LANXESS AG
Germany, Specialty Chemicals

STABLE
BBB+

Corporate profile

LANXESS AG, based in Cologne (Germany), is a producer of specialty chemicals. In 2020, it had EUR 6.1bn in sales and EBITDA of EUR 757m. The company is organised into four divisions: Advanced Intermediates, Specialty Additives, Engineering Materials, and Consumer Protection. The product portfolio includes chemical intermediates, additives, specialty chemicals and polymers used in industries such as automotive, construction, agricultural, nutrition and industrial manufacturing.

Key metrics

			Scope estimates	
Scope credit ratios	2019	2020	2021E	2022E
EBITDA/interest cover	9.6x	6.6x	8.1x	9.7x
Scope-adjusted debt (SaD)/EBITDA	2.3x	1.8x	2.4x	1.9x
Scope-adjusted FFO/SaD	30%	48%	34%	39%
Free operating cash flow (FOCF)[1]/SaD	2%	4%	3%	10%

Rating rationale

Scope Ratings GmbH (Scope) has today affirmed the BBB+/Stable corporate issuer rating on German LANXESS AG. The S-2 short-term rating, BBB+ senior unsecured debt rating and BBB- subordinated (hybrid) debt rating have also been affirmed.

The affirmed issuer rating continues to reflect the business risk and financial risk profiles, each assessed at BBB+. Market position and diversification are the main supports for LANXESS' competitive position. The company continues to be a top player in numerous medium-sized and niche specialty chemicals markets, which are often characterised by high concentration, a few dominant players and limited competition. Diversification by end-market and country have also improved in the last years. The end-market mix is now less concentrated and less exposed to highly cyclical end-markets, which is in the context of a more resilient company set-up. In this regard, we acknowledge the acquisition of Emerald Kalama Chemical (Emerald) (see: **LANXESS: Acquisition of Emerald Kalama Chemical**). This acquisition is the blueprint for future M&A based on our understanding of LANXESS' corporate development strategy. We foresee acquisitions of companies that benefit from regulatory protection to strengthen the Consumer Protection business. The tendency of such businesses to have considerable pricing power would support LANXESS' competitive position which remains hampered by weak profitability. On the positive side profitability have been improving following the measures to clean-up the portfolio. However, weak profitability cascades into comparably weak free operating cash flow[1] compared to European chemicals peers.

Following the Emerald acquisition for an enterprise value of USD 1,075m, we expect key credit ratios to temporally weaken in 2021 but remain in line with a BBB+ rated financial risk profile. As a key credit ratio, SaD/EBITDA, is likely to revert to 1.9x in 2022.

[1] adjusted for lease amortisations according to our Corporate Rating Methodology

Ratings & Outlook

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

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Related Methodologies

Chemical Corporates Rating Methodology April 2021

Corporate Rating Methodology July 2021

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Bloomberg: RESP SCOP

LANXESS remains committed to maintaining an investment grade credit rating in the BBB rating category. As such, utilising opportunities for growth is likely pursued without threatening the credit profile. The assessment of the financial risk profile is hampered by weak free operating cash flow resulting in weak cash flow cover (FOCF/SaD).

Financial policy remains the most important supplementary rating driver. Although we have not modified LANXESS' stand-alone rating, our positive view on its commitment to a conservative financial policy is already incorporated in the financial risk profile assessment.

Outlook and rating-change drivers

Stable Outlook

The Outlook for the issuer rating remains Stable. This mirrors our view of a SaD/EBITDA of around 2.0x in the foreseeable future, which goes hand in hand with our assumption of ongoing growth in profitability.

Positive rating trigger

A positive rating action may be triggered if SaD/EBITDA is sustained below 1.5x. This could be achieved via a continued improvement in the EBITDA margin through, for example, higher price-setting power.

Negative rating trigger

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

Rating drivers

Positive rating drivers	Negative rating drivers
• Industry risk profile – specialty chemicals (assessed A) • Powerful position in medium-sized markets with considerable barriers to entry • Increased, more resilient end-market mix due to portfolio clean-up and acquisitions • Attractive innovation and growth projects in the pipeline (e.g. with Standard Lithium and Tinci Materials Technologies, CheMondis) • Financial risk profile (assessed BBB+), driven by improved credit profile following portfolio realignment • Conservative financial policy, reflected in financial risk profile assessment	• Mature product portfolio and comparably weak spending on product innovation relative to the specialty chemicals industry • Highly cyclical end-markets generating around 40% of sales (based on our calculations) • Positive profitability trend but still weak compared to key competitors' as well as profitability and efficiency thresholds under our methodology • Weak free operating cash flow resulting in weak FOCF/SaD ratio against 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**	**2020**	**2021E**	**2022E**
EBITDA/interest cover	9.6x	6.6x	8.1x	9.7x
Scope-adjusted debt (SaD)/EBITDA	2.3x	1.8x	2.4x	1.9x
Scope-adjusted FFO/SaD	30%	48%	34%	39%
Free operating cash flow (FOCF)[2]/SaD	2%	4%	3%	10%
Scope-adjusted EBITDA in EUR m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	910	757	915	1,091
Other items	1	1	0	0
Scope-adjusted EBITDA	**911**	**758**	**915**	**1,091**
Scope-adjusted funds from operations (FFO) in EUR m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	910	757	915	1,091
less: (net) cash interest as per cash flow statement	-40	-74	-60	-58
less: cash tax paid as per cash flow statement	-193	-131	-54	-149
less: pension interest	-56	-42	-56	-55
add: dividends received from equity-accounted entities	0	150	0	0
less: disposal gains on fixed assets included in EBITDA	1	1	0	0
less: capitalised interest	-3	-3	-3	-3
Other items	-24	-20	0	0
Scope-adjusted funds from operations	**595**	**638**	**742**	**826**
Scope-adjusted debt (SaD) in EUR m	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt (excl. hybrid debt)	2,343	2,331	1,831	1,831
add: hybrid debt	250	250	250	250
less: cash and cash equivalents	-1,064	-1,794	-455	-527
add: cash not accessible	0	0	0	0
add: pension adjustment	388	407	407	407
add: other items (contingent liabilities)	153	143	143	143
Scope-adjusted debt	**2,070**	**1,337**	**2,176**	**2,104**

[2] adjusted for lease amortisations according to our Corporate Rating Methodology

Business risk profile: BBB+

Industry risk profile: A

The specialty chemicals industry is characterised 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 low quantities of specialty chemicals to maintain their assembly and prices tend to be negotiated individually.

Powerful position in medium-sized markets…

… reinforced by acquisition of Emerald

The business risk profile is driven by LANXESS' strong position in multiple medium-sized and niche markets. These markets are often characterised by: i) high concentration; ii) domination by a few players; iii) modest competition; and iv) stable conditions. The Consumer Protection activities are protected by tight regulatory requirements. The Emerald acquisition will reinforce the LANXESS' powerful position in that division within food preservatives production as it commands the market for sodium benzoates, applied in the production of soft drinks.

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	Among the leading players	No. 1 to no. 3	No. 1 in bromine, bromine intermediates and brominated flame retardants	No. 1 in hot cast elastomer systems

Source: LANXESS, Scope

Weaker orientation towards R&D…

LANXESS' ability to and focus on strengthening its product portfolio through innovation continues to be weaker than the specialty chemicals industry average. This exposes the company somewhat to a deterioration in market position because: i) most of its products are relatively mature; ii) its spending on product innovation is low for the specialty chemicals industry (around 2.0% versus around 3.0% for the broader sector); and iii) most of its R&D is focused on optimising and improving existing products.

… focus on partnerships and cooperations instead

As part of a partnership with Chinse Tinci, LANXESS intends to produce electrolyte formulations for lithium-ion batteries starting in 2022 at its site in Leverkusen. This is on top of partnerships and collaborations already in the pipeline: Standard Lithium (testing to extract battery grade lithium from tail brine) and CheMondis (an internet-based marketplace for chemicals).

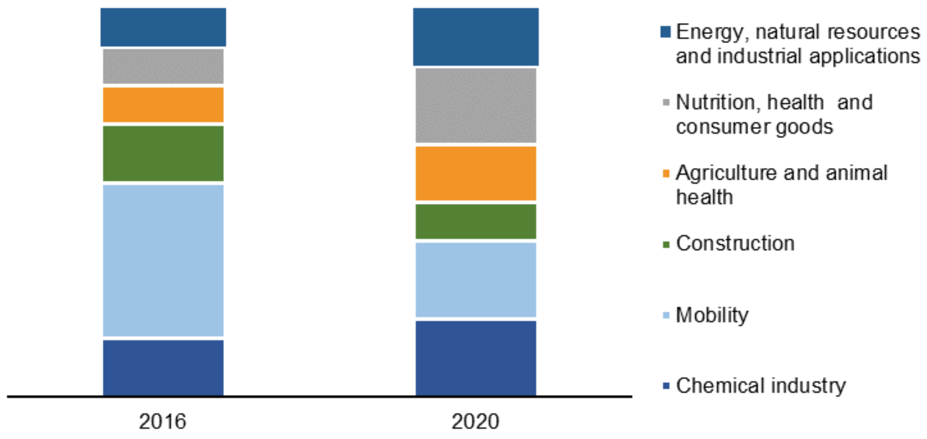
Supportive diversification due to improved end-market diversification

Intensive portfolio realignment in past years has improved the revenue mix by end-markets, which improves diversification substantially. Divestments have had no negative impact on the company's scale given their respective revenue contributions, in addition various small, medium and large companies were acquired.

Share of cyclical end-markets is likely to decrease in future

LANXESS' substantial share of highly cyclical end-markets is, however, negative for diversification. We calculate that up to 40% of revenues comes from the automobiles, chemicals and construction industries, in which aftermarket demand correlates strongly with global GDP. On a positive note, the company is much less dependent on automobiles and tyres than in previous periods. Given our understanding of LANXESS' strategy, we anticipate further efforts to make the end-market mix even more resilient to cyclicality.

Figure 2: Sales by end-markets, 2016 versus 2020 (including Emerald)



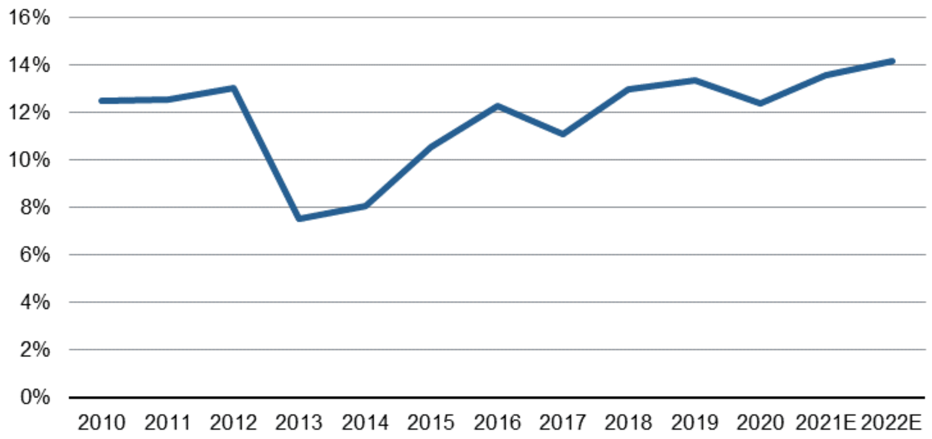
Source: LANXESS, Scope

EBITDA margins by division in 2020:

Advanced Intermediates 16.9%
Specialty Additives 15.5%
Engineering Materials 12.6%
Consumer Protection 21.0%

In accordance with our chemical corporates rating methodology, we focus on the through-the-cycle profitability when assessing profitability and operating efficiency. From 2010 to 2020, LANXESS' EBITDA margin averaged around 11.5%, which is weaker than peers' as well as the profitability and efficiency thresholds under our methodology. Between 2010 and 2018, profitability suffered from the weak performance of the formally consolidated synthetic rubber division (it was transferred into a joint venture with Saudi Aramco in 2016) and considerable one-off costs for the portfolio clean-up. That said, profitability is growing, which we expect to continue, thanks to high-margin products such as preservatives, aroma ingredients, disinfectants, all under Consumer Protection. Moreover, the company remains committed to achieving its EBITDA pre-margin target (before exceptional costs) of 14%-18% through the cycle, combined with a volatility objective of 2%-3%.

Figure 3: Profitability (EBITDA margin)



Source: LANXESS, Scope estimates, Bloomberg

ESG pioneer in European chemicals industry

While sustainability-related elements have no direct impact on the business risk profile assessment, we acknowledge LANXESS' pioneering role in ESG in the European chemicals industry. During 2004-20, the company reduced its greenhouse gas emissions by roughly 60% and aims to be CO2-neutral by 2040. LANXESS also ensures acquisition targets align with its sustainability footprint. Furthermore, in upgrading sites, LANXESS is willing to temporarily weaken credit ratios as these investments have different returns than those in usual growth projects.

Financial risk profile: BBB+

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 (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 added to SaD, given the high coverage of annual pension payments through dedicated pension assets
- Interest adjusted for the (estimated) interest component of pension provisions, operating leases (pre 2019) and contingent liabilities
- We do not adjust for restricted cash
- The issued hybrid bond (ISIN: XS1405763019, EUR 500m) rated BBB-, 50% equity credit according to our Corporate Rating Methodology

Financial risk profile: BBB+

For 2021, we expect credit ratios to weaken from 2020 levels, due to the Emerald acquisition, but recover in 2022, with SaD/EBITDA reverting to 1.9x. These levels align with the BBB+ rated financial risk profile. This is likely to be helped by good sentiment in the European chemicals industry, strong demand in most of the company's aftermarkets, and the higher prices for base products such as benzene being passed on to most of its customers due to contractual clauses. As mentioned earlier, LANXESS' commitment to maintaining a investment grade credit rating and will also apply to future external growth opportunities.

Recap 2020

Overall, we have judged LANXESS to have performed solidly during 2020 – the year of the Covid-19 pandemic. EBITDA decreased by more than major European specialty chemicals peers'. However, credit profile was bolstered by disposal proceeds of arround EUR 740m from the divestment of Currenta, an operator of chemical sites in Leverkusen, Dormagen and Krefeld-Uerdingen (see: **LANXESS: Disposal of 40% stake in Currenta will further support credit metrics**).

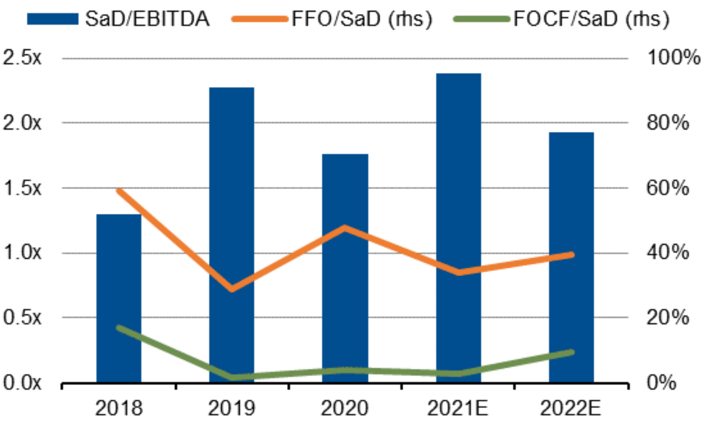
Positive sentiment a key driver for solid operating performance

We expect chemicals industry tailwinds to boost LANXESS' sales and EBITDA to around EUR 6.7bn and EUR 915m (including contribution from Emerald from H2 2021) in 2021 and facilitate a return to pre-Covid levels already in 2021. We anticipate higher earnings for all operations, with those selling to Covid-hit industries to contribute the most to growth. This is especially true for businesses exposed to the automotive industry, which account for roughly 20% of LANXESS' sales. In addition, demand for disinfection products, aroma ingredients and preservatives should remain healthy. We assume former Emerald activities to contribute to Consumer Protection from the second half of 2021. The running recovery in earnings could be potentially hampered, however, by high logistic costs persisting into the second half of 2021 (due to global supply chain constraints) or the expected dampening of the favourable business conditions being stronger than expected later in 2021.

Key building blocks of the rating base case

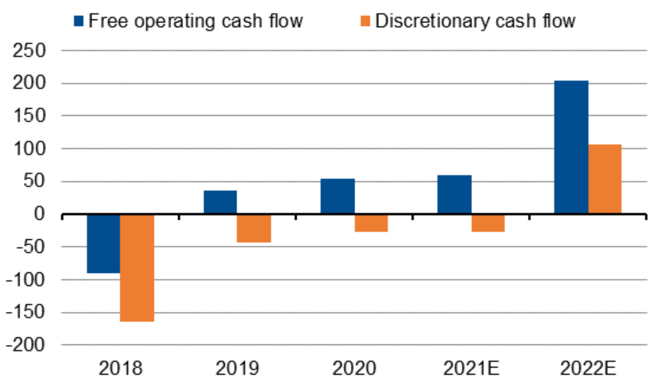
The following key assumptions of the rating scenario are worth mentioning: i) ongoing M&A and shareholder remuneration to be undertaken in line with the conservative financial policy, but our rating case excludes any share buybacks; ii) no further material asset disposals, after an active disposal history; iii) capex of around EUR 500m yearly, including on projects to reduce its CO_2 footprint; iv) investment in working capital, to comply the targeted working capital/sales ratio of about 20%; and v) earnings contribution from Emerald from the second half of 2021.

Figure 4: Credit metrics



Source: LANXESS, Scope estimates

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



Source: LANXESS, Scope estimates

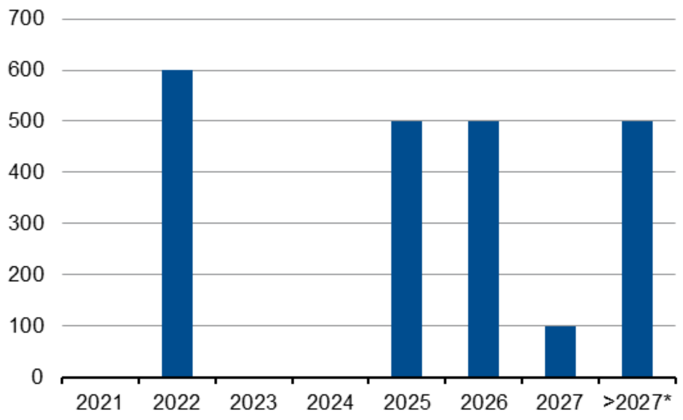
Free operating cash flow remains weak against the specialty chemicals industry

A negative rating driver is still free operating cash flow generation, weakened primarily by weak EBITDA margin and voluntary payments to strengthen pension assets. Moreover, the annual capex of around EUR 500m, of which roughly EUR 300m is spent on maintenance, increased through investments aimed at reducing greenhouse gas emissions.

Liquidity: adequate

We continue to assess liquidity as adequate. Ratios on internal and external liquidity coverage continue to be strong thanks to a diversified maturity profile against a EUR 1.0bn credit facility and positive (although weak) free operating cash flow. Interest on this credit facility is conditional to ESG criteria, which include a reduction in greenhouse gas emissions (Scope 1) and an increase in the proportion of women in the top three management tiers.

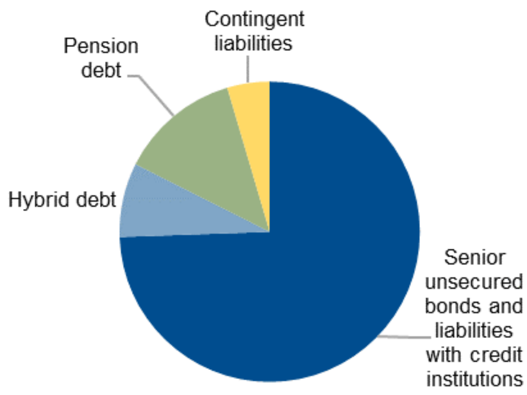
Figure 6: Maturity profile (EUR m; 30 June 2021)



*The hybrid bond can be called in 2023

Source: LANXESS, Scope

Figure 7: Composition of SaD (2020)



Source: LANXESS, Scope

Diversified maturity profile and debt composition

Our view on LANXESS' liquidity also applies to the composition of SaD. While most of the debt comes from capital markets and credit institutions (predominantly bonds), the diversification into hybrid debt when acquiring Chemtura in 2016, with the aim of keeping rating-relevant leverage under control, is positive.

Supplementary rating drivers

Conservative financial policy reflected in company's financial risk profile

Financial policy remains the most important supplementary rating driver. We continue to consider LANXESS' financial policy as conservative, which cascades into the affirmed financial risk profile. We understand that the company is selective in its external growth opportunities, considering valuations and the potential effect on its credit rating. LANXESS intends to maintain a BBB category rating, excluding the commitment to a specific target range on financial leverage.

Long-term and short-term debt ratings

Short-term rating: S-2

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

Rating for unsecured debt: BBB+

All senior unsecured debt has been affirmed at BBB+, the level of the issuer.

Rating for subordinated (hybrid) debt: BBB-

We have affirmed the subordinated (hybrid) 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, accumulation of payments, contractual subordination and the remaining maturity.

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