

**Credit Opinion: Weir Group Plc (The)**

Global Credit Research - 13 Aug 2015

United Kingdom

**Ratings**

Category	Moody's Rating
Outlook	Negative
Issuer Rating -Dom Curr	Baa1
Commercial Paper	P-2

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**Key Indicators**

[1]Weir Group Plc (The)

	7/3/2015(L)	1/2/2015	1/3/2014	12/28/2012	12/30/2011
Revenue (USD Billion)	\$3.6	\$4.0	\$3.8	\$4.0	\$3.7
EBITA Margin	12.9%	16.4%	19.1%	18.9%	18.0%
EBITA / Interest Expense	5.9x	8.6x	7.3x	9.3x	15.9x
Debt / EBITDA	3.3x	2.6x	1.9x	2.3x	2.1x
Retained Cash Flow / Net Debt	24.1%	27.8%	35.5%	36.5%	36.1%
Free Cash Flow / Debt	11.1%	5.8%	16.9%	5.9%	4.3%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

**Opinion**

**Rating Drivers**

Modest scale, but market leadership positions

Very high share of aftermarket business providing more stability and high profitability

Exposure to cyclical end markets, such as mining and oil and gas, both of which are currently in downturn

M&A risk, but within publicly committed leverage targets

**Corporate Profile**

Headquartered in Glasgow, UK, Weir is an engineering solution provider focusing on designing, manufacturing and

supplying products and engineering services for the minerals, oil & gas, and power & industrial markets. The group is organized into three divisions: Weir Minerals (46% of group revenues in 2014), Weir Oil and Gas (41%) and Weir Power and Industrial (13%). In 2014, Weir generated revenues of GBP2.4 billion with a headcount of more than 16,000 employees in global manufacturing as well as in service footprint. Weir is a publicly listed company.

## **Rating Rationale**

Weir's Baa1 issuer rating is weakly positioned. Weir's key markets of mining and oil and gas are currently in a cyclical downturn, with the North American pressure pumping and pressure control markets seeing particularly severe investment cuts. As a result, the group's credit metrics on a Moody's adjusted basis for the 12 months to June 2015 period, with an EBITA margin of around 13%, debt/EBITDA of 3.3x and retained cash flow (RCF)/net debt of 24%, are below expectations through the cycle for the Baa1 rating. These metrics include around EUR45 million of restructuring costs and around EUR35 million of receivables and inventories impairments, but still benefit from a strong underlying earnings in H2 2014. We consider a temporary increase of the leverage towards 3x as acceptable in a cyclical downturn. However, should market conditions remain weak for a prolonged period of time and should Weir's metrics not show a trajectory of improvement back towards levels commensurate with the Baa1 rating over the next 12-18 months, negative pressure on the rating may develop. This is reflected in the negative outlook.

The Baa1 issuer rating is supported by Weir's: (1) strong market leadership in product niches which are key to the mining and oil and gas industries, with the group being typically the leader or among the leaders in respective addressable markets; (2) good geographical diversity at group level and wide manufacturing and services footprint enabling proximity to customers; (3) business model focused on fairly inexpensive but operation-critical products, with very high aftermarket potential (e.g., around 70% of revenues in the largest Minerals division), resulting in fairly resilient and high margins; (4) maintenance of healthy free cash flow generation even when profitability is under pressure; and (5) conservative financial policies with a public commitment to keep reported net leverage below 2.0x at all times (1.8x for 12 month to June 2015 period).

The main constraints for the Baa1 rating are: (1) modest scale with turnover of GBP2.4 billion in 2014 and somewhat narrower product portfolio compared with similarly rated peers; (2) short lead time businesses with limited backlog, constraining revenue visibility on new equipment side; (3) exposure to very cyclical end markets such as mining or oil and gas that are currently both in a downturn; and (4) M&A risk, yet within the publicly stated management target of 2.0x reported net leverage.

## **DETAILED RATING CONSIDERATIONS**

### **MODEST SCALE, BUT MARKET LEADERSHIP POSITIONS**

With revenues of GBP2.4 billion in 2014 Weir is one of the smallest companies in the Baa1 rated universe. The modest scale, together with a somewhat narrower product portfolio compared to similarly rated peers, is also one of the main constraining factors for an upgrade to the A rating category. By a combination of organic and controlled external growth, we expect Weir to continue expanding the size of its addressable markets, particularly in the Minerals and Oil and Gas divisions.

Weir believes to be typically the leader or among the leaders in relatively consolidated markets. In the Minerals division the management claims to be the market leader, with circa 25% market share in its addressable market, well ahead of the closest competitor, competing with companies like Metso Corporation (Baa2 stable), FLSmidth (unrated), KSB (unrated) and Outotec (unrated). Specifically for slurry pumps, which are the core product generating revenues in excess of 50% of the division, Weir claims to be clear market leader with significant market share of around half of its addressable market. Similar to its main European competitors, Weir focuses on hard rock mining, such as copper, iron and gold.

In the Oil and Gas division, where the majority of revenues are derived from pressure pumping and pressure control equipment and services, Weir also claims to have a combined leadership position, competing with companies like Cameron International Corporation (Baa1 stable), Gardner Denver, Inc (B2 negative) or Halliburton Company (A2 stable). However, we note that there is some dependence on the US upstream oil and gas market, which is currently facing a severe decline in activity due to low oil prices.

By utilising its strong global footprint and long customer relationships with key players in the mining and oil and gas industries, we believe Weir is well positioned to protect its market shares in the foreseeable future.

## VERY HIGH SHARE OF AFTERMARKET BUSINESS PROVIDING MORE STABILITY AND HIGH PROFITABILITY

Weir's product strategy, primarily in the Minerals and Oil and Gas divisions, is focused on relatively inexpensive, but operation-critical equipment that is used in extreme environments (high abrasion, temperature or pressure) and therefore exposed to high wear rates. This creates very significant aftermarket opportunities for Weir (e.g around 70% of revenues in the largest Minerals division). According to management, the aftermarket capture rate is very high, enabled by Weir's high installed base and a very strong service footprint that creates a barrier to entry given that downtimes can be very costly for Weir's customers.

The high share of its aftermarket business has two major benefits for Weir. First, it is far more profitable than the original equipment business, which explains why Weir has been able to outperform the majority of its manufacturing peers in terms of profitability. Second, it partially mitigates the cyclical nature and limited visibility of the business, because unlike the original equipment business, the aftermarket business is dependent on activity levels rather than customers' expansion capex, which are more predictable and less volatile. The Minerals' aftermarket continues to be fairly robust, as Weir's customers, the key mining companies are not shutting down their mines, which supports stable production levels. The Oil and Gas's aftermarket, driven by drilling and completion activity, is however currently severely affected by customers' destocking and asset cannibalisation in the oversupplied North American pressure pumping market, which we however expect to be temporary.

Apart from the high share of aftermarket business, we note that Weir enjoys fairly flexible operations, with relatively limited capex needs at around 4% of sales and a fairly flexible cost base, with cost of goods sold representing around 80% of the cost base, being mostly variable.

## EXPOSURE TO CYCLICAL END MARKETS, SUCH AS MINING AND OIL AND GAS, BOTH OF WHICH ARE CURRENTLY IN DOWNTURN

Weir is currently facing a downturn in its mining and oil and gas end markets, owing to unprecedentedly low metals and oil prices which have caused Weir's customers to substantially cut investment in new equipment. Weir's oil and gas business, which is centred around pressure pumping and pressure control products primarily for North American upstream oil market, has seen the most severe investment cuts. In H1 2015, Weir's Oil and Gas division's order intake and sales declined by around 40% and 30% year on year, respectively, and the division's operating margin before exceptional items (as reported by Weir) declined to around 11% in H1 2015, from 22% in the same period the year before. This operational performance, however, compares well vis-a-vis other players active in the North American pressure pumping and pressure control markets.

The visibility of the oil and gas business still remains fairly low. Moody's forecasts the oil price (Brent crude) to be around USD55 by the end of 2015, only modestly increasing to USD57 in 2016 and USD65 in 2017, which might not be enough to support major improvement in activity and increase in investments in the coming quarters. As such, we believe that Weir will find it challenging to reach again its historical profitability levels of above 20% in its Oil and Gas division over the next two to three years.

The mining business has continued to perform reasonably well and broadly in line with Moody's expectations, despite miners cutting expansionary capex further as metal prices, in particular iron ore, keep decreasing. However, the highly profitable aftermarket business, constituting around 70% of the Minerals division's revenues, remains robust. Moody's forecasts that the expansionary capex could see up to 20% decline in 2015 as well as in 2016, if conditions remain difficult. However, the high share of stable and profitable aftermarket business will help to maintain the division's profit margin at high teens in % terms (around 18% in H1 2015) even in such scenario.

## M&A RISK, BUT WITHIN PUBLICLY COMMITTED LEVERAGE TARGETS

In the last decade Weir has been rather acquisitive, spending around GBP210 million p.a. on average during 2010-2014 on external growth, which compares to around GBP90million p.a. of internally generated free cash flow. Although part of that growth was debt-financed, Weir has kept its leverage at all times below the publicly stated maximum level of 2.0x reported net debt/EBITDA, with around 1.4x on average over the last five years.

We expect the controlled growth to continue with Weir acquiring small to mid-sized targets, predominantly in the Minerals and Oil and Gas divisions. However, the Baa1 rating assumes that such acquisitions will be financed conservatively and that Weir will remain within its net leverage target at all times, also considering its temporarily weaker operating performance. Any indication of management relaxing this discipline would lead to downward rating pressure.

## Liquidity Profile

We view Weir's liquidity profile as solid. As of June 2015 Weir reported around GBP230 million of cash and short-term deposits on balance sheet, which was further underpinned by a USD800 million revolving credit facility maturing in July 2019 (with an option of two one year extensions), with GBP165 drawn. The facility has a net leverage and net interest cover covenants, both with good headroom. These liquidity sources should comfortably cover all the liquidity needs in the next 12-18 months. Overall we expect Weir to generate material positive FCF, helped by release of working capital, which typically occurs when demand is depressed. Debt maturities are well spread, with roughly GBP160 million short term debt as of June 2015.

## Rating Outlook

The negative outlook reflects the increasing risk that amidst a severe economic downturn in some of its end markets, Weir's credit metrics, its leverage in particular, may remain sustainably weaker than expected by Moody's for the Baa1 rating category.

## What Could Change the Rating - Up

Given the company's limited size, and business and product diversification, the potential for an upgrade is limited at this stage. An upgrade could be driven by increased scale and product diversification, complemented by stronger financial policies, as exhibited by a Moody's adjusted gross debt/EBITDA sustainably below 1.0x.

## What Could Change the Rating - Down

We would consider a downgrade, if: (1) there is an indication of relaxed financial discipline, as exemplified by a Moody's adjusted gross debt/EBITDA sustainably above 2.0x through the cycle or Moody's adjusted RCF/net debt sustainably below 30%; (2) the last-12-months' free cash flow turns negative; or (3) Moody's-adjusted EBITA margins decrease towards the mid-teens in percentage terms, because of the company's loss of market share or an inability to adapt its cost base to its economic environment.

## Other Considerations

The principal methodology used in rating Weir was the Global Manufacturing Companies Rating Methodology, published in July 2014. The grid outcome for the 12 month to June 2015 period as well as for our 12-18 month forward view indicates a Baa3 rating. The two notches difference can be explained by the fact that Weir is currently affected by a severe downturn in two major end markets and hence its point-in-time metrics are unlikely to be representative of our expectation of through the cycle credit metrics.

## Rating Factors

### Weir Group Plc (The)

Manufacturing Industry Grid [1][2]	Current LTM 7/3/2015		[3]Moody's 12-18 Month Forward ViewAs of 8/13/2015	
Factor 1 : Business Profile (20%)	Measure	Score	Measure	Score
a) Business Profile	Baa	Baa	Baa	Baa
Factor 2 : Scale (20%)				
a) Revenue (USD Billion)	\$3.6	Ba	\$2.9 - \$3.4	Ba
Factor 3 : Profitability (10%)				
a) EBITA Margin	12.9%	Baa	13% - 16%	Baa
Factor 4 : Coverage and Leverage (40%)				
a) EBITA / Interest Expense	5.9x	Baa	5x - 7x	Baa
b) Debt / EBITDA	3.3x	Ba	2.8x - 3.3x	Baa
c) Retained Cash Flow / Net Debt	24.1%	Ba	20% - 25%	Ba
d) Free Cash Flow / Debt	11.1%	Baa	5% - 10%	Ba
Factor 5 : Financial Policy (10%)				
a) Financial Policy	A	A	A	A

<b>Rating:</b>				
a) Indicated Rating from Grid		Baa3		Baa3
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] As of 7/3/2015(L); Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

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