FITCH DOWNGRADES UNITED TECHNOLOGIES IDR TO 'A-'; OUTLOOK STABLE

News / Finance

Fitch Ratings has **downgraded** United Technologies Corporation’s (UTC;NYSE: UTX) long term Issuer Default Rating (**IDR)** and long-term debt ratings to ‘A-’ from ‘A’. Fitch has also downgraded UTC’s short-term IDR and commercial paper ratings to ‘F2’ from ‘F1’. The Rating Outlook is Stable. A detailed list of rating actions follows at the end of this release.

KEY RATING DRIVERS

The downgrade of UTC's ratings reflects the company's aggressive cash deployment for share repurchases, which Fitch expects will contribute to higher debt levels in 2016 and result in consistently weaker credit metrics. The company's increased emphasis on returns to shareholders through share repurchases and dividends indicates a shift to a less conservative financial strategy than UTC has followed in the past. UTC plans to deploy all proceeds from the pending divestiture of Sikorsky to repurchase shares, and Fitch expects the company to go beyond this amount.

The Stable Outlook incorporates Fitch's view that UTC's operating profile remains consistent with the 'A' category despite near-term challenges surrounding market share at Otis and expected margin pressure in the aerospace businesses related to production ramp-ups. The company generates favorable EBITDA margins across most of its businesses (17.3% at June 30, 2015 on an LTM basis), and consolidated margins will improve upon completion of the Sikorsky divestiture near the end of 2015. UTC maintains competitive positions in its key aerospace and building-related markets, and it has a large installed base that supports attractive aftermarket revenue. Free cash flow is consistently strong through the business cycle, which provides flexibility to fund discretionary spending for acquisitions, share repurchases and other uses.

Fitch estimates debt/EBITDA could increase to 2.25x – 2.5x in the near term due to loss of earnings from Sikorsky, the negative impact of currency exchange rates, weaker earnings at Otis, and the impact of higher debt levels. Debt increased by $2.6 billion, to $22.4 billion, during the first half of 2015, primarily due to higher commercial paper balances. Debt/EBITDA was slightly above 2.0x at June 30, 2015. Fitch views this level as near the weak end of the range for UTC's 'A-' rating and would expect an improvement below 2x over a two to three year timeframe.

UTC's FCF margin has been lower than historical levels, partly due to high spending on aerospace development. FCF/total adjusted debt was slightly less than 13% at June 30, 2015 compared to 15% in 2014. As a result of higher debt levels and margin pressure, Fitch believes UTC will be slow to rebuild FCF/total adjusted debt to a level in excess of 20% which the company had achieved historically.

Rating concerns include the risk of large acquisitions or share repurchases that lead to additional and sustained increases in debt and leverage. Also, if UTC encounters challenges rebuilding market share at Otis or ramping up aerospace production, earnings and cash flow could be weaker than anticipated and lead to additional negative rating actions. Other rating concerns include risks on aerospace development programs, slower growth in China and other developing markets, and a slow recovery in global construction markets outside the U.S.

Fitch estimates FCF after dividends in 2015 will decline toward $3 billion compared to nearly $3.6 billion in 2014. FCF includes the impact of higher dividends, German tax litigation payments, pension contributions, and spending for aerospace programs. Capital spending is likely to be elevated to support UTC's aerospace programs but should decline slightly as UTC moves past the peak development cycle. However, the impact will be offset by negative margins in the aerospace businesses associated with Pratt & Whitney's GTF engine and new programs at the UTC Aerospace Systems segment.

FCF includes the impact of pension contributions. UTC expects to contribute $150 million to global pension plans in 2015 compared to $517 million in 2014; there are no required contributions before 2020. UTCestimated its U.S. plans were approximately 92% funded as of June 30, 2015. Globally, pension plans were underfunded by $5.1 billion at the end of 2014 compared to $1.7 billion at the end of 2013.

The negative impact on UTC’s earnings and cash flow from the Sikorsky divestiture is mitigated by its moderate size relative to UTC; Sikorsky accounted for 6.5% of UTC’s segment profit in 2014 before special items and eliminations. Fitch views the divestiture, before considering UTC’s cash deployment plans, as neutral to the ratings. UTC will lose some diversification, but the divestiture will reduce platform development risks. UTC will continue to benefit from significant global scale and a good balance between aerospace and commercial businesses.

Otis generates the highest profit margins among UTC’s business segments, but the unit has lost market share in China and Europe. UTC has indicated it intends to rebuild market share in these regions and would consider slightly lower margins in order to increase its competitiveness. The impact could be offset over the long term by additional sales volume and increased high-margin aftermarket business, which represents approximately 60% of segment revenue.

The ratings for UTC also incorporate the company’s product and geographic diversification, relatively stable operating performance through economic cycles, and technological capabilities that support strong competitive positions. The company has attractive positions on commercial and military aerospace programs and is well positioned to benefit from rising production of commercial aircraft.

KEY ASSUMPTIONS

Fitch’s key assumptions within the rating case for the issuer include:

—Sales in 2015 are down slightly, excluding Sikorsky, due to lower revenue at Otis and the negative impact of currency;

—Aerospace revenue during the next several years benefits from increasing deliveries of engines and systems for new aircraft programs;

—UTC’s development spending in the aerospace businesses declines gradually from elevated levels;

—Sikorsky is divested near the end of 2015, with net cash proceeds of approximately $6 billion used to repurchase shares;

—Outstanding debt at the end of 2015 is approximately $2.6 billion higher compared to the end of 2014 and will likely rise again in 2016 as a result of UTC’s spending for share repurchases in excess of net proceeds from the Sikorsky divestiture;

—Margin improvement at the Climate, Controls & Security segment is offset by lower margins at Otis and the aerospace businesses.

RATING SENSITIVITIES

Future developments that may, individually or collectively, lead to a negative rating action include:

—Execution challenges on the production ramp for the GTF engine that could reduce expected long-term benefits from market share gains and after-market expansion;

—At Otis, a significant loss of market share or persistent deterioration in margins that impairs UTC’s overall profitability and FCF;

—Sustained shareholder-focused cash deployment results in debt/EBITDA above 2.5x in the near term, or prevents an eventual improvement in debt/EBITDA below 2.0x;

—Weak operating results or FCF resulting in FCF/total adjusted debt consistently below 10%.

An upgrade is unlikely in the near term given that some of UTC's credit metrics are weak even at the current rating level. However, future longer-term developments that may, individually or collectively, lead to a positive rating action include:

—A shift in UTC's financial policies, including a reduced emphasis on share repurchases compared to current plans, that allows the company to quickly rebuild credit metrics;

—Significant, sustained long-term market share gains or higher aftermarket revenue at Otis and the aerospace businesses;

—Consistently stronger credit metrics including debt/EBITDA below 1.5x-1.75x and FCF/total adjusted debt approaching 20%.

LIQUIDITY

At June 30, 2015, UTC's liquidity included $5.9 billion of cash and equivalents, of which 97% was located outside the U.S., and $4.35 billion of committed bank facilities that mature in 2019. UTC generally has access to foreign cash, and while much of it would be subject to taxes, Fitch believes UTC has considerable flexibility regarding repatriation. Liquidity was offset by nearly $2.8 billion of short-term debt, primarily commercial paper, and $172 million of long-term debt due within one year. UTC's outstanding debt totaled $22.4 billion at June 30, 2015 compared to $19.8 billion at the end of 2014.

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