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DBRS Morningstar Confirms Volkswagen AG at A (low); Trend Remains Stable

Industry Group: Corporate Finance

Sub-Industry: Autos & Auto Suppliers

Region: Canada

DBRS Limited (DBRS Morningstar) confirmed Volkswagen AG's (VW or the Company) Issuer Rating at A (low) with a Stable trend. DBRS Morningstar also confirmed the Senior Unsecured Debt and Commercial Paper ratings of VW Credit Canada, Inc. at A (low) and R-1 (low), respectively, both with Stable trends. The rating confirmations reflect the Company's ongoing solid financial performance notwithstanding extended disruptions in automotive production and volumes, initially attributable to the global progression of Coronavirus Disease (COVID-19) and, subsequently, to the semiconductor shortage. Despite emerging headwinds across certain markets and sizable investment requirements for the foreseeable future, DBRS Morningstar expects VW's financial risk assessment (FRA) to remain strong in the context of the currently assigned ratings, which remain supported by the Company's solid business risk assessment as a major automotive original equipment manufacturer of substantial scale with a highly diversified brand portfolio. Notwithstanding the above, DBRS Morningstar notes that certain environmental, social, and governance (ESG) risk factors continue to negatively affect the ratings.

The 2021 financial performance of VW's Automotive division improved considerably following 2020 results that were weakened because of the coronavirus. While volumes remained significantly curtailed as a result of the semiconductor shortage (and other supply base challenges), this was more than offset by firmer product mix (that reflected the deliberate allocation of available semiconductors to the production of higher-margin vehicles) and strong pricing (facilitated by sizable pent-up demand); higher product development costs and other cost increases represented additional partial offsets. Moreover, the profitability of the Company's Financial Services business attained record levels amid reduced provisions for credit losses and very favourable residual value performance (reflecting strong used car values given the ongoing scarcity of available vehicles). As a result, VW's 2021 annual consolidated profit effectively doubled year over year (YOY), exceeding EUR 19 billion; earnings continued to trend positively in H1 2022 with the underlying factors cited above remaining essentially constant. For the 2022 full year, amid an anticipated moderation of the semiconductor shortage, VW is projecting consolidated revenues to be higher in the range of 8% to 13% YOY, with the operating margin likely in the range of 7.0% to 8.5% (absent special items). DBRS Morningstar deems the Company's outlook to be attainable. While DBRS Morningstar acknowledges various impending headwinds, including softening consumer sentiment stemming from inflationary pressures, rising interest rates, and increased geopolitical uncertainty, these are estimated to be more than offset by the sizable pent-up demand resulting from the protracted disruptions in automotive supply that have now spanned more than two years.

Going forward, reflecting tightening emissions legislation worldwide (albeit most notably in Europe and in China), the Company is targeting a leadership position in the automotive industry's transition away from internal combustion engines (ICEs) and toward battery electric vehicles. Additionally, VW is seeking to further transform itself into a major provider of new mobility services. While these objectives are projected to entail substantial financial outlays over the next several years in the form of requisite capital spending and anticipated merger and acquisition activity, DBRS Morningstar expects these to be sufficiently covered by the Company's legacy ICE business' ongoing free cash flow generation; VW benefits further from its strong presence in the premium automotive segment, which is projected to outgrow the automotive industry as a whole while typically generating considerably stronger margins relative to mainstream brands. DBRS Morningstar

also notes that the possible initial public offering of a partial stake in Porsche AG would provide the Company with considerable additional flexibility in this regard.

Consistent with the Stable trends, DBRS Morningstar expects the ratings to remain constant over the near to medium term, and DBRS Morningstar notes that VW's FRA provides some cushion against unexpected challenges at the current rating level, rendering a downgrade rather unlikely. Conversely, an upgrade is not anticipated over the aforementioned time horizon given the cost headwinds facing the automotive industry amid the substantial financial outlays projected to be incurred by the Company in pursuit of its strategic objectives.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

DBRS Morningstar considered that the environmental factor related to carbon and greenhouse gas costs represents a relevant negative factor as VW, consistent with its automotive peers, is facing a fundamental transformation process in line with the implementation of ever more stringent emission and fuel consumption regulations across several jurisdictions. Accordingly, the Company is undergoing substantial investments associated with the electrification of its model portfolio, including the further development of modular toolkits for its volume, premium, and sports brands. Similarly, VW is investing in the gradual conversion of its locations for the production of electric vehicles and in the creation of battery manufacturing capacity with the aim of establishing a battery supply chain under its own control.

DBRS Morningstar considered that the social factor related to product governance represents a significant negative factor in connection with VW's diesel issue, which dates back to 2015 and initially spanned 482,000 vehicles in the United States, only to quickly increase to 11 million units globally. Associated costs in the form of vehicle refits, fines, and provisions for legal claims have exceeded EUR 30 billion. While this likely represents the majority of such charges, DBRS Morningstar notes that there may yet be additional increases pending further developments, litigation, and regulatory sanctions.

DBRS Morningstar considered that the governance factor related to corporate/transaction governance, specifically with respect to VW's shareholder structure and distribution of voting rights, represents a relevant negative factor. As of 2021 year-end, Porsche Automobil Holding SE, Stuttgart held 53.3% of voting rights. The State of Lower Saxony (the second-largest shareholder) held 20.0% of the voting rights, with Qatar Holding LLC holding 17.0% of voting rights. Accordingly, external shareholders have very few voting rights; these amounted to 9.7% as of 2021 year-end. Similarly, VW's supervisory board is composed primarily of shareholders and worker representatives, with only a nominal proportion of independent members; this potentially limits the board's ability to oversee risks.

The combination of the ESG factors cited above negatively affects the ratings.

A description of how DBRS Morningstar considers ESG factors within the DBRS Morningstar analytical framework can be found in the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings at <https://www.dbrsmorningstar.com/research/396929/dbrs-morningstar-criteria-approach-to-environmental-social-and-governance-risk-factors-in-credit-ratings>.

Notes:

All figures are in euros unless otherwise noted.

The principal methodologies are Rating Companies in the Automotive Manufacturing and Supplier Industries (October 14, 2021; <https://www.dbrsmorningstar.com/research/385892>), DBRS Morningstar Criteria: Guarantees and Other Forms of Support (April 4, 2022; <https://www.dbrsmorningstar.com/research/394683>), DBRS Morningstar Criteria: Commercial Paper Liquidity Support for Nonbank Issuers (March 1, 2022; <https://www.dbrsmorningstar.com/research/393065>), and



DBRS Morningstar Criteria: Preferred Share and Hybrid Security Criteria for Corporate Issuers (October 21, 2021; <https://www.dbrsmorningstar.com/research/386355>), which can be found on [dbrsmorningstar.com](https://www.dbrsmorningstar.com) under Methodologies & Criteria. Other applicable methodologies include the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings (May 17, 2022; <https://www.dbrsmorningstar.com/research/396929>).

The related regulatory disclosures pursuant to the National Instrument 25-101 *Designated Rating Organizations* are hereby incorporated by reference and can be found by clicking on the link under Related Documents or by contacting us at info@dbrsmorningstar.com.

The rated entity or its related entities did participate in the rating process for this rating action. DBRS Morningstar had access to the accounts and other relevant internal documents of the rated entity or its related entities in connection with this rating action.

This rating is endorsed by DBRS Ratings Limited for use in the United Kingdom, and by DBRS Ratings GmbH for use in the European Union, respectively. The following additional regulatory disclosures apply to endorsed ratings:

Each of the principal methodologies employed in the analysis addressed one or more particular risks or aspects of the rating and were factored into the rating decision. Specifically, “Rating Companies in the Automotive Manufacturing and Supplier Industries” (October 14, 2021) was the primary rating methodology applied in determining the rating of parent company Volkswagen AG. Subsequently, “DBRS Morningstar Criteria: Guarantees and Other Forms of Support” (April 4, 2022) was applied in determining the ratings of VW Credit Canada, Inc., which benefits from a Guarantee of Volkswagen AG. The Guarantee, in combination with DBRS Morningstar’s assessment of additional implicit support considerations, including (but not limited to) business, reputational, and financial factors (that are deemed likely to motivate a parent or affiliated company to support its subsidiary issuer), results in a flow-through of Volkswagen AG’s rating to VW Credit Canada, Inc. DBRS Morningstar also applied “DBRS Morningstar Criteria: Commercial Paper Liquidity Support for Nonbank Issuers” (March 1, 2022) to ensure that the provided liquidity in support of the Commercial Paper rating of VW Credit Canada, Inc. was consistent with DBRS Morningstar criteria. Finally, DBRS Morningstar applied “DBRS Morningstar Criteria: Preferred Share and Hybrid Security Criteria for Corporate Issuers” (October 21, 2021) to determine the equity treatment of various hybrid notes issued by Volkswagen AG.

The last rating action took place on August 10, 2021, when DBRS Morningstar confirmed Volkswagen AG’s rating at A (low) and changed the trend to Stable from Negative.

The conditions that lead to the assignment of a Negative or Positive trend are generally resolved within a 12-month period. DBRS Morningstar trends and ratings are under regular surveillance.

For further information on DBRS Morningstar historical default rates published by the European Securities and Markets Authority (ESMA) in a central repository, see: <https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml>. DBRS Morningstar understands further information on DBRS Morningstar historical default rates may be published by the Financial Conduct Authority (FCA) on its webpage: <https://www.fca.org.uk/firms/credit-rating-agencies>.

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Rating Committee Chair: Charles Halam-Andres, Managing Director, Diversified Industries & Sports Finance

Initial Rating Dates: Volkswagen AG – May 16, 2001; VW Credit Canada Inc. – April 24, 2000



DBRS Morningstar will publish a full report shortly that will provide additional analytical detail on this rating action. If you are interested in receiving this report, contact us at info@dbrsmorningstar.com.

For more information on this credit or on this industry, visit www.dbrsmorningstar.com or contact us at info@dbrsmorningstar.com.

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- Rating Companies in the Automotive Manufacturing and Supplier Industries (October 14, 2021)
<https://www.dbrsmorningstar.com/research/385892/rating-companies-in-the-automotive-manufacturing-and-supplier-industries>
- DBRS Morningstar Criteria: Guarantees and Other Forms of Support (April 4, 2022)
<https://www.dbrsmorningstar.com/research/394683/dbrs-morningstar-criteria-guarantees-and-other-forms-of-support>
- DBRS Morningstar Criteria: Commercial Paper Liquidity Support for Nonbank Issuers (March 1, 2022)
<https://www.dbrsmorningstar.com/research/393065/dbrs-morningstar-criteria-commercial-paper-liquidity-support-for-nonbank-issuers>
- DBRS Morningstar Criteria: Preferred Share and Hybrid Security Criteria for Corporate Issuers (October 21, 2021)
<https://www.dbrsmorningstar.com/research/386355/dbrs-morningstar-criteria-preferred-share-and-hybrid-security-criteria-for-corporate-issuers>

Issuer	Debt	Rating Action	Rating	Trend
Volkswagen AG	Issuer Rating	Confirmed	A (low)	Stable
* VW Credit Canada Inc.	Senior Unsecured Debt	Confirmed	A (low)	Stable
* VW Credit Canada Inc.	Commercial Paper	Confirmed	R-1 (low)	Stable

* Guaranteed by Volkswagen AG

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