Research Update:

Valeo S.E. Outlook Revised To Negative On Weaker Cash Flow Expectations; 'BB+' Ratings Affirmed

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Rating Action Overview

- We anticipate Valeo S.E.'s profitability and cash generation will be hindered by higher research and development (R&D) investments, capital expenditure (capex), and restructuring costs in 2024. We expect this will translate into declining S&P Global Ratings-adjusted EBITDA margins and free operating cash flow (FOCF) to debt of 6.6%-6.8% and 2.9%-3.5%, respectively, from already relatively weak levels for the rating of 7.5% and 3.8% in 2023.
- At the same time, we believe that the group's solid order book in higher-margin components and its focus on cost savings will pave the way for further above-average revenue growth and improve profitability and cash conversion in 2025. Hence, we expect adjusted EBITDA margins and FOCF to debt to improve to 9.0%-10.5% and 6%-11% in 2025, respectively.
- We therefore revised our outlook on Valeo to negative from stable.
- We also affirmed our 'BB+' long-term issuer credit and issue-level ratings on the company and its unsecured debt.
- The negative outlook reflects the potential for a downgrade if we expect that Valeo is unlikely to improve S&P Global Ratings-adjusted funds from operations (FFO) to debt to more than 25%, FOCF to debt comfortably within 5%-10%, along with adjusted EBITDA margin well above 8% for 2025.

Rating Action Rationale

We expect Valeo's FOCF will remain weak for the 'BB+' rating in 2024, and any further delay in its 2025 financial roadmap would likely pressure the rating. We anticipate the group's adjusted FOCF will decline to about €150 million-€200 million in 2024 from €201 million in 2023. This is mainly due to higher R&D and capex investments, as well as restructuring costs of about €150 million linked to the merger of its powertrain and thermal systems business units and other operating initiatives. We estimate this will translate to FOCF to debt staying well below 5% in 2024, after the 3.8% and 3.6% recorded in 2023 and 2022, respectively. In addition, excluding working capital inflows of a few hundred million euros this year (mainly from inventory reduction), our estimate of Valeo's FOCF is negative. We also note that in 2023 and 2022, the group's FOCF heavily relied on working capital inflows of about €230 million and €180 million (excluding factoring effects), respectively.

For 2025, we anticipate a substantial improvement in FOCF to at least €300 million from improving profitability and a lower investment intensity, while assuming more modest working capital inflows. That said, we estimate that any setback in the group reaching its 2025 reported operating margin target of 5.5%-6.5% (from 3.8% in 2023) will likely translate to FOCF to debt not improving well above 5%, pressuring the rating.

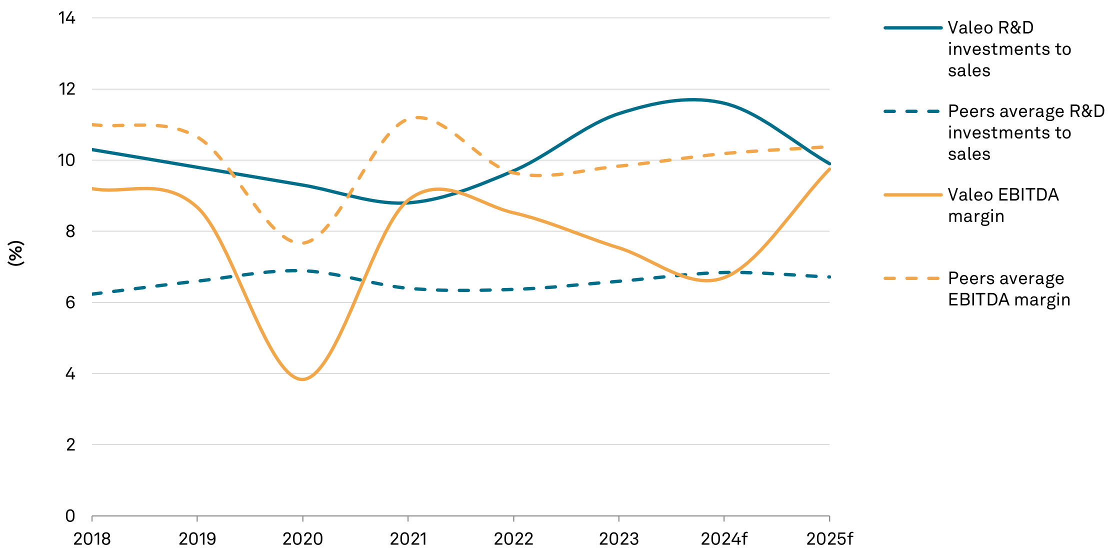
Valeo's favorable order intake momentum has yet to turn into stronger profitability and cash conversion. The group recorded a total order intake of €67.5 billion in 2022-2023, equivalent to a strong book to bill ratio of about 1.9x. This included large contributions from Valeo's advanced driver-assistance systems (ADAS) business (more than 50% of 2023's total orders) and further growth in high-voltage powertrain solutions (€6 billion orders in 2023). We anticipate this will support the company's long-term competitive position in the markets for these components. We also anticipate an improvement in the EBITDA margin in our base case to 9.0%-10.5% in 2025 from moderating R&D costs, higher revenue, operating efficiencies, and the progressive delivery of higher-margin orders.

At the same time, we expect the group's operating margins and FOCF will remain temporarily constrained by high associated R&D and launch costs, as well as capacity investments as it prepares to deliver these orders from 2025. We expect Valeo's R&D investments to sales ratio (including capitalized development costs) will further rise to 11.6% in 2024 from an already high level of 11.3% in 2023, where it will remain well above the peer average of about 6.5%-7.0% in those years. Combined with our expectations of €200 million in booked restructuring expenses, we anticipate this will translate to Valeo's S&P Global Ratings adjusted EBITDA margin declining to about 6.6%-6.8% in 2024 from 7.5% last year, which is in the low end of its peer group and well below the average peer profitability of about 10% (see chart 1).

Chart 1

Valeo S.E.'s R&D investments and EBITDA margin vs. peers

Valeo's larger-than-average R&D investments do not translate to above-average profitability



Peers include Aptiv, FORVIA, Continental, ZF, Plastic Omnium and Schaeffler. Total R&D investments include R&D expenses and capitalized development costs. R&D--Research and development. f--Forecast. Source: S&P Global Ratings.

We expect Valeo's financial policy to support gradual deleveraging beyond 2024. While we anticipate FFO to debt of about 19% in 2024, which is weak for the rating, we attribute most of the decline from 22.2% in 2023 to higher R&D costs and restructuring expenses this year, which we consider temporary.

At the same time, the company plans to complete its €500 million noncore asset disposal program by the end of 2025, which we believe will result in adjusted debt staying stable at around €5.2 billion in the next two years. Our base case for 2024 includes proceeds from the sale of Valeo's thermal business for commercial vehicles, after the disposal of its Ichikoh mirror business last year. In addition, we expect shareholder remuneration to remain relatively moderate in the next two years, with total dividend payouts (including to minority shareholders) modestly increasing to €160 million-€170 million, from €127 million in 2023.

Assuming profitability improves, we expect Valeo can swiftly restore FFO to debt to well above 25% in 2025. The company aims to decrease its reported net debt to EBITDA to 1.0x in 2025 from 1.5x at Dec. 31, 2023. We estimate that would lead to S&P Global Ratings-adjusted EBITDA improving to about 2.0x, from 3.2x at Dec. 31, 2023, and FFO to debt increasing well above 30%.

Outlook

The negative outlook reflects the potential for a downgrade if we expect that Valeo is unlikely to significantly improve its profitability and free cash flow generation in 2025 from its trough in 2024.

Downside scenario

We could lower our ratings if we do not expect Valeo to improve its S&P Global Ratings-adjusted EBITDA margin to more than 8% and FOCF to debt within 5%-10% in 2025. This could stem from a delay in the company's profitability improvements, higher-than-expected investments, or a deterioration in automotive market conditions globally.

Upside scenario

We could revise our outlook on Valeo to stable if we anticipate it can restore and sustain FOCF to debt of 5%-10% in 2025 and beyond while maintaining adjusted EBITDA margin above 8% and FFO to debt above 25%. We believe this will hinge on the company's ability to progressively convert its order book into profitable growth while gradually reducting its investment intensity.

Company Description

Valeo S.E. is a large tier-1 automotive supplier operating globally, with reported sales of about €22 billion in 2023 across Europe (48% of total sales), Asia (31%, including 15% in China), North America (19%), and South America (2%). The group designs, produces, and sells components, systems, and modules for automobiles, for both the original equipment market (about 85%-90% of revenue) and the aftermarket (about 10%-15% of revenue). Valeo produces a broad range of components, including sensors, LIDARs and radars, cameras, domain controllers, electric converters, inverters and motors, climate control systems, motor and battery cooling solutions, heat pumps, as well as front, rear, and interior lighting and wipers. Its product portfolio is mainly structured around four business lines:

- Powertrain systems (32% of 2023 sales);
- Comfort and driving assistance systems (21%);
- Thermal systems (22%); and
- Visibility systems (25%).

Our Base-Case Scenario

Assumptions

- Global light vehicle production growth slows up to 2% this year and 1%-3% in 2025, after the 9% and 6.6% rise in 2023 and 2022, respectively.
- Revenue grows about 6% annually in 2024-2025 as the group delivers on its sizable order book.
- S&P Global Ratings-adjusted EBITDA margin declines to 6.6%-6.8% in 2024 from 7.5% in 2023

due to higher R&D costs and restructuring costs of about €150 million, up from €90 million in 2023. We assume a sizable EBITDA margin improvement to 9.0%-10.5% in 2025 from cost savings, higher-margin orders, and lower R&D costs.

- Adjusted R&D expenditure (including capitalized development costs) increases to about 11.6% in 2024 from 11.3% in 2023, and moderates close to 10% in 2025.
- Working capital inflows of a few hundred million euros in 2024 and more modest in 2025, mainly come from reduced electronic components inventory and other cash-collection initiatives.
- Adjusted capex (excluding capitalized development costs) increases to 5.7% in 2024 and 5.5% in 2025 from 4.6% in 2023 as the company increases capacity production in ADAS and high-voltage components.
- Asset sales total about €250 million in 2024, with additional proceeds of €50 million in 2025 after the €80 million received in 2023.
- Cash dividends (including minorities) increase to €160 million-€170 million in 2024-2025 from €127 million in 2023.
- There are no material acquisitions.

Valeo S.E.--Forecast summary

Industry sector: Automotive - parts producers & suppliers

	--Fiscal year ended Dec. 31--							
(Mil. €)	**2018a**	**2019a**	**2020a**	**2021a**	**2022a**	**2023a**	**2024f**	**2025f**
Global light vehicle production (mil. units)	94	89	75	77	82	90	91	92
Revenue	19,124	19,477	16,699	17,640	20,240	22,044	23,445	24,738
EBITDA (reported)	2,311	2,172	1,130	1,997	2,502	2,627	2,700-2,800	3,200-3,600
Less: Capitalized development costs	(716)	(769)	(598)	(586)	(657)	(995)	(1,188)	(1,000)
Less: high-voltage e-powertrain business consolidation	--	--	(170)	(129)	(33)	--	--	--
Plus/(less): Expense (income) of unconsolidated companies	111	237	278	243	(115)	(17)	(12)	(13)
Plus: Dividend from equity investments	64	44	28	17	16	14	7	7
Less: Pension and postretirement expense	(6)	(19)	(60)	(4)	(9)	7	7	7
Plus: Stock compensation expense	3	24	33	28	21	25	25	25
EBITDA	1,767	1,689	641	1,566	1,725	1,661	1,500-1,600	2,200-2,600
Less: Cash interest paid	(86)	(99)	(102)	(99)	(154)	(261)	(291)	(289)
Less: Cash taxes paid	(267)	(292)	(188)	(237)	(291)	(225)	(265)	(410)
Funds from operations (FFO)	1,414	1,298	351	1,230	1,280	1,175	975-1,025	1,500-1750
Capital expenditure (capex)	1,352	1,197	967	850	853	1,006	1,332	1,356

Valeo S.E.--Forecast summary (cont.)

Industry sector: Automotive - parts producers & suppliers

	--Fiscal year ended Dec. 31--							
(Mil. €)	2018a	2019a	2020a	2021a	2022a	2023a	2024f	2025f
Free operating cash flow (FOCF)	50	503	54	50	186	201	150-200	300-550
Dividends	324	343	122	101	143	127	160	170
Share repurchases	118	29	1	--	50	--	--	--
Discretionary cash flow (DCF)	(392)	131	(70)	(51)	(7)	74	(5)	150
Debt (reported)	4,839	4,438	5,734	5,395	6,725	6,490	6,491	6,052
Plus: Lease liabilities debt	376	441	394	510	617	581	593	604
Plus: Pension and other postretirement debt	907	981	867	823	619	675	675	675
Plus: Trade receivables sold	368	290	297	261	301	340	340	340
Plus: Reverse factoring	--	--	99	99	110	121	121	121
Plus: Put options on minority stakes	89	79	68	17	12	--	--	--
Less: Accessible cash and liquid Investments	(1,957)	(1,713)	(2,777)	(2,259)	(3,201)	(2,920)	(2,950)-(3,000)	(2,600)-(2,850)
Debt	4,622	4,516	4,682	4,846	5,183	5,287	5,225-5,275	4,950-5,200
Adjusted ratios								
Debt/EBITDA (x)	2.6	2.7	7.3	3.1	3.0	3.2	3.3-3.5	1.9-2.4
FFO/debt (%)	30.6	28.7	7.5	25.4	24.7	22.2	18-20	29-35
FOCF/debt (%)	1.1	11.1	1.1	1.0	3.6	3.8	2.8-3.8	5.8-11.1
DCF/debt (%)	(8.5)	2.9	(1.5)	(1.1)	(0.1)	1.4	(0.5)-0.5	2.5-7.6
Annual revenue growth (%)	3.5	1.8	(14.3)	5.6	14.7	8.9	6.4	5.5
EBITDA margin (%)	9.2	8.7	3.8	8.9	8.5	7.5	6.4-6.8	9.0-10.5

All figures include S&P Global Ratings adjustments' unless stated as reported. a--Actual. f--Forecast.

Liquidity

We assess liquidity as adequate, based on our expectation that liquidity sources to uses will exceed 1.5x in the next 12 months period started Jan. 1, 2024. Volatile market conditions could lead to large swings in cash flow and require Valeo to raise funding in severe downside scenarios. This leads us to maintain the adequate liquidity assessment.

Principal liquidity sources

- Cash and cash equivalents of €3.0 billion on Dec. 31, 2023;
- About €1.6 billion in undrawn committed credit lines with maturities extending beyond one year;
- Our forecast of about €2.1 billion of cash FFO;

- Working capital inflows of a few hundred million euros; and
- Contracted disposal proceeds of about €250 million.

Principal liquidity uses

- About €1.5 billion of debt maturing in the next 12 months, including €700 million of commercial paper;
- Seasonal working capital outflows of about €500 million;
- Approximately €2.5 billion of capex; and
- Annual dividends of approximately €160 million.

Covenants

In our base-case scenario, Valeo enjoys comfortable headroom of over 50% under its 3.5x net leverage covenant built in its revolving credit facility (RCF).

Environmental, Social, And Governance

ESG factors have an overall neutral influence on our credit rating analysis of Valeo. The company is less exposed to environmental risks than the auto industry because it was an early mover on clean and safe technologies. The group is targeting 38 tons of carbon dioxide per million euros by 2025 (a 23% reduction compared to about 50 tons in 2019), a 45% reduction by 2030, and carbon neutrality by 2050. The group has invested the equivalent of approximately 10% of sales per year in technologies that support the decarbonization of the auto industry.

Issue Ratings - Recovery Analysis

Key analytical factors

- The senior unsecured notes--issued by Valeo S.E.--have an issue-level rating of 'BB+' and a recovery rating of '3', reflecting the pari passu ranking of the notes and credit facilities.
- In our hypothetical default for Valeo, a cyclical downturn in the industry, combined with intensified competition, would lower production volumes and prices. This causes Valeo's operating performance to deteriorate markedly and EBITDA and cash flow generation to decline sharply.
- We value Valeo as a going concern based on its strong market position in the auto supply industry and its diverse base of customers.

Simulated default assumptions

- Year of default: 2029
- Jurisdiction: France

Simplified waterfall

- Emergence EBITDA: €1.06 billion (maintenance capex assumed to be 4% of revenue; cyclical adjustment of 10%, standard for the sector)
- Multiple: 5.5x
- Gross recovery value: €5.9 billion
- Net recovery value (after 5% administrative expenses): €5.6 billion
- Estimated priority claims (factoring lines and debt at subsidiary level): €285 million
- Value available for senior unsecured claims: €5.3 billion
- Senior unsecured claims (including about €1.7 billion of committed credit lines that we assume 85% drawn at default): €7.0 billion*
- --Recovery expectations: 50%-70% (rounded estimate: 65%§)

*All debt amounts include six months of prepetition interest. §Final recovery estimate capped at 65% due to the unsecured nature of the debt.

Ratings Score Snapshot

Issuer Credit Rating	BB+/Negative/B
Business risk:	Satisfactory
Country risk	Low
Industry risk	Moderately high
Competitive position	Satisfactory
Financial risk:	Significant
Cash flow/leverage	Significant
Anchor	bb+
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Neutral (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bb+

Related Criteria

- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For

Corporate Entities, Jan. 7, 2024

- 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
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Industry Credit Outlook 2024: Autos, Jan. 9, 2024
- Credit Outlook: Global Autos, Oct. 31, 2023
- Valeo S.E., Jul. 25, 2023

Ratings List

Ratings Affirmed

Ratings Affirmed; Outlook Action		
	To	**From**
Valeo S.E.		
Issuer Credit Rating	BB+/Negative/B	BB+/Stable/B
Senior Unsecured	BB+	BB+
Recovery Rating	3(65%)	3(65%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.