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Research Update:

German Automaker Volkswagen Outlook Revised To Stable From Negative; 'BBB+/A-2' Ratings Affirmed

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Table Of Contents

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Overview

- We forecast Germany-based global automotive manufacturer Volkswagen AG (VW) will maintain better-than-expected operating performance as well as show improving cash flow generation in 2018 and 2019.
- We are therefore revising to stable from negative the outlook on our long-term ratings on VW.
- At the same time, we are affirming our 'BBB+/A-2' ratings on VW.
- The stable outlook reflects our expectation that VW will maintain adjusted leverage ratios of funds from operations to debt above 45% and debt to EBITDA below 2x, on a sustained basis, even if there are limited further charges related to diesel emissions.

Rating Action

On Nov. 6, 2017, S&P Global Ratings revised to stable from negative its outlook on Volkswagen AG (VW). At the same time, we affirmed our 'BBB+/A-2' long- and short-term credit and issue ratings on VW.

Furthermore, we revised to stable from negative the outlook and affirmed the 'BBB+/A-2' long- and short-term credit and issue ratings on certain core subsidiaries of Volkswagen, including Volkswagen Financial Services AG (VW FS). We also affirmed the 'A-/A-2' long- and short-term credit and issue ratings on Volkswagen Bank GmbH (VW Bank). The outlook on VW Bank remains negative. (See "Volkswagen Financial Services Outlook To Stable, 'BBB+' Ratings Affirmed; VW Bank Ratings Affirmed, Outlook Negative," published today on RatingsDirect.)

Rationale

Our outlook revision and ratings affirmation reflect our view that VW will maintain a better-than-expected operating performance as well as show improving cash flow generation in 2018 and 2019, and thereby maintain adjusted leverage metrics consistent with the 'BBB+' long-term corporate credit rating. Specifically, we forecast VW to maintain ratios of funds from operations (FFO) to debt above 45% and debt to EBITDA below 2x, on a sustained basis. This is despite the recently reported and unexpected €2.6 billion diesel-related charge and the risk of further charges in the next couple of years, which in

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our forecasts we have factored in our own estimate of €2.0 billion in each of 2018 and 2019.

VW's underlying business performance has been improving. Latest group figures for the nine months to Sept. 30, 2017, show volumes ahead by 2.6% to 7.8 million units (including China joint-venture volumes of 2.9 million units). For the 12 months to Sept. 30, VW's S&P Global Ratings-adjusted EBITDA margin was 10.1%, much stronger than the 6.4% during the same period in 2016, albeit there was a further €2.6 billion diesel emission-related charge taken in the third quarter. Furthermore, EBITDA and FFO were €19.6 billion and €12.5 billion and, on this basis, VW's ratios of FFO to adjusted debt and adjusted debt to EBITDA were 51% and 1.3x compared to 36% and 2.1x for full-year 2016. On an adjusted basis for the 12 months to Sept. 30, 2017, VW demonstrated negative free operating cash flow (FOCF) of about €6.2 billion.

Our assessment is supported by our expectation of FFO to adjusted debt and debt to EBITDA in 2017 of 50%-55% and about 1.5x; and in 2018 of about 55% and 1.4x. A constraining factor is the remaining cash payments of about €6.3 billion related to diesel emissions-related charges, of which about €2.5 billion remains to be paid in 2017 and the rest in 2018. We expect strongly negative FOCF in 2017, improving to a broadly neutral level in 2018 then positive in 2019.

Our base case assumes:
- Global GDP growth in 2018 of about 3.7%, including 1.7% in Western Europe, 5.5% in Asia-Pacific, and 2.3% in North America.
- In line with our GDP growth expectations, we forecast global light vehicle volume growth of around 2% in 2018 and 2019, with Asia-Pacific remaining the main growth market, Europe slightly ahead, the U.S. slightly lower.
- For VW, we see slightly positive volume growth and slightly higher group revenues in 2018 and 2019.
- Adjusted EBITDA margins of 12%-13% in 2017 and 2018, after including €2.6 billion of existing diesel-related charges in 2017 and a further €2.0 billion in each of 2018 and 2019, based on our estimate.
- Slightly lower equity-accounted profits and dividends from joint ventures in China due to weaker market conditions.
- Substantial cash outflows of about €17 billion in 2017, related to diesel-emissions-related charges.
- Annual capital expenditure (capex; including capitalized development costs) of around €19 billion.
- Negative FOCF in 2017, becoming broadly neutral in 2018 then positive in 2019.
- Annual dividends to be declared and paid, in line with a 30% payout ratio.
- No material acquisitions or disposals.

This leads us to the following credit ratios:
- FFO to debt of 50%-55% in 2018 and about 55% in 2019.
- Debt to EBITDA of about 1.5x in 2017 and 1.4x in 2018.

Our business risk profile assessment is still supported by VW's market position as the world's largest automotive manufacturer. During 2016, the group sold 10.3 million passenger cars and commercial vehicles, across 12 brands in volume, premium, and luxury segments (including volumes sold by unconsolidated joint ventures in China). Key brands in the passenger car segment include: VW, Audi, Porsche, Skoda, SEAT, and Bentley; and the commercial vehicles area: Scania, MAN, and VW. VW's geographic diversity is balanced across Europe and Asia, with each representing about 40% of volumes, but it has only a very small market position in North America. The VW group also has financial services activities that support the sale and leasing of VW's vehicles. On Dec. 31, 2016, the group had about 9.5 million leasing and financing contracts in the financial services division. In 2016, the group reported consolidated revenues of about €217 billion.

Our assessment is constrained by the negative reputational and brand consequences from VW's manipulation of diesel emissions in 11 million vehicles, which came to light in September 2015, and the subsequent €25.2 billion of charges taken since. Contingent liabilities of €7.4 billion have been recognized, mostly in relation to the diesel issue, including investor lawsuits filed against the company, which indicates that VW may need to make additional payments in the future.

Other constraining factors include major disruptions over the next decade and beyond, notably the phasing out of internal combustion engines and their gradual replacement by hybrid and electric vehicles, in some countries.

Stringent environmental standards, new technology, consumer trends, new market entrants, and the emergence of new forms of mobility threaten the business models of the incumbents. The industry's response--with the electrification, digitalization, connectivity, and autonomy of vehicles--will add billions to VW's research, development, and capital spending budgets, which will pressure profit margins and cash flows, which we expect to require mitigating cost-cutting steps. We regard VW's cost structure to be less flexible than peers.

We do not expect VW to participate in large-scale acquisitions or mergers, but anticipate further investments in joint ventures, partnerships, and alliances to work more closely with suppliers and technology providers, and in some cases with direct peers, to collaborate on investments and share R&D costs. We do not expect large-scale divestments in the near term.

Our financial risk profile assessment is supported by our expectations of adjusted credit ratios of FFO to adjusted debt and adjusted debt to EBITDA in 2017 of 50%-55% and about 1.5x; and in 2018 of about 55% and 1.4x. Constraining factors are substantial capex, and cash payments of emissions-related provisions, which we expect to lead to strongly negative FOCF in 2017.

VW has a substantial financial services business, which supports the sale and leasing of its vehicles. On Sept. 30, 2017, the group had captive finance receivables and operating lease assets of about €161 billion. We regard the asset quality of the €123 billion of finance receivables (which are primarily vehicle-financing term loans) to be excellent, based on annual net credit losses being less than 1% in recent years.

Lease assets of about €38 billion for the group expose the parent to the risk of residual value losses. These arise when proceeds from the sale of the assets at the end of the lease period are lower than expected. VW manages this as part of its risk management framework. Such losses are naturally unpredictable and can be significant during periods of stress, thereby potentially weakening the overall creditworthiness of the group. For VW, lease assets comprise a relatively small share (24%) of the group's total captive finance-related assets.

To finance these captive assets, VW has incurred significant debt obligations. These stood at about €153 billion on Sept. 30, 2017, which represented almost all of the group's total gross debt of €159 billion. Leverage in the captive finance operations (that is, reported debt to equity) was 6.1x, which was relatively lower than peers, and we expect it to be maintained at a similar level. VW's captive finance operations rely heavily on short-term financial liabilities, which stood at about €80 billion on Sept. 30, 2017. We see these liabilities as relatively concentrated in terms of duration, but consider them to be broadly matched to short-term finance receivables and other short-term assets.

We exclude the reported gross debt of the financial services division from the reported group debt to calculate our adjusted debt figures. On this basis, adjusted debt was €24.8 billion at Sept. 30, 2017. Our main analytical adjustments to total reported gross debt of €159 billion are to deduct €153 billion of financial services debt and €26 billion of surplus cash. We add about €25 billion for pensions, €6 billion of diesel emissions-related charges which have not yet been disbursed, €4 billion for operating leases, a €4 billion put option in respect of German trucking subsidiary MAN, and about €6 billion for hybrids. VW is one of the largest corporate issuers of hybrids at €11.0 billion (including €3.5 billion issued in June 2017). These qualify for intermediate equity content, so are treated as 50% debt and 50% equity in our debt figures.

We continue to regard VW's management and governance as a weakness given the deficiencies seen in its risk management, internal controls, and the legal infractions that occurred with the diesel emissions issue. We also view VW's ownership structure as negatively influencing its corporate decision making, with limited consideration given to minority shareholders. In particular, this reflects the continued disproportionate voting rights of Porsche Automobil Holding SE (Porsche SE) at 52.2%, held through only 30.8% of VW's subscribed capital, which gives Porsche SE full control of VW. Porsche SE is itself 100%-owned and controlled by members of the Porsche and Piech families. Without improvements in VW's management and governance framework, a rating in the 'A' category is unlikely.

We continue to regard VW's captive finance entities Volkswagen Financial Services AG and Volkswagen Bank GmbH as core entities under our criteria, reflecting our view that the parent would support them under any foreseeable circumstances.

Liquidity

The short-term rating on VW is 'A-2', reflecting the long-term issuer credit rating of 'BBB+'. We consider VW's liquidity to be strong, reflecting our expectations that the ratio of sources of liquidity to uses in the automotive division will remain above 1.5x during the next year and above 1.0x during the following year, and remain sufficient to cover uses even if EBITDA were unexpectedly 30% lower than our forecasts.

On a consolidated basis including the financial services division, VW had substantial cash and marketable securities of about €38 billion as of Sept. 30, 2017. VW also has undrawn committed bank lines maturing in more than 12 months, notably a €5 billion revolving credit facility that matures in 2020. There are substantial short-term financial liabilities, which stood at about €80 billion, of which €37 billion comprised bonds, commercial paper, and notes; €13 billion due to banks; and €29 billion of bank deposits.

Resilient access to debt capital markets remains important to enable refinancing, and we view positively VW's return to the senior unsecured bond market this year, with an issue of €8 billion in March 2017 across several maturities, and a €3.5 billion hybrid issue in June 2017.

We do not think that the financing needs of the captive pose additional risks for the parent.

On Sept. 30, 2017, the liquidity profile of the automotive division included the following sources:

- Retained cash of €16 billion and marketable securities of €14 billion (from which we deduct €3 billion as unavailable for debt repayment);
- An undrawn €5.0 billion revolving credit facility maturing in April 2020; and
- Sizable cash flow from operations.

The automotive division had the following liquidity uses at the same date:

- Remaining cash disbursements of about €6 billion in relation diesel emissions charges, largely in 2018;
- Capex of about €19 billion annually (including capitalized development costs);
- Increased annual dividend payments compared to 2016 at a 30% payout ratio; and
- Annual capital increases for Volkswagen Financial Services, in line with previous years.

Outlook

The stable outlook on VW reflects our expectation of steady operating performance as well as show improving cash flow generation, with only limited further charges in relation to the diesel emission issue. We expect VW will maintain leverage ratios in line with our forecasts of FFO to adjusted debt and adjusted debt to EBITDA of above 45% and below 2x during the next two years.

Downside scenario

We could lower the ratings if VW continues to bear material additional diesel emissions-related charges to meet fines or litigation damages without taking sufficient offsetting measures. Ongoing negative FOCF would also be a negative factor, as would VW's leverage metrics sustainably weakening to adjusted FFO to debt below 45% or adjusted debt to EBITDA above 2x.

Upside scenario

We do not expect to raise the ratings during the next two years. To do so, we would need to see VW sustainably demonstrate FFO to adjusted debt above 60%, and healthy positive FOCF. This could occur if the company shows operating results ahead of our current expectations. Additionally, we would need to see improvements in VW's management and governance framework, without which a rating in the 'A' category is unlikely.

Ratings Score Snapshot

Corporate credit rating: BBB+/Stable/A-2

Business risk: Satisfactory
- Country risk: Intermediate
- Industry risk: Moderately high
- Competitive position: Strong

Financial risk: Modest
- Cash flow/leverage: Modest

Anchor: bbb+

Modifiers
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Fair (no impact)
- Captive finance: Neutral (no impact)
- Comparable rating analysis: Neutral (no impact)

Issue Ratings

Capital structure

VW's outstanding debt consists largely of senior unsecured obligations issued by a number of financing entities including Volkswagen Financial Services AG, Volkswagen International Finance NV, and others.

Analytical conclusions

We consider that issuers such as VW, whose financial risk profile assessment is modest, have leverage that is low enough to limit the possibility of any lenders being more significantly disadvantaged than others. Therefore, we rate the senior unsecured long-term debt issued by such issuers at the same level as the issuer credit rating of the issuer.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, June 1, 2016
- Criteria - Corporates - General: Methodology: The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers, Dec. 14, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Auto And Commercial Vehicle Manufacturing Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology And Assumptions: Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments, April 1, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Criteria - Financial Institutions - General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010

- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Volkswagen AG		
Volkswagen Group Services S.A.		
Corporate Credit Rating	BBB+/Stable/A-2	BBB+/Negative/A-2
Volkswagen Insurance Co. Ltd.		
Counterparty Credit Rating		
Local Currency	BBB+/Stable/--	BBB+/Negative/--
Financial Strength Rating		
Local Currency	BBB+/Stable/--	BBB+/Negative/--

Ratings Affirmed

Volkswagen AG	
VW Credit Inc.	
Volkswagen Group of America Finance LLC	
Senior Unsecured[1]	BBB+
Commercial Paper	A-2
Porsche Holding GmbH	
Commercial Paper	A-2
VW Credit Canada Inc.	
Senior Unsecured[1]	BBB+
Commercial Paper[1]	A-1(LOW)
Commercial Paper[1]	A-2
Volkswagen Canada Inc.	
Commercial Paper[1]	A-1(LOW)
Commercial Paper[1]	A-2
Volkswagen Group Services S.A.	
Commercial Paper[1]	A-2
Volkswagen International Finance N.V.	
Senior Unsecured[1]	BBB+
Junior Subordinated[1]	BBB-
Commercial Paper[1]	A-2
Volkswagen International Luxemburg S.A.	

Senior Unsecured	BBB+
Commercial Paper	A-2

[1]Guaranteed by Volkswagen AG.

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