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Research Update:

Deutsche Bahn Ratings Raised To 'AA' On German Government's Climate Change Objectives; Outlook Stable

October 8, 2019

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Rating Action Overview

- Deutsche Bahn (DB) will benefit from increased support from the German federal government in order to attract more passengers and freight to rail travel by making it more efficient and cheaper than other means of travel.
- Under its Climate Action Programme 2030, the federal government will inject €11 billion into DB over 11 years, reduce value-added tax (VAT) on long-distance rail tickets, and raise air travel surcharges, demonstrating stronger-than-ever ongoing support.
- Consequently, we are raising our long-term ratings on DB to 'AA' from 'AA-'.
- Our stable outlook reflects our expectation that DB's growth trajectory will improve on the back of its stronger ties to the government, and that profitability will improve, allowing DB's average funds from operations (FFO) to debt to remain above 13% over 2020-2022.

Rating Action Rationale

In our view, the Climate Action Programme 2030 announced by the German government in September 2019 demonstrates stronger-than-ever ongoing support to DB. The government sees DB as instrumental in achieving Germany's climate targets. The program exceeds that announced in 2017, under which the government provided about €2.7 billion, including a €1.0 billion one-off capital increase and an annual reduction in dividends by €350 million over 2017-2021. Germany's climate targets include cutting greenhouse gas emissions by 55% of the 1990 level by 2030, including transport-related emissions by 40%-42% by 2030. The increased ongoing support has led us to revise DB's stand-alone credit profile to 'a-' from 'bbb+'.

The government will inject €1 billion a year into DB from 2020 to 2030. This recognizes that DB would be unable to fund its part of the ongoing extensive investment program without this government support. The government has also approved DB issuing a €2 billion deeply subordinated hybrid note, which in our view will create a loss-absorbing cushion for the company

in the context of the capital expenditure (capex) program. Under the Climate Action Programme, the federal government is undertaking a number of measures aimed at promoting rail travel over other means of transport. These include increased investment in track infrastructure to modernize, expand, and electrify the rail network to allow more goods to be transported by rail.

The government will also reduce VAT on long-distance rail tickets to 7% from 19%. It aims to make rail travel more attractive in price terms than other means of transport. At the same time, the government will raise the air traffic surcharge to make short flights more expensive and increase vehicle tax in line with carbon dioxide emissions per kilometer. We expect that these measures will translate into DB generating noticeable additional earnings from long-distance passenger tickets sales in 2020.

DB continues to face competitive pressures in the industry. These, combined with the business' high capital intensity and the need to invest in both the network and rolling stock, are constraining the company's cash flow metrics, which remain weak for the rating. We expect the equity injection and increased long-distance earnings in 2020 will help in maintaining the weighted-average ratio of FFO to net debt above 13% in 2020-2023.

Our assessment of extraordinary state support (expected in times of stress) remains unchanged at very high, reflecting DB's very important role and very strong link.

Outlook

The stable outlook takes into account the strong ongoing and extraordinary government support. The federal support package of over €11 billion by 2030, in addition to continued ongoing investment grants that cover about 70% of DB's capex, will support capex required to modernize track infrastructure and the operating costs required to improve passenger travel comfort. We expect this support will lead to growth in passenger numbers, especially for long-distance travel, and growth in rail freight volume in Germany, which will support DB's adjusted FFO to debt at about 13%-15% over 2019-2021.

Downside scenario

We could lower the rating to 'AA-' if we expected DB's weighted-average FFO to debt to drop below 13%. This could occur if, despite substantial investments, the company failed to improve its competitiveness and attract more passengers, if management was unsuccessful in improving the company's current weak profitability (with a trough expected in 2019), or if growth in earnings took longer to materialize than we expect.

If we were to lower the sovereign rating to 'AA+', we would also lower our rating on DB by one notch, to 'AA-', as long as DB's FFO to debt remained above 13%.

Although not expected, we could also lower the rating if the company's corporate structure changed, such that infrastructure or passenger transport was no longer part of DB's operations.

Upside scenario

While we do not think it likely by 2023, we could raise the long-term rating on DB to 'AA+' if its profitability recovered substantially or the government made additional injections, such that FFO to debt improved to 20% or higher.

Although currently not envisaged, rating upside could also stem from us raising our assessment of

extraordinary support to extremely high from very high.

Company Description

DB is Germany's integrated rail group. It owns and manages Germany's rail network and is the country's dominant rail passenger and freight operator. Although DB operates as an integrated company, its railway transport services and infrastructure companies are operationally separate, in line with the fourth European Railway Package.

While rail business in Germany accounts for about 70% of DB's EBITDA, the company also has significant asset-light international operations that it uses to strengthen its overall market position--partly given a gradually shrinking market share in regional and rail freight transportation services in Germany, but primarily to strengthen the group's financial position. The platform for operating passenger transport outside Germany is DB Arriva, one of the largest transport service operators in Europe providing services in 14 countries. DB Arriva generates about 10%-15% of DB's EBITDA. It is considered as a noncore operation, and is being offered for sale, which is expected to complete by the end of 2019. DB also conducts global freight forwarding and logistics operations through DB Schenker.

With about €44 billion of reported revenues and €4.5 billion reported EBITDA in 2018, DB is one of the largest rail and logistics companies in the world, operating in over 130 countries.

Our Base-Case Scenario

In our base case we assume:

- Annual average revenue growth of about 3% over 2019-2021, supported by our forecast of German GDP increasing by 1.4% in 2019, 1.7% in 2020, and 1.8% in 2021. We forecast average rail fares increasing in line with the change in the consumer price index, by 0.6% in 2019, 1.1% in 2020, and 1.2% in 2021.
- A decline in the S&P Global Ratings-adjusted EBITDA margin to about 11%-12% in 2019 and 2020, from 12.7% in 2017, mainly driven by higher spending to improve service quality. We expect the margin to improve to about 14% by 2023, thanks to new services, cost savings, and groupwide streamlining of cost structure. However, profitability growth will remain constrained by a high level of competition and personnel cost increases as a result of collective bargaining agreements with trade unions.
- We exclude from our forecasts the U.K. train operating companies, their contribution to DB's revenues and EBITDA, and their investment plans, as their earnings and cash are not freely available to the parent company. We also do not incorporate any potential proceeds from the disposal of DB Arriva.
- Net capex of about €22 billion in 2019-2023, mostly for rolling-stock upgrades (ICE4). Most of the investment in infrastructure modernization is not reflected in our forecast because it is financed by nonrefundable government investment grants under the performance and financing agreements (LuFV II and LuFV III) between the Federal Republic of Germany and DB.
- Dividends of about €650 million per year over 2019-2023. The dividends are returned to DB via investment grants for investment in rail infrastructure.
- Debt issuance of about €4 billion in 2019, including a planned €2 billion deeply subordinated unsecured fixed-rate resettable dual-tranche note, whose equity content we anticipate to classify as intermediate.

Based on these assumptions, we arrive at the following credit measures:

	2018A	2019E	2020E
FFO to debt (%)	14.5	12.0-13.0	13.0-14.0
EBITDA margin (%)	12.7	11.0-12.0	11.5-12.5
Debt to EBITDA (x)	5.6	6.0-7.0	5.5-6.5

FFO--Funds from operations. A--Actual. E--Estimate.

Liquidity

The short-term rating is 'A-1+'. We assess the company's liquidity as adequate, since sources of liquidity cover uses of liquidity by 1.2x over the 12 months to June 30, 2020. Our assessment continues to be supported by DB's high standing in the capital markets, sound relationship with banks, and generally prudent risk management, ensuring the maintenance of adequate liquidity.

Principal liquidity sources over 12 months to June 30, 2020:

- Unrestricted cash of about €2.6 billion, as of June 30, 2019;
- Availability on committed credit facilities expiring beyond 12 months of about €1.9 billion;
- FFO of about €4.48 billion;
- Equity injections of about €2 billion including the hybrid note.

Principal liquidity uses:

- Debt maturities of €3.5 billion in the next 12 months;
- Net capex (capex net of government grants) of €4.8 billion; and
- Dividends of about €650 million-€690 million.

Environmental, Social, And Governance

Environmental factors influence our credit analysis because DB is expected to play an increasingly important role in Germany's climate change and social policies. There is a need to attract more passengers to rail transport to fulfil the German government's climate targets to reduce carbon dioxide emissions. These factors are propelling the large investments to modernize the rail infrastructure and fleet and the use of low-emission vehicles, which have negatively affected DB's credit metrics, despite receiving government subsidies that cover about two-thirds of the capex.

Social factors, such as workforce, customer service, and noise, are more material to DB compared with other transportation infrastructure companies due to its size and social responsibility as one of Germany's largest employers. The company has relatively high fixed operating leverage, with about 40% of fixed costs related to staff, which in turn constrains DB's profitability. We expect profitability will remain under pressure, given plans to hire additional staff in 2019 to improve reliability and punctuality, as well as salary increases under new wage agreements with the unions.

Issue Ratings--Subordination Risk Analysis

Capital structure

DB's capital structure consists primarily of senior unsecured bonds (€21 billion on Dec. 31, 2018) issued by finance subsidiary Deutsche Bahn Finance GmbH, which continues to act as the only capital-market-focused legal entity within the DB Group.

The priority liabilities at subsidiaries correspond to less than 10% of the group's debt. On Dec. 31, 2018, they included €0.9 billion of interest-free loans from the federal government and €0.4 billion of loans from the European Investment Bank to DB Netz AG. The remaining amount of about €0.5 billion consisted of 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: Intermediate

- Cash flow/Leverage: Intermediate

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 ratings analysis: Positive (+1 notch)

Stand-alone credit profile: a-

- Related government rating: AAA
- Likelihood of government support: Very high (+4 notches from SACP)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019

- General Criteria: Hybrid Capital: Methodology And Assumptions, 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: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Transportation Infrastructure Industry, 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: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Upgraded; Ratings Affirmed

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

Upgraded

	To	From
Deutsche Bahn Finance GmbH		
Senior Unsecured	AA	AA-

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