Research Update:

Deutsche Bahn AG Downgraded To 'AA-' On Tight Headroom And COVID-19-Related Traffic Drop; Outlook Negative

June 11, 2020

Rating Action Overview

- In response to the COVID-19 pandemic, the German government has implemented mobility restrictions that we forecast will cause a 30% reduction in Deutsche Bahn's (DB) long-distance passenger rail revenue and a 20% reduction in its regional rail passenger revenue in Germany.
- The German state has committed to equity injections, and we maintain our view of a very high likelihood of extraordinary state support.
- DB plans to carry out €4 billion-€5 billion of capital expenditure (capex) including International Financial Reporting Standard 16 (IFRS 16) effects, net of investment grants, over 2020-2024. This, together with the fallout from the COVID-19 pandemic, will reduce the company's S&P Global Ratings-adjusted funds from operations (FFO) to debt to about 10% over 2021-2022.
- We are lowering our long-term issuer credit on DB to 'AA-' from 'AA', revising downward the company's stand-alone credit profile to 'bbb+' from 'a-', and lowering the issue rating on DB's €2 billion hybrid to 'BBB-' from 'BBB'. We are affirming the 'A-1+' short-term issuer credit rating on the company.
- The negative outlook reflects the one-in-three chance that we could lower the rating further if rail traffic recovery is more protracted than we currently expect, or if DB's liquidity weakens due to delayed approvals of government support.

PRIMARY CREDIT ANALYST

Tania Tsoneva, CFA
Dublin
+353 1 568 0611
tania.tsoneva
@spglobal.com

SECONDARY CONTACT

Beata Sperling-Tyler
London
(44) 20-7176-3687
beata.sperling-tyler
@spglobal.com

Rating Action Rationale

The downgrade reflects S&P Global Ratings' forecasts that COVID-19-related disruption will reduce DB's rail passenger volumes in the German rail network by up to 35% in 2020, and recovery could take two years. Governmental measures to contain the spread of COVID-19 have severely reduced rail traffic. We forecast an approximate 35% drop in revenue in the long-distance segment in Germany in 2020, which assumes two months of lockdown during which passenger numbers are down 70%-80%. In regional rail, where a significant proportion of the contracts are on a gross basis--that is, no passenger risk--we forecast an approximate 20% decline in revenue in 2020. This does not factor in the effects of the German government's economic stimulus. We expect a somewhat quicker rebound than in neighbouring countries because Germany was one of the first European countries to ease mobility restrictions. Rail travel and rail freight might benefit from the German government's €130 billion economic stimulus program, which include further lowering of value-added tax (VAT)--the government had already reduced VAT on long-distance rail tickets to 7% from 19% as of Jan. 1, 2020.

That said, we think the recovery will likely be protracted over the next two years because passengers could be less willing to use crowded trains instead of cars and less able to afford rail travel due to the global recession in 2020. At this stage, it is difficult to anticipate any long-term behavioral changes as a result of the pandemic due to increased reliance on remote working and the need to implement social-distancing measures on trains, for example.

DB's other segments--the logistics business DB Schenker and the rail freight DB Cargo--are even more sensitive to the macroeconomic environment, as well as to the slowdown in Germany's key sectors such as automotive and industrial production. At the same time, DB Schenker has a flexible cost base so the overall bottom line impact from the crisis is relatively marginal.

The state government has committed to equity injections that will cover 80% of the estimated losses from the pandemic (after countermeasures), which underpins our view of a very high likelihood of extraordinary state support. Following the outbreak of COVID-19, the German government was one of the first in Europe to pledge to cover rail operator losses, paying for 80% of DB's shortfall after countermeasures. DB is due to receive the first tranche of €4.5 billion shortly, subject to approval under the European Commission's (EC) state aid rules. Together with the increasing of the debt ceiling to €30 billion, and if received in good time, the COVID-19 package could provide a sufficient liquidity cushion for DB to absorb the losses from the pandemic. DB plans to partly offset the expected losses by reducing operating expenditure and capex in the integrated rail system by a cumulative €4.1 billion, with additional measures for DB Schenker and DB Arriva, in 2020-2024. We think the cost savings are ambitious but achievable, since there are some volume effects linked to the traffic drop and price links benefitting from the forecast low inflationary environment.

We understand DB is pursuing a different approach for approval under state aid rules than the EC's temporary framework for COVID-19-related support. DB's approach reflects that it is a state-owned company and the dividend is an important part of the rail infrastructure financing system in Germany. We therefore assume in our base case that the EC will not prevent DB from making dividend and hybrid coupon payments. However, if the EC assesses the support under the temporary framework,we could see a higher risk of deferral under DB's €2 billion hybrid instrument issued in 2019. This is because the EC's temporary framework prohibits companies from paying dividends and nonmandated coupons until the full reimbursement of the government support. In line with our hybrid criteria, if a hybrid permanently defers a coupon, despite this being part of the terms and conditions, we will likely lower the issue rating on the hybrid to 'D'.

The government sees DB as instrumental in achieving Germany's climate targets, and we therefore think DB's large capex plan is largely mandatory. The investments in track infrastructure are intended to modernize, expand, and further electrify the rail network to increase its capacity to operate more passenger and freight trains. The planned gross amount of infrastructure capex for 2020-2024 is a substantial €55 billion. However, investment grants cover approximately 85% of this capex. In addition to the grants, the federal government has also pledged €5.5 billion of the total €11 billion under the Climate Action Program in the form of equity. This is also subject to approval under state aid rules.

We see a one-in-three chance that adjusted FFO to debt could decline below 9% on average in 2021-2022. DB had limited headroom prior to the COVID-19 pandemic because additional expenses to improve punctuality, customer service, and digitalization were weakening its profitability. Despite making some progress, DB is still lagging behind its long-term targets, which have high social and reputational importance.

This, coupled with annual net investments of about €4.0 billion-€4.5 billion (excluding IFRS 16 effects), places significant pressure on cash flows and leverage. We anticipate a significant decline in cash flow coverage ratios, with negative adjusted FFO to debt in 2020 recovering to about 10% on average over 2021-2022. We anticipate adjusted EBITDA will remain suppressed at 25% below the 2019 level in 2021 before recovering to pre-pandemic levels in 2022. High operating leverage inherent for the transportation infrastructure sector means there is limited scope in our base case for additional cost savings beyond the announced €4.1 billion countermeasures in the integrated rail system for 2020-2024.

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Environmental, social, and governance (ESG) factors relevant to the rating action:

- Health and safety

Outlook

The negative outlook reflects the uncertainties related to the pace of recovery in passenger rail. It also reflects the effect of a global recession on DB's logistics and cargo business. We take into account the strong ongoing and extraordinary government support, manifested by the federal support package of more than €11 billion by 2030 under the Climate Action Program and the COVID-19-related equity injection to cover 80% of losses after countermeasures. Rating downside could arise from pressure on liquidity if the state aid approval process takes longer than we currently anticipate. Although we do not currently consider it likely, we could lower the rating on the hybrid issue by multiple notches if there were any indication that the EC would require deferral on nonmandatory coupons as part of the state aid approval.

Downside scenario

We could lower the rating to 'A+' if we expected DB's weighted-average FFO to debt to drop below 9% on average over 2021-2022, which we would consider commensurate with a 'bbb+' SACP. This could stem from:

- The abovementioned pandemic-related and macroeconomic effects;
- DB failing to improve its competitiveness and attract more passengers despite substantial

investments;

- Management failing to improve the company's current weak profitability; or
- Earnings expansion taking longer to materialize than we currently expect.

If we were to lower the sovereign rating on Germany to 'AA', we would also lower our rating on DB by one notch to 'A+', as long as DB's FFO to debt remained above 9%.

Although we do not currently expect it, 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

We could revise the outlook to stable if the operating environment stabilizes after the pandemic is contained and we have more clarity regarding the extent of the recovery. We would also need more certainty that DB will be able to maintain an adjusted FFO-to-debt ratio sustainably above 9%. Although we do not currently expect it, we could raise the rating if we raised our assessment of extraordinary support to extremely high from very high.

Company Description

DB is Germany's integrated rail company. It is 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 operates as an integrated company, its railway transport services and infrastructure companies are operationally separate, in line with the fourth European Railway Package. DB generates about 50% of its EBITDA from passenger transport services, both in Germany and internationally through DB Arriva. The infrastructure segment generates about 40%, and about 16% comes 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 reported EBITDA in 2019, DB is one of the largest rail and logistics companies in the world, operating in more than 130 countries.

Our Base-Case Scenario

In our base case we assume:

- Revenue decline of about 16%-18% in 2020 and recovery to pre-pandemic levels by 2022. We forecast German GDP to decline by 6% in 2020 before rebounding by 4.3% in 2021 and 3.3% in 2022.
- Longer-term growth in long-distance travel of 5%, above historical rates. This stems from the reduction in VAT on long-distance rail tickets to 7% from 19% and the significant investment in customer experience.
- Adjusted EBITDA margin to stay suppressed at about 10%-12% in 2022 from 10.9% in 2019, mainly driven by higher spending to improve service quality. However, a high level of competition and personnel cost increases--the result of collective bargaining agreements with trade unions--will continue to constrain profitability growth.
- 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. We also exclude any potential proceeds from the disposal of DB Arriva.

- Net capex of about €30 billion in 2020-2024 (including IFRS 16 effects), mostly for rolling-stock upgrades (mainly ICE 4). Our forecast does not take into account most of the investment in infrastructure modernization because this is financed by nonrefundable government investment grants under the performance and financing agreement, LuFV II, between Germany and DB.
- Dividends of about €650 million per year over 2020-2024. The dividends are returned to DB via investment grants for investment in rail infrastructure.
- We do not factor in the sale of DB Arriva, which DB announced but then delayed due to the current challenging environment.
- Capital injections under the Climate Action Program of €11 billion until 2030 and 80% of COVID-19 related losses after countermeasures covered by the German state. At this stage, we do not include any benefit under the announced €2.1 billion funds for regional rail, pending further clarity on DB's share.
- No further hybrid issuance after the €2 billion issued in 2019, which we view as having intermediate equity content.

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

- FFO to debt of 12.3% in 2019, negative 2%-0% in 2020, 8%-10% in 2021, and 10%-12% in 2022
- EBITDA margin of 10.9% in 2019, not meaningful in 2020, 8%-10% in 2021, and 10%-12% in 2022; and
- Debt to EBITDA of 6.9x in 2019, not meaningful in 2020, 10x in 2021, and 6x-8x in 2022.

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, 2020. The following factors continue to support our assessment: DB's high standing in the capital markets, sound relationship with banks, and generally prudent risk management, ensuring the maintenance of adequate liquidity.

We expect the principal liquidity sources over the 12 months from March 31, 2020 will include:

- Unrestricted cash of about €1.9 billion;
- Availability on committed credit facilities expiring beyond 12 months of about €2.1 billion;
- FFO of about €0.5 billion;
- Debt issuance of €2.6 billion (since the start of 2020); and
- Equity injections under the Climate Action Program and to cover COVID-19 losses, once approved by the EC.

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

- Debt maturities of €4.7 billion in the next 12 months;

- Net capex (capex net of government grants and excluding IFRS 16 effects) of €4.2 billion; and
- Dividends of €650 million.

Ratings Score Snapshot

Issuer Credit Rating: AA-/Negative/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 ratings 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: 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

Downgraded

	To	From
Deutsche Bahn AG		
Issuer Credit Rating	AA-/Negative/A-1+	AA/Stable/A-1+
Senior Unsecured	AA-	AA
Junior Subordinated	BBB-	BBB
Ratings Affirmed		
Deutsche Bahn AG		
Commercial Paper	A-1+	