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Morningstar DBRS Confirms Volkswagen AG's Issuer Rating at A (low); Trend Remains Stable

Industry Group: Corporate Finance
Subindustry: Autos & Auto Suppliers
Region: Global

DBRS Limited (Morningstar DBRS) confirmed Volkswagen AG's (VW or the Company) Issuer Rating at A (low) with a Stable trend. Morningstar DBRS also confirmed the Issuer Rating of Volkswagen International Finance N.V. at A (low) as well as the Senior Unsecured Debt and Commercial Paper credit ratings of VW Credit Canada, Inc. at A (low) and R-1 (low), respectively, all with Stable trends.

KEY CREDIT RATING CONSIDERATIONS
The credit rating confirmations reflect the Company's solid business risk assessment as a leading global automotive original equipment manufacturer (OEM) of substantial scale with a highly diversified brand portfolio (that notably includes several strong premium automotive brands). Moreover, VW's financial performance has remained resilient despite extended disruptions in automotive production and volumes. Notwithstanding challenges across certain markets (notably including China) and sizable investment requirements for the foreseeable future, Morningstar DBRS expects VW's financial risk assessment (FRA) to remain strong in the context of the currently assigned credit ratings. Despite the above, Morningstar DBRS notes that certain environmental, social, and governance (ESG) risk factors continue to negatively affect the credit ratings.

CREDIT RATING DRIVERS
Consistent with the Stable trends, Morningstar DBRS expects the Company's credit rating to remain constant over the near to medium term. Like its peers, VW is facing substantial costs and investment requirements associated with the progressive electrification of its vehicle fleet (in addition to the expansion of its software services). While the Company announced certain revisions and delays in planned model launches across certain markets given the recent slowing momentum in the adoption of electric vehicles (EVs), VW's planned investments persist at elevated levels, rendering positive credit rating actions rather unlikely. Conversely, significantly weaker earnings amid these high investments—resulting in sizable negative free cash flow generation and thereby adversely affecting credit metrics—could have negative credit rating implications, although this is mitigated by the Company's favourable FRA (relative to its current credit ratings) that provides some cushion against unexpected challenges.

EARNINGS OUTLOOK
Morningstar DBRS considers prevailing automotive conditions (notwithstanding some softening from very favourable levels) to remain sound, reflecting residual pent-up demand, partly offset by cost headwinds and geopolitical uncertainties. For 2024, VW's earnings are estimated to approximate prior-year levels, with Morningstar DBRS noting further that the Company's 2023 financial performance was solid. VW's Q1 2024 operating profit contracted somewhat vis-à-vis the similar prior-year period amid a slight (2%) decrease in vehicle sales, with weaker product mix and cost increases representing additional negative factors. However, the Company indicated that Q1 2024 sales volumes, notably models of the premium Audi brand with V6 and V8 engines, were constrained because of temporary supply shortages. With such shortages expected to be resolved and VW's order book remaining solid, the Company's performance is projected to progressively improve over the remainder of the year, with anticipated declines in raw material costs and targeted efficiencies also supporting earnings. Going forward, over the medium term, Morningstar DBRS expects VW's profitability to remain solid, ranging from essentially flat to slightly softer levels (vis-à-vis recent years) given an anticipated slowing of volume growth, moderation in pricing, and ongoing cost headwinds. Morningstar DBRS also notes that VW's earnings will likely be influenced by

the sales progression of EVs, which continue to generate lower margins vis-à-vis legacy internal combustion engine (ICE) vehicles.

FINANCIAL OUTLOOK

Morningstar DBRS anticipates VW's cash flow from operations in 2024 to remain solid, likely approximating prior-year levels amid essentially constant projected earnings. Capital expenditures (capex) are forecast to remain substantial and increase year over year (YOY) in line with ongoing investments associated with VW's electrification efforts and expansion into new mobility businesses. Dividend payments in 2024 are to be markedly lower YOY (taking into account the non-repeat of the EUR 6.7 billion special dividend paid in 2023 in connection with the Porsche initial public offering) while remaining material, likely approximating 30% of the prior year net income (the Company's targeted payout ratio). As a function of the above, Morningstar DBRS expects gross free cash flow (i.e., before working capital items) in 2024 to remain significantly positive, likely exceeding EUR 4 billion (as calculated by Morningstar DBRS). Working capital, which represented a sizable use of cash of EUR 4.6 billion in Q1 2024 (as calculated by Morningstar DBRS), is estimated to be significantly reversed over the remainder of the year, although still likely to represent a moderate use of cash on an annual basis. Despite this, Morningstar DBRS forecasts net free cash flow for the year to be materially positive.

Going forward, cash flow from operations is projected to remain solid but could potentially decline somewhat over the medium term amid some anticipated pressure in earnings. Capex will likely persist at substantial levels for the foreseeable future, notwithstanding some potential moderation as VW seeks to attain some efficiency gains in its investments. Dividends are projected to remain essentially constant over the next few years, likely ranging from EUR 4.5 billion to EUR 5.0 billion annually. Notwithstanding the substantial capex and roughly constant dividend payments, Morningstar DBRS anticipates VW's free cash flow to persist at positive levels over the medium term, with VW's strong financial profile estimated to sufficiently absorb potentially sizable mergers and acquisitions activities in connection with its ongoing new mobility business initiatives.

CREDIT RATING RATIONALE

VW's credit ratings are supported by its favourable position as the world's second-largest automotive OEM (according to 2023 sales data), with the Company being the leader in its core European market while also remaining a major player in China. VW's brand portfolio is extensive, ranging from value to luxury brands. The Company's geographic and product diversity, in addition to its strong presence in the premium vehicle segments, contribute significantly to its earnings stability. Regarding VW's electrification ambitions, while there are several notable challenges (notably including increasing competition in Europe from Chinese new energy vehicle manufacturers), the Company appears reasonably well positioned relative to its immediate peers, with ongoing solid earnings/cash flow generation of VW's legacy ICE vehicle sales facilitating its EV efforts and expansion into new mobility businesses. VW's financial services business provides further diversification benefits and plays an important role in supporting vehicle sales, with the segment being a source of significant and stable earnings. Finally, the Company's liquidity position is substantial, with the industrial operations having a sizable net cash position.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE CONSIDERATIONS

Environmental (E) Factors

Morningstar DBRS considered that the E factor, specifically costs related to carbon and greenhouse gas emissions, represents a relevant negative factor as VW, consistent with its automotive peers, is facing a fundamental transformation process in line with the implementation of ever more stringent emission and fuel consumption regulations across most global jurisdictions. Accordingly, the Company is undergoing substantial investments associated with the electrification of its model portfolio, including the further development of modular toolkits for its volume, premium, and sports brands. Similarly, VW is investing in the gradual conversion of its locations for the production of EVs and in the creation of battery manufacturing capacity with the aim of establishing a battery supply chain under its own control. (For further details, please refer to the following commentary: "The Future is Electric: Climate Change and the Global Automotive Sector" at https://dbrs.morningstar.com/research/413419.)

Social (S) Factors
Since the last credit rating action, the relevance or significance of the following S Factor, product governance, has changed. Morningstar DBRS notes that this factor was previously deemed to have a relevant negative effect on the credit ratings, with associated costs in the form of vehicle refits, fines, and provisions for legal claims exceeding EUR 30 billion (albeit spread out over several years). However, with the substantial majority of associated charges and financial outlays now behind the Company, Morningstar DBRS no longer deems this factor to be applicable.

Governance (G) Factors
Morningstar DBRS considered that the G factor related to corporate/transaction governance represents a relevant negative factor, specifically with respect to VW's shareholder structure and distribution of voting rights. As of YE2023, Porsche Automobil Holding SE, Stuttgart held 53.3% of voting rights. The State of Lower Saxony (the second-largest shareholder) held 20.0% of the voting rights, with Qatar Holding LLC holding 17.0% of voting rights. Accordingly, external shareholders have very few voting rights; these amounted to 9.7% as of YE2023. Similarly, VW's supervisory board is composed primarily of shareholders and worker representatives, with only a nominal proportion of independent members; this potentially limits the board's ability to oversee risks.

There were no Social factors that had a significant or relevant effect on the credit analysis.

A description of how Morningstar DBRS considers ESG factors within the Morningstar DBRS analytical framework can be found in the Morningstar DBRS Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings (January 23, 2024), https://dbrs.morningstar.com/research/427030.

BUSINESS RISK ASSESSMENT (BRA) AND FINANCIAL RISK ASSESSMENT (FRA)
(A) Weighting of BRA Factors
In the analysis of VW, the relative weighting of the BRA factors was approximately equal.

(B) Weighting of FRA Factors
In the analysis of VW, the relative weighting of the FRA factors was approximately equal.

(C) Weighting of the BRA and the FRA
In the analysis of VW, the BRA carries greater weight than the FRA.

Notes:
All figures are in euros unless otherwise noted.

Morningstar DBRS applied the following principal methodology:
-- Global Methodology for Rating Companies in the Automotive Manufacturing and Supplier Industries (June 28, 2024), https://dbrs.morningstar.com/research/435216

Morningstar DBRS credit ratings may use one or more sections of the Morningstar DBRS Global Corporate Criteria (April 15, 2024), https://dbrs.morningstar.com/research/431186, which covers, for example, topics such as holding companies and parent/subsidiary relationships, guarantees, recovery, and common adjustments to financial ratios.

The following methodology has also been applied:

-- Morningstar DBRS Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings (January 23, 2024), https://dbrs.morningstar.com/research/427030

The credit rating methodologies used in the analysis of this transaction can be found at: https://dbrs.morningstar.com/about/methodologies.

A description of how Morningstar DBRS analyzes corporate finance transactions and how the methodologies are collectively applied can be found at: https://dbrs.morningstar.com/research/431153.

The related regulatory disclosures pursuant to the National Instrument 25-101 *Designated Rating Organizations* are hereby incorporated by reference and can be found by clicking on the link under Related Documents or by contacting us at info-DBRS@morningstar.com.

The following additional regulatory disclosures apply to VW and VW Credit Canada, Inc.:

The credit ratings were initiated at the request of the rated entity.

The rated entity or its related entities did participate in the credit rating process for this credit rating action.

Morningstar DBRS had access to the accounts, management, and other relevant internal documents of the rated entity or its related entities in connection with this credit rating action.

These are solicited credit ratings.

The following additional regulatory disclosures apply to Volkswagen International Finance N.V.:

The credit rating was not initiated at the request of the rated entity.

The rated entity or its related entities did participate in the credit rating process for this credit rating action.

Morningstar DBRS had access to the accounts, management, and other relevant internal documents of the rated entity or its related entities in connection with this credit rating action.

This is an unsolicited credit rating.

These credit ratings are endorsed by DBRS Ratings Limited for use in the United Kingdom, and by DBRS Ratings GmbH for use in the European Union, respectively. The following additional regulatory disclosures apply to endorsed credit ratings:

Regarding Volkswagen International Finance N.V., with respect to FCA and ESMA regulations in the United Kingdom and European Union, respectively, this is an unsolicited credit rating. This credit rating was not initiated at the request of the issuer.

With Rated Entity or Related Third Party Participation: YES
With Access to Internal Documents: YES
With Access to Management: YES

The conditions that lead to the assignment of a Negative or Positive trend are generally resolved within a 12-month period. Morningstar DBRS trends and credit ratings are under regular surveillance.

For further information on Morningstar DBRS historical default rates published by the European Securities and Markets Authority (ESMA) in a central repository, see: https://registers.esma.europa.eu/cerep-publication. For further information on Morningstar DBRS historical default rates published by the Financial Conduct Authority (FCA) in a central repository, see https://data.fca.org.uk/#/ceres/craStats.

Lead Analyst: Robert Streda, Senior Vice President
Rating Committee Chair: Anke Rindermann, Managing Director
Initial Rating Date: Volkswagen International Finance N.V. – December 27, 2023; Volkswagen AG – May 16, 2001; VW Credit Canada, Inc. – April 24, 2000

Information regarding Morningstar DBRS ratings, including definitions, policies, and methodologies, is available on dbrs.morningstar.com or contact us at info-DBRS@morningstar.com.

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Issuer	Debt	Rating Action	Rating	Trend
Volkswagen AG	Issuer Rating	Confirmed	A (low)	Stable
* VW Credit Canada Inc.	Senior Unsecured Debt	Confirmed	A (low)	Stable
* VW Credit Canada Inc.	Commercial Paper	Confirmed	R-1 (low)	Stable
* Volkswagen International Finance N.V.	Issuer Rating	Confirmed	A (low)	Stable

* Guaranteed by Volkswagen AG

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