquisitions and shareholder distribution to sustain rating-commensurate credit measures.

This view is supported by the company's continued strong credit performance, which currently provides headroom for potential cash and debt-funded bolt-on acquisitions. We think it likely that the company will continue to pursue an overall conservative financial policy--moderated, however, by sizable shareholder distributions--including strong liquidity and flexibility to adjust growth objectives to underlying operating performance and prospects.

We take the view that Atlas Copco's strong market position, good pricing power, and good cost flexibility have allowed the company to largely insulate itself from the economic downturn in 2009. The company's advantageous position further lent support to its improved operating performance in 2010, with sales

increasing by 10% year-on-year, while the reported EBIT margin increased to 19.9% from 14.3% the previous year. The company benefited from better capacity utilization and operating efficiencies, which were essential factors in helping to improve its margin. Over the medium term, we anticipate a solid operating performance, thanks to management's prudent strategy to expand into fast-growing and high-margin products and markets solutions, and improving capacity utilization through recovering sales volumes.

Atlas Copco's cash flow performance in 2010 was above our expectations, along with better earnings, and disciplined capital expenditure. What's more, the company reduced leverage from discretionary cash flows and improved credit protection measures. We estimate (pending the full-fledged 2010 year report) the ratios of adjusted funds from operations (FFO) to debt at above 100% and adjusted debt to EBITDA at about 0.5x in 2010. In our view, this leaves headroom for the new rating level.

Our current base-case scenario assumes a mid-single-digit rise in sales in 2011 and a low-single-digit decline in margins, due to general cost inflation and a slightly less beneficial product mix. We further assume a gradual modest increase in capital spending and a Swedish krona (SEK) 11 billion shareholder payout (dividend plus a mandatory share redemption), with a dividend payout ratio of 50% from 2012 and onward.

We expect Atlas Copco to continue to make bolt-on small-to-midsize acquisitions of about SEK2 billion annually. The anticipated increase in debt levels would still leave the FFO-to-debt ratio well above 50%. In our view, this would still be commensurate with an 'A' rating level, given our view of Atlas Copco's strong business risk profile.

The ratings continue to reflect our view of the company's strong business risk profile and modest financial risk profile. Support for the ratings comes from the group's leading market positions, good cost flexibility, strong profitability, a high share of more stable aftermarket sales, and a fairly diverse earnings base. In addition, Atlas Copco enjoys strong and relatively stable cash generation and, in our view, demonstrates good liquidity management. Offsetting these strengths is the group's exposure to demand cyclicality and meaningful competition, and what we see as a shareholder-friendly financial policy.

Short-Term Credit Factors

The short-term rating on Atlas Copco is 'A-1'. It reflects our view of the company's overall strong liquidity. On Dec. 31, 2010, liquidity sources consisted of:

- Cash and liquid assets of SEK14.3 billion (of which we consider about SEK11.3 billion as excess cash).
- An undrawn committed revolving credit facility of \$1 billion (about SEK 6.4 billion) maturing in 2012, and a SEK6.4 billion committed revolving credit facility, maturing in 2017. Both facilities are free of financial

covenants that would restrict Atlas Copco from drawing on the facility.

- Our expectation of FFO of about SEK10 billion in 2011 and beyond.

This compares with the following near-term expected cash calls:

- Debt maturities of about SEK2.5 billion in 2012.
- Total shareholder returns of about SEK11 billion in 2011 (SEK4.9 billion of dividends and SEK6.1 billion of extraordinary share redemptions).
- Potential acquisition payments of about SEK2 billion.

Furthermore, the proposed share buyback program could result in cash outflows of up to SEK7.5 billion, which we view highly unlikely on the back of the large share redemption program in 2011.

Outlook

The stable outlook reflects our expectation that Atlas Copco will continue to balance investments, acquisitions, and shareholder payouts to maintain adequate cash flow protection ratios for the 'A' rating level. We expect a continued strong operating performance in 2011 and 2012, with slightly weakening credit metrics from the current high levels. This is due to our expectation of increased investments, acquisitions, and shareholder distribution.

Atlas Copco does not have an explicit publicly stated leverage target, but to our understanding, the company's management is committed to maintain prudent credit ratios, commensurate with its 'A' rating.

At the current rating level, we expect adjusted FFO-to-debt of 50% or more and adjusted debt-to-EBITDA of 1.5x. In our view, the current debt metrics therefore give the company meaningful flexibility for debt-funded acquisitions. We have fully factored management's guidelines of an annual SEK2 billion acquisition-spend and 50% earnings payout into our forecasts and the ratings. Barring any unforeseen deterioration in financial performance, potentially larger acquisitions could also be compatible with the current rating level if the company were to adapt other discretionary spending measures so as not to substantially deviate from our new guideline ratios.

Following today's upgrade, we see limited potential for an upgrade, given the combination of business and financial risk. However, we would consider raising the ratings if the company demonstrates a sustained and strong financial performance that exceeds the current rating requirements, coupled with a public statement reflecting what we would consider to be a conservative financial policy.

Conversely, we would consider lowering the ratings if Atlas Copco were to adopt a significantly more aggressive financial behavior leading it to breach our credit ratio expectations, notably on the back of large debt-funded acquisitions or aggressive shareholder returns. These two aspects are the main

factors with the greatest likelihood -although still moderate-- of negatively impacting the rating, in our view.

Related Criteria And Research

- Principles Of Credit Ratings, Feb. 16, 2011
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009

Ratings List

Upgraded

	To	From
Atlas Copco AB		
Corporate Credit Rating	A/Stable/A-1	A-/Stable/A-2
Senior Unsecured	A	A-
Commercial Paper	A-1	A-2

Ratings Affirmed

Atlas Copco AB	
Nordic Scale Corporate Credit Rating	
Local Currency	--/--/K-1
Nordic Scale Commercial Paper Rating	K-1

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