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Research Update:

Orano Outlook Revised To Stable On Better-Than-Expected Results Carrying Into 2020; 'BB+' Ratings Affirmed

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PRIMARY CREDIT ANALYST

Christophe Boulier
Paris
(39) 02-72111-226
christophe.boulier@spglobal.com

SECONDARY CONTACTS

Andrey Nikolaev, CFA
Paris
(33) 1-4420-7329
andrey.nikolaev@spglobal.com

Elad Jelasko, CPA
London
(44) 20-7176-7013
elad.jelasko@spglobal.com

ADDITIONAL CONTACT

Industrial Ratings Europe
Corporate_Admin_London@spglobal.com

Rating Action Overview

- A recovery in market prices and internal initiatives have resulted in better-than-expected 2019 results for the France-based nuclear services group Orano.
- In addition, Orano saw a sharp decline in asset retirement obligation (ARO) liabilities thanks to strong returns of the equity market.
- We project that positive free cash flow from 2020 on should result in lower debt and support stronger credit metrics.
- We are therefore revising our outlook on Orano to stable from negative, and affirming our 'BB+' ratings on the group and its debt.
- The stable outlook reflects Orano's ability to generate material free operating cash flow (FOCF) in the coming years, supporting a lower debt and ultimately better credit metrics with somewhat lower volatility.

Rating Action Rationale

Orano's stronger-than-expected profitability and credit metrics in 2019 brighten performance projections over the coming years. The outlook revision points to our expectation that Orano will sustain strong performance in 2020 and beyond. We estimate material positive free cash flow of about €1 billion over the coming three years, likely resulting in improved and less volatile credit metrics.

Industry conditions remain challenging, but recovering prices should soften the impact. The nuclear enrichment industry has been under pressure for about a decade, with countries shifting away from nuclear energy--a trend that is likely to gain momentum. However, the curtailment of production and no appetite for investments have started to coax prices into a slow recovery. We therefore expect that the demand for Orano's services and mining production might continue to trend down. That said, the tight supply in the market may offset the pressure. For example, current uranium prices are about $27 per pound U308 (/lbU3O8), compared with about $20/lbU3O8 at the trough in 2018, and are now projected to recover to about $35/lbU3O8 in 2021 and about $40/lbU3O8 in 2022.

Stronger profitability will support deleveraging, but further improvements will be needed to cover the company's overall cash needs. Higher production volumes, more favorable prices, and ongoing cost-cutting initiatives have ushered in stronger-than-expected results in 2019 that should continue in 2020. Under our base case, we now expect an underlying EBITDA of about €1 billion in 2020, versus last year's €900 million. However, with cash needs of slightly more than €1 billion (interest, taxes, capital expenditure [capex], and dividends to minorities), Orano's ability to reduce debt will be limited. In 2019, the company saw a material working capital inflow of more than €350 million, which is expected to be the case in the coming years. We now see the company's S&P Global Ratings-adjusted debt to EBITDA at about 4x, in line with the 4x-5x range commensurate with the 'BB+' rating.

A volatile equity market will continue to affect the company's asset retirement obligations. On the back of the equity market's strong performance, the company's financial assets appreciated by slightly more than €0.9 billion (equivalent to about 20% of the company's overall adjusted debt) in 2019. This resulted in improvements in the company's credit metrics. However, this contrasts with the reduction of about €0.6 billion that company saw in 2018, and we cannot exclude a reversal in 2020 given the current market conditions. In our view, credit metrics are still highly sensitive to the equity market performance. Positively, this volatility won't have an immediate impact on the company's short-term liquidity needs.

Orano expects more stable liabilities over time thanks to its newly established framework. The company must comply with a new framework for measuring its obligations and covering potential shortfalls. We understand that this framework will limit the increase in and volatility of these liabilities.

Outlook

The stable outlook reflects Orano's ability to generate material FOCF in the coming years, supporting lower debt and ultimately better credit metrics with somewhat lower volatility.

Under our base case, we project an underlying EBITDA of €0.9 billion-€1.0 billion in the coming two years. In our view, this profitability level is on par with the company's capex and other cash flow needs. However, thanks to a substantial working capital inflow of about €1 billion over the coming three years, we expect the company's adjusted debt to EBITDA to be about 4x in 2020 and in 2021.

We continue to view an adjusted debt to EBITDA in the range of 4x-5x as commensurate with the rating. In addition, we expect the company to generate a positive FOCF (excluding changes in working capital) for the current 'BB+' rating. This is likely going to be the case on average in 2020-2021.

Lastly, while we expect Orano's relationship with the French government to remain the same, any sign of a lower likelihood of government support could limit ratings upside, or even lead to a downgrade.

Upside scenario

In our view, the improved results and credit metrics are not likely to lead to a positive rating action in the next 12 months. Such a rating action would hinge on the company's ability to achieve positive FOCF (excluding changes in working capital) of at least €200 million (equivalent to an adjusted EBITDA of about €1.1 billion-€1.2 billion with the current capex and other cash needs). Other supportive factors for an upgrade include:

- An adjusted debt to EBITDA of about 4x.
- No material deviation from the current industry trajectory (a gradual decline in the demand for the company's services, offset by recovering prices).

Downside scenario

In our view, a negative rating action could be triggered by one or more of the following:

- Lower-than-expected EBITDA and FOCF, for example, as a result of a continued weak market environment or major operational disruption, leading to an adjusted debt to EBITDA going over 5x without an imminent recovery prospects.
- A permanent increase in the company's asset-retirement obligations or pension obligations.

Company Description

France-headquartered Orano is a spinoff of former nuclear services provider AREVA. Orano offers products and services for the entire nuclear fuel cycle, from raw materials to waste processing. Its activities--ranging from mining to decommissioning and including conversion, enrichment, recycling, logistics, and engineering--contribute to the production of low-carbon electricity. The group has about 16,000 employees worldwide. At year-end 2019, Orano's revenues totaled €3.8 billion, with S&P Global Ratings-adjusted EBITDA of €1.0 billion.

Orano operates mainly through three business divisions:

- Mining (34% of sales in 2019): This operates through three uranium mines in Canada, Niger, and Kazakhstan. The mineral reserves in Orano's deposits amounted to 187,060 metric tonne units as of Dec. 31, 2019 (Orano's equity share).
- Front end (24% of sales in 2019): This combines all of the operations required to convert natural uranium into enriched uranium to be used in nuclear fuel assemblies designed to generate electricity. Customers are primarily nuclear power plant operators.
- Back end (42% of sales in 2019): This includes treating and recycling used fuel for reuse in the reactor, developing storage systems, organizing the transportation of radioactive materials, and cleaning up and dismantling nuclear facilities. Orano is the main global player in this space.

The main peers for both the mining and front-end divisions are the State Atomic Energy Corporation Rosatom, China National Nuclear Corporation, Cameco Corporation, and, for mining only, Kazatomprom.

Our Base-Case Scenario

Under our current base case, we project an adjusted EBITDA of about €1 billion in 2020 (equivalent to an underlying EBITDA of slightly below €1 billion), in line with the adjusted EBITDA in 2019. As part of its 2019 results, the company has indicated continued revenue growth in 2020 with EBITDA margins between 23%-26% (meaning €840 million-€950 million based on flat revenues with a further upside of €10 million with a change of 1% in the revenues). Given the uncertain nature of the company's provisions, our adjusted EBITDA doesn't assume material changes going forward (in 2019 some provisions reversal resulted in an increase of about €100 million in the adjusted EBITDA). Looking beyond 2020, we expect the company's EBITDA to soften gradually, reflecting the structural changes of the industry, with lower demand of its services, mitigated somewhat by improving prices.

In our base case we assume:

- Spot market prices for uranium, enrichment, and conversion of uranium to gradually improve over the next few years.
- The order book to decrease in the coming years but to remain equivalent to several years of revenue and continue to provide good visibility over cash flows in the next few years.
- Some contribution from the company's €250 million cost-cutting program by 2020. The company reported reduced expenses dropped by slightly more than €120 million in 2019 alone.
- High recurring capex requirements of about €600 million-€700 million per year on average in 2020-2021.
- Substantial positive working capital movements in 2020-2021 related to advance payments for capex in the back-end segment, as well as some destocking in the front-end segment.
- No changes in the decommission provisions and pension liabilities.
- Minimal dividends.

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

- Adjusted debt to EBITDA between 4x and 5x in 2020 and 2021.
- FOCF between €300 million and €400 million in 2020 and 2021.

Liquidity

We assess Orano's liquidity as strong. This is supported by our estimate that the company's liquidity sources will cover uses by more than 2x in the 24 months started Jan. 1, 2020. We also factor in the company's prudent liquidity management and solid bank.

Principal liquidity sources in the 12 months started Jan. 1, 2020, include:

- Our estimate of about €1.5 million of unrestricted cash on the balance sheet, including about €450 million made up of highly liquid marketable securities;
- €940 million available under a committed syndicate credit revolving facility maturing in July 2022 (plus two extensions, one year each); and
- FOCF of about €400 million including positive working capital movements of several hundred millions.

Principal liquidity uses in the same period:

- €500 million bond due in September 2020 and €750 million bond due in March 2021;
- Some moderate intrayear working capital swings that we don't expect will exceed €200 million;
- Under certain circumstances, the company may be required to use its cash to balance its end-of-cycle liabilities deficit, which was virtually nil on Dec. 31, 2019 (on a regulatory basis) after it made a voluntary contribution of €134 million in 2019. We understand that the company will not need to make such deposits in the coming two years at least; and
- No dividends.

Covenants

There are no covenants in the debt documentation.

Government Influence

The French government's influence remains critical for Orano's creditworthiness. We continue to believe it's highly likely Orano would receive support from the French government, which is reflected in a three-notch uplift in the rating above the company's stand-alone credit profile (SACP). We consider Orano to be a government-related entity (GRE). The French government owns directly and indirectly 90% of Orano. We view the government as committed to ensuring that any potential liquidity pressure would be addressed in a timely manner, as demonstrated by its past commitment to provide new equity and intermediate funding to Orano.

We view Orano as a GRE with a high likelihood of receiving government support because of its:

- Important role as France's leading nuclear services provider to the country's largest power producer. Orano ensures supplies of uranium and enriched uranium for France, which generates about 75% of its electricity from nuclear plants; and
- Very strong link with the French government. The group's ties with the government are reinforced by the politically sensitive nature of its enrichment and back-end recycling activities and its strategic importance to France's energy policies. As a commercial enterprise, Orano operates autonomously. The French government closely follows Orano's performance and must authorize strategic investments and acquisitions. Orano also has to provide its analysis of events and answer questions from specific parliamentary committees.

We don't factor in any impact in our base case from the proposed French Multi-Year Energy Plan (Programmation Pluriannuelle de l'Energie; PPE), which notably sets a roadmap for ambitious growth in renewables and reduced nuclear energy in the energy mix to 50% by 2035 from about 75% today. While this might hurt Orano's activities and financial performance over time, we think implications would be very long term and the plan is flexible, which allows for security of supply and to integrate neighbors' evolving mix, with no preset closures due before 2027.

Issue Ratings - Recovery Analysis

Key analytical factors

- The issue ratings on Orano's various senior unsecured obligations are 'BB+'.
- We cap the recovery rating at '3' according to our methodology for unsecured financial instruments of companies rated in the 'BB' category. This is because we assume, based on empirical analysis, that the size and ranking of debt and non-debt claims will change before the hypothetical default for companies at this rating level.
- We expect recovery for noteholders of 95% in the event of a payment default. The ratings are supported by the company's robust asset base and minor prior-ranking debt claims, but constrained by the substantial amount of pari passu unsecured debt.
- Under our hypothetical default scenario for Orano, we assume a combination of loss of key customers and a prolonged downturn in the industry, leading to lower pricing and operational issues.
- We value Orano as a going concern, given its market-leading position and diversified product offering.
- In our calculations, we exclude any end of lifecycle obligations.

Simulated default assumptions

- Year of default: 2025
- Jurisdiction: France

Simplified waterfall

- Gross recovery value: €4.6 billion
- Net recovery value after admin. expenses (5%): €4.4 billion
- Senior unsecured debt claims: €4.4 billion*
- Recovery range: 90%-100% (rounded estimate: 95%)
- Recovery rating: 3

*All debt amounts include six months of prepetition interest. Assuming some refinancing of the debt.

Ratings Score Snapshot

Issuer Credit Rating: BB+/Stable/--

Business risk: Satisfactory

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

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b+

Modifiers

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

Stand-alone credit profile: b+

- Related government rating: AA
- Likelihood of government support: High (3 notches from SACP)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Engineering And Construction Industry, 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: 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

Ratings Affirmed; Outlook Action

	To	From
Orano		
Issuer Credit Rating	BB+/Stable/--	BB+/Negative/--
Senior Unsecured	BB+	BB+
Recovery Rating	3(65%)	3(65%)