

28 April 2014 | 15 pages

Machinery
Western Europe | Sweden

Sandvik (SAND.ST)

How Much More Can Sandvik's Orders Fall?

■ Estimate Change

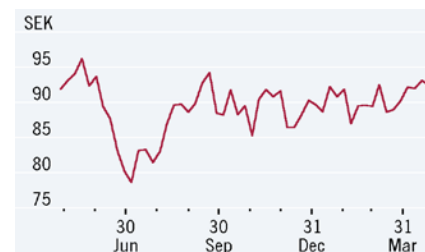
■ **Waiting For Short-Term Headwinds To Clear** — Yet another earnings miss by Sandvik (5% miss on clean EBIT vs SME consensus), but there was some positives in Sandvik's results: 1) pricing in Mining still holding up qoq, 2) aftermarket is more stable (similar to Metso), and 3) whilst equipment orders slipped this quarter, orders are now at a very low level. Equipment orders down 75% since peak, similar to CAT, and Komatsu are now talking about orders at a ten-year low in FY3/15. In this note, we discuss how much further Sandvik's orders in Mining can fall. Conclusion is that the next leg down (beyond 2014) seems to be more limited to buildings and structures, not upstream equipment. We also look at Sandvik's ROCE potential, concluding that the market is currently pricing in a static ROCE of ~15% (1Q14 adjusted), whilst Sandvik's supply chain effort can drive FCF conversion close to best in class peers Atlas Copco and Assa Abloy (from 60% FCF conversion to >90%) and thus expand ROCE to at least 21%. A potential divestment of SMT could almost close the gap to Sandvik's ROCE target of 25%. The long-term potential is clearly there but it is too early though to get constructive as we are concerned about the sharp underperformance of Construction vs CAT and Volvo and think equipment orders and margin in Mining can still be volatile until 2H14. We transfer coverage from Natalia Mamaeva to Klas Bergelind, keeping Neutral and our SKr 90 TP.

■ **2Q Likely To Be Yet Another Messy Quarter** — Four reasons to be careful going into 2Q14: 1) The SKr 500m in cyclical savings in Mining have already reached full run-rate vs target 2Q14; with sales sequentially weaker (orders missed this quarter) and limited sequential savings to protect profitability, we think the margin in Mining can fall to 8.5% vs 10.4% in 1Q14; 2) No seasonal build-up of inventory in SMS expected, thus margin up only with volume increase; 3) Construction still carry too much inventory, which suggests no margin expansion until 2H14; and 4) Venture will carry out a maintenance stop in the quarter, so no margin expansion from 1Q.

■ **Adding Sandvik's relative EV/EBIT to our Target Price** – TP continues to be based on our DCF but have added our target sector EV/EBIT multiple (11x) on our 2015 forecasts reflecting Sandvik's relative valuation over the last 10 years.

Neutral	2
Price (25 Apr 14)	SKr92.45
Target price	SKr90.00
Expected share price return	-2.7%
Expected dividend yield	3.8%
Expected total return	1.1%
Market Cap	SKr115,968M
	US\$17,601M

Price Performance
(RIC: SAND.ST, BB: SAND SS)



Sandvik (SEK)

Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Sales (SKrM)	98,529.0	87,327.0	87,173.2	91,848.1	96,000.3
Net Income (SKrM)	8,949.8	6,794.8	6,520.2	8,088.5	9,534.9
Diluted EPS (SKr)	7.13	5.42	5.20	6.45	7.60
Diluted EPS (Old) (SKr)	7.23	5.70	6.03	6.56	na
PE (x)	13.0	17.1	17.8	14.3	12.2
EV/EBITDA (x)	5.9	7.8	7.4	7.5	5.6
DPS (SKr)	3.50	3.50	3.50	3.75	4.01
Net Div Yield (%)	3.8	3.8	3.8	4.1	4.3

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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SAND.ST: Fiscal year end 31-Dec						Price: SKr92.45; TP: SKr90.00; Market Cap: SKr115,968m; Recomm: Neutral					
Profit & Loss (SKrm)	2012	2013	2014E	2015E	2016E	Valuation ratios	2012	2013	2014E	2015E	2016E
Sales revenue	98,529	87,327	87,173	91,848	96,000	PE (x)	13.0	17.1	17.8	14.3	12.2
Cost of sales	-63,826	-58,846	-56,092	-60,685	-59,627	PB (x)	3.6	3.5	3.3	3.1	2.8
Gross profit	34,703	28,481	31,081	31,163	36,373	EV/EBITDA (x)	5.9	7.8	7.4	7.5	5.6
Gross Margin (%)	35.2	32.6	35.7	33.9	37.9	FCF yield (%)	6.1	0.8	6.1	3.9	7.3
EBITDA (Adj)	17,812	13,329	15,056	14,898	19,569	Dividend yield (%)	3.8	3.8	3.8	4.1	4.3
EBITDA Margin (Adj) (%)	18.1	15.3	17.3	16.2	20.4	Payout ratio (%)	49	65	67	58	53
Depreciation	-4,322	-4,690	-4,201	-4,501	-4,704	ROE (%)	25.0	15.2	19.2	17.2	24.0
Amortisation	0	0	0	0	0	Cashflow (SKrm)	2012	2013	2014E	2015E	2016E
EBIT (Adj)	14,690	11,042	10,728	12,898	14,865	EBITDA	17,812	13,329	15,056	14,898	19,569
EBIT Margin (Adj) (%)	14.9	12.6	12.3	14.0	15.5	Working capital	-592	1,672	1,591	-765	-3
Net interest	0	0	0	0	0	Other	-5,328	-9,868	-4,375	-4,152	-5,336
Associates	0	0	0	0	0	Operating cashflow	11,892	5,133	12,271	9,982	14,230
Non-op/Except	-1,974	-1,885	-1,900	-1,900	-1,900	Capex	-4,820	-4,186	-5,217	-5,511	-5,760
Pre-tax profit	11,516	6,754	8,954	8,498	12,965	Net acq/disposals	889	-338	-4,774	0	0
Tax	-3,409	-1,746	-2,346	-2,252	-3,436	Other	0	0	0	0	0
Extraord./Min.Int./Pref.div.	-2	5	5	5	5	Investing cashflow	-3,931	-4,524	-9,991	-5,511	-5,760
Reported net profit	8,105	5,013	6,613	6,251	9,535	Dividends paid	-4,082	-4,394	-4,390	-4,390	-4,698
Net Margin (%)	8.2	5.7	7.6	6.8	9.9	Financing cashflow	489	-9,265	-7,007	-4,390	-4,698
Core NPAT	8,950	6,795	6,520	8,088	9,535	Net change in cash	8,450	-8,656	-4,728	80	3,772
Per share data	2012	2013	2014E	2015E	2016E	Free cashflow to s/holders	7,072	947	7,054	4,471	8,470
Reported EPS (SKr)	6.46	4.00	5.27	4.98	7.60						
Core EPS (SKr)	7.13	5.42	5.20	6.45	7.60						
DPS (SKr)	3.50	3.50	3.50	3.75	4.01						
CFPS (SKr)	9.48	4.09	9.78	7.96	11.34						
FCFPS (SKr)	5.64	0.75	5.62	3.56	6.75						
BVPS (SKr)	25.85	26.71	28.27	29.75	33.61						
Wtd avg ord shares (m)	1,254	1,254	1,254	1,254	1,254						
Wtd avg diluted shares (m)	1,254	1,254	1,254	1,254	1,254						
Growth rates	2012	2013	2014E	2015E	2016E						
Sales revenue (%)	4.7	-11.4	-0.2	5.4	4.5						
EBIT (Adj) (%)	7.3	-24.8	-2.8	20.2	15.3						
Core NPAT (%)	10.8	-24.1	-4.0	24.1	17.9						
Core EPS (%)	4.8	-24.1	-4.0	24.1	17.9						
Balance Sheet (SKrm)	2012	2013	2014E	2015E	2016E						
Cash & cash equiv.	13,829	5,076	335	415	4,187						
Accounts receivables	21,511	20,136	19,875	20,941	21,600						
Inventory	25,508	23,318	22,462	23,421	24,000						
Net fixed & other tangibles	25,516	25,255	28,564	29,575	30,631						
Goodwill & intangibles	11,423	11,947	14,387	14,387	14,387						
Financial & other assets	6,268	8,150	8,290	8,290	8,290						
Total assets	104,055	93,882	93,913	97,029	103,095						
Accounts payable	0	0	0	0	0						
Short-term debt	2,698	7,047	4,774	4,774	4,774						
Long-term debt	0	0	0	0	0						
Provisions & other liab	68,821	53,225	53,588	54,849	56,083						
Total liabilities	71,519	60,272	58,362	59,623	60,857						
Shareholders' equity	32,429	33,510	35,456	37,316	42,154						
Minority interests	107	100	95	90	84						
Total equity	32,536	33,610	35,551	37,406	42,238						
Net debt	-11,131	1,971	4,439	4,359	587						
Net debt to equity (%)	-34.2	5.9	12.5	11.7	1.4						

For definitions of the items in this table, please click [here](#).

How Much More Can Sandvik's Orders Fall?

Yet another earnings miss by Sandvik, but there was some positives in Sandvik's results: 1) pricing in Mining still holding up qoq, 2) aftermarket is more stable (similar to Metso), and 3) whilst equipment orders slipped this quarter, orders are now at a very low level. Equipment orders down 75% since peak, similar to CAT, and Komatsu are now talking about orders at a ten-year low in FY3/15. In this note, we discuss how much further Sandvik's orders in Mining can fall. Conclusion is that the next leg down (beyond 2014) seems to be more limited to buildings and structures, not upstream equipment. We also look at Sandvik's ROCE potential, concluding that the market is currently pricing in a static ROCE of ~15% (1Q14 adjusted), whilst Sandvik's supply chain effort can drive FCF conversion close to best in class peers Atlas Copco and Assa Abloy (from 60% FCF conversion to >90%) and thus expand ROCE to at least 21%. A potential divestment of SMT could almost close the gap to Sandvik's ROCE target of 25%. If the current headwinds in Construction levels off in 2H14 (demand is picking up in DM, according to at least 10 companies so far this reporting season), we think the equity story will start to look interesting. A 21% ROCE at present value suggests upside to SKr 115, at 25% ROCE suggests upside to SKr 145. We stay at Neutral, as we are concerned about the sharp underperformance of Construction vs CAT and Volvo and think equipment orders and margin in Mining can still be volatile until 2H14. We transfer coverage from Natalia Mamaeva to Klas Bergelind, keeping Neutral and our SKr 90 target price.

2Q likely to be yet another messy quarter

Four reasons to be careful going into 2Q14: 1) The SKr 500m in cyclical savings in Mining have already reached full run-rate vs target 2Q14; with sales sequentially weaker (orders missed this quarter) and limited sequential savings to protect profitability, we think the margin in Mining can fall to 8.5% vs 10.4% in 1Q14; 2) No seasonal build-up of inventory in SMS expected, thus margin up only with volume increase, which suggest a flattish margin qoq; 3) Construction still carry too much inventory, which suggests no margin expansion until 2H13; and 4) Venture will carry out a maintenance stop in the quarter, so no margin expansion from 1Q's 17.1%.

Mining Orders: trough to be seen 2H14, in our view

Total Mining capex in Australia is down 18% from the peak in 2012, which is also mirroring our capex model (including capex projections for 40 miners). Within that exploration and equipment will have fallen ~70% through to 2014 with infrastructure spend (buildings, structures, processing plants) down 30%. The Australian Bureau of Statistics have provided 10 scenarios of how Mining capex might fall in 2015-16, providing a range of 10-30% (i.e., an accelerated fall from what we have seen thus far and a clear reason to be prudent when setting our volume forecasts). Just eye-balling figure 2 below suggests a 70% cumulative fall in total capex from today's level in total spend just to reach a more normalized level of AUS 7-8bn, or pre super-cycle years. There are, however, reasons to believe that the equipment component (upstream products supplied by Sandvik such as drill rigs and loaders) will soon trough and that the further leg down will be limited to buildings, structures.

We make the following three points.

- There has been a clear shift of the composition of Mining capex pre and post the super-cycle years. From the 1990s to just before the super-cycle started in 2003, spending on equipment and infrastructure was equally split at 50%, but this clearly shifted when the miners started to chase significant growth post 2003. Data from the Australian Bureau of statistics suggests only 15% of total spend was equipment at the 2012 peak, with most of the growth in the super-cycle

stemming from investments in building, structures and ports. We believe this is the case elsewhere, not only in Australia, with Vale recently telling our US capex goods team that the share of spending towards equipment now had halved vs historical averages. The bet on super-cycle growth meant increased Greenfield spending and the trend towards larger mines and often in remote locations meant that there was a clear need to ramp infrastructure. We still expect further capex cuts to be visible in 2014-15, but this as a result of that existing greenfield projects wrap up with few new projects being added, hitting infrastructure spend further, not so much equipment. Above all, we believe that the shift now towards brownfield investments can help equipment spend to stabilize.

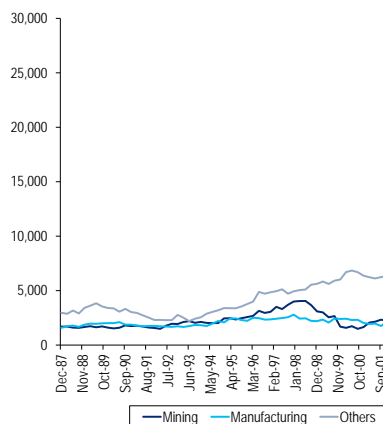
- The reason for equipment and exploration falling quicker than infrastructure spending (down 60-70% from the peak vs infrastructure only down 10% thus far) is that it is more difficult for a miner to stop the construction of a large-scale facility once it is substantially started. Cutting back equipment spending is relatively easy, such as utilizing two drill rigs instead of three. We don't expect a recovery in equipment spending, but we want to make the point that spending on equipment has already fallen a long way. Caterpillar recently highlighted that equipment sales in Mining were currently at half of the replacement level, which together with increased production at mines, and a push-back on services, would mean increased wear and tear of the existing fleet which could lead to some improvement in orders rates in 2H14.
- CAT during its 1Q14 conference call said that orders for Mining trucks were down 80% from the peak, very close to the numbers we get when we strip out aftermarket and systems orders for Sandvik - orders down 75% from 1H12 (SKr 1.5bn in 1Q14 orders; annualized SKr 6bn vs SKr 24bn at peak 1H12). When we use these numbers as a proxy for Australia, we can see that this represent a level of AUS 1bn in equipment demand. This is approximately 50% of total capex before the super-cycle years in Australia (i.e., the average spending in 1997-2003). To see demand falling further from this level seems highly unlikely, in our view. Not only do we think the existing fleet is being run down hard right now given the aggressive push back on services (need of replacement grows with every quarter of delayed repair work), but to see equipment demand falling further we believe China needs to collapse, given the step change in the country's share of consumption of global commodities.

Figure 1. Australian Mining Capex

Total Mining Capex (annualised)	1H12	1H14	2014	2015	2016
Equipment	3,675	1,470	1,029	1,080	1,188
% change		-60%	-30%	5%	10%
% share	15%	7%	7%	11%	17%
vs peak		-60%	-72%	-71%	-68%
Infrastructure	20,825	18,743	14,057	9,137	5,939
% change		-10%	-25%	-35%	-35%
% share	85%	93%	93%	89%	83%
vs peak		-10%	-33%	-56%	-71%
Total spend (\$Amn)	24,500	20,213	15,086	10,217	7,128
% change		-18%	-25%	-32%	-30%

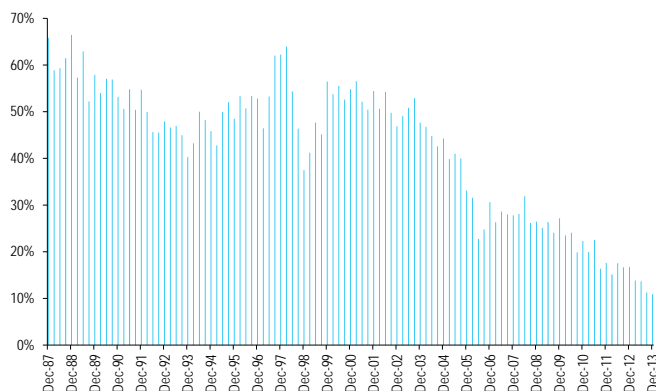
Source: Australian Bureau of Statistics, Citi Research

Figure 2. Australian Capex by broad industry sector



Source: ABS, Citi Research

Figure 3. Equipment as % of Australian Mining Capex has fallen sharply since the super-cycle



Source: ABS, Citi Research

Organic ROCE uplift still possible; potential divestment of SMT to almost close the gap to 25% ROCE

As part of Sandvik's strategy (announced in September 2011) and response to weakness in its end market, CEO Olof Faxanader have announced a myriad of cost cutting efforts, such as adjustments owing to over-capacity at the previous peak (SMS, Mining), the step-change program in SMT (to improve the mix, reduction of costs enabling an improvement of ROCE) and the cost cutting due to cyclical weakness in Mining and Construction.

Sandvik's latest announcement during the CMD in September 2013 (supply chain optimization) was however more credible in our view as it addressed the core issue of how to improve the ROCE at a group level and not just by a single division. The main difference compared with previous actions is that Sandvik is now taking out real capacity (factory closures) vs. just staff and is now working to improve the inventory turns in Mining by centralizing its supply chain vs carrying too much inventories locally (a legacy of over 30 acquisitions since the 1980s).

Sandvik's ROCE has considerably lagged its peers with ROCE halving since the 2008 peak vs key peer Atlas seeing returns relatively flat. What is concerning is that this has happened amid only a 7% fall in volumes and with only limited build-up of intangibles. The 2013 September announcement however showed that management takes the problem with Sandvik's low returns seriously, in our view. Fixing the inventory problem in Mining is a defining factor to improve ROCE closer to the previous peak of 27% (2008). Sandvik's target is to improve ROCE to 25% in 2016-17 (within 3-4 years from the 2013 CMD).

Sandvik's program, announced in September 2013, targets a cut in the number of production units from 150 to 125 over the next 3 to 4 years. The initial phase of the program (details specified in December 2013) will affect around 10 production units (predominantly in Europe). Around half of these sites are in Mining, rest in SMS.

In Figure 4 and Figure 5 below, we summarize the costs and benefits from all the restructuring actions since 2011. In total, we expect Sandvik to spend c. SKr 7.4bn and attain savings of SKr 6.1bn by 2016. We estimate SKr2.8bn of the cost savings

still to be realized, which accounts for more than c.7-8% of 2014-15E clean EBIT, respectively.

We expect a SKr 2bn release of working capital, as a result of the new supply chain, effectively seeing Sandvik reaching its 25% WC/Sales target in 2016-17 vs 28% currently. This should lift FCF cash conversion from 50-60% through the cycle average to 90% 2014-16, which is in line with best in class peers Atlas Copco and Assa Abloy. Together with the incremental cost savings (structural, capacity closures), this will lift ROCE to 21% 2016/17, up from 15% currently. Below, in the valuation section, we show that this is currently not priced by the market.

Figure 4. Restructuring Cash Costs (by segment) over 2011-2015E

	2011	2012	2013	2014E	2015E	2016E
Mining	223	170	750	0	1,000	0
SMS	200	83	490	0	1,125	0
SMT	1,400	668	0	0	0	0
Construction	367	0	200	0	375	0
Venture	172	0	200	0	0	0
Cost	2,363	921	1,640	0	2,500	0
Cumulative	2,363	3,284	4,924	4,924	7,424	7,424

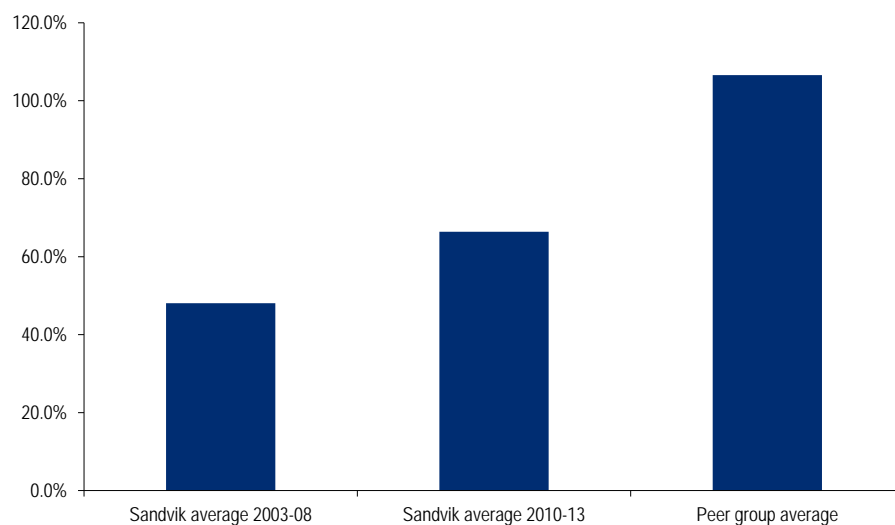
Source: Company reports, Citi Research

Figure 5. YoY Cost Savings (by segment) Over 2011-20106E

	2011	2012	2013	2014E	2015E	2016E
Mining	0	105	388	616	448	458
SMS	440	646	89	192	244	407
SMT	0	640	300	125	75	0
Construction	0	400	211	44	83	153
Venture	0	40	0	0	0	0
Savings	440	1,831	988	976	850	1,018
Cumulative	440	2,271	3,259	4,235	5,085	6,103

Source: Company reports, Citi Research

Figure 6. Sandvik FCF Conversion has lagged peers considerably in the past; Step-Up closer to best in class peer Atlas Copco and Assa Abloy FY14 onwards*



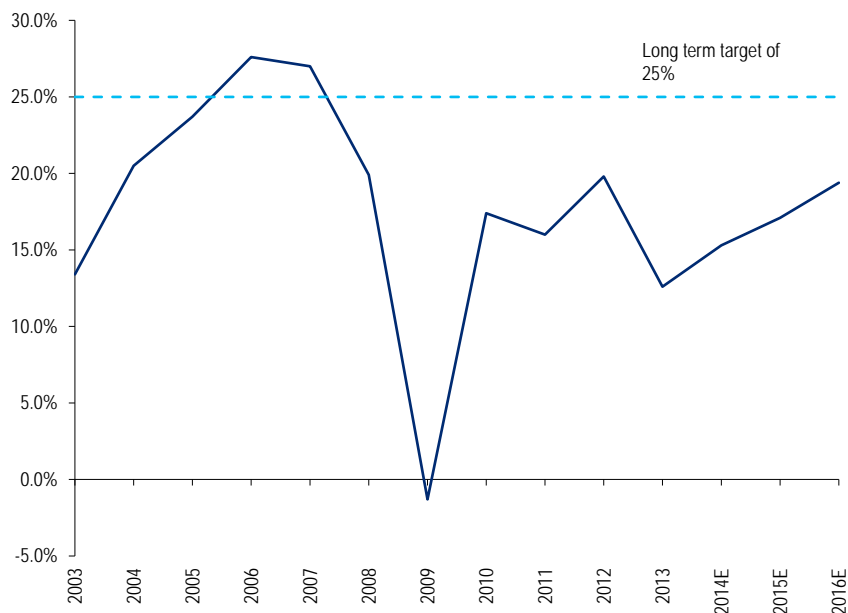
Source: Citi Research; Company Reports; *Peer Group average between 2003-2010

Figure 7. Sandvik Free Cash Conversion: Step Change towards best in Class Peers

	2014E	2015E	2016E	2017E
Operating Cash Flow	12,271	9,982	14,230	15,810
Capex	-5,217	-5,511	-5,760	-6,221
Free Cash Flow	7,054	4,471	8,470	9,589
Net Income	6,613	6,251	9,535	8,822
Free Cash Flow conversion	107%	72%	89%	92%

Source: Citi Research; Company Report

Figure 8. Sandvik ROCE development



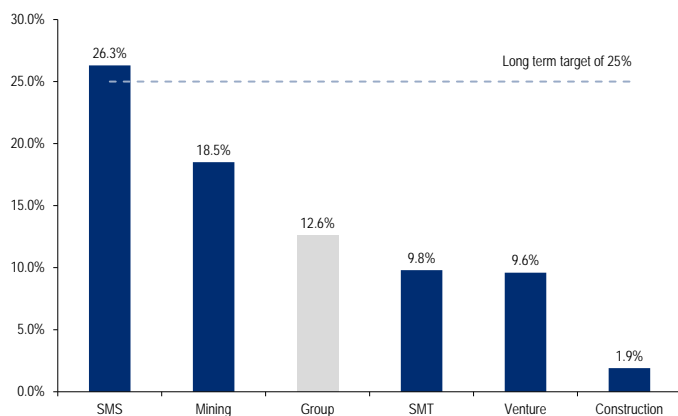
Source: Company Report, Citi Research

Figure 9. Sandvik ROCE – Citi assumptions

ROCE Calculations	2014E	2015E	2016E	2017E
Sh Equity	35,456	37,316	42,154	42,154
Interest Bearing Debt	37,562	37,285	33,479	28,889
Operating Cash Flow	12,270	10,179	14,264	15,810
<i>o/w Change in WC</i>	-267	867	600	1,440
M&A	-4,800	0	0	0
Capex	-5,217	-5,511	-5,760	-6,221
Dividend	-4,390	-4,390	-4,698	-5,000
Delta cash flow (reduction in interest bearing debt)	-2,138	278	3,806	4,589
Capital Employed	73,018	74,601	75,632	71,043
Avg Capital Employed	70,976	73,809	75,117	73,338
EBIT	10,854	12,898	14,865	15,967
ROCE	15.3%	17.5%	19.8%	21.8%
Net Working Capital	23,014	23,881	24,480	25,920
% of Sales	26.4%	26.0%	25.5%	25.0%

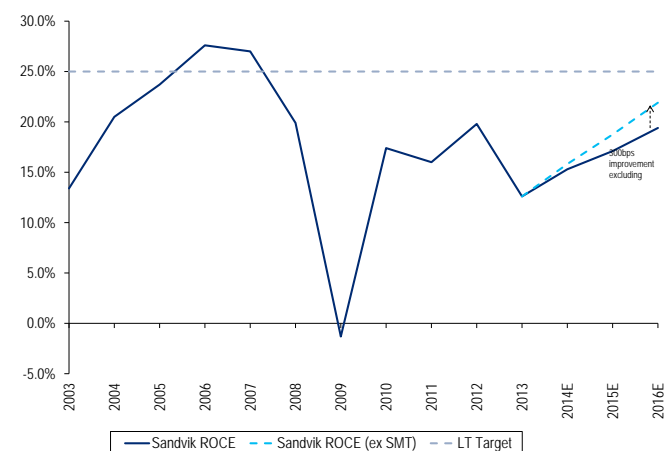
Source: Citi Research; Company Reports

Figure 10. Sandvik ROCE by segment



Source: Citi Research

Figure 11. Spinning off SMT to Boost ROCE by 300bps*



Source: Citi Research. *When Sandvik presented its new strategy in 2011, under the new CEO Olof Faxander, it said that a divestment of SMT could be possible within 2-3 years

Market pricing in a static ROCE; upside to SKr 115 if Sandvik achieves 21% ROCE by 2016/17

To be clear, we believe it is too early to turn constructive on Sandvik given expectations of continued margin dwindle in both Mining and Construction for the next couple of quarters. The belief in a ROCE improvement and thus a re-rating, can only happen if investors can be sure that earnings have troughed.

Figure 12. Sandvik Share Price under Three ROCE scenarios

	Current	2016/17	2016/17
ROCE	15.0%	21.0%	25.0%
WACC	8.5%	8.5%	8.5%
g	2.5%	2.5%	2.5%
Tax	28.0%	28.0%	28.0%
EV/CE	1.95	3.00	3.67
Capital Employed	74,601	71,043	71,043
Enterprise value	145,472	213,129	260,728
Less: Net debt incl pensions, or Add: net cash	-32,809	-28,889	-28,889
Less: market value of minorities	-279	-300	-300
Equity	112,384	183,940	231,538
Number of shares	1,254	1,254	1,254
Present Value	90	115	145

Source: Citi Research; Company Reports

New forecasts

We transfer coverage from Natalia Mamaeva to Klas Bergelind. Our FY14E EPS is cut by 9% due to lower volumes and margins in Mining and Construction. Our FY15E EPS is increased by 7%, as we have now have included the acquisition of Varel and due to our changed view of the realization of Sandvik's cost savings following a detailed analysis of Sandvik's restructuring plan.

Valuation and target price

We transfer coverage and continue to base our target price on our DCF, but is also adding our sector target EV/EBIT multiple of 11x on our 2015 forecasts, to reflect Sandvik's relative valuation over the last ten years (Sandvik valued in line with the sector). Our target price of SKr 90 remains unchanged.

Figure 13. Sandvik Valuation Table

Sandvik Valuation History	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E	LT avg	Norm avg
Share price average/actual	43.0	51.0	64.5	85.8	125.0	82.3	64.8	97.9	102.4	94.4	93.0	92.5	92.5	92.5		
EV/Sales	1.4x	1.4x	1.5x	1.7x	2.1x	1.4x	1.5x	1.7x	1.6x	1.5x	1.7x	1.7x	1.6x	1.5x	1.6x	1.6x
EV/EBITDA	7.5x	7.8x	7.9x	8.0x	9.7x	7.4x	17.4x	9.5x	7.6x	7.7x	9.3x	10.0x	8.6x	7.4x	9.1x	8.2x
EV/EBIT clean	12.0x	11.1x	10.1x	9.9x	11.7x	9.2x	64.2x	13.0x	10.9x	9.9x	13.3x	13.9x	11.5x	9.8x	15.9x	11.3x
EV/EBIT	13.5x	10.9x	10.2x	10.0x	12.4x	10.4x	-77.0x	12.8x	14.7x	10.8x	17.0x	13.7x	14.3x	9.8x	4.1x	12.7x
EV/CE	1.9x	2.2x	2.4x	2.7x	3.0x	1.9x	1.8x	2.4x	2.4x	2.4x	2.3x	2.2x	2.1x	2.0x	2.3x	2.4x
PE clean	17.0x	15.2x	13.4x	13.6x	15.7x	11.7x	-240.6x	18.3x	15.0x	12.4x	17.2x	17.8x	14.3x	12.2x	-8.3x	15.3x
PE reported	19.7x	14.8x	13.3x	13.5x	16.3x	13.1x	-29.0x	17.5x	22.1x	14.5x	23.3x	17.5x	18.6x	12.2x	12.6x	18.0x
FCF yield	5.9%	3.6%	4.5%	3.2%	0.1%	2.6%	10.0%	7.6%	2.3%	6.0%	0.8%	6.1%	3.9%	7.3%	4.2%	5.3%
Dividend yield	4.9%	4.3%	4.2%	3.8%	3.2%	3.8%	1.5%	3.1%	3.2%	3.7%	3.8%	3.8%	4.1%	4.3%	3.6%	3.3%
P/B	2.6x	2.9x	3.4x	4.0x	5.2x	2.7x	2.7x	3.6x	3.7x	3.7x	3.5x	3.3x	3.1x	2.8x	3.4x	3.7x

Source: Datastream, Citi Research

Sandvik

Company description

Sandvik AB is a high-technology engineering group with advanced products and business activities that are conducted through representation in 130 countries. Divisions include: Mining, Machining Solutions, Materials Technology, Construction and Venture.

Investment strategy

Despite another earnings miss by Sandvik, there were some positives noted in 1Q14 earnings: 1) pricing in Mining still holding up, 2) aftermarket is more stable, and 3) equipment orders are now at a very low level (down 75% since peak similar to CAT and Komatsu). We believe the next leg down (beyond 2014) seems to be more limited to buildings and structures, not upstream equipment. Market is currently pricing in a static Sandvik ROCE of ~15%, whilst Sandvik's supply chain effort can drive FCF conversion close to best in class peers (from 60% FCF conversion to >90%) and thus expand ROCE to at least 21%. A potential divestment of SMT could close the gap to Sandvik's ROCE target of 25%. The long-term potential is clearly there but it is too early though to get constructive as we are concerned about the sharp underperformance of Construction vs CAT and Volvo and think equipment orders and margin in Mining can still be volatile until 2H14. We reiterate Neutral.

Valuation

Our SKr 90 TP continues to be based on our DCF but have added our target sector EV/EBIT multiple (11x) on our 2015 forecasts reflecting Sandvik's relative valuation over the last 10 years. Our DCF fair value of SKr92/share is based on a number of assumptions: Through-cycle top-line growth of 3.0% (in-line with our sector average of 3.0%), Through-cycle EBIT margins of c13%, Terminal growth of 2.5% and WACC of 8.5% (in-line with sector average).

Risks

We see a number of industry- and company-specific risks in the case of Sandvik where fluctuations could cause significant changes to our earnings forecasts and valuation and cause the shares to deviate significantly from our target price. Most notably, Sandvik is economically sensitive. High leverage, however, works both ways; when recovery eventually comes, the profit bounce-back should be equally strong. Sandvik also has notable currency risk and its Materials Technology business is exposed to metals price fluctuations.

Appendix A-1

Analyst Certification

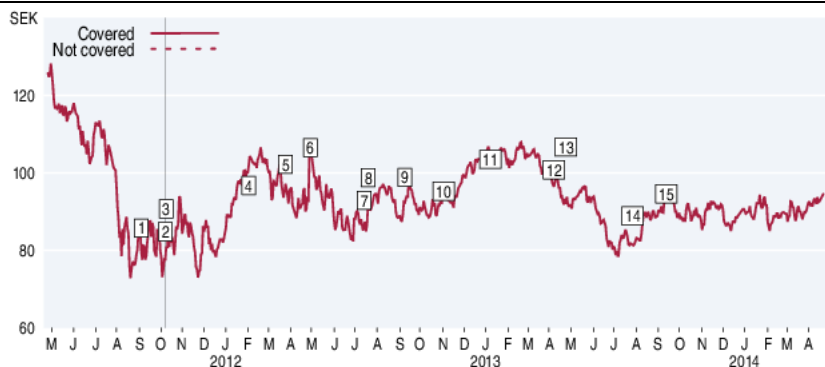
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Sandvik (SAND.ST)

Ratings and Target Price History Fundamental Research

Analyst: Natalia Mamaeva



	Date	Rating	Target Price	Closing Price
1	5-Sep-11	1H	*110.00	79.55
2	7-Oct-11	Stock rating system changed		
3	8-Oct-11	*1	110.00	77.40
4	2-Feb-12	1	*115.00	102.00
5	26-Mar-12	1	*110.00	97.20

* Indicates change

	Date	Rating	Target Price	Closing Price
6	30-Apr-12	1	*125.00	106.50
7	13-Jul-12	1	*105.00	86.45
8	19-Jul-12	1	*110.00	92.15
9	10-Sep-12	1	*100.00	92.35
10	2-Nov-12	1	*110.00	94.60

	Date	Rating	Target Price	Closing Price
11	8-Jan-13	1	*120.00	105.00
12	8-Apr-13	*2	*100.00	96.45
13	24-Apr-13	2	*90.00	92.00
14	26-Jul-13	2	*85.00	81.45
15	12-Sep-13	2	*90.00	93.50

Rating/target price changes above reflect Eastern Standard Time

Sandvik (SAND.ST)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Natalia Mamaeva



	Date	Rating	Target Price	Closing Price
1	11-Jan-12	*ADD MP	-	91.95

* Indicates change

	Date	Rating	Target Price	Closing Price
2	18-Oct-12	*REM MP	-	93.25

Rating/target price changes above reflect Eastern Standard Time

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% of companies in each rating category that are investment banking clients

12 Month Rating			Relative Rating		
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55%	53%	45%	58%	53%	42%

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