LANXESS AG
Germany, Specialty Chemicals

SCOPE BBB+ STABLE

Corporate profile

LANXESS AG, based in Cologne, Germany, is a major producer of specialty chemicals with sales of about EUR 6.8bn and an EBITDA of EUR 910m 2019. The company is organised into four divisions: Advanced Intermediates, Specialty Additives, Engineering Materials, and Consumer Protection. Chemical intermediates, additives, specialty chemicals and plastics are consumed by companies operating in areas including automotive, construction, agricultural, industrial manufacturing.

Key metrics

		Scope estimates		
Scope credit ratios	**2019**	**2020F**	**2021F**	**2022F**
EBITDA/interest expense (x)	9.6x	8.4x	9.7x	10.6x
Scope-adjusted debt (SaD)/EBITDA	2.3x	1.9x	1.7x	1.6x
Scope-adjusted FFO/SaD	30%	39%	45%	48%
Free operating cash flow (FOCF)/SaD	4%	13%	5%	14%

Rating rationale

Scope Ratings has today affirmed its BBB+/Stable corporate issuer rating to German-based LANXESS AG. The agency also affirmed the S-2 short-term rating, the BBB+ senior unsecured debt rating, and the BBB- subordinated debt rating.

LANXESS still meets all the requirements for a business risk profile of 'BBB+'. The company continues to hold leadership positions across numerous medium-sized and niche specialty chemicals markets, which are often concentrated, dominated by few players, and less competitive. Diversification remains supportive of the company's business risk profile, as end-market diversity and global setup have improved in recent years. LANXESS' set-up is now more resilient and less concentrated. On the negative side, the company's business risk profile continues to be constrained by improved but still comparably weak profitability (EBITDA margin 2019: 13.4%). The positive trend in profitability is mainly attributable to the various measures taken to clean-up the portfolio. Due to the relatively small size of divestments executed in 2019/2020, we left our assessment of LANXESS's business risk profile unchanged.

The company's financial risk profile is affirmed at 'BBB+'. Although LANXESS has also been hit by the Covid-19 pandemic, we assume that its credit profile will even improve in the current year. This is due to: i) proceeds of EUR 740m in April 2020 from the company's sale of its stake in Currenta (see: **LANXESS: Disposal of 40% stake in Currenta will further support credit metrics**), plus a profit participation of EUR 150m; and ii) numerous countermeasures including cost savings, capex reduction and the pausing of the company's share buy-back scheme. We anticipate SaD/EBITDA of 1.9x and FFO/SaD of 39% at year-end 2020, compared to the previous year's leverage ratios of 2.3x and 30% respectively. Furthermore, liquidity continues to be 'adequate'. In the current environment, it is positive that the next significant debt maturities are in October 2021 (EUR 500m), April 2022 (EUR 100m) and November 2022 (EUR 500m). LANXESS also has access to an undrawn revolving credit facility of EUR 1.0bn.

Ratings & Outlook

Corporate rating	BBB+/Stable
Short-term rating	S-2
Senior unsecured rating	BBB+
Subordinated debt	BBB-

Analysts

Klaus Kobold
+49 69 6677389 23
k.kobold@scoperatings.com

Olaf Tölke
+49 69 6677389 11
o.toelke@scoperatings.com

Related methodology

Rating Methodology Chemical Corporates

Corporate Rating Methodology

Scope Ratings GmbH

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

In the supplementary rating driver section the part on financial policy continues to be the most important for our assessment of LANXESS. The company continues to pursue a conservative financial policy in order to maintain a credit rating in the 'BBB area'.

Outlook

Stable Outlook

The unchanged Stable Outlook incorporates our opinion of LANXESS' conservative financial policy, coupled with some vulnerability due to the Covid-19 pandemic, and ample liquidity. Including a less volatile EBITDA margin thanks to improved end-market diversification and spending on M&A to further upgrade the portfolio, we expect SaD/EBITDA fluctuate around 2.0x over a medium-term horizon.

Ratings upside

A higher rating may be triggered if SaD/EBITDA persistently falls below 1.5x. This could be achieved via a sustained improvement in the company's EBITDA margin e.g. by the exertion of higher pricing setting power.

Ratings downside

The rating could come under pressure if SaD/EBITDA increases to above 2.5x on a sustained basis. This could be triggered by an aggressive financial policy, for instance.

Rating drivers

Positive rating drivers	Negative rating drivers
• Strong position in medium-sized markets with considerable barriers to entry • Increased, more resilient end-market mix as a consequence of portfolio clean-up • Conservative financial policy, with selective M&A strategy and commitment to maintaining a credit rating in the 'BBB range' • New organisational structure increases overall visibility of activities • Attractive innovation projects in the pipeline (e.g. cooperation with Standard Lithium, CheMondis start-up)	• Positive trend in profitability (EBITDA margin 2019: 13.4%), but still weak compared to key competitors and the thresholds for profitability and efficiency set out in our methodology • Highly cyclical end-markets at around 40% of sales • Weaker free operating cash flow and cash flow cover (FOCF/SaD 2019: 4%) than other key credit ratios due to organic growth programme in 2019/2020 • Mature product portfolio and weak spending on product innovations relative to the specialty chemicals industry

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/EBITDA of less than 1.5x on a sustained basis	• SaD/EBITDA of above 2.5x on a sustained basis

Financial overview

		Scope estimates		
Scope credit ratios	**2019**	**2020F**	**2021F**	**2022F**
EBITDA/interest expense (x)	9.6x	8.4x	9.7x	10.6x
Scope-adjusted debt (SaD)/EBITDA	2.3x	1.9x	1.7x	1.6x
Scope-adjusted FFO/SaD	30%	39%	45%	48%
Free operating cash flow (FOCF)/SaD	4%	13%	5%	14%
Scope-adjusted EBITDA in EUR m	**2019**	**2020F**	**2021F**	**2022F**
EBITDA	910	780	902	997
Operating lease payments in respective year	-	-	-	-
Other items	1	0	0	0
Scope-adjusted EBITDA	911	780	902	997
Scope-adjusted funds from operations (FFO) in EUR m	**2019**	**2020F**	**2021F**	**2022F**
EBITDA	910	780	902	997
less: (net) cash interest as per cash flow statement	-40	-40	-40	-40
less: cash tax paid as per cash flow statement	-193	-110[1]	-106	-133
less: pension interest	-56	-56	-56	-55
add: depreciation component operating leases	-	-	-	-
add: dividends received from equity-accounted entities	0	0	0	0
less: disposal gains on fixed assets included in EBITDA	1	0	0	0
less: capitalised interest	-3	-3	-3	-3
Other items	0	0	-	-
Scope-adjusted funds from operations	619	571	697	766
Scope-adjusted debt (SaD) in EUR m	**2019**	**2020F**	**2021F**	**2022F**
Reported gross financial debt	2,843	2,843	2,343	2,343
Hybrid debt	-250	-250	-250	-250
less: cash and cash equivalents	-1,064	-1,679	-1,062	-1,022
Cash not accessible	0	0	0	0
add: pension adjustment	388	387	376	376
add: operating lease obligations	-	-	-	-
Other items (contingent liabilities)	153	153	153	153
Scope-adjusted debt	2,070	1,454	1,559	1,599

[1] Taxes from the Currenta transaction were deducted from the cash proceeds.

Business risk profile

Industry risk profile: A

The specialty chemicals industry is dominated by a wide range of different-sized companies as well as factors such as production expertise and relationships with customers in aftermarkets. All of these factors serve as de-facto high entry barriers. The assessment of low substitution risk is based on the high technical production requirements and a lack of alternative production methods. We believe specialty chemicals companies face medium sensitivity to changes in GDP, because aftermarkets require lower quantities of specialty chemicals in their product processes and prices tend to be negotiated individually.

Strong position in medium-sized markets

The business risk profile (rated 'BBB+') is based on the company's focus on medium-sized and niche markets. These markets are often: i) concentrated; ii) dominated by a few number of players; iii) less competitive; and iv) characterised by stable conditions. Overall, LANXESS still holds a stable position among the leading producers in each segment offering numerous brands, such as Bayferrox (Inorganic Pigments/Advanced Intermediates), TEPEX (High Performance Materials/Engineering Materials). In addition, company's activities clustered in its newly established Consumer Protection segment are protected by considerable regulatory requirements.

Figure 1: Selected market positions

Business line (segment)	Inorganic Pigments (Advanced Intermediates)	Lubricant Additives Business (Specialty Additives)	Material Protection Products (Consumer Protection)	High Performance Materials (Engineering Materials)
Market position	No. 1	No. 1 to no. 3	Market leader in bromine, bromine intermediates and brominated flame retardants	No. 2 in Europe and top 5 globally

Source: LANXESS, Scope

Focus on optimising and improving existing products and some attractive innovation projects in the pipeline

LANXESS' ability and focus in terms of strengthening its product portfolio through innovation continues to be weaker compared to the specialty chemicals industry as a whole. This exposes the company somewhat to a deterioration in its market position because: i) most of its products are at a relatively mature level; ii) spending on product innovation is low for the specialty chemicals industry (around 1.8% versus around 3.0% for the specialty chemicals sector); and iii) most R&D is focused on optimising and improving existing products. That said, we view positively LANXESS' cooperation with Standard Lithium (testing to extract battery grade lithium from tail brine) and the investment in the CheMondis start-up (an internet-based marketplace for the chemicals industry).

Still supportive diversification due to improved end-market diversification

Intensive portfolio realignment over the past couple of years has improved LANXESS' mix of revenue per end-market, which continues to be highly positive for diversification. The divestments executed have had no negative impact on the company's scale, given the respective revenue contribution.

Figure 2: Summary – disposals and acquisitions 2015 to present

Acquisitions			Disposals		
Year	**Name**	**Amount**	**Year**	**Name**	**Amount**
2016	Chemtura	EUR 1.8bn	2015/2018	ARLANXEO	EUR 2.6bn
2016	Chemours Clean and Disinfect unit	EUR 200m	2019	Currenta (40%)	EUR 740m (+ EUR 150m profit participation)
2018	IMD Natural Solutions	n.a.	2019	Chrome chemicals	n.a.
2018	Solvay's Phosphorus Additive Business	n.a.	2019	Gallium-based organometallics	n.a.
			2020	Reverse osmosis membranes	n.a.
			2020	Organic leather chemicals	EUR 80m (+ a performance-related component up to ~EUR 115m)

Source: LANXESS, Scope

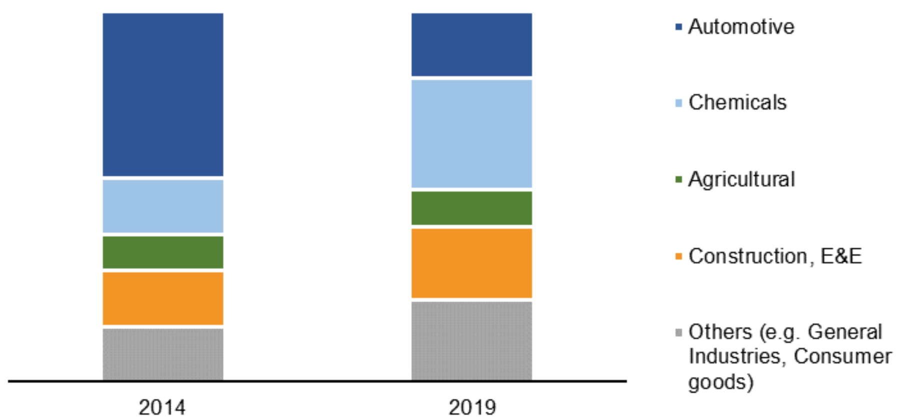
Relatively high share of cyclical end-markets…

LANXESS' substantial share of highly cyclical end-markets is, however, negative for diversification: automobiles, chemicals and construction account for up to 40% of revenue, and demand from these aftermarkets correlates strongly with global GDP development. On a positive note, the company has reduced its dependency on automobiles and tyres significantly, compared with previous periods.

… which is likely to decrease in future

The company continues to post a considerable share of sales in agriculture. This industry is driven by different factors than the general economic cycle and is less correlated to global GDP. The agricultural industry is primarily served by the Saltigo division, via long-term supply contracts including take-or-pay clauses, which increases visibility of the business. However, LANXESS intends to further improve its end-market mix to become even more resilient to cyclicality. According to the company, 'phase 3' of the realignment includes the evaluation of options to increase exposure to less volatile after-markets.

Figure 2: Sales by end-markets: 'Old' vs 'New' LANXESS structure (based on our estimates)



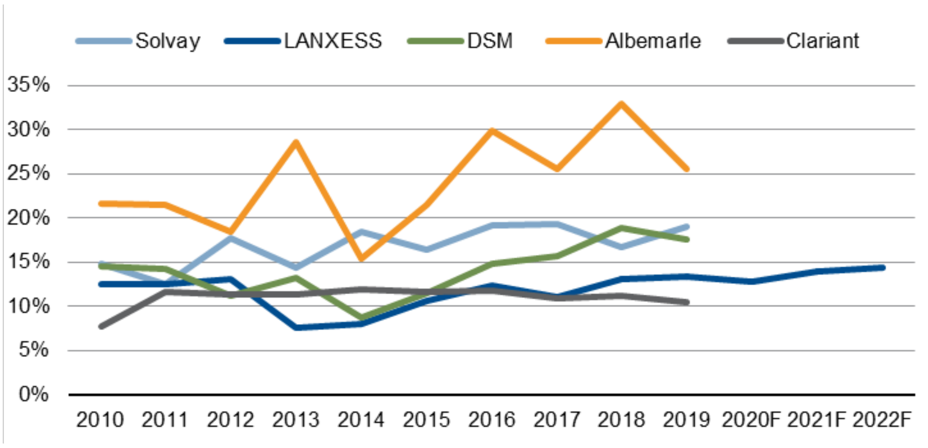
Source: Scope

Prospects for higher profitability

In accordance with our rating methodology for chemical corporates, we focus on through-the-cycle profitability when assessing profitability and operating efficiency. From 2010 to 2019, LANXESS' EBITDA margin averaged around 11.4%, which is weaker than peers and the thresholds for profitability and efficiency set out in our methodology. Between 2010 and 2018 LANXESS' profitability was compromised by the consolidation of the

ARLANXEO division and considerable one-off costs for the portfolio clean-up. That said, profitability is on an upward trend, which even continued in bumpy H1 2020 (EBITDA margin: 13.2%). Despite the current environment's many uncertainties, we believe the company's positive EBITDA margin trend will continue in the foreseeable future. This is based on LANXESS': i) strong commitment to its communicated medium-term EBITDA margin target (before exceptional costs) of 14% to 18% through the cycle, combined with a volatility objective of 2% to 3%; ii) more resilient and streamlined portfolio; and iii) products being used in growing applications/areas, such as water purification, lightweight solutions, alternative energies, and battery technologies.

Figure 3: Profitability (EBITDA margin): LANXESS versus selected peers



Source: LANXESS, Scope, Bloomberg

Financial risk profile

Key adjustments of the rating case include:

- Net present value of operating lease obligations added to SaD (pre 2019, as LANXESS implemented IFRS 16 as of 01 January 2019)
- 80% of provisions for environmental protection provisions (contingent liabilities) are included in SaD and 5% of contingent liabilities included in Scope-adjusted interest expense to reflect the interest proportion of these liabilities
- Half of the company's unfunded pension provisions, given the high coverage of annual pension payments through dedicated pension assets added to SaD
- Interest adjusted for the (estimated) interest component of pension provisions, operating leases and contingent liabilities
- No netting of cash on the balance sheet, as the company does not hold restricted cash
- The issued hybrid bond (ISIN: XS1405763019; EUR 500m; rated at 'BBB-', according to our Corporate Rating Methodology) is treated as 50% equity credit, reducing SaD and Scope-adjusted interest expense

The financial risk profile was affirmed at 'BBB+' in view of LANXESS' solid credit metrics; free cash flow generation is likely to remain comparably weak.

Key credit metrics bolstered by proceeds from the Currenta transaction

LANXESS' credit profile has improved in recent years, following portfolio realignment and a focus on deleveraging. Although the company has been hit by the Covid-19 pandemic, our rating scenario assumes an enhanced credit profile in the current year. This is due to: i) proceeds of EUR 740m in April 2020 from the company's sale of its stake in Currenta (see: **LANXESS: Disposal of 40% stake in Currenta will further support credit metrics**), plus a profit participation of EUR 150m; and ii) numerous countermeasures including cost savings, capex reduction, the pausing of the company's share buy-back scheme, and the temporary usage of the EUR 1.0bn revolving credit facility to bolster liquidity. We anticipate EBITDA of roughly EUR 780m for the current year, based on the financial results for H1 2020 (EBITDA of EUR 417m) and the company's guidance for the full year 2020 of an EBITDA pre (before exceptional costs) of EUR 800m to EUR 900m. Similar to the broader European specialty chemical industry, LANXESS was hit by a sharp fall in demand from the automobile, construction and oil and gas industry. At the same time, LANXESS benefited from higher demand for the products provided by its recently formed Consumer Protection division, predominately biosecurity product Virkon. While the company was able to weather temporary production shutdowns and raw material shortages, countermeasures also pushed operating costs slightly upwards.

M&A continue to be an essential tool for growth

We have included a proxy for cash spending on M&A of EUR 250m per year and positive contribution to EBITDA from 2021 onwards. This is based on our understanding that M&A will play an important part in LANXESS' growth strategy, particularly in the Advanced Industrial Intermediates, Lubricant Additives Business, Rhein Chemie, Material Protection Products, and Liquid Purification Technologies business lines as well as to strengthen its existing product portfolio for lithium-ion batteries.

Further assumptions of our rating case

Our rating scenario assumes that the company will maintain its progressive dividend policy (dividend payments in 2019: about EUR 80m). As far as LANXESS' most recent M&A deal is concerned, we have assumed proceeds of EUR 80m plus a performance-related component of EUR 15m for the next five years from the disposal of the global organic leather business to TFL Ledertechnik. The transaction is expected to close in mid-2021, subject to regulatory approval.

In summary, we expect the most relevant key credit ratios on leverage of 1.9x and 39% at year-end 2020.

Weak free operating and discretionary cash flow, but slight improvement expected

While LANXESS continues to post supportive interest coverage, its cash flow cover (FOCF/SaD) remains weak. This is due to tax payments related to the Currenta transaction and a weaker EBITDA margin and cash generation (free cash flow margin 2020F: 4%). In this regard, LANXESS' free cash flow generation continues to be a negative rating driver. That said, FOCF/SaD is supported by the abovementioned reduction of capex by EUR 50m. We acknowledge the company's announced investment of up to EUR 120m over a five year horizon in new capacity in ion exchange resins, benefiting from the growing biotechnology market.

Free cash flow expected to develop positively

Going forward, we anticipate a moderate increase in both free operating and discretionary cash flow, as LANXESS' financial goals for 2021 include cash conversion, defined as (EBITDA pre less capex)/EBITDA pre exceeding 60%.

Liquidity: 'adequate'

Liquidity continues to be 'adequate'. In the current environment, it is positive that the next significant debt maturities are in October 2021 (EUR 500m), April 2022 (EUR 100m) and November 2022 (EUR 500m). Furthermore, LANXESS has access to a revolving credit facility for a total amount of EUR 1.0bn.

Figure 4: Credit metrics

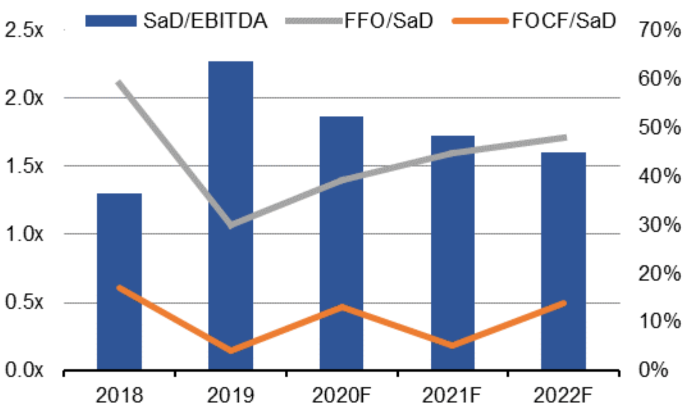
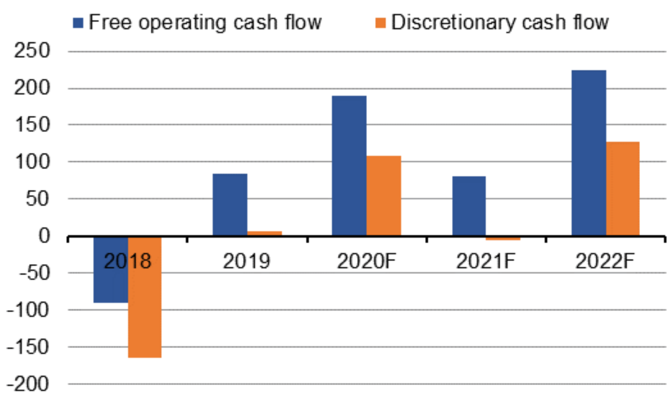


Figure 5: Free operating and discretionary cash flow (EUR m)



2018: In contrast to company's reporting, we have not retroactively adjusted the ratios reflect the treatment of ARLANXEO as discontinued operations from January 01, 2018 ('New' LANXESS structure).

Source: Scope

Source: Scope

Supplementary rating drivers

Conservative financial policy: equal treatment of shareholder and debtholder interests

Financial policy remains the most important supplementary rating driver. In our opinion, LANXESS' financial policy continues to be conservative, targeting the equal treatment of shareholders and debtholders. Among others, this conclusion is grounded on:

- Ongoing commitment to uphold an investment-grade rating in the 'BBB range';
- The EUR 500m share buy-back scheme launched following the Currenta transaction was paused at the beginning of April 2020 in order to save liquidity amid the many uncertainties caused by the Covid-19 pandemic;
- The sale of the remaining 50% stake in ARLANXEO strengthened LANXESS' cash position by EUR 1.4bn in 2018. This allowed the company to start a share repurchase programme of EUR 200m in January 2019 and simultaneously increase its pension assets by the same amount;
- Financing structure of the acquisitions in 2016/2017 included a hybrid bond of EUR 500m to avoid negative effects on LANXESS' credit rating.

Short-term rating

Short-term rating: S-2

We have affirmed the S-2 short-term rating, based on LANXESS' issuer rating as well as its 'better than adequate' internally and externally provided liquidity cover, banking relationships and standing in capital markets.

Senior unsecured debt rating

Rating for senior unsecured debt: BBB+

All senior unsecured debt has been issued by LANXESS AG.

Subordinated debt rating

Rating for subordinated debt: BBB-

In accordance with our corporate rating methodology we have affirmed the subordinated debt category at 'BBB-'. At present, one hybrid bond is outstanding (ISIN: XS1405763019, EUR 500m). The two notches below the issuer rating reflect the key structural elements of the outstanding hybrid debt: convertibility, replacement, coupon deferral and cumulation of payments, contractual subordination and remaining maturity.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

London

3rd Floor
111 Buckingham Palace Road
UK-London SW1W 0SR

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Regus Porta Venezia
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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