Research Update:

French Engine And Equipment Maker Safran Upgraded To 'A-' On Solid Free Cash Flow; Outlook Stable

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Rating Action Overview

- Safran has continued to generate solid free operating cash flow (FOCF) and its credit metrics have strengthened, and we expect its S&P Global Ratings' adjusted debt to EBITDA will decrease to about 0.3x-0.5x at year-end 2022 from 1.2x in 2021 and 2.0x in 2020.
- The steep ramp-up in LEAP engine build rates, coupled with supply chain bottlenecks and input cost inflation, could weigh on Safran's EBITDA margins in 2023-2024, but we think that pricing, cost discipline, and large advance payments from customers will support sizeable recurring FOCF generation and a stronger balance sheet.
- We also believe that Safran will maintain its reported debt to EBITDA (leverage) in the lower end of its 0x-1x target range while comfortably accommodating shareholder returns and mergers and acquisitions (M&As).
- We therefore raised our long-term issuer credit rating and issue rating on Safran to 'A-' from 'BBB+'.
- The stable outlook reflects our expectation that Safran's large exposure to narrowbody aircraft and strong cost discipline will mitigate weakening macroeconomic conditions and input cost inflation, such that it will maintain an EBITDA margin of 16%-17% and solid annualized FOCF of about €2 billion over the next two years.

Rating Action Rationale

Safran has demonstrated strong deleveraging capabilities amid extremely difficult market conditions that will result in its S&P adjusted debt to EBITDA ratio decreasing to 0.3x-0.5x by year-end 2022. Safran is set to generate solid FOCF of above €2.4 billion in 2022, up from about €2.0 billion in 2021, owing to the continued recovery in air traffic in Europe and the U.S. In China, which accounts for about 18% of the fleet in service of CFM International, the 50/50 joint company between Safran Aircraft Engines and GE, the recovery in flying hours has been more erratic due to the government's zero-COVID policy. The global narrowbody capacity (measured by average seat kilometers) reached an average of 81% of its 2019 level in the first nine months of 2022, up from 63% in 2021, and 38% in the last three quarters of 2020. The company's free cash flow generation is also boosted by favorable working capital dynamics. This is due to sizeable advance payments on M88 engines and the ramp-up of rate-per-flight-hour (RPFH) contracts. RPFH contracts are services contracts with airlines whereby the airlines pay a fee to Safran based on the number of hours flown by their planes in advance of future shop visits for maintenance. In 2022, we estimate that Safran's working capital will decrease by €700 million-€800 million.

Safran can cope with the market headwinds we foresee for 2023. Weakening economic growth in Europe and the U.S. could slow recovery in air traffic in 2023, while input cost inflation will likely persist. S&P Global Ratings' economists forecast that U.S. GDP growth will fall to 0.2% in 2023 from 1.6% expected in 2022, before returning to 1.6% in 2024. Similarly, Europe will likely face tougher macroeconomic conditions, translating into its GDP growth dropping to 0.7% in 2023 from 2.7% expected in 2022, then recovering to 2.1% in 2024. We think that persisting high levels of inflation coupled with higher interest rates could slow demand for air travel as consumers and potentially businesses reduce their discretionary spending; thereby delaying the recovery in air traffic toward pre-pandemic levels. Nevertheless, we see fewer risks for cheaper domestic and regional flights than for long-haul and international flights (i.e., prospects are much better for narrowbody versus widebody aircraft); placing Safran in a better place than some of its competitors, since it generates most of its profitable aftermarket revenue from narrowbody aircraft that typically serve domestic and regional routes. Exposure to widebody aircraft is more prominent for its equipment and interiors divisions. For China, we expect that the government will relax its stance on the zero-COVID policy from the second quarter of 2023, supporting our forecast of GDP growth of 4.7% in 2023, up from an expected 2.7% in 2022.

On the operating profit margin side, we anticipate some dilution from the increased production rate of LEAP engines, as per the normal ramp-up cycles for new generation of engines. Safran indicated at its last capital market day in December 2021 that its LEAP engines will reach original equipment (OE) gross margin breakeven in 2025 at the latest. In addition, even though OE contracts typically include escalation clauses, we think that it will be difficult for Safran to fully compensate for the expected increase in input costs, such as labor, energy, transportation, and some raw materials. Safran's pricing power is more meaningful in the aftermarket business, as demonstrated by the successive price increases implemented in November 2021 of about 6%-7% and in November 2022 of about 10%. Overall, we forecast that Safran's EBITDA margin will hover around the lower end of the 16%-17% range in 2023, from the higher end of the 16%-17% range we expect in 2022.

Over the longer term, Safran's growth prospects remain supported by a strong order backlog of 737MAX and A320neo and its young installed fleet of engines. Beyond 2023, Safran's leading market share (of about 70% based on net cumulative orders and commitments) in the narrowbody market with its LEAP engines will support revenue growth. In addition, the young age of its CFM56-5B/7B installed fleet will continue to drive first shop visits, which usually occur after six-to-seven years of service. The first two shop visits are usually the most profitable.

We expect that returns to shareholders will increase from 2023 without weighing on Safran's financial risk profile or our 'A-' rating on the company, due to its strong balance sheet and rating headroom. Safran plans to return to its historic 40% payout ratio from 2023. We think that this is compatible with our 'A-' rating on Safran based on our current base-case scenario. Similarly, we believe that Safran could accommodate moderate shares buyback as well as bolt-on acquisitions. We expect that Safran will conduct a financial policy in terms of distributions to shareholders and acquisitions that will protect its balance sheet and maintain reported leverage well below 1x.

Safran's limited diversification outside the commercial aerospace sector is a constraining factor for our assessment of the group's business risk profile relative to that of peers. About 75% of the company's activities relate to commercial aerospace, a sector that has been heavily affected by the pandemic. Defense and helicopter related operations make up the remaining 25%. Within commercial aerospace, Safran offers a very broad range of products covering extensive functions of an aircraft (such as engines, nacelles, brakes, wheels, fluid systems, cabins, seats, and lavatories). However, we think that Safran lacks the diversity of peers, such as Thales, Raytheon Technologies (RTC), or BAE Systems, and which are likely to demonstrate more resilient revenue, EBITDA, and cash flow in a downturn. For instance, France-based engineering company Thales covers diverse end markets, including commercial aerospace, defense, and digital security. U.S.-based RTC, which was formed from the merger between UTC Technologies and Raytheon, is one of the largest aerospace and defense companies; its revenue profile is more balanced than Safran's, with 55%-65% of sales correlated to commercial aerospace and 35%-45% related to defense. Finally, although BAE Systems is a pure defense player, it exhibits a large diversity of programs being on air, marine, and field platforms.

We view Safran as having limited importance to its 11.2% shareholder, France. 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 'a-' stand-alone credit profile. 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.

Outlook

The stable outlook reflects our expectation that Safran's large exposure to narrowbody aircraft and discipline on costs will mitigate weakening macroeconomic conditions and input cost inflation such that it will maintain an EBITDA margin of 16%-17%, and solid annualized FOCF of about €2 billion over the next two fiscal years.

Downside scenario

We could lower our rating on Safran if its credit metrics weaken such that:

- Funds from operations (FFO) to debt decreases below 60%;
- FOCF to debt decreases below 40%; or
- Debt to EBITDA increases to above 1.5x.

This could occur due to a slower-than-expected recovery in air traffic, or supply chain issues.

Upside scenario

Further rating upside is unlikely at this stage, based on our current assessment of Safran's business risk profile characterized by a high exposure to the commercial aerospace sector and in particular narrow body aircraft platforms.

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

Assumptions

- 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 international.
- Revenue growth of about 25% in 2022, driven by pent-up demand in all segments and favorable foreign exchange rates; followed by 15%-17% in 2023 and 11%-13 in 2024. We see faster recovery prospects from the propulsion engines division as opposed to aircraft equipment and interiors division due to the larger exposure to widebody airplane production within the aircraft equipment and interiors division.
- EBITDA margin of 16%-17% in 2022 and 2023 and improving to 16.5%-17.5% in 2024 from the growth of profitable aftermarket sales through increased shop visits and the turnaround of the interiors division, offsetting negative mix effects from the LEAP ramp-up. We deduct capitalized development costs from our adjusted EBITDA figures, which we expect will stay at about €300 million over 2022-2024 from €311 million in 2021.
- Annual capital expenditure (capex) of €650 million-€750 million in 2022 and €900 million-€1,100 million in 2023-2024, excluding capitalized research and development (R&D), compared with €440 million in 2021.
- Working capital inflow of about €800 million in 2022 and €400 million-€500 million 2023-2024, reflecting more advance payments linked to the Rafale program and the increase in RPFH contracts, 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% of net income in 2023 and 2024.

- Share buyback of €1 billion in 2023 to avoid the dilution from the convertible OCEANE bonds maturing in 2027, and €1 billion in 2024 although no announcement has been made from Safran.
- Annual bolt-on acquisitions of about €500 million.
- No material disposals in our base-case scenario, although 30% of ex-Zodiac activities have been identified as non-core given that valuations and timing are still uncertain.

Key metrics

Safran SA--Key Metrics*

	--Fiscal year ended Dec. 31--					
Mil. €	**2019a**	**2020a**	**2021a**	**2022e**	**2023f**	**2024f**
Revenue	24,640	16,498	15,257	18,950-19,150	22,000-23,000	24,000-25,000
Revenue growth (%)	17.2	(33.0)	(7.5)	24-26	15-17	11-13
EBITDA	4,461	2,322	2,452	3,150-3,250	3,500-3,700	4,100-4,200
EBITDA margin (%)	18.1	14.1	16.1	16-17	16-17	16.5-17.5
Funds from operations (FFO)	3,481	2,099	2,066	2,450-2,550	2,700-2,900	3,200-3,400
Capital expenditure	837	506	440	650-750	850-1,050	1,000-1,200
Free operating cash flow (FOCF)	2,303	1,419	1,957	2,450-2,550	1,900-2,100	2,000-2,200
Dividends	817	4	188	225	600-700	700-800
Debt	5,997	4,639	2,838	1,150-1,250	1,300-1,500	1,600-1,800
Debt to EBITDA (x)	1.3	2.0	1.2	0.3-0.5	0.3-0.5	0.3-0.5
FFO to debt (%)	58.1	45.2	72.8	200-210	190-200	185-195
FOCF to debt (%)	38.4	30.6	69	200-210	135-145	115-125

*All figures adjusted by S&P Global Ratings. Key debt adjustments include €508 million for pension liabilities. a--Actual. e--Estimate. f--Forecast.

Liquidity

We expect Safran will maintain strong liquidity and that sources of liquidity will exceed uses by more than 1.5x over the 12 months from July 1, 2022, 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.

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

- Cash of about €5.8 billion, excluding about €400 million of cash considered not readily accessible.
- Full availability under its €2.0 billion revolving credit facility maturing in May 2027.

- Forecast FFO of €2.4 billion-€2.6 billion (before capitalized R&D).

Principal liquidity uses for the same period are:

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

Issue Ratings - Subordination Risk Analysis

Capital structure

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

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	A-/Stable/--
Business risk:	Satisfactory
Country risk	Intermediate
Industry risk	Intermediate
Competitive position	Satisfactory
Financial risk:	Minimal
Cash flow/leverage	Minimal
Anchor	a-
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:	a-

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

Upgraded; Outlook Action

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