Research Update:

Deutsche Bahn AG Outlook Revised To Stable From Negative On Traffic Recovery And Strong State Support; 'AA-' Affirmed

July 29, 2022

Rating Action Overview

- We forecast a solid rebound in Deutsche Bahn AG's (DB) rail passenger volumes, with revenue for the long-distance segment to reach about 85%-90% of 2019 levels in 2022 (from about 60% in 2021), and at least 100% in 2023 due to fleet expansion and improved services.
- Regional rail passenger revenue, which is less exposed to traffic risk, may also approach 2019 levels in 2022, from about 90% in 2021.
- Robust performance from the logistics segment under DB Schenker (more than 30% revenue growth in 2021) is expected to continue in 2022 and, combined with prudent cost control, will mitigate increasing inflationary pressures, despite tightening rating headroom in 2023.
- We expect German state support--including an additional €2.2 billion to compensate for COVID-19 losses in 2022 after €3.8 billion in 2021 and an €11 billion capital injection (equity and investment grants spread over 2020-2030), announced in 2019 under the Climate Action Program--will support DB's credit profile, although material deleveraging beyond 2022 will remain constrained by significant investments hampering cash flow.
- We therefore revised our outlook on DB to stable from negative and affirmed our 'AA-/A-1+' long- and short-term issuer credit ratings, 'AA-' issue ratings on its senior unsecured debt, and 'BBB-' issue rating on the €2 billion hybrids.
- The stable outlook reflects our view that DB will maintain funds from operations (FFO) to debt above 9% over 2022-2024, on the back of its strong ties to the government, a rebound in passenger volumes, and effective cost controls.

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Rating Action Rationale

We assume the recovery in long-distance passenger traffic, higher logistics earnings, and continuous COVID-19 state support will enable FFO to debt of above 9% on average over 2022-2024, from about 6.6% in 2021, although with limited rating headroom in 2023. After passenger volumes for DB's long-distance segment reached close to 2019 levels in second-quarter 2022, we forecast segment revenue will rebound to 85%-90% of 2019 levels in 2022, from about 60% in 2021, and reach 2019 levels or above in 2023, fueled by new and improved services. Although leisure traffic has recovered steadily to pre-pandemic levels in recent months, in our view, the remote working environment could continue to weigh on business traffic in the medium term. In contrast, the recovery in regional rail has been slower, but this is mitigated by a significant share of transportation contracts not being exposed to passenger risk. Therefore, we forecast revenue on regional services could reach close to 2019 levels in 2022, from about 90% in 2021. We expect the regional traffic recovery will be boosted by the €9 ticket initiative for all passengers in June, July, and August 2022, which will be fully funded by the federal government. Our EBITDA forecasts factor about €800 million of government support in 2022, compared with €2.6 billion in 2021, reflecting about €500 million of COVID-19-related train-path price support for long-distance transport and about €300 million for regional transport.

We forecast that revenue for logistics business DB Schenker will remain high in 2022, after more than 30% growth in 2021, reflecting recent positive trends (about 36% revenue growth in first-half 2022), continued constrained air freight capacity, and higher rates. Nevertheless, we factor in about a 20% revenue decline for the segment in 2023 when supply chain pressure may start to ease. The logistics segment has lower profitability than passenger rail services, with a reported EBITDA margin (adjusted) of 6.3% versus 15.8% for the long-distance segment in 2019. Under our base case, we forecast DB's S&P Global Ratings-adjusted EBITDA will be about €5.4 billion-€5.6 billion in 2022 (from €3.3 billion in 2021), followed by €4.6 billion-€4.8 billion in 2023, broadly in line with 2019 levels, given higher inflationary pressures and normalization of the logistics segment.

We believe strong German state support will continue to reinforce DB's credit profile, although leverage is not expected to return to 2019 levels given relatively high committed investments over the next three years. Despite large state support, we expect cash flows will remain largely negative over the next 18-24 months, constraining the group's ability to deleverage to pre-pandemic levels. Nevertheless, state support should enable S&P Global Ratings-adjusted debt to EBITDA to move toward 7x-9x in 2022-2023 from 11.6x in 2021. In our base case, we assume gross capital expenditure (capex) of about €48 billion over 2022-2024, of which investment in infrastructure modernization and capacity expansion will be funded by the state through investment grants as per the performance and financing agreement (LuFV III) between Germany and DB. In our view, the government considers DB instrumental in achieving Germany's climate and traffic shift policy targets, such as reducing German carbon dioxide (CO_2) emissions 48% compared with 1990 by 2030. Therefore, we believe DB has limited flexibility to defer or cut its significant capex program. Our current base case factors the potential inflationary pressures on building materials, although we believe this should be largely mitigated by contractual protection against consumer price index (CPI) increases on new and expansion infrastructure projects and the potential for further compensation by the state under the existing agreement.

In addition to the investment grants covering about 60% of total annual capex, we factor a €1.1 billion annual equity injection over 2022-2024 (€2.1 billion in 2021) and €0.9 billion of investment grants over 2025-2030 under the federal government's Climate Action Program 2030 announced in 2019 (€11 billion in total). In 2022, we expect an additional €2.2 billion of state support to compensate for COVID-19 losses (of which €800 million will be reported in operating income), after €3.8 billion received in 2021. We do not reflect compensation for the €9 ticket initiative in our base case, since it is currently uncertain how much DB will receive of the €2.5 billion the government has allocated to the rail sector to increase passenger volumes amid high energy and fuel prices.

We believe that DB's hedging measures against electricity cost increases, as well as benefits from its cost-saving program, will mitigate significant inflationary pressures. We assume limited effects from inflationary pressures in 2022, reflecting that a very high level of DB's electricity costs have been hedged--representing about 4%-5% of its total cost base. DB secured fixed wage agreement with staff at a lower rate than our CPI forecast of 7.8% for Germany. Besides, a significant share of regional transport contracts include pass-through clauses, which are supportive of DB's revenue, and we expect its strong competitive position will support yield optimization in the long-distance and cargo segments. Furthermore, the state's abolition of the Energy Sources Act levy (a renewable surcharge) should enable additional energy cost savings over 2022-2024. Starting 2023, we assume inflationary pressure will hit margins more than we previously expected, because personnel expenses are likely to keep up with inflation and hedges on energy costs will ease off. As a result, we forecast FFO to debt of about 9.0%-9.5%, leaving little headroom under the 9% rating threshold. This should be partly offset by the cost savings program, under which the group plans to cover half its COVID-19 losses (estimated at more than €10.0 billion as of July 2022), which should generate more than €4 billion of EBITDA savings by 2024, compared with about €1.8 billion realized in 2020-2021.

Outlook

The stable outlook reflects the strong ongoing and extraordinary government support toward DB.

The federal support package of over €11 billion by 2030, in addition to ongoing investment grants that cover about 60% of DB's capex, will help it cover investments to modernize track infrastructure and improve passenger travel comfort. We also expect an additional €2.2 billion of state support to compensate for COVID-19 damages, after €3.8 billion received in 2021. Combined with a strong anticipated rebound in passenger volumes, higher logistics revenue, and cost control measures, this will support adjusted FFO to debt of above 9% over 2022-2024.

Downside scenario

We could lower the rating to 'A+' if we expect DB's weighted-average FFO to debt to drop below 9%. This could be the result of materially slower traffic volume recovery than anticipated, or if the company's cost-saving initiatives cannot contain earnings pressures from the current inflationary environment. It could also occur if, despite substantial investments, the company fails to improve its attractiveness to passengers and profitability, such that leverage remains materially higher than what we expect.

Although not expected, we could also lower the rating if the company's corporate structure changes, such that infrastructure or passenger transport is no longer part of DB's operations, or if we believe that its link with or role for the state have weakened.

Upside scenario

We could raise the long-term rating to 'AA' if DB's profitability substantially recovers or the government makes additional injections, such that FFO to debt improves to 13% or higher.

Rating upside could also follow if we revise up our assessment of extraordinary support to extremely high from very high.

Company Description

DB is Germany's integrated rail company and the largest regional rail passenger transport company in Europe. It owns and manages Germany's rail network and is the country's dominant rail passenger and freight operator. Although DB is an integrated company, its railway transport services and infrastructure companies operate separately, in line with the fourth European Railway Package.

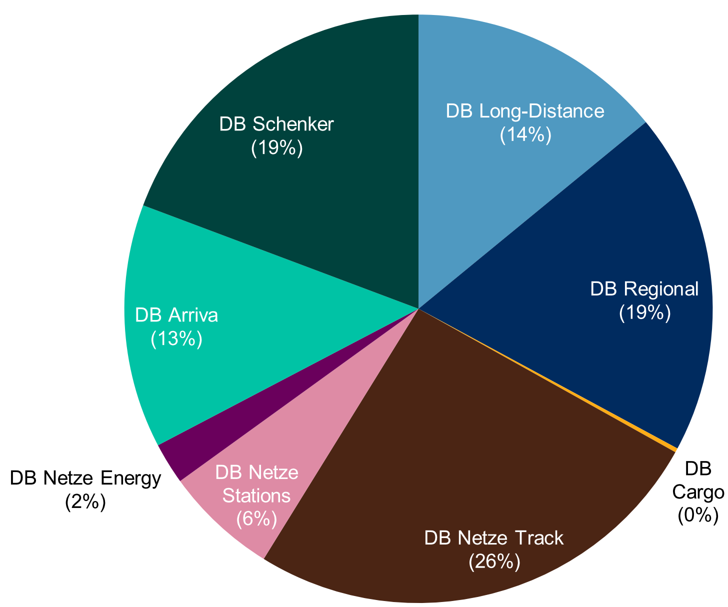
In 2019, DB generated about 50% of its EBITDA from passenger transport services, both in Germany and internationally through DB Arriva. The infrastructure segment generated about 40% of EBITDA, with the remainder from the more volatile transport and logistics segment via DB Schenker and DB Cargo.

With about €44 billion of reported revenue and €5.1 billion of reported EBITDA in 2019 (€47.1 billion and €3.5 billion in 2021), DB is one of the largest rail and logistics companies in the world, operating in more than 130 countries.

Chart 1

DB's EBITDA Distribution By Activity In 2019

About 50% of DB's pre-pandemic EBITDA was from passenger transport services



Source: S&P Global Ratings.

Our Base-Case Scenario

Assumptions

- German GDP growth of 1.9% in 2022 and about 2.3%-2.5% over 2023-2024.
- German CPI growth of 7.6% in 2022, 3.1% in 2023, and 2.2% in 2024.
- Long-distance segment revenue at 85%-90% of 2019 levels in 2022, compared with about 60% in 2021, and above 2019 levels in 2023, integrating the fleet expansion and improved services. Regional rail segment revenue approaching 2019 levels in 2022, after about 90% in 2021.
- Total revenue growth of about 8%-9% in 2022, spurred by a recovery in passenger volumes and growth in logistics revenue, followed by a 8%-9% contraction in 2023, as logistics segment growth normalizes. From 2024, we expect revenue growth broadly in line with German GDP.
- Adjusted EBITDA margin to stay suppressed at about 10%-11% in 2022-2023, compared with 10.9% in 2019. As traffic normalizes and inflationary pressures start to ease, we assume margins of about 12%-13%.
- Our forecasts do not include U.K. train operating companies, their contribution to DB's revenue and EBITDA, and their investment plans, because their earnings and cash are not freely available to the parent company.
- Capex, net of investment grants, to remain high at about €19 billion over 2022-2024 (excluding €0.9 billion- €1 billion International Financial Reporting Standard [IFRS] 16 effects per year), mostly for rolling-stock upgrades (mainly long-distance intercity high-speed ICE trains).
- No dividends in 2022 after being replaced in full by federal funds and dividends of about €650 million per year over 2023-2024. The dividends are returned to DB via investment grants for rail infrastructure.
- We do not factor the sale of DB Arriva and any potential proceeds, although we understand DB expects it in 2023-2024.
- Government support including about €2.2 billion related to COVID-19 in 2022, assuming European Commission approval, from €3.8 billion in 2021, and capital injections under the Climate Action Program of €11 billion until 2030.
- No further hybrid issuances after the €2 billion instrument in 2019, which we view as having intermediate equity content.

Key metrics

Deutsche Bahn AG--Key Metrics*

	--Fiscal year ended Dec. 31--					
Mil. €	**2019a**	**2020a**	**2021a**	**2022e**	**2023f**	**2024f**
Revenue	42,397	38,729	46,034	49,700-49,900	45,500-45,700	47,200-47,400
EBITDA margin (%)§	10.9	0.8	7.1	10.0-12.0	9.0-11.0	11.0-13.0
Funds from operations (FFO)	3,925	-380	2,478	4,400-4,600	3,800-4,000	4,800-5,000

Deutsche Bahn AG--Key Metrics* (cont.)

	--Fiscal year ended Dec. 31--					
Mil. €	**2019a**	**2020a**	**2021a**	**2022e**	**2023f**	**2024f**
Capital expenditure**	3,757	4,557	4,956	6,500-6,700	6,400-6,600	6,100-6,300
Debt	31,983	39,094	37,731	38,800-39,200	42,200-42,600	44,300-44,700
Debt to EBITDA (x)	6.9	129.8	11.6	6.5-7.5	8.5-9.5	7.0-8.0
FFO to debt (%)	12.3	-1	6.6	11.0-12.0	8.5-9.5	10.5-11.5

*All figures adjusted by S&P Global Ratings. $In 2022, our adjusted EBITDA includes about €800 million of COVID-19 state support. Excluding this support, the EBITDA margin would be about 9.0%-10.0% **Capex is presented net of investment grants from the state. a--Actual. e--Estimate. f--Forecast.

Liquidity

The short-term rating is 'A-1+'. We assess the company's liquidity as adequate since sources of liquidity cover uses by 1.2x over the 12 months from March 31, 2022. DB's high standing in the capital markets, sound relationships with banks, and generally prudent risk management, ensuring the maintenance of adequate liquidity, continue to support our assessment.

We expect principal liquidity sources over the 12 months from March 31, 2021, will include:

- Unrestricted cash of about €2.9 billion;
- Availability on committed credit facilities expiring beyond 12 months of about €2.0 billion and undrawn portions of committed facilities used to meet working capital needs of about €175 million;
- FFO of about €3.8 billion;
- Debt issuance of €900 million (since April 1, 2022);
- Equity injections under the Climate Action Program and to cover COVID-19 losses, once approved by the European Commission, of €1.1 billion and €800 million respectively; and
- Proceeds from the sale of Arriva Sweden.

We expect principal liquidity uses over the same period will include:

- Debt maturities of €2.3 billion in the next 12 months;
- Working capital outflows of €650 million;
- Net capex (capex net of government grants and excluding IFRS16 effects) of €6.5 billion; and
- No dividend payments.

Environmental, Social, And Governance

ESG credit indicators: E-1, S-2, G-2

Environmental factors are a positive consideration in our rating analysis of DB, given its role in the

German government's strong carbon reduction objectives. Its sole owner, the German government, pledged €5.5 billion of the €11 billion under the Climate Action Program as equity support to DB, alongside investment grants to cover approximately 85% of DB's infrastructure capex for 2020-2024 (€55 billion) to further improve the network and attract more passengers and cargo. DB aims to reduce CO2 emissions by half by 2030 (compared to 2006) and increase the use of renewable energies for traction to 100% by 2038 from 62.4% in 2021. Social factors are an overall neutral consideration in our credit rating analysis of DB. This balances the key social mandate of the company--underscoring DB's very important role for and very strong link to the German government, versus negative influences from the pandemic and labor union actions. The COVID-19 pandemic has severely reduced passenger volumes, but this is mitigated by state support measures (about €5 billion) and COVID-19 related support for regional transport (about €1.5 billion).

Issue Ratings - Subordination Risk Analysis

Capital structure

DB's capital structure consists primarily of senior unsecured bonds (€27.4 billion on Dec. 31, 2021) issued by finance subsidiary Deutsche Bahn Finance GmbH, which continues to act as the only capital-market-focused legal entity within the DB group.

Analytical conclusions

The priority liabilities at subsidiaries correspond to less than 15% of the group's debt. On Dec. 31, 2021, they totaled €4.1 billion including €0.4 billion of interest-free loans from the federal government and several smaller amounts at various subsidiaries.

Ratings Score Snapshot

Issuer Credit Rating	AA-/Stable/A-1+
Business risk:	Strong
Country risk	Low
Industry risk	Low
Competitive position	Strong
Financial risk:	Significant
Cash flow/leverage	Significant
Anchor	bbb
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Satisfactory (no impact)

Comparable rating analysis	Positive (+1 notch)
Stand-alone credit profile:	bbb+
Related government rating	AAA
Likelihood of government support	Very high (+4 notches from SACP)

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- 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
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings List

Ratings Affirmed	
Deutsche Bahn AG	
Commercial Paper	A-1+
Deutsche Bahn Finance GmbH	
Senior Unsecured	AA-
Junior Subordinated	BBB-

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Deutsche Bahn AG		
Issuer Credit Rating	AA-/Stable/A-1+	AA-/Negative/A-1+