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## Research Update:

# Danish Freight Forwarder And Logistics Provider DSV Rated 'BBB+'; Outlook Stable

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## Overview

- DSV, one of the largest global freight forwarders and logistics providers, has an extensive transport and logistics network, and displays high operating efficiency, as reflected in industry-leading profit margins.
- The company's asset-light business model allows for solid free cash flow generation, and a transparent financial policy targets net debt to EBITDA (as defined by DSV) of 1.0x-1.5x.
- We are assigning our 'BBB+' issuer credit rating to DSV.
- The stable outlook reflects our expectation that DSV's credit measures will improve sustainably in 2018, with adjusted funds from operations to debt increasing to about 40% and adjusted debt to EBITDA falling below 2.0x once integration costs diminish, EBITDA expands, and strong free cash flow provides financial headroom for shareholder returns and bolt-on acquisitions.

## Rating Action

On Sept. 19, 2018, S&P Global Ratings assigned its 'BBB+' issuer credit rating to Denmark-based global freight forwarder and logistics provider DSV A/S. The outlook is stable.

## Rationale

The rating reflects DSV's strong position in third-party freight transportation and logistics, which is a somewhat cyclical business, as well as its modest financial leverage and transparent financial policy. The key factors supporting our satisfactory business risk assessment include the company's large scale and extensive transport and logistics network; industry-leading profitability; and high operating efficiency, thanks to tight cost control, leading to our forecast of relatively high S&P Global Ratings-adjusted EBIT margins of 7% in 2018.

DSV is a top-five global freight forwarder offering transport and logistics services that support the entire supply chain. The company operates with an asset-light business model by booking the transportation of shipments from trucking, railroad, ocean shipping, and air freight firms. Since DSV's business model does not rely on owning material transportation fixed assets,

the company can scale up its service offerings without having to acquire additional equipment, and is not hindered by excess equipment when volumes decline. DSV offers traditional freight services as well as a variety of value-added services like purchase order management, pick-up and delivery, cargo consolidation, customs clearance, and cargo insurance. Around 75% of DSV's gross profit is generated from these value-added products, which highlights its services-focused value proposition to customers. The business model results in low gross capital expenditure requirements (around 1.4% of 2017 revenues) and the flexibility to react quickly to secular shifts. DSV generates about 62% of its revenue in Europe and about 17% in North America, while Asia-Pacific, the Middle East, Africa, and South America account for the remainder. Even though its customers are concentrated in Europe, DSV's broad transport and logistics network allows it to serve its customers' needs on a global basis.

Although DSV is large for a freight forwarder, having generated Danish krone (DKK) 74.9 billion (\$11.7 billion) in 2017, the underlying industry is fragmented, and we estimate DSV's market share to be just about 2%. Additionally, the company's revenues are somewhat cyclical and driven by GDP and global trade levels, meaning that a global economic downturn or increasing trade barriers could weigh on growth and profitability. Current protectionist negotiations in the U.S. and the U.K. are examples of events that could hamper global trade levels and pose a risk to DSV. However, these regions account for less than 20% of DSV's revenues, and global trade remains healthy overall. We expect DSV's revenues to increase in the low-single-digit percent range annually in the medium term, consistent with our projections for consistent global GDP growth of 3%-4%.

We view DSV's profitability as strong relative to industry peers', such as C.H. Robinson Worldwide Inc. and CEVA Logistics AG. DSV's EBIT margin was 6.5% in 2017, which included around DKK525 million of nonrecurring integration costs related to its acquisition of UTi Worldwide Inc., which closed in January 2016. These costs declined in the first half of 2018 and we don't expect meaningful restructuring costs for full-year 2018. According to our base case, we expect the EBIT margin will expand toward 7% in 2018 and remain at that level in 2019. We believe DSV's decent margins are partly a result of its scalable IT infrastructure and standardized work flows. The company has demonstrated its ability to onboard acquired companies onto its platform efficiently and realize synergies quickly. DSV's acquisition of UTi was large (a \$1.35 billion purchase price) but it was able to complete the integration and generate synergies from a previously unprofitable company within two years.

Our assessment of financial risk includes our forecast of S&P Global Ratings-adjusted funds from operations (FFO) to debt of about 40% and adjusted debt to EBITDA below 2.0x in 2018 on a sustainable basis, absent large debt funded mergers or acquisitions (M&A). The company is committed to its financial gearing target of 1.0x-1.5x net debt to EBITDA, as defined by DSV, and is currently operating below that range, with the ratio at 0.9x in the 12 months ended June 30, 2018. As of that date, our standard adjustments add

about 0.7x to adjusted debt to EBITDA, mostly from capitalizing operating leases and netting only readily available cash against debt.

The key factors supporting our financial risk assessment is DSV's decent EBITDA to free operating cash flow (FOCF) conversion, given the asset-light nature of its business model. We expect solid FOCF of DKK3.4 billion-DKK3.5 billion in 2018 and 2019, and since the company is meeting its financial gearing target, we anticipate free cash flow will be distributed to shareholders in the form of dividends and share repurchases. At the same time, we believe that, if the company were to pursue debt-funded M&A, the financial gearing ratio could temporarily increase above the target range, as was the case when DSV acquired UTi in 2016. Nevertheless, if leverage were to increase, we expect the company would shift its priority to using FOCF for net debt reduction rather than shareholder returns until adjusted debt to EBITDA recovered to that consistent with the 'BBB+' rating.

The company has a favorable position compared with peers in terms of high EBIT margins and this, combined with financial measures that in aggregate point toward the higher end of intermediate financial profile category, lift the anchor by one notch, leading to the 'BBB+' rating. We also factor in management's long tenure with the company and its track record of achieving above-industry-average profitability and effectively integrating acquisitions, while articulating and maintaining a transparent financial policy and conservative risk tolerance.

In our base case, we assume:

- Eurozone real GDP growth of 2.0% in 2018 and 1.7% in 2019, compared with 2.3% in 2017.
- North America real GDP growth of 2.8% in 2018 and 2.2% in 2019, compared with 2.3% in 2017.
- Asia-Pacific real GDP growth of 5.4% in 2018 and 5.6% in 2019, compared with 5.6% in 2017.
- DSV's revenue will increase by a low-single-digit percent annually (in line with GDP growth in regions where it operates), fueled by global trade volume, which we believe is tied to GDP growth.
- EBIT margins reaching 7% in 2018 from 6.5% in 2017 largely due to a reduction in integration costs related to DSV's acquisition of UTi. We forecast the EBIT margin will remain at about 7% in 2019.
- Gross capital expenditures of about DKK1 billion in 2018 and 2019, including the purchase of software-related intangibles.
- FOCF of DKK3.4 billion-DKK3.5 billion in 2018 and 2019, which we believe will be mostly distributed to shareholders provided that the company remains within its financial gearing target.

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

- Adjusted debt to EBITDA below 2.0x in 2018-2019, an improvement from 2.1x in 2017.
- Adjusted FFO to debt of about 40% in 2018-2019, up from about 37% in 2017.
- Adjusted FOCF to debt of 33%-34% in 2018-2019, largely stable on about 35% in 2017.

## **Liquidity**

We view DSV's liquidity as strong, supported by solid cash flow generation, ample cash balances, and availability under its revolving credit facility. We anticipate that the company's sources of liquidity will be about 1.9x its uses over the next 12 months starting from June 30, 2018 and above 1.5x for the following 12 months. We believe that net sources will remain positive even if EBITDA declined by 30%.

We also believe that DSV:

- Would be able to absorb high-impact negative credit events without the need to refinance, due to its low capital requirements;
- Has well-established and solid relationships with banks; and
- Has sufficient headroom under covenants to support a strong liquidity assessment.

As of June 30, 2018, we estimate DSV's liquidity sources for the upcoming 12 months mainly include:

- About DKK400 million of cash and short-term investments that we view as readily available for debt repayment.
- About DKK745 million in unused and committed financing available for more than one year.
- Our base-case forecast of FFO of around DKK4.5 billion.

We also note that DSV had about DKK1.5 billion available on a revolving credit facility due for renewal in September 2019.

As of June 30, 2018, we estimate liquidity sources for the upcoming 12 months mainly include:

- Gross capital expenditures of around DKK1 billion, including the purchase of software-related intangibles.
- Working capital outflows averaging DKK50 million annually, with potential intrayear volatility of up to DKK1 billion.
- Short-term debt of DKK880 million.

## **Outlook**

The stable outlook reflects our expectation that DSV's revenue will increase in the 2%-3% range over the next two years, fueled by similar global GDP and

trade growth, and that the company's EBIT margins will improve and remain healthy compared with peers'. While we expect the company will use its strong free cash flow for shareholder returns and bolt-on acquisitions, we believe it would shift its priority to deleveraging should leverage increase materially, for example, to fund a sizable acquisition, such that credit measures recovered to rating-commensurate levels within 12 months. We consider adjusted FFO to debt of about 40% and adjusted debt to EBITDA below 2.0x to be commensurate with the 'BBB+' rating on DSV.

### **Upside scenario**

Although unlikely over the next 12 months, we could raise the rating if DSV's adjusted FFO to debt ratio improved to more than 50% because, for example, it consistently applies free cash flows for debt reduction while adjusting its financial policy to ensure that such a ratio level is sustainable.

We could also raise the rating if DSV significantly expands its revenue, global market share, and geographic scale outside Europe, while maintaining EBIT margins above the industry average.

### **Downside scenario**

We could downgrade DSV if, for example, we expected its adjusted FFO to debt to fall significantly below 40%, with limited prospects for recovery in the short term because of, for example, an unexpected shift in the company's financial policy toward materially higher shareholder remuneration than we foresee, or an unexpected large debt-funded acquisition.

We could also consider a downgrade if DSV's business profile weakened. This could stem from macroeconomic headwinds or operational missteps, resulting in substantial revenue decline, EBIT margin compression to less than 6% for a prolonged period, or an increase in the volatility of the company's profitability.

## **Ratings Score Snapshot**

Issuer Credit Rating: BBB+/Stable/--

Business risk: Satisfactory

- Country risk: Low risk
- Industry risk: Low risk
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb

#### Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

### Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Railroad And Package Express Industry, Aug. 12, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

### Ratings List

#### New Rating

DSV A/S

Issuer Credit Rating

BBB+/Stable/--

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