

# Credit Summary: Rockwell Automation Inc (A, stable)

## Strong Competitive Advantage Supports its Creditworthiness

**Morningstar Credit Ratings, LLC**  
30 July 2018

### Contents

- 1 Pillar Analysis
- 3 Company Overview
- 5 Financial Projections
- 7 Capital Structure and Liquidity Analysis
- 7 Capital-Allocation Policy
- 8 Credit Rating History
- 10 Appendix

Basili Alukos, CFA, CPA  
Assistant Vice President  
+1 312 384-4984  
basili.alukos@morningstar.com

### Executive Summary

Morningstar Credit Ratings, LLC's A corporate credit rating on Rockwell Automation incorporates Rockwell's superior business quality and strong credit profile, offset slightly by its capital-allocation priorities. Rockwell will redeploy the majority of its excess cash over the next 18-24 months in the form of increased share repurchases and mergers and acquisitions as a result of U.S. tax reform. Although we think these moves are likely to leave Rockwell in a net debt position versus its net cash position today, we think they will have an overall negligible impact on its credit profile and assign the company a stable outlook.

### Key Takeaways

- ▶ Rockwell Automation's credit profile benefits from its low Business Risk. The company's intangible assets from its Allen-Bradley brand and resulting high customer switching costs underpin its rating.
- ▶ The company's very strong Solvency Score is supported by impressive returns on invested capital, high interest coverage, modest leverage, and its historical cash-rich balance sheet.
- ▶ Rockwell is a leader in industrial automation—the backbone of the manufacturing process—with a strong presence in heavy industry, primarily for discrete production, although its Logix enables the company to also capture demand in both continuous and hybrid production processes.

### Pillar Analysis

**Exhibit 1** Rockwell Automation Inc Credit Pillar Summary

#### Current Rating: A

Rating Pillars  
Business Risk  
Cash Flow Cushion  
Solvency Score  
Distance to Default

		Strongest ←————→ Weakest									
		1	2	3	4	5	6	7	8	9	10
Business Risk											
Cash Flow Cushion											
Solvency Score											
Distance to Default											

Source: Morningstar Credit Ratings, LLC

Please refer to the appendix for a full description of the rating pillars.

- ▶ Business Risk (4): Rockwell Automation benefits from a strong competitive advantage because of its intangible assets and high customer switching costs, and its medium uncertainty. However, the

company's score is negatively affected by our take on its rather narrow product/customer concentration and its overall elevated levels of cyclicality.

- ▶ **Size (Large):** Rockwell Automation generated \$6.3 billion in revenue in 2017, and we project nearly \$6.8 billion in 2018.
  - ▶ **Economic moat (Wide):** Morningstar's Equity Research Group awards Rockwell Automation a wide moat rating based on intangible assets and a meaningful amount of customer switching costs.
  - ▶ **Uncertainty (Medium):** Despite its large exposure to cyclical industrial end markets, Rockwell Automation earns a medium uncertainty rating due to its stout profitability and because its products are essential to the customer's production process. This helps smooth out some of variability in projecting its financial results over the long run.
  - ▶ **Product/customer concentration (Concentrated):** We view Rockwell as having a concentrated product/customer exposure. The company derives 70% of its revenue from the industrial sector, with a meaningful exposure to automotive (15%) and heavy industry (50%), implying that what affects one customer within this sector is likely to affect them all
  - ▶ **Management (Neutral):** Rockwell management has historically operated the company with gross leverage hovering around or below 1.5 times, although it hoarded copious cash and investments that often produced a net cash position. This reasonable leverage is offset by the management's propensity to repurchase shares—\$1.5 billion for fiscal 2018—boost its \$420 million dividend, and grow revenue inorganically by at least 1 percentage point per year.
  - ▶ **Dependence on capital markets (Low):** We forecast that Rockwell will generate sufficient cash flow per year over our forecast period to meet all of its debt and debtlike obligations an average of 4.7 times. Although 2018 is the weakest year because management will repurchase \$1.5 billion in shares, the metric is still an impressive 2.2 times.
  - ▶ **Cyclicality (Cyclical):** Rockwell Automation sells products that are intertwined in the manufacturing process of its customers. However, its prospects are tethered to highly cyclical end markets like heavy industry and automotive—65% of sales—that eroded revenue growth profitability during much of the last few years despite solid global economic growth.
- ▶ **Cash Flow Cushion (5):** We forecast that Rockwell Automation will generate average operating cash flow of nearly \$1 billion annually, while reinvesting around \$160 million (or 2.3% of sales) back into the business each year. The company has now guided toward repurchasing \$1.5 billion of share during fiscal 2018, in addition to an annual dividend of approximately \$420 million. We also forecast modest acquisition spending per year, as Rockwell aims to achieve at least 1 percentage point of inorganic growth. The company announced in June that it was making a \$1 billion equity investment in PTC Inc., a global software and services company focused on helping customers thrive in the smart, connected world. Still, Rockwell faces a benign maturity schedule, with its only meaningful obligation coming due over the next five years is a \$300 million bond that matures in March 2020.

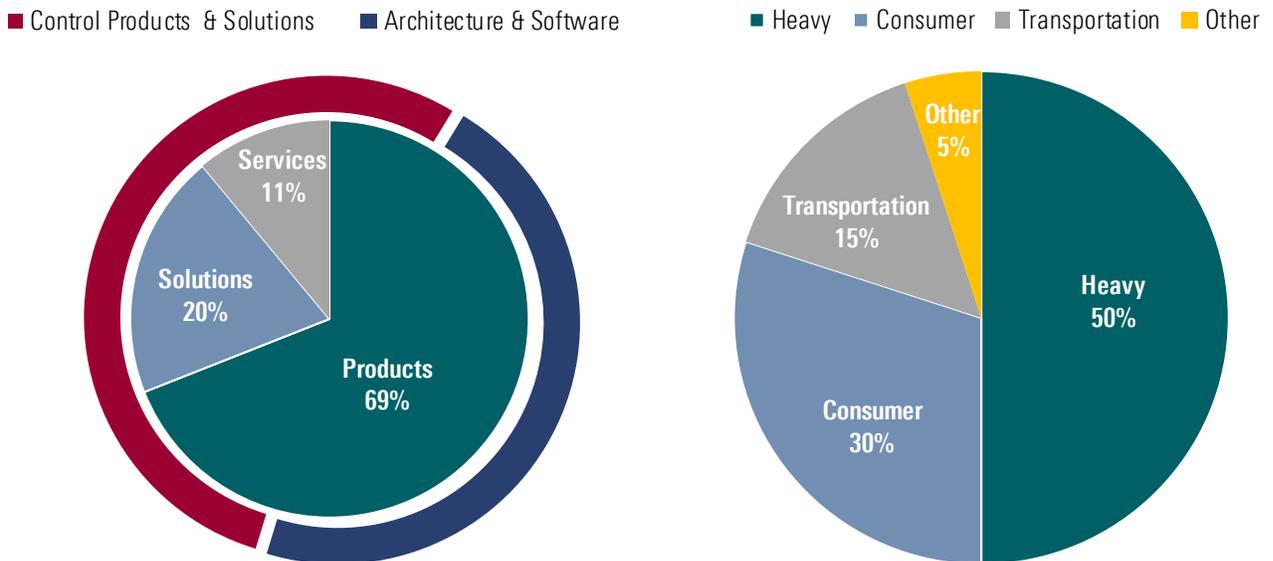
- ▶ **Solvency Score (2):** Rockwell Automation's Very Strong pillar rating stems from its lofty near-30% returns on invested capital. The company's total liabilities/total assets is elevated given its gross leverage of around 1.5-to-2.0 times, but its impressive profitability results in a strong interest coverage metric. The company has traditionally operated with a net cash position, which helps it boast a quick ratio that neared 2.0 times. However, this metric will decline as management returns the majority of its cash to shareholders. Over time, we expect the falling cash balance will cause the quick ratio and the TL/TA to worsen and possibly put further pressure on the Solvency Score.
- ▶ **Distance to Default (2):** Over the last 12 months, Rockwell Automation was thrice the recipient of a takeover by peer Emerson Electric Co (not rated), but its stock has modestly underperformed since the company formally walked away. Even still, Rockwell bondholders have plenty of equity cushion: The company trades at an enterprise multiple of 16.0 times, resulting in a market capitalization of more than \$23 billion that dwarfs its total debt of \$1.2 billion.

**Rockwell Automation**

**Company Overview**

Rockwell Automation believes it is the world's largest company dedicated to industrial automation and information. Rockwell, with its Logix platform, helps companies, primarily within heavy industry, design, control, and run their production processes for both discrete (automotive, consumer electrics, packaging) and process (oil refining, chemicals, food and beverage) manufacturing. The company generated \$6.3 billion in fiscal 2017 sales primarily through its two segments: controls products & solutions and architecture & software.

**Exhibit 2** Rockwell Automation at a Glance

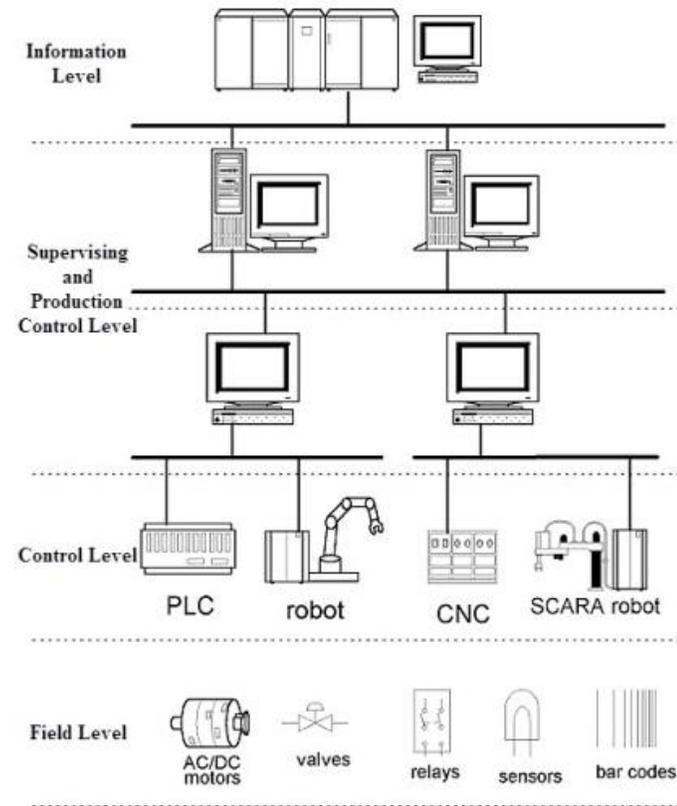


Source: Company analyst day

### What Is Industrial Automation?

The production process has evolved to incorporate sophisticated technology to achieve the goal of manufacturing a quality product with high reliability rates at the lowest possible per-unit cost. Specifically, industrial automation uses technology to automate the process without significant human intervention for previously mundane and dangerous tasks. At its core, each piece must connect and transmit information while coordinating throughout the entire process from machines on the line (field level) while providing data output to assess the production process all the way from operational managers at the plant level to the top of the enterprise. Exhibit 3 helps conceptualize the role automation plays throughout the production process.

**Exhibit 3** Hierarchy of an Industrial Automation System



Source: Electrical Technology

Integral in the industrial automation are programmable logic controllers, or PLCs. Pioneered by Rockwell Automation's Allen-Bradley brand in the 1970s, the PLC is essentially the brains behind the industrial digital computer that is responsible for sending and receiving the information across all devices. As computing technology has expanded, so too has the desire for more advanced technology, while enabling companies like Rockwell Automation to move beyond the line and factory level to the

connected enterprise. Automation falls on a continuum of two categories that are defined by the countability of the finished product: discrete and process (continuous).

**Exhibit 4** The Continuum of Industrial Automation

Process	Hybrid	Discrete
Power	Metals and mining	Printing
Chemicals	Pulp and Paper	Electronics
Oil and Gas	Life Science	Textiles
Refining	Food and Beverage	Packaging
Water/Wastewater	Consumer Products	Automotive

Source: Company reports, Morningstar Credit Ratings, LLC

Rockwell has a dominant position in discrete automation through its Logix platform. Mastering discrete automation has its advantages for Rockwell and is highly valuable, as Emerson Electric's failed 2017 acquisition attempt proved. The PLC footprint is much smaller, yet the decision loop speed is much faster than discrete, thus Rockwell can participate in both discrete and continuous sectors. Today, Rockwell offers a full suite of products from control systems, components, and networks, to visualization and software to engineered systems and solutions. The business world's embracing of the Internet of Things, including estimates for nearly 20 billion connected devices by 2020, will provide Rockwell with growth opportunities. It will help companies embrace the next generation of smart manufacturing through its focus on the connected enterprise by converging plant-level and enterprise networks while securely connecting people, processes, and technologies.

**Exhibit 5** Rockwell Automation Product Offerings



Source: Company report

**Financial Projections**

Rockwell projects revenue growth of between 4.5% and 7.5% for 2018 on the heels of the strong economic backdrop. Longer term, we expect that growth to continue, and we forecast that revenue will grow 5.9% on average per year over our forecast period. Included in our forecast is nearly 1% of

inorganic growth per year, which is consistent with management's plan to grow via acquisitions. We project that profitability will improve over the next few years as a result of better revenue growth, but we expect that long-run EBITDA margins will settle around 21%, which is closer to the company's historical average.

**Exhibit 6** Financial Projections (\$ in Millions Unless Otherwise Noted)

All values (except per share amounts) in: USD Millions	Forecast								
	Years	2015	2016	2017	2018	2019	2020	2021	2022
<b>Income Statement</b>									
Revenue	6,308	5,880	6,311	6,745	7,141	7,702	7,933	8,407	
Gross Profit	3,010	2,795	2,972	3,238	3,463	3,697	3,729	3,993	
Operating Income	1,197	1,008	1,033	1,324	1,450	1,629	1,480	1,585	
Adjusted EBITDA	1,359	1,180	1,202	1,496	1,630	1,821	1,676	1,792	
Net Income	828	730	826	988	1,088	1,229	1,111	1,194	
<b>Balance Sheet</b>									
Cash + Investments	2,149	2,429	2,536	650	1,083	1,473	1,253	1,442	
Total Debt	1,501	1,965	1,844	1,950	2,201	2,550	2,347	2,508	
Total Adjusted Debt	2,437	2,889	3,455	2,960	3,239	3,617	3,445	3,637	
<b>Cash Flow Statement</b>									
Cash Flow From Operations	1,188	947	1,034	1,120	1,244	1,365	1,310	1,369	
Capital Expenditures	(123)	(117)	(142)	(152)	(161)	(173)	(178)	(189)	
Free Cash Flow (CFO-Capex)	1,065	830	892	969	1,083	1,191	1,132	1,180	
Free Cash Flow / Sales	16.9%	14.1%	14.1%	14.4%	15.2%	15.5%	14.3%	14.0%	
<b>Growth (% YoY)</b>									
Revenue	-4.8%	-6.8%	7.3%	6.9%	5.9%	7.9%	3.0%	6.0%	
Gross Profit	-1.1%	-7.2%	6.4%	8.9%	7.0%	6.7%	0.9%	7.1%	
Operating Income	1.1%	-15.8%	2.4%	28.2%	9.5%	12.4%	-9.2%	7.1%	
Adjusted EBITDA	1.7%	-13.2%	1.8%	24.5%	9.0%	11.7%	-7.9%	6.9%	
<b>Profitability (%)</b>									
Gross Margin	47.7%	47.5%	47.1%	48.0%	48.5%	48.0%	47.0%	47.5%	
Operating Margin	19.0%	17.1%	16.4%	19.6%	20.3%	21.2%	18.7%	18.9%	
Adjusted EBITDA Margin	21.5%	20.1%	19.0%	22.2%	22.8%	23.6%	21.1%	21.3%	
Net Margin	13.1%	12.4%	13.1%	14.7%	15.2%	16.0%	14.0%	14.2%	
Adjusted ROIC	25.7%	21.5%	24.1%	25.0%	23.9%	25.5%	21.7%	21.9%	
Adjusted RONIC	7.0%	-256.6%	88.6%	128.8%	71.1%	76.5%	-121.3%	53.5%	
<b>Coverage / Cash Flow</b>									
Adjusted EBITDA / Interest Expense	21.3	16.6	15.8	19.2	20.9	23.3	21.5	23.0	
(Adj. EBITDA-CapEx) / Int. Exp.	19.4	14.9	13.9	17.2	18.8	21.1	19.2	20.5	
Adj. EBITDAR / (Int. Exp. + 1/3 Rents)	14.4	11.8	11.5	13.7	14.8	16.2	14.9	15.7	
Dividends / FCF	33%	46%	44%	44%	43%	43%	45%	43%	
Share repurchase (issuance) / FCF	51%	57%	18%	155%	37%	34%	35%	34%	
<b>Leverage</b>									
Total Debt / Adj. EBITDA	1.1	1.7	1.5	1.3	1.4	1.4	1.4	1.4	
Net Debt / Adj. EBITDA	0.1	0.4	0.4	1.6	1.4	1.2	1.3	1.2	
Total Adj. Debt / Adj. EBITDAR	1.7	2.2	2.6	1.8	1.8	1.9	1.9	1.9	
EV / Adj. EBITDA	9.7	13.2	18.7	13.5	-	-	-	-	
Debt / Capital	40%	50%	41%	53%	53%	53%	49%	48%	
FCF / Total Debt	71%	42%	48%	50%	49%	47%	48%	47%	

Source: Morningstar Credit Ratings, LLC

### Capital Structure and Liquidity Analysis

Rockwell employs a simple capital structure, composed primarily of U.S.-dollar-denominated senior unsecured notes, to finance its business. The firm also relies on commercial paper, which is backed by a \$1 billion revolver with a \$350 million accordion feature that expires in 2020 and a separate facility for its non-U.S. subsidiaries, to meet short-term financing needs. The credit facility used to contain a debt/total capital ratio covenant not to exceed 60%, but this was replaced with a minimum EBITDA/interest ratio of 3.0 times, which is well below current levels of 17 times based on our calculations. Pro forma for its July PTC investment, we estimate that Rockwell had total debt of \$1.9 billion, which is 1.0 times EBITDA, compared with cash and short-term investments of \$1.2 billion. We forecast that Rockwell Automation will generate average operating cash flow of nearly \$1 billion annually, while reinvesting around \$160 million (or 2.3% of sales) back into the business each year. The company has guided toward repurchasing \$1.5 billion of shares during fiscal 2018, in addition to an annual dividend of approximately \$420 million. We also forecast modest acquisition spending per year, as the firm aims to achieve at least 1 percentage point of inorganic growth, although management noted that it has a few larger deals in the pipeline. Combined, this should lead to rising debt and supports our rising leverage forecast of around 1.5 times. Rockwell faces a benign maturity schedule: Its only meaningful obligation coming due over the next five years is a \$300 million bond that matures in March 2020. We expect the company will look to refinance this maturity.

**Exhibit 7** Capital Structure June 2018 Pro Forma for the PTC Investment (\$s in Millions)

Type	Maturity in USD	Debt/ EBITDA
Commerical Paper	\$ 675	
2.05% Senior notes	2020 \$ 300	
2.875% Senior notes	2025 \$ 300	
6.70% Senior notes	2028 \$ 250	
6.25% Senior notes	2037 \$ 250	
5.20% Senior notes	2098 \$ 200	
Unamortized discount and other	\$ (72)	
Total Gross Debt	\$1,903	1.4x
Cash	\$1,164	-0.9x
Net Debt	\$ 739	0.5x
EBITDA (TTM)	\$1,351	

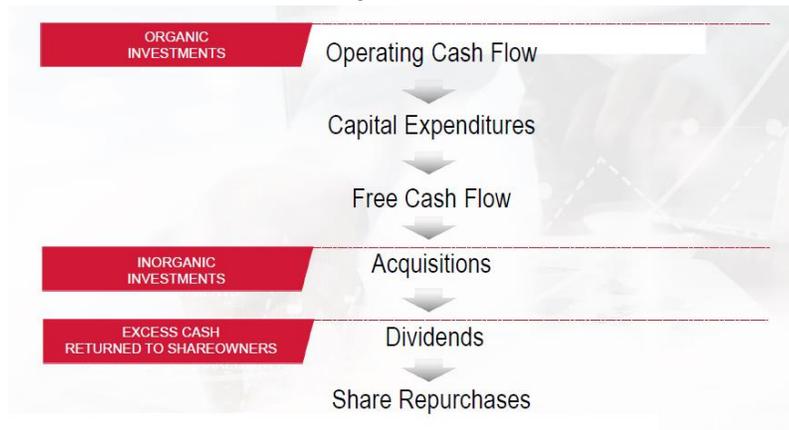
Source: Company filings, Morningstar Credit Ratings, LLC

### Capital-Allocation Policy

Rockwell Automation operates an asset-light business model with minimal capital reinvestment needs that have traditionally ranged between 2.0% and 2.5% of sales. In turn, the company targets a net income/free cash flow conversion rate of at least 100%—\$1 billion target for 2018. Having raised its dividend 10.2% in April, we forecast that the company will pay \$420 million in dividends this year, and we expect it to increase with earnings over time. Management has recently quantified its acquisition aspirations that are the equivalent of at least 1% of inorganic growth per year—it is investing \$1 billion

to buy the 10% equity stake in PTC. Recently, Rockwell announced it will return the majority of its cash on hand back to shareholders via repurchasing \$1.5 billion in shares during 2018.

#### Exhibit 8 Rockwell Automation Investing Priorities

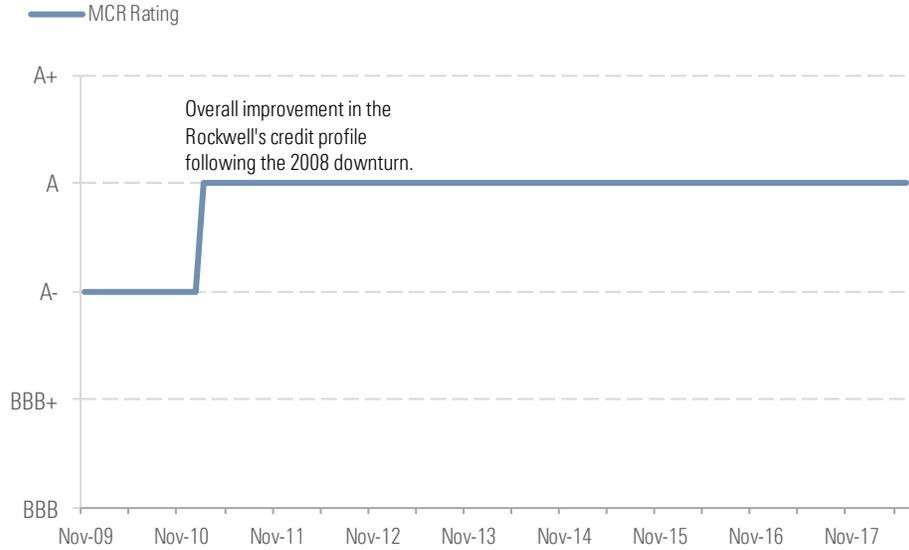


Source: Company report

#### Credit Rating History

- ▶ We initiated coverage of Rockwell Automation in November 2009 with an A- rating. Our rating at the time incorporated Rockwell Automation's solid Business Risk from its strong competitive position. This was offset by the negative effects that the recession had on its credit profile, including a nearly 50% drop in earnings and a doubling of gross leverage to 2.0 times.
- ▶ We upgraded our rating one notch to A in February 2011. The updated rating incorporated the dramatic reversal in operating results following the 2008 downturn, as EBITDA growth enabled gross leverage to contract to 0.9 times from nearly 2.0 times in 2009. ■■

**Exhibit 9** Rockwell Automation Inc Credit Rating History



Source: Morningstar Credit Rating, LLC

## Appendix

### **Rockwell Automation Moat and Trend**

The following description comes directly from Morningstar's Equity Research Group.

"In our view, Rockwell's wide economic moat is supported by a strong portfolio of intangible assets and a high degree of customer switching costs. If Logix is Rockwell's brain, then its research and development organization serves as the cells. R&D spending as a percentage of sales averaged close to 5% over the past five years. Rockwell's in-house hardware and software engineers have managed to develop a versatile system that not only bridges two distinct forms of manufacturing, but can also communicate with competing systems. In our view, this adaptability gives Rockwell the ability to grow its installed base by either displacing aging systems altogether or enhancing an already established system belonging to a competitor. Either way, Rockwell gains a foothold in the factory and can use technological innovation to continue upselling the customer even when working with components of a third-party system.

"Depending on the intensity of the process, automation systems have useful lives that can reach 20 years or longer. Consistent with this time frame, Rockwell assigns fairly lengthy useful lives to several of the intangible assets that support its installed base: Trademarks represent three to 15 years of useful life and technology five to 17 years. Even as individual components give out or software becomes obsolete, we believe that companies with robust innovation pipelines and strong customer relationships can extend the life of a branded platform for decades by implementing systematic upgrades and enhancements. As such, we believe it is feasible for Rockwell to generate economic profit consistently over the 20-year horizon indicated by our wide economic moat rating.

"Capturing market share by laying down an installed base of equipment remains one of the most important advantages for many manufacturers of industrial equipment. Not only does a vast installed base often represent significant customer commitment in the form of invested capital, but it also serves as a barrier to entry. Economic lives assigned to customer relationships on Rockwell's balance sheet span anywhere from eight to 20 years, a statistic that supports a high degree of customer stickiness. Customers are loath to overhaul a manufacturing system when what they have is good enough, as the threat of costly downtime is often enough to deter manufacturers from frequently considering large-scale upgrades.

"In Rockwell's favor, it remains the only company capable of controlling both discrete and manufacturing systems on a common platform. The company already enjoys strong market share in discrete manufacturing through the legacy of its Allen-Bradley line; however, it has taken the better part of a decade for Rockwell to chip away at established vendors such as Siemens and Emerson in process-oriented applications. Nevertheless, the versatility of the platform provides Rockwell with an edge. Rather than completely displacing a competing system, Rockwell can deploy experienced engineers to make Logix talk with virtually any existing factory configuration. As such, customers that have historically relied on separate vendors for different systems across the factory floor can eventually control the entire manufacturing operation through Logix. Rockwell's formerly stalwart competitors have certainly taken notice, as evidenced by Emerson's recent unsolicited proposals to acquire Rockwell.

"Furthermore, Logix's Ethernet-enabled platform can reach beyond the factory floor, enabling the full potential of a connected enterprise inspired by the "Internet of Things" movement. Traditionally, factory automation systems operated in a closed-loop network, providing few points of outside access in order to preserve security. Rockwell partners with Cisco to provide secure connectivity to corporate enterprise systems, allowing for enhanced data collection, monitoring, and analytics that can inform labor scheduling, maintenance, and sourcing systems. This scalability supports a compelling value proposition from the customer's perspective and provides Rockwell with the opportunity to increase customers' reliance on its system as their needs evolve.

"We assign Rockwell a stable moat trend. Rockwell's versatile, scalable Logix system remains the only automation platform in the industry capable of controlling a complex manufacturing operation on a common platform. While this remains a clear source of competitive differentiation, the manufacturing industry is notoriously slow in rolling out technology upgrades of any kind, whether equipment or software-related. For us to ascribe a positive moat trend to Rockwell, we'd need greater evidence that incremental spending with existing customers increases over time, suggesting strengthening switching costs. Furthermore, lengthy upgrade cycles invite competition; for example, over the past five years, GE managed to develop Predix, an open system that advertises a robust array of automation and predictive analytics capabilities. As such, we believe that the next generation of automation systems incorporating enhanced connectivity is still in its early days, and the Internet of Things has definitely captured the attention of well-capitalized competitors like Emerson, Honeywell, and Siemens. We believe that Rockwell's wide moat will protect its positioning in this growing market, but we suspect that it will be difficult for any one of Rockwell's moat sources to strengthen if, or perhaps more certainly when, competition intensifies."

**Exhibit 10** Descriptors for Pillar Analysis

Rating Pillars					
Score Range		Business Risk	Cash Flow Cushion	Solvency Score	Distance to Default
Strongest	1-2	Minimal	Very Strong	Very Strong	Very Strong
	3-4	Low	Strong	Strong	Strong
	5-6	Moderate	Moderate	Moderate	Moderate
	7-8	High	Weak	Weak	Weak
Weakest	9-10	Very High	Very Weak	Very Weak	Very Weak

**Business Risk Pillar Components**

Country Risk (10% of Business Risk Score)

Weakest	Very High Risk
	High Risk
	Moderate Risk
Strongest	Low Risk

**Company Risk (90% of Business Risk Score)**

	Size	Economic Moat	Competitive Advantage	or Sustainable Uncertainty
Weakest	Very Small	None	None	Extreme
	Small			Very High
	Moderate	Narrow	Moderate	High
	Large			Medium
Strongest	Very Large	Wide	Substantial	Low
	Product/Customer Concentration	Management	Dependence on Capital Markets	Cyclicality
Weakest	Highly Concentrated	Aggressive	Extremely Dependent	Highly Cyclical
	Concentrated	Fairly Aggressive	Highly Dependent	Cyclical
	Neutral	Neutral	Dependent	Average Cyclicality
	Diversified	Fairly Conservative	Low Dependence	Mild Cyclicality
Strongest	Highly Diversified	Conservative	Very Low Dependence	Non-Cyclical

Source: Morningstar Credit Ratings, LLC

Economic Moat provided by Morningstar's Equity Research Group

## Morningstar® Credit Research

### For More Information

Todd Serpico  
+1 312 384-5488  
todd.serpico@morningstar.com



22 West Washington Street  
Chicago, IL 60602 USA

©2018 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. The information, data, analyses, and opinions presented herein do not constitute investment advice; are provided solely for informational purposes and therefore are not an offer to buy or sell a security; and are not warranted to be correct, complete, or accurate. The opinions expressed are as of the date written and are subject to change without notice. Except as otherwise required by law, Morningstar shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses, or opinions or their use. References to "Morningstar Credit Ratings" refer to ratings issued by Morningstar Credit Ratings, LLC, a credit rating agency registered with the Securities and Exchange Commission as a nationally recognized statistical rating organization ("NRSRO"). Under its NRSRO registration, Morningstar Credit Ratings issues credit ratings on financial institutions (e.g., banks), corporate issuers, and asset-backed securities. While Morningstar Credit Ratings issues credit ratings on insurance companies, those ratings are not issued under its NRSRO registration. All Morningstar credit ratings and related analysis are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. Morningstar credit ratings and related analysis should not be considered without an understanding and review of our methodologies, disclaimers, disclosures, and other important information found at <http://morningstarcreditratings.com>. Investment research is produced and issued by subsidiaries of Morningstar, Inc. including, but not limited to, Morningstar Research Services LLC, registered with and governed by the U.S. Securities and Exchange Commission. The information contained herein is the proprietary property of Morningstar and may not be reproduced, in whole or in part, or used in any manner, without the prior written consent of Morningstar. To license the research, contact Vanessa Sussman (+1 646 560-4541) or by email to: [vanessa.sussman@morningstar.com](mailto:vanessa.sussman@morningstar.com).