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CREDIT OPINION

14 November 2018

Update

Rate this Research

RATINGS

SKF AB

Domicile	Sweden
Long Term Rating	Baa1
Type	Senior Unsecured - Fgn Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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SKF AB

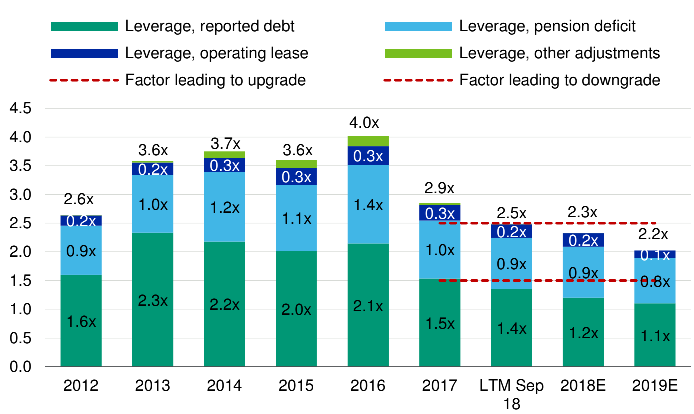
Update following ratings upgrade

Summary

SKF's Baa1 rating is supported by its (1) market leadership in bearings, seals and lubrication products, with a strong focus on customer service and innovation; (2) good level of diversification in terms of end markets, customers and geographies, which, together with high service and aftermarket content, help reduce the volatility of results; (3) track record of solid and stable profitability over the last years despite pressure from organic sales declines and a good Moody's-adjusted EBITA margin of 12.4% in the last twelve months ending September 2018, translating into healthy operating cash flow, despite material and recurring restructuring costs; and (4) strong liquidity, with a well-balanced debt maturity profile.

The Baa1 rating is constrained by SKF's (1) exposure to cyclical end markets, often with short lead times, which require the timely adjustment of its cost structure to protect margins against demand swings and pricing pressure; (2) history of elevated Moody's-adjusted debt/EBITDA above 3.0x, albeit improving strongly recently and inflated by its pension deficit representing around 1.0x; and (3) risk of new restructuring and efficiency measures, depressing profitability in the short term.

Exhibit 1
By paying down debt, debt/EBITDA has improved to 2.5x



Forecasts represent our view, not the view of the issuer, and unless noted in the text do not incorporate significant acquisitions and divestitures.
Source: Moody's Financial Metrics™, Moody's Investors Service estimates

THIS REPORT WAS REPUBLISHED ON 14 NOVEMBER 2018 due to the wrong rating being stated on the sidebar on p.1 and in the ratings table on p.8

Credit strengths

» Market-leading positions in a relatively consolidated industry and global footprint

» Fairly resilient and high margins owing to good end-industry diversification and high share of aftermarket sales, despite exposure to cyclical markets

» Ability to generate positive free cash flow even during cyclical downturns

Credit challenges

» Low sales visibility owing to inherently short lead times in components such as bearings

» Risk of continuous restructuring, although abated, needed to offset pricing and inflationary pressures

» Low margin automotive business, although improving over the last three years

Rating outlook

The stable outlook is anchored in our expectations of the company sustaining a Moody's-adjusted debt/EBITDA of 2.5x or below over the next 12-18 months, as seen in the last twelve months ending in September 2018. Following a significant working capital build up in 2018 due to organic growth of 8%, putting pressure on free cash flow, our expectations on free cash flow to debt of above 10% next year is based on a more normalized business environment. The healthy free cash flow generation, coupled with an already very high cash balance, will most likely be used to retire €192 million of debt maturing next year, even if the company executes a mid-sized acquisition.

Factors that could lead to an upgrade

» Moody's-adjusted debt/EBITDA of 1.5x

» Moody's-adjusted RCF/net debt ratio sustained above 30%

Factors that could lead to a downgrade

» Moody's-adjusted EBITA margin falling below 10%

» Moody's-adjusted debt/EBITDA above 2.5x

» Moody's-adjusted RCF/net debt trending towards 20%

Key indicators

Exhibit 2
Key indicators for SKF

	2012	2013	2014	2015	2016	2017	LTM Sep 2018	2018-proj[1]
Revenue (USD billions)	9.5	9.8	10.4	9.0	8.5	9.1	9.9	9.9
EBITA Margin %	11.7%	10.8%	11.5%	10.6%	9.7%	11.4%	12.4%	13.0%
EBITA / Interest Expense	7.1x	8.5x	8.8x	7.1x	7.0x	7.3x	9.4x	9.9x
Debt / EBITDA	2.6x	3.6x	3.7x	3.6x	4.0x	2.9x	2.5x	2.3x
RCF / Net Debt	23.5%	18.0%	14.2%	14.9%	20.6%	23.5%	30.4%	47.5%
FCF / Debt	6.2%	1.6%	5.8%	7.4%	8.0%	5.8%	10.1%	13.4%

[1] Projections (proj.) are Moody's opinion and do not represent the views of the issuer.
Source: Moody's Financial Metrics™, Moody's Investors Service estimates

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

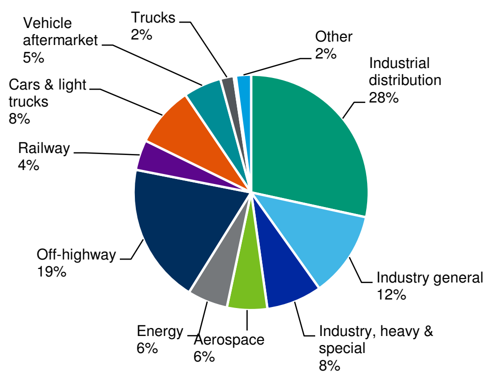
Profile

Headquartered in Gothenburg, Sweden, SKF AB (SKF) is one of the leading suppliers of roller bearings, seals, mechatronics (that is, integration of mechanical and electronic engineering with software engineering), services and lubrication systems, operating in more than 130 countries with a global manufacturing and distribution footprint. The group's business is organized into two business areas: Industrial Market (around 70% of group revenue) and Automotive (around 30%). In 2017, SKF generated sales of SEK77.9 billion through its work force of more than 45,000 employees. As of 31 December 2017, SKF's largest shareholder was the Wallenberg family, holding 13.6% of share capital (around 28.9% of voting rights) through Foundation Asset Management AB.

Exhibit 3

SKF boasts diversified end-market exposure, although to cyclical industries

Revenue by end market as of 2017

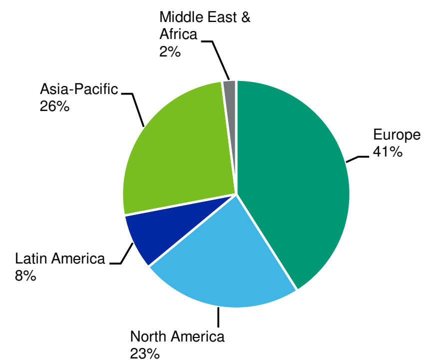


Source: SKF year-end report 2017

Exhibit 4

SKF has consistently generated about one-third of its revenue from emerging markets

Revenue by geography as of 2017



Source: SKF year-end report 2017

Detailed credit considerations

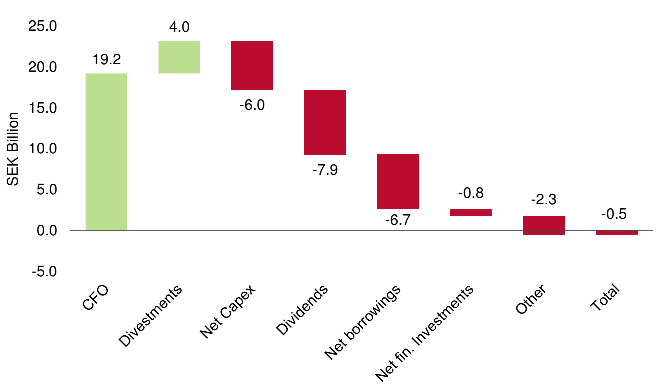
Focus on balance sheet yielding material results

Since 2015, the company has refocused its strategy to improve its capital structure and by divesting non core businesses. This has yielded material results - reported debt has decreased by 18% and the pension deficit has been paid down in absolute number by some SEK1.5 billion. Coupled with restructuring initiatives and good growth momentum last and this year, debt/EBITDA has gone from 3.6x to 2.5x (trailing twelve months number ending September in respective year). This has created a capital structure more resilient to changing business conditions and thus a stronger credit profile.

Exhibit 5

Disciplined balance sheet focus, deleveraging with some SEK6.7 billion...

Source and uses of cash flows 2015 - 2018



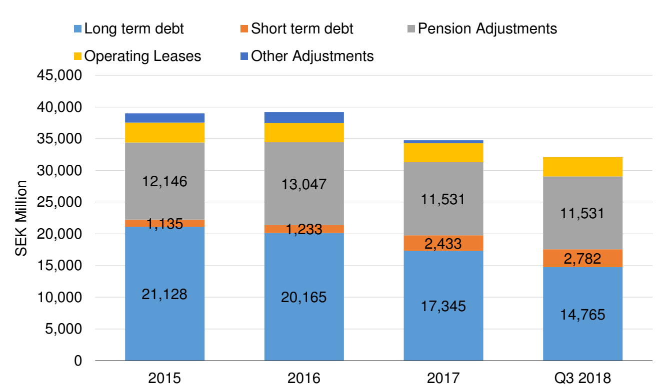
Numbers as reported by the company

Source: Annual & interim reports

Exhibit 6

Has taken down Debt/EBITDA from 3.6x to 2.5x

Moody's-adjusted debt reconciliation



Source: Moody's Financial Metrics™

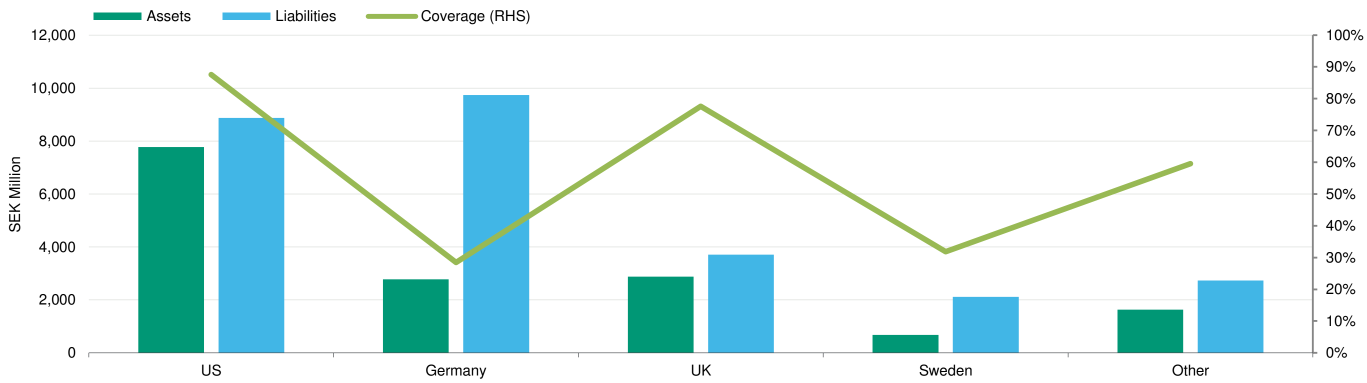
Material free cash flow generation and high cash balance presents optionality

The very low debt lever relative to where the company has been operating since the Kaydon acquisition in 2013, will yield operational as well as financial flexibility going forward. Absent any larger acquisition, our base case includes the company continuing to retire debt coming due rather than refinancing it. This still leaves room to start funding the large german pension deficit, representing 60% of the total pension liability. This has already been done for the US defined benefit schemes, where such payment are tax deductible (which they are not in Germany). Following extra funding of SEK1.5billion since 2015 and change in actuarial calculations, the deficit has decreased from SEK3.5 billion in 2015 to SEK1.1 billion in 2017. The natural step would be to target the German schemes, totaling some SEK7.0 billion (equivalent to 0.5x trailing EBITDA).

Exhibit 7

Lack of statutory funding requirement for German DB schemes has resulted in large pension deficit

Reported pension assets and liabilities as of 2017



Source: SKF 2017 annual report

Worth highlighting is that even if the company went after a mid-sized acquisition, it could be managed without any material increase in gross leverage. This is because SKF today already has (1) a very high cash balance of SEK8.0 billion, equivalent to around 10% of trailing sales end of Q3 this year; (2) free cash flow generation of around SEK4.0 billion annually according to our projections and (3) an inflow in Q4 this year or Q1 next year of SEK2.75 billion, stemming from the divestment of its linear and actuation technology business to funds affiliated with private equity company Triton. These numbers point to a cash balance of around SEK13 billion end of this year.

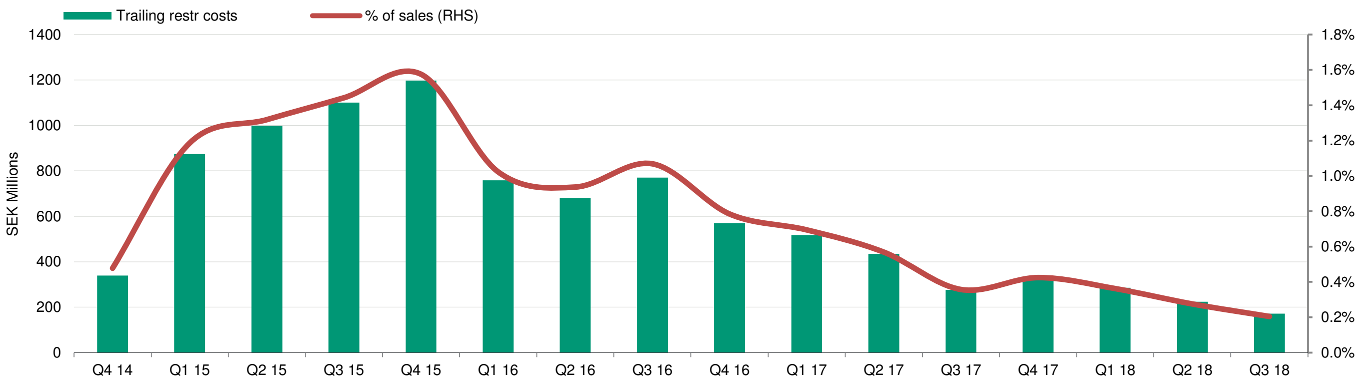
Risk of continuous restructuring needs abated

Maintenance of good margins is a reflection of the fairly inexpensive, but operation critical, nature of bearings for customers who are, therefore, willing to pay a premium for reliability and service. This is further supported by high switching costs for customers because SKF's bearings are often designed into specific original equipment manufacturer products. On the other hand, constant technology investments on the supplier side are crucial to remaining competitive and withstanding pricing pressure. SKF's R&D to sales ratio has increased to around 3%, up from around 1.5% in 2007.

One of SKF’s rating constraints have been the recurring cost-saving programs on the back of weaker trading conditions for the company. Costs associated with such programs peaked in 2015, amounting to SEK1.2 billion, or 17% of reported EBIT. The corresponding figure for 2017 was SEK328 million, or 3% of reported EBIT. Despite credit negative implications short term, were large expenses puts downward pressure on operating margins and cash flow, long-term benefits include a reduced work force of 3,000 employees yielding annual savings of over SEK1.0 billion.

Exhibit 8

Historic trend with large restructuring costs reverted in 2018



Year to date there has been no reported restructuring costs

Source: Annual and interim reports

Market-leading positions and global footprint

SKF's business profile benefits from a wide product portfolio, including bearings, polymer seals, lubrication systems, motion control and mechanical power transmission products. For bearings, which is still the largest product category, SKF believes to be the global leader, competing in a fairly consolidated market with Schaeffler AG (Schaeffler, Baa3 stable), Timken Company (The) (Baa3 stable), NSK, NTN and JTEKT. For other product categories, SKF also considers itself to be one of the global leaders, with the main competitors including, for instance, Freudenberg SE (A3 stable) for polymer seals.

SKF has a global presence with a wide network of distributors, which is also an important advantage enabling customer proximity. SKF has continuously improved its regional diversification, with reduced dependence on Europe (2017: 41% of group sales versus 2008: 56%), while Asia-Pacific, Latin America and Middle East and Africa increasingly contribute to group sales (36% in 2017 versus 19% in 2008), indicating a sizeable exposure to the emerging markets. We expect this trend to continue, with SKF consolidating its manufacturing footprint in developed economies, moving the production to emerging markets to align it more with sales distribution.

Despite exposure to cyclical markets, the company has fairly resilient margins owing to good end-industry diversification and high share of aftermarket sales

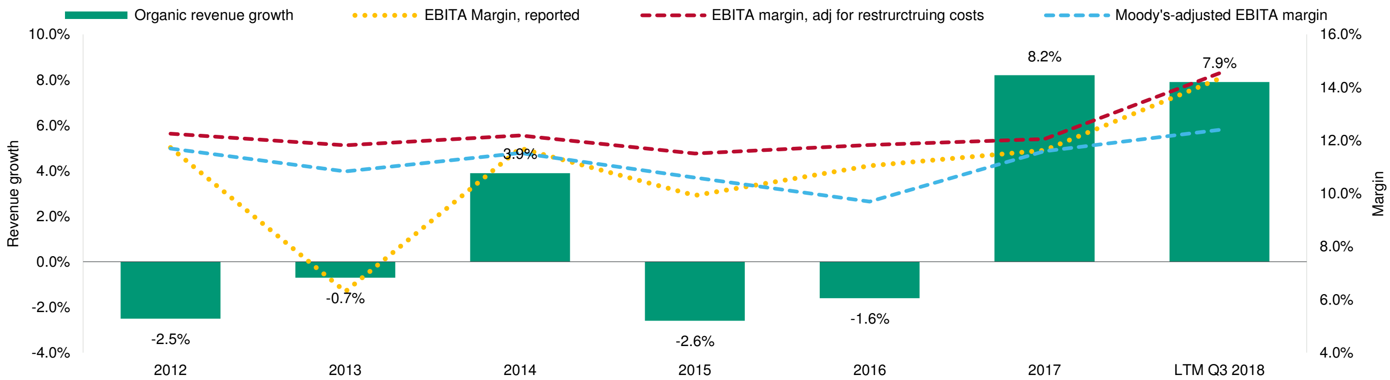
Despite exposure to cyclical end markets, SKF has defended double-digit EBITA margins since 2004, with the only exception in 2009 when amid the global financial crisis, Moody's-adjusted EBITA margin declined to a still fairly healthy level of around 7%. One of the key factors enabling such resilience is that SKF's portfolio is well diversified in terms of end markets, which include automotive (roughly 30% of sales), automation, aerospace, energy, railway, off-highway, mining, and pulp and paper. This also translates into good customer diversification on a group level.

Besides diversification, other factors explaining good resilience include (1) a relatively flexible cost base, with more than 50% of purchases being direct material; (2) a good track record of management making decisive actions to adjust the cost base, with continuous focus on improving efficiency, for instance, through moving the manufacturing footprint to low-cost countries, divesting and outsourcing component production or reducing fixed costs and invested capital; and (3) a high share of service and aftermarket business (around 40% of group revenue), which is typically more resilient than the original equipment manufacturer business.

Exhibit 9

Strong organic growth in 2017 and YTD 2018 has helped profitability improve

Historical overview of organic growth and profitability



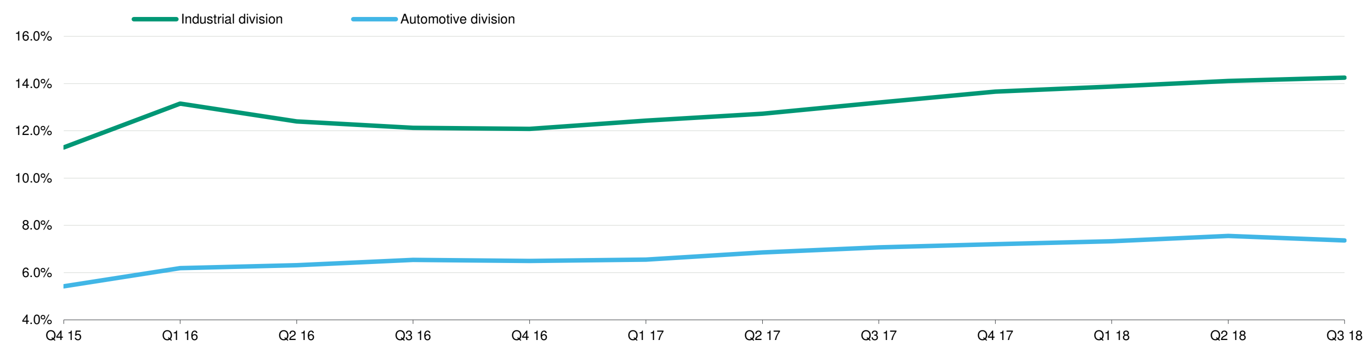
Source: Moody's Financial Metrics™, Moody's estimates, company data

Around 30% of turnover is generated within SKF's Automotive Division, a business that for some years was showing weak profitability, especially compared with Schaeffler's automotive division. The main reason for this is that while Schaeffler is more focused on components and system solutions for engines and transmission, SKF is more component focused. Nevertheless, SKF's Automotive Division has improved its profitability over the last three years and showed an EBIT margin before unusual items of 7.8% in the first nine months of 2018. Schaeffler's corresponding figure was 10.4%.

Exhibit 10

Improved profitability in both divisions, most notably in the Automotive Division, with 56% EBIT growth since Q4 2015

Trailing divisional EBIT margins before unusual costs, as reported by the company



Source: SKF annual and interim reports

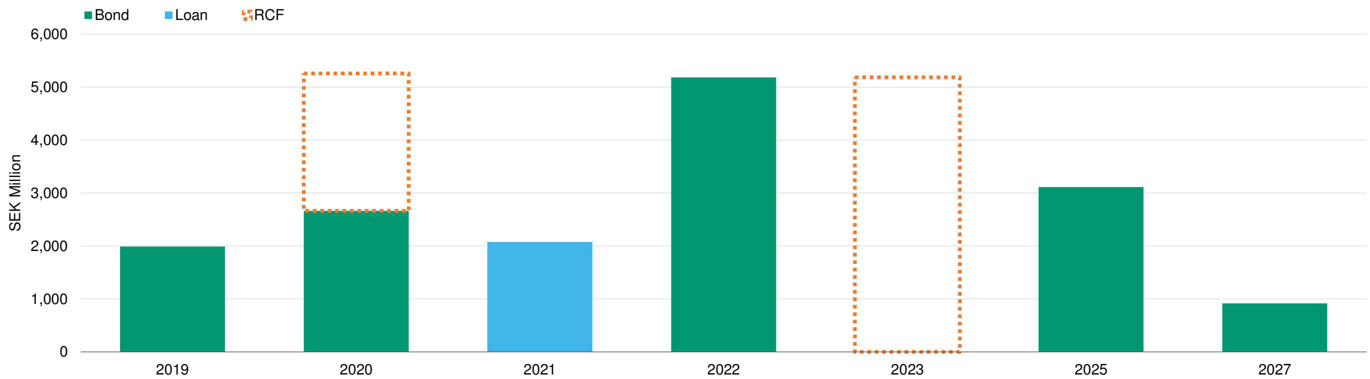
Liquidity analysis

We consider the liquidity profile of SKF to be strong. As of September 2018, SKF reported SEK8.0 billion of cash and cash equivalents, further supported by a €500 million credit facility maturing in 2023 and a €250 million facility maturing in 2020. We view these facilities as high-quality cash sources, given the absence of financial covenants or repeating material change clauses. We expect SKF to continue generating material positive free cash flow in the next 12-18 months, with intra-year seasonality in cash flow comfortably covered by available sources. As of September 2018, SKF reported a short-term debt of SEK2.8 billion. The debt maturity profile is well spread.

Exhibit 11

SKF has a well-balanced maturity profile, with the majority of funding represented by unsecured bonds

Debt maturity profile as of Q3 2018



Source: Company data

Rating methodology and scorecard factors

The principal methodology used in rating SKF is the Global Manufacturing Companies rating methodology, published in June 2017. The assigned rating of Baa1 is in line with the grid indicated rating as per the forward view, but it is one notch above the current view. The difference is explained by our expectations of higher FCF/debt and RCF/net debt going forward.

Exhibit 12

Grid-indicated rating for SKF under current and 12-18-month forward view

Manufacturing Industry Grid [1]	Current 09/30/2018[2]		Moody's 12-18 Month Forward View As of 9/11/2018 [3]	
Factor 1 : Business Profile (20%)	**Measure**	**Score**	**Measure**	**Score**
a) Business Profile	Baa	Baa	Baa	Baa
Factor 2 : Scale (20%)				
a) Revenue (USD billions)	$9.9	Baa	$9.9 - $10.1	A
Factor 3 : Profitability (10%)				
a) EBITA Margin	12.4%	Baa	12% - 13%	Baa
Factor 4 : Coverage and Leverage (40%)				
a) EBITA / Interest Expense	9.4x	A	9x - 11x	A
b) Debt / EBITDA	2.5x	Baa	2.2x - 2.5x	Baa
c) Retained Cash Flow / Net Debt	30.4%	Baa	40% - 50%	Aa
d) Free Cash Flow / Debt	10.1%	Baa	12% - 14%	Baa
Factor 5 : Financial Policy (10%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Rating:				
a) Indicated Rating from Grid		Baa2		Baa1
b) Actual Rating Assigned				Baa1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] Based on preliminary and unaudited 2017 year-end financials and Moody's estimates.
[3] This represents Moody's forward view, not the view of the issuer.
Source: Moody's Financial Metrics™, Moody's estimates

Appendix

Exhibit 13

Moody's-adjusted EBITDA breakdown

(in KRONA Millions)	FYE Dec-13	FYE Dec-14	FYE Dec-15	FYE Dec-16	FYE Dec-17	LTM Ending Sep-18
As Reported EBITDA	**5,467.0**	**9,928.0**	**9,929.0**	**9,919.0**	**10,943.0**	**12,533.0**
Pensions	10.0	-62.0	1.0	-618.0	-200.0	-200.0
Operating Leases	579.0	898.0	769.0	760.0	838.0	838.0
Unusual	2,890.0	-32.0	-115.0	-544.0	-180.0	-180.0
Non-Standard Adjustments	-2.0	-6.0	-4.0	-8.0	-9.0	-9.0
Moody's-Adjusted EBITDA	**8,944.0**	**10,726.0**	**10,580.0**	**9,509.0**	**11,392.0**	**12,982.0**

Source: Moody's Financial Metrics™

Exhibit 14

Moody's-adjusted debt breakdown

(in KRONA Millions)	FYE Dec-13	FYE Dec-14	FYE Dec-15	FYE Dec-16	FYE Dec-17	LTM Ending Sep-18
As Reported EBITDA	**5,467.0**	**9,928.0**	**9,929.0**	**9,919.0**	**10,943.0**	**12,533.0**
Pensions	10.0	-62.0	1.0	-618.0	-200.0	-200.0
Operating Leases	579.0	898.0	769.0	760.0	838.0	838.0
Unusual	2,890.0	-32.0	-115.0	-544.0	-180.0	-180.0
Non-Standard Adjustments	-2.0	-6.0	-4.0	-8.0	-9.0	-9.0
Moody's-Adjusted EBITDA	**8,944.0**	**10,726.0**	**10,580.0**	**9,509.0**	**11,392.0**	**12,982.0**

Source: Moody's Financial Metrics™

Exhibit 15

Peers

	SKF AB Baa1 Stable			Schaeffler AG (P)Baa3 Stable			Timken Company (The) Baa3 Stable			Freudenberg SE A3 Stable		
(in US millions)	FYE Dec-16	FYE Dec-17	LTM Sep-18	FYE Dec-16	FYE Dec-17	LTM Jun-18	FYE Dec-16	FYE Dec-17	LTM Sep-18	FYE Dec-16	FYE Dec-17	LTM
Revenue	$8,490	$9,136	$9,879	$14,758	$15,842	$16,902	$2,670	$3,004	$3,449	$8,741	$10,559	
EBITDA	$1,112	$1,335	$1,527	$2,729	$2,705	$2,843	$418	$491	$629	$1,349	$1,719	
Total Debt	$4,209	$3,968	$3,612	$6,480	$6,703	$6,841	$910	$1,267	$2,042	$3,022	$3,495	
Cash & Cash Equiv.	$1,203	$992	$829	$787	$486	$227	$149	$122	$154	$1,013	$1,199	
EBITA Margin	9.7%	11.4%	12.4%	12.7%	11.2%	10.9%	11.1%	12.0%	14.5%	10.8%	11.6%	
EBITA / Int. Exp.	7.0x	7.3x	9.4x	5.4x	7.8x	7.9x	6.7x	7.6x	9.0x	11.3x	13.7x	
Debt / EBITDA	4.0x	2.9x	2.5x	2.5x	2.3x	2.5x	2.2x	2.6x	3.2x	2.3x	1.9x	
RCF / Net Debt	20.6%	23.5%	30.4%	29.1%	31.9%	27.8%	37.0%	29.7%	22.1%	42.9%	53.0%	
FCF / Debt	8.0%	5.8%	10.1%	10.8%	1.7%	1.2%	20.4%	3.9%	4.8%	14.3%	9.5%	

Source: Moody's Financial Metrics™

Ratings

Exhibit 16

Category	Moody's Rating
SKF AB	
Outlook	Stable
Senior Unsecured	Baa1

Source: Moody's Investors Service

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