Moody's
INVESTORS SERVICE

Rating Action: Moody's assigns Baa2 rating to Volkswagen's proposed hybrid security; positive outlook.

Global Credit Research - 29 Aug 2013

Frankfurt am Main, August 29, 2013 -- Moody's Investors Service has today assigned a Baa2 long-term rating to Volkswagen Aktiengesellschaft's ("Volkswagen" or "VW") proposed issuance of "Undated Euro-denominated subordinated notes issued by Volkswagen International Finance N.V. guaranteed by Volkswagen Aktiengesellschaft. The size of the hybrid debt remains subject to market conditions.

RATINGS RATIONALE

The Baa2 rating assigned to VW's hybrid debt is two notches below the company's senior unsecured rating of A3. This rating differential reflects the deeply subordinated nature of the hybrid debt. The hybrid (1) is a perpetual instrument; (2) is senior only to common equity; (3) provides VW with the option to defer coupons on a cumulative basis; (4) has no step-up prior to year 10 and none beyond 100 basis points (bps) overall.

Moody's notes that the proposed issuance of hybrid debt is in line with VW's conservative financial policies and objective to maintain long-term credit ratings at the single-A level. In Moody's view, the notes have equity-like features to allow it to receive basket "C" treatment, i.e. 50% equity and 50% debt for financial leverage purpose (please refer to Moody's Rating Methodology "Revisions to Moody's Hybrid Tool Kit" of July 2010).

VW's A3 issuer rating is supported by its strong competitive position with a diverse product range, high brand recognition and successful model launches over recent years. Despite the deterioration in the group's operating performance during the industry downturn in late 2008 and 2009, VW's financial metrics proved to be more resilient than those of its European automotive peers and showed a strong and rapid recovery over the past three years. The group benefits from a good product offering and leading market positions in the car markets of Europe, China and Brazil. The company's solid competitive position should in our opinion support future sales and market share growth also in the US, Russia and India.

However, the rating remains constrained by the cyclicality of global auto demand and its dependence on the overall global economic environment. In our view the uncertainty surrounding the strength and sustainability of the pace of economic growth in emerging markets like China and Brazil remains high as evidenced by the muted development of the Brazilian passenger car market and slowing demand growth in China.

Moreover profitability needs to contend with intense price competition in the industry, continued high R&D needs for alternative drivetrains and the volatility of raw material prices and foreign exchange rates. VW's high positive free cash flows (FCF) generated in the past few years have been challenged recently by earnings by a substantial increase in capex and higher dividend payments in 2012, though we expect these to remain solid.

In addition, the rating incorporates our expectation of a smooth integration of MAN and Porsche into VW and the group's ability to preserve its financial flexibility during the integration process. We caution that it will be crucial for VW to maintain its operational excellence and preserve adequate allocation of management resources despite multiple development projects.

The positive outlook reflects VW's relatively good resilience through the crisis in 2009 and its stronger and faster than anticipated recovery in operating performance thereafter. Should VW be able to sustain its operating performance and financial metrics achieved over the last two to three years despite rising challenges and risks from a slowing economic growth in many of VW's key markets we could upgrade the ratings within the next 12-18 months.

WHAT COULD CHANGE THE RATING UP/DOWN

The hybrid rating could be affected by a change in the issuer rating of VW. An upgrade of VW's issuer rating would require that the company evidences ability to sustain its recent strong operating performance in the current financial year as well as at least defend its market share in each of the major regions where it operates, against an environment of increasing macro-economic risk. The company would also need to evidence continued progress in executing its ambitious development plans, in particular through further investments in the US, Brazil, India and

China as well as in trucks (MAN) and sports cars (Porsche). This would translate in sustained metrics of strong cash flow generation despite rising capital expenditure needs evidenced by FCF/ Debt ratio around 10.0% as well as; (ii) EBITA margin above 7.0%; (iii) Interest Cover above 7.0x; (iv) Debt/Capital of around 40%.

Conversely, although not currently expected the A3 issuer rating could come under pressure in case of VW's inability to maintain financial ratios such as (i) a significant positive operating income over the next few years; (ii) a material positive free cash flow in the automotive business after dividend payout; (iii) as well as Net Debt/EBITDA ratio not exceeding 1.0x and (iv) interest coverage ratio of at least 4.5x (all ratios as adjusted by Moody's).

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was the Global Automobile Manufacturer Industry published in June 2011 and Updated Summary Guidance for Notching Bonds, Preferred Stocks and Hybrid Securities of Corporate Issuers published in February 2007. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

Headquartered in Wolfsburg, Germany, Volkswagen Group is Western Europe's largest car manufacturer in terms of passenger car unit sales with a market share of 24.4% in fiscal year 2012 and ranks number two globally with a market share of 12.8% in 2012. VW manufacturers mass-market and premium cars under the Volkswagen Passenger Cars, Skoda, Seat, Audi, Bentley, Lamborghini, Bugatti and Porsche brands, as well as commercial vehicles under the Volkswagen Commercial Vehicles, MAN and Scania brands. In addition, VW has a 100.0% stake in Ducati and 19.9% stake in Suzuki. In 2012, the group sold nearly 9.3 million vehicles and had group revenues of EUR193 billion.

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