

Research Update:

Safran Outlook Revised To Positive On Further Deleveraging Prospects Despite Supply Chain Issues; 'BBB+' Rating Affirmed

April 29, 2022

Rating Action Overview

- France-based aircraft engine manufacturer Safran is deleveraging its balance sheet faster than previously anticipated through solid free operating cash flow (FOCF), combined with a prudent financial policy. Supply chain disruptions and input cost inflation are key challenges in the short-term, but S&P Global Ratings thinks that Safran remains well positioned to benefit from commercial air traffic recovery thanks to its exposure to narrowbody aircraft and the young age of its CFM engine fleet.
- We revised our outlook to positive from stable and affirmed our 'BBB+' long-term issuer credit rating on Safran. We have also affirmed our 'BBB+' issue rating on Safran's unsecured debt.
- The positive outlook indicates that we could raise our rating on Safran by one notch within the next 12 months if it can overcome supply chain constraints and rising input costs, such that its adjusted EBITDA margin stays above 16%. It also reflects our expectation that Safran will continue to operate with a prudent financial policy, translating to FFO to debt above 60% and FOCF to debt above 40%.

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Rating Action Rationale

Safran's rating headroom is increasing, but supply chain constraints and China's zero-COVID policy could cloud the positive trend in demand. Although Safran's revenue decreased 7.5% in 2021 due to the lingering effects of the COVID-19 pandemic on travel restrictions, the company managed to increase its S&P Global Ratings-adjusted EBITDA margin to 16.1% from 14% in 2020, reflecting the successful implementation of its cost reduction plan. Over 2022-2024, commercial air traffic recovery should support a more positive demand momentum for Safran's engines and spare parts. The company's exposure to narrowbody aircraft is an advantage because pent-up demand for domestic flights is set to recover quicker than for international flights. Nevertheless, successful cost management and control over the supply chain will remain key levers to protect earnings and cash flows in an environment marked by trade sanctions with Russia, rising input

costs, shortages of raw material and labor, and continued travel restrictions in China due to its strict COVID-19 policy. The supply situation around titanium is particularly tense in the aerospace industry because Russia-based VSMPO used to provide for about 50% of total needs. Safran has safety stocks covering its needs until the end of 2022 and is looking to secure alternative sourcing from already qualified suppliers based in the U.S. and in Japan. Overall, Safran currently estimates that the impact from the conflict in Ukraine and from higher input costs will represent a headwind of about 150 basis points on its earnings, which it plans to fully offset through additional cost reduction initiatives, deferring expenses, and other commercial actions including price escalation. As the Russia-Ukraine conflict evolves, Safran will continue to assess its balance sheet exposure, including for the companies accounted for under the equity method.

Safran's FOCF is benefiting from favorable working capital swings. Safran's FOCF generation has been solid in the past two years (cumulative €3.4 billion) despite the demand shock in the aerospace industry from the COVID-19 pandemic. The company has been extremely agile in managing its costs (also benefiting from state-backed short-time work) and capital expenditures (capex). In 2022 and 2023, Safran's cash conversion rate will benefit from material advance payment linked to orders for its M88 engines that go into the Rafale. In our base case, we have assumed that Safran's FOCF will hover around €2 billion in 2022 and 2023, compared with the same level in 2021 and €1.4 billion in 2020. Beyond 2023, we understand that advance payments related to the M88 program could fall. Thus, we have been more cautious about our assumptions for working capital changes after 2023, also considering the expected increase in LEAP production of more than 2,000 units (up from 845 in 2021).

Safran's prudent financial policy is a key driver to its rapid deleveraging. Safran's strong balance sheet remains key for the rating. By the end of 2023, we forecast that Safran's debt to EBITDA will decrease to below 0.5x from 1.2x in 2021, driven by strong FOCF generation combined with modest returns to shareholders. In 2022, Safran's management will propose to stick to a moderate payout ratio with a proposed dividend payment of about €215 million. This follows the suspension of the roughly €1 billion dividend payment in 2020 for the 2019 results and a low dividend payment of €188 million (including €5 million paid by foreign subsidiaries to noncontrolling shareholders) in 2021. Following the May 2022 annual general meeting, Safran's board of directors will review its practice regarding returns to shareholders. This is not a concern, in our view, given the financial flexibility that it should have built by then. Safran has indicated that it aims to maintain its reported leverage well below 1x; which could be consistent with a higher rating.

Decarbonization of the commercial aerospace industry will require investments. Safran and other Tier 1 engine manufacturers Rolls-Royce PLC (BB-/Stable/--) and Pratt & Whitney (part of Raytheon Technologies (A-/Negative/--)) are committed to supporting their customers Boeing and Airbus in the transition to greener air transport by offering more efficient engines, developing engines that are compatible with sustainable fuels, and alternative propulsion (e.g., electric, hybrid, and hydrogen). To that end, Safran has extended its partnership with GE to 2050 and created a new technology demonstration program called RISE under CFM. Safran intends to be ready to offer next-generation engines by 2035 by dedicating 75% of its research and technology spending (equivalent to 2.5%-3.0% of sales) to green aviation. Furthermore, its strong balance sheet provides headroom to accelerate investments if needed.

Outlook

The positive outlook indicates that we could raise our rating on Safran by one notch within the next 12 months if it can overcome challenges related to supply chain constraints and rising input costs, such that its S&P Global Ratings-adjusted EBITDA margin can stay above 16%. It also reflects our expectation that Safran will continue to operate with a prudent financial policy and is further strengthening its balance sheet.

Downside scenario

We could revise the outlook back to stable if:

- Safran's earnings or cash flows suffer from weaker-than-expected air traffic recovery due to the resurgence of new variants of COVID-19; or
- Supply chain issues occur, leading its EBITDA margin to fall below 16% or its FFO to debt and FOCF to debt to fall below 60% and 40%, respectively.

This would also require that Safran maintains EBITDA margin of 16%-18%, and a conservative financial policy.

Upside scenario

We could raise our rating on Safran if it can maintain solid credit metrics, such that:

- Adjusted funds from operations (FFO) to debt stays above 60%; and
- Adjusted FOCF to debt is consistently higher than 40%.

Company Description

Safran is a global Tier 1 aerospace and defense group focused on the design, manufacture, sale, and servicing of aircraft and helicopters systems. Its main business is aerospace propulsion (49% of 2021 revenue) as a leading engine manufacturer and aftermarket services provider for commercial single-aisle aircraft, helicopters, and military aircraft. The aircraft equipment, defense, and aerosystems division (41%) provides a broad range of products such as landing gears, wheels, brakes, nacelles, wiring, avionics, optronics, and fluid systems. The aircraft interiors division (10%) provides cabin interiors (such as lavatories), seats, water and waste systems, and in-flight entertainment.

Safran is headquartered in France. It generated revenue of about €15.3 billion in 2021. The company is listed on the Euronext stock exchange. As of December 2021, the French state held about 11.2% of Safran's shares, employees held about 7% of shares, and the rest was free float.

Our Base-Case Scenario

- Global passenger air traffic (as measured by revenue passenger kilometers) to gradually recover to 2019 levels by 2024, with quicker recovery prospects for domestic flights than for international flights.

- Revenue growth of 17%-18% in 2022 and 10%-12% in 2023 driven by pent-up demand in all segments. We see faster recovery prospects from the propulsion engines division as opposed to aircraft equipment and interiors division due to the larger exposure to wide-body airplane production within the aircraft equipment and interiors division.
- EBITDA margin improving in 2022 and 2023 from the growth of profitable aftermarket sales through higher shop visits and the turnaround of the interiors division, offsetting negative mix from the LEAP ramp-up. We deduct capitalized development costs from our adjusted EBITDA figures, which we expect will stay around €300 million over 2022-2023 from €311 million in 2021. We assume no material restructuring costs in 2022 and 2023, compared with €79 million in 2021 and €131 million in 2020.
- Annual capex of €700 million-€750 million in 2022 and €850 million-€900 million in 2023 excluding capitalized research and development (R&D), compared with €440 million in 2021.
- Working capital inflow of about €300 million in 2022 and 2023 reflecting more advance payments linked to the Rafale program and to the LEAP, offsetting higher inventories from a ramp-up in activity from 2022.
- Dividend payment of €220 million in 2022 after €188 million in 2021. Dividend payout of 40% in 2023.
- No material acquisitions or material disposals on a net basis in our base-case scenario.

Safran S.A.--Key Metrics*

Mil. €	--Fiscal year ended Dec. 31--				
	2019a	2020a	2021a	2022e	2023f
Revenue	24,640	16,498	15,257	17,800-18,000	19,500-20,000
Revenue growth (%)	17	(33)	(7.5)	17-18	10-12
EBITDA	4,461	2,322	2,452	2,900-3,000	3,400-3,500
EBITDA margin (%)	18	14	16	16-17	17-18
Funds from operations (FFO)	3,481	2,099	2,066	2,300-2,400	2,600-2,700
Capital expenditure	837	506	440	700-750	850-900
Free operating cash flow (FOCF)	2,303	1,419	1,957	1,800-1,900	2,000-2,100
Dividends	817	4	188	220	500-600
Debt	5,997	4,639	2,838	1,600-1,700	600-700
Debt to EBITDA (x)	1.3	2	1.2	0.5-0.7	0.1-0.3
FFO to debt (%)	58	45	73	130-150	400-420
FOCF to debt (%)	38	31	69	100-120	300-320

*All figures adjusted by S&P Global Ratings. Key adjustments to debt include pension liabilities for about €508 million and accessible cash of about €4.9 billion. a--Actual. e--Estimate. f--Forecast.

Liquidity

We expect Safran will maintain a strong liquidity profile and that sources of liquidity will exceed uses by more than 1.5x over the 12 months from Dec. 31, 2021, and by more than 1.0x in the following 12 months. We also expect liquidity sources to exceed uses, even if EBITDA unexpectedly

fell 30% below our base-case forecast. Safran maintains well-established bank relationships and access to debt capital markets, as demonstrated by the signing of a €3 billion bridge facility in April 2020, now cancelled. We consider Safran's debt maturity profile manageable.

Principal liquidity sources for the 12 months started Jan. 1, 2022, are:

- Cash of about €4.9 billion, excluding about €400 million of cash considered not readily accessible;
- Forecast FFO of €2.4 billion-€2.6 billion (before capitalized R&D); and
- €500 million drawing under a new loan from the European Investment Bank.

We do not include the undrawn revolving credit facility of €2.52 billion that is maturing in December 2022.

Principal liquidity uses for the same period are:

- About €1.8 billion of debt maturing (including commercial paper).
- Up to €600 million-€700 million of working capital needs including intrayear swings;
- Capex of about €1 billion including capitalized development costs; and
- About €220 million in annual dividend payments (including dividend payment to noncontrolling shareholders from foreign subsidiaries).

Covenants

There are no financial maintenance covenants under the revolving credit facility agreement. The U.S. private placement agreement includes one maintenance covenant stipulating that net debt to EBITDA must remain below 2.5x. We expect at least 30% headroom under this covenant in our base-case forecast. As of Dec. 31, 2021, Safran's net debt to EBITDA ratio stood at about 0.6x.

Government Influence

Under our criteria for rating government-related entities, we view Safran as having limited importance to its 11.2% shareholder, France. This assessment reflects our view that the French government is primarily interested in the company's critical operations and employment, and to a lesser extent by its credit standing. We likewise view the link between Safran and the French government as limited. This is because the French government occupies only two seats out of 18 at the company's board of directors and acts just as any other minority shareholder. As a result, we assess the likelihood of extraordinary government support as low and do not add any uplift for government support to Safran's 'bbb+' stand-alone credit profile.

Issue Ratings - Subordination Risk Analysis

Capital structure

Safran's financial debt mostly comprises unsecured bonds and unsecured bank loans located at Safran S.A.

Analytical conclusions

We rate Safran's notes at the same level as the long-term issuer credit rating because there are no significant elements of subordination risk present in its capital structure.

Ratings Score Snapshot

Issuer credit rating: BBB+/Positive/--

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Satisfactory

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: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: BBB+

ESG credit indicators: E-2, S-3, G-2

Related Criteria

- 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: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global

Corporate Issuers, Dec. 16, 2014

- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Safran SA		
Issuer Credit Rating	BBB+/Positive/--	BBB+/Stable/--
Senior Unsecured	BBB+	

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.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914

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