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**Research Update:**

# German Rail Operator Deutsche Bahn Ratings Affirmed At 'AA-' Despite IPO Being Put On Hold; Outlook Stable

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## Overview

- The partial privatization of two subsidiaries of German rail operator Deutsche Bahn AG (DB), DB Arriva and DB Schenker, originally planned to take place in 2017-2018, has been put on hold. Instead, the German government will provide a support package intended to fund DB's capital expenditure (capex) program and reduce the pressure on its balance sheet.
- The support package comprises a €1 billion one-off capital increase in 2017 and a €350 million reduction in the annual dividend. During the 2017-2021 financial years, this support will exceed €2.7 billion.
- We expect DB's S&P Global Ratings-adjusted funds from operations (FFO)-to-debt ratios will remain at about 17%-20% over 2016-2018. While the credit metrics will improve as a result of the government's expected support package, increasing competition in the industry and the high capex required to improve operating performance will limit the company's ability to deliver a sustainable and significant improvement in financial performance.
- We are therefore affirming our 'AA-' ratings on DB, reflecting the very high likelihood of extraordinary support from the German government. The stable outlook reflects our expectations that DB's FFO to debt will remain at about 17%-20% over 2016-2018.

## Rating Action

On Jan. 18, 2017, S&P Global Ratings affirmed its 'AA-' long-term corporate credit and issue ratings on German rail operator Deutsche Bahn AG (DB). We also affirmed our 'A-1+' short-term corporate credit rating on DB. The outlook is stable.

## Rationale

In December 2016, the plans to sell minority stakes in DB subsidiaries DB Arriva and DB Scheneker were put on hold on the expectation that the proceeds may be lower than anticipated. Instead, the government has committed to an overall support package comprising a €1 billion one-off capital increase in 2017, and a reduction of dividends by €350 million a year, implying that a larger part of capital expenditure (capex) will now be financed by the government directly. During the 2017-2021 financial years (ended Dec. 31) this support will exceed €2.7 billion.

Although an improvement is expected in DB's ratios in the 2017 financial year (FY2017), this is primarily thanks to the capital increase; we expect that DB's S&P Global Ratings-adjusted (FFO)-to-debt ratios will remain at about 17%-20% over 2016-2018. In our view, the company continues to face competitive pressures in the industry which, combined with high capital intensity of the business and the need to invest in both the network and rolling stock, could continue putting pressure on the company's cash flow metrics.

Our base-case scenario assumes:

- Annual revenue growth of 0.5% in 2016, and 2.5%-5.0% a year in 2017-2020, supported by German GDP and consumer price index increases; the introduction of new long-distance rail routes; new contract opportunities for DB Regional; DB Arriva contract wins; and volume growth in DB Schenker.
- A gradual increase in the adjusted EBITDA margin to 14%-16% thanks to cost efficiencies.
- A gradual decrease in the total debt, primarily thanks to the €1 billion capital injection in 2017 and lowering of the dividend to €450 million-€650 million a year.

Based on the above assumptions, in FY2016 we expect an S&P Global Ratings-adjusted five-year weighted average FFO-to-debt ratio of around 17.5%-19.0% and a debt-to-EBITDA ratio of 4.2x-4.6x.

We consider DB as a government-related entity. As a result, the 'AA-' rating incorporates a four-notch uplift from the stand-alone credit profile (SACP) due to our view that there is a very high likelihood that the German government would provide extraordinary financial support to DB if needed. Our assessment of the very high likelihood that the German state would provide timely and sufficient extraordinary support to DB if needed is based on our view of its:

- Very important role, due to its dominant position and its strategic, socioeconomic, and political importance as the country's leading provider of passenger rail services and the rail network owner, as well as its position as the dominant rail-freight and logistics operator.
- Very strong link to the government, reflecting a constitutional requirement that the state remains the owner of the country's rail infrastructure with responsibility for providing a functional rail network.

The support package committed by the government demonstrates its willingness and availability to support DB in line with our assessment of a very high likelihood of support. In our view, the postponement of the IPOs and the support now committed does not warrant a change in the assessment.

## Liquidity

The short-term rating is 'A-1+'. We assess DB's liquidity as adequate. We estimate that liquidity sources will cover uses by about 1.8x in the 12 months

to Sept. 30, 2017. Our liquidity assessment continues to be supported by DB's high standing in the capital markets, sound relationship with banks, and generally prudent risk management ensuring maintenance of adequate liquidity.

We expect DB's principal liquidity sources in the 12 months to Sept. 30, 2017 to be:
- Unrestricted cash of about €3.6 billion as of Sept. 30, 2016;
- About €2.0 billion of availability under committed credit facilities expiring beyond 12 months;
- Unadjusted FFO of about €5.4 billion over the coming 12 months; and
- A €1 billion capital injection from the government.

We assume DB's main liquidity uses over the same period will be:
- Debt maturities of about €2.0 billion;
- Working capital outflow of about €300 million;
- Net (of subsidies) capex of €3.9 billion (of which maintenance capex will be about €1.6 billion); and
- Dividend payments of €600 million.

We understand that DB's loan agreements and bond documentation do not contain any financial covenants.

## Outlook

The stable outlook reflects our expectation that while the credit metrics will improve as a result of the government's expected support package of more than €2.7 billion over 2017-2021, we expect DB's adjusted FFO to debt will be constrained to about 17%-20% over 2016-2018 due to increasing competition in the industry and the high capex.

### Downside scenario

We could lower the ratings to 'A+' if we expected DB's weighted-average FFO to debt to drop below 13%. This could occur if weak macroeconomic conditions or increased competition in the passenger transport segment resulted in lower than currently expected revenues, if net investment or working capital needs were higher than DB currently plans, or if the company's cost-saving actions proved less efficient or took longer to materialize than we expect.

We could also lower the rating if the company's corporate structure changes such that infrastructure or passenger transport are no longer part of DB's operations.

A downgrade of Germany or a downward reassessment of extraordinary state support could also lead to a downgrade of DB. We could lower our assessment of the likelihood of state support due to:
- Adverse changes in the national or European regulatory framework or a decreasing public service role for the government;
- Increasing exposure to competitive markets or markets outside Germany,

for example, as a result of acquisitions; or
- The sole shareholder adopting a more aggressive financial policy, for instance, by increasing dividends or significantly reducing funding for new investments.

### Upside scenario

We could raise the long-term rating on DB to 'AA' if its FFO-to-debt ratio improves above 20% and we believe that this improvement is sustainable, assuming that the likelihood of extraordinary state support remains the same. We expect credit metrics to strengthen, in particular thanks to improved operational performance as a result of the implementation of the "Railway for the Future" program.

## Ratings Score Snapshot

Corporate Credit Rating: AA-/Stable/A-1+

Business risk: Strong
- Industry risk: Low
- Country risk: Low
- Competitive position: Strong

Financial risk: Intermediate
- Cash flow/leverage: Intermediate

Anchor: bbb+

Modifiers:
- Diversification: Neutral(no impact)
- Quality of capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb+
- Related government rating: AAA/Stable/A-1+
- Likelihood of government support: Very high (+4 notches from SACP)

## Related Criteria

- 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
- Criteria - Corporates - Industrials: Key Credit Factors For The Transportation Infrastructure Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013

- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

## Ratings List

Ratings Affirmed

| | |
|---|---|
| Deutsche Bahn AG | |
| Corporate Credit Rating | AA-/Stable/A-1+ |
| Commercial Paper | A-1+ |
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| Deutsche Bahn Finance B.V. | |
| Senior Unsecured | AA- |
| Commercial Paper | A-1+ |

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