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Credit Opinion: Clariant AG

Global Credit Research - 16 Dec 2010

Muttenz, Switzerland

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	Ba1
Senior Unsecured -Dom Curr	Ba1/LGD4
Clariant Finance (Luxembourg) S.A.	
Outlook	Stable
Bkd Senior Unsecured -Dom Curr	Ba1/LGD4

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Key Indicators

Clariant AG

	Q3 2010 LTM	2009	2008
EBITDA Margin	9.3%	4.7%	8.6%
EBIT / Avg. Assets [1]	7.6%	0.8%	6.1%
Debt / EBITDA	3.1x	7.0x	3.4x
EBITDA / Interest Expense	5.6x	3.0x	5.1x
FFO + Interest / Interest	5.6x	3.7x	5.3x
RCF / Debt [2]	26.1%	12.6%	23.9%
RCF-Capex / Debt [2]	15.1%	2.9%	7.4%
FCF / Debt [2]	19.4%	26.2%	4.0%
Ratios are consistent with Moody's Global Standard Adjustments			

[1] Excludes cash [2] Reduction in share capital treated as dividend

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Corporate Profile

Headquartered in Pratteln, Switzerland, Clariant AG is a leading international chemicals group. In the nine months ending in September 2010, Clariant reported revenues of approximately CHF 7.1 billion (CHF 6.6 billion reported for the whole 2009).

Rating Rationale

The Ba1 rating reflects our expectation that Clariant will continue to successfully execute the large-scope restructuring programme to support the improvement in the profitability of the businesses achieved to date and will maintain a strong balance sheet position during the restructuring. The company is in the process of re-defining its asset footprint (including reducing its European capacity) to align it with the structural changes that have been under way on the demand front and to improve its cost structure and profitability, as well as return on capital, towards product segment averages. Clariant has a strong management team that is executing on this restructuring process, but, in our opinion, there remains significant execution risk associated with the restructuring, due to the scope of the on-going investments underway to reposition and realign the assets. The rating is supported by the relatively extended maturity profile of the liabilities, as well as high cash balances, while the company also retains flexibility to gradually reduce debt before the next refinancing need arises in 2013. Further evidence of the successful repositioning of the business and sustainable tangible improvement in profitability with the prospect of further gross debt reduction will lead to positive pressure developing on the rating.

Recent Developments

Clariant reported strong operating results for the 9 months of 2010, reflecting the on-going restructuring, as well as a strong recovery in its core markets. The company reported a 10% recovery in sales y-o-y, primarily driven by a 13% increase in volumes (before FX effects). All sectors, with exception of textiles, reported an improvement in margins to double-digit levels supported by improvements in the company's cost structure. Clariant did not pay dividend for 2009 while incurring a relatively low level of capital investments and also managing its working capital requirements at lower levels. We therefore expect the company to generate strong FCF in 2010.

DETAILED RATING CONSIDERATIONS

Business Profile

Clariant's business position in the low-"Baa" category reflects its role as a leading producer of intermediate products with strong market positions in pigments, masterbatches and chemicals for textile and leather. We note a high degree of commoditisation in the company's key markets and increasing competition from lower-cost producers. The company maintains substantial market positions, notwithstanding the consolidation in several market segments following the acquisitions of Cognis and Ciba by BASF. Noting the geographical diversification of the portfolio, we also take into account the company's considerable exposure to highly cyclical end-markets that limits the benefits of diversification and constraints our assessment of the relative quality of the revenue base. Clariant is also relatively exposed to volatile raw materials (ethylene, ethylene oxide, polyethylene, propylene glycol).

Clariant is implementing a broad and comprehensive restructuring of the business to address longer-term structural shifts, such as the commoditisation of the portfolio and the geographical shift in demand. The restructuring plan entails the re-designing of the production chains to lift profitability of the businesses, improve logistics and get proximity to customers and reduce capital employed. The company has already achieved a substantial reduction in the fixed costs (following reductions in personnel and reorganisation of some of the European facilities). In the course of 2011-2013, it plans to further close 22 production sites and relocate part of the production to China (for its ICS division), India (for Pigments and Textile divisions) and Brazil (Pigments) to match the existing demand patterns.

In January 2010, Clariant moved from a divisional structure to 10 business units ("BUs") that have been previously arranged into four larger divisions. At the end of 3Q 2010, Clariant derived c. 47% of its revenues from Europe, 13% in the US and 40% in emerging markets. The Industrial and Consumer Specialties (ethylene oxide derivatives), Masterbatches and Pigments business units remained the largest contributors to the company's EBIT during the 9 months of 2010 (accounting for 23%, 15% and 25% of respectively).

Size and Stability

Clariant's operational size (measured by sales) places it in the "Baa" category. As noted above, we see some limitations to the benefits of diversification with a "Ba" assessment on the number of divisions of equal size (3 divisions accounting for 63% of 2010 9 months EBIT). Taking into account the on-going restructuring, we note that exposure to more commoditised markets and highly cyclical end-markets will be reflected in the relatively weak assessment of the stability of its EBITDA.

Cost Position

Clariant's historical profitability metrics (measured by Moody's after restructuring costs) do not yet fully reflect the benefits of the on-going restructuring, while the assessment benefits from the strong operating performance in 2010, partially supported by a robust improvement in volumes. The improvement is also supported by estimated CHF 200 m reduction in fixed costs achieved to date, which Moody's regards as an important achievement as part of its broader restructuring initiative.

Since 2005, Clariant has been engaged in restructuring programmes aimed at improving its competitiveness that resulted in an average P&L charge of CHF 120 m per year from 2005-2008. Since the beginning of the last comprehensive restructuring programme, Clariant booked CHF 240 m of restructuring cost in 2009 and guided towards a CHF 320 m cost bill in 2010. Looking into 2011, we expect that the scope of the restructuring programme and the remaining associated costs are now well identified and will be largely expensed, and we also do not expect write-off charges going forward.

Moody's notes that the company continues to enjoy a relatively low WACC, further supported by the placement of CHF 300 m convertible notes in 2009. The assessment of the Cost Position is underpinned by the expectation that Clariant will lift profitability levels before the next refinancing and will maintain the benefits of the structural reduction in working capital, that should also support better returns.

Management Strategy

While the company is implementing a broad restructuring of the business, its Ba1 rating and the stable outlook are underpinned by its strong liquidity position and the proactive prefunding of the restructuring process (via the placement of the convertible notes in 2009) that created financial flexibility required for the successful execution of the programme and guarded against a migration towards a typical sub-investment grade funding structure.

We also note that Clariant retained flexibility to gradually reduce debt levels (with smaller facilities maturing in 2011 and 2012 and the potential conversion of the CHF 300 m notes into equity in 2012, subject to share price performance) that would support further improvement in the financial metrics contributing to positive pressure developing on the current ratings.

Clariant's historical "Baa" score on this debt leverage focused factor is underpinned by the sustained prudent financial policy. We expect that the company will continue to be focused on the execution of the restructuring plan and take comfort from the management's reiterated view that the group's strategy does not accommodate debt-financed acquisitions at this stage.

Financial Strength

We continue to focus on the gross debt position of the group, recognising the likely transitional nature of the high cash balances accumulated by the company as a result of a large working capital inflow in 2009, the placement of the convertible bonds and a robust improvement in cash flow generation this year on the back of the recovery.

Looking ahead, we note that successful implementation of the restructuring plan will likely require a higher level of CAPEX over the near term, while we also expect that the company will be gradually returning to the higher levels of investment in the business seen prior to the crisis. During the execution stage, the cash flow generation will also be affected by the restructuring charges, as the company continues to implement the measures already reflected in its P&L. As Clariant is guiding towards further growth in 2011, we note that such growth will require some increase in working capital (in absolute terms), as would higher raw material costs, that we expect will become a more prominent issue in 2011.

Liquidity

Clariant maintains a significant cash balance (CHF 1.2 billion at the end of 3Q 2010) and it has no committed working capital facilities. We expect that the company will gradually reduce the cash balances through repayment of debt, and it will prepare to refinance its EUR 600 m notes maturing in 2013. The company faces only limited maturities of EUR 100 m in 2011 and CHF 250 m in 2012.

Rating Outlook

The stable outlook on the Ba1 ratings reflects the improvement in operating results in 2010 that begin to reflect a continuing positive momentum in profitability and stronger operating cash flow generation, also supported by the strong recovery in market fundamentals and demand in the last nine months. We are continuing to closely monitor the progress and expect that further evidence of a successful repositioning of the business and sustainable tangible improvement in profitability with the prospect of further debt reduction will lead to positive pressure on the ratings. The progress reported to date does suggest that Clariant became more strongly positioned in the rating category.

What Could Change the Rating - Up

A strong trend improvement in underlying profitability towards 12% (on EBITDA basis) underpinned by the successful and timely restructuring leading to robust operating performance, as well as strong operating cash flow with (RCF-CAPEX) / Debt in mid to high single digits and sustained FCF generation would generate positive pressure on the rating.

What Could Change the Rating - Down

The rating could be downgraded should Clariant experience some additional erosion in its operating profitability, despite the ongoing efforts, or suffer additional costs / delays in the implementation of the restructuring. A sustained weakness in cash flow generation and leverage, with expectation of sustained negative (RCF-CAPEX) / Debt generation and sustained negative FCF generation beyond 2010 will put negative pressure on the ratings.

The ratings on the bonds may be downgraded if the company were to raise secured debt. We note that at the end of 3Q 2010, Clariant had approximately CHF 128 million outstanding under bilateral working capital / roll-over loans raised by its operating subsidiaries.

Rating Factors

Clariant AG
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Clariant AG

Chemical Industry	Aa	A	Baa	Ba	B	Caa
Factor 1: Business Profile						
a) Business Position Assessment			X			
Factor 2: Size & Stability						
a) Revenue (Billions of US$)			USD 7.1b			
b) # of Divisions of Equal Size				3		
c) Stability of EBITDA				20%		
Factor 3: Cost Position						
a) EBITDA Margin (5 Yr. Avg.)				9.0%		
b) ROA - EBIT / Assets (5 Yr. Avg.)				5.4%		
Factor 4: Management Quality						
a) Net Debt / Capital		33%				
b) Net Debt / EBITDA (5 Yr. Avg.)			2.8			
Factor 5: Financial Strength						
a) EBITDA / Total Interest Expense (5 Yr. Avg.)				4.8		
b) Retained Cash Flow / Net Debt (5 Yr. Avg.) [1]			22.5%			
c) Free Cash Flow / Net Debt (5 Yr. Avg.) [1]				5.6%		
Rating:						
a) Indicated Rating from Methodology				Ba		
b) Actual Rating Assigned				Ba1		

[1] Reduction in share capital treated as dividend

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