2018 Corporate Outlook: Mature Credit Cycle with Signs of Exuberance

Scope's corporate ratings team has assessed the 2018 credit outlook for the 10 main industrial sectors we cover (see next page for summary). The very mature credit cycle which began in 2010 is unlikely to end any time soon. This uninterrupted and, by historical standards, long period of healthy economic conditions has been supported over the last five years by an unprecedented combination of low oil prices, low inflation and low interest rates. Thus, 2017 qualified as another year of reduced corporate defaults.

Based on industry fundamentals and capacity utilisation, Scope does not see a recession in the near term. However, activity motivated by shareholder value considerations has increased. Examples include share buybacks or the payment of high M&A multiples, both of which tend to increase leverage. In our view, risks for external shocks from political and military conflicts have also grown.

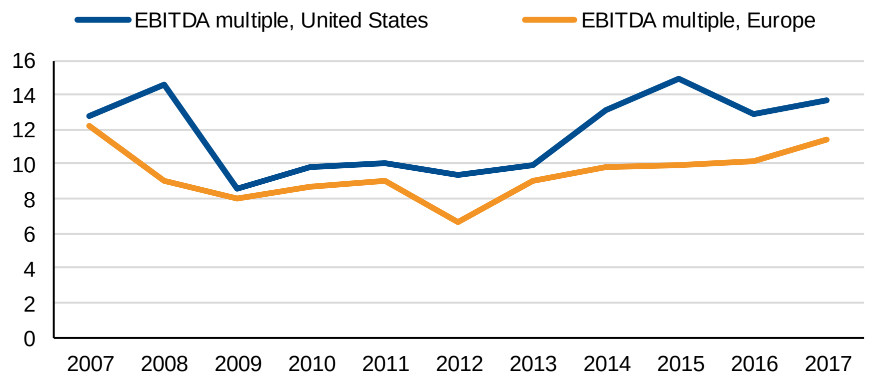
We conclude that the risk of selective downgrades, or even defaults, will rise in 2018 for companies with more aggressive financial policies or a high share of variable interest rate debt – particularly if the likelihood of an external shock puts an abrupt end to the prevailing 'party mood'.

Favourable cycle prompts record dividends and pricey takeovers

Scope's main concerns for corporates are related to share buybacks and M&A multiples, especially compared with levels before 2008, when the last global recession of unparalleled dimensions erupted. Regarding buybacks, the most extreme activity is in the United States, where this instrument plays a much larger role than in Europe. During 2006-2008, US companies allocated about USD 500bn per year to buybacks on average, more than five times that in Europe. Share buybacks in the US are expected to again reach USD 500bn in 2017, according to Goldman Sachs Investment Research; whereas the European figure is expected to be only about half its pre-crisis level. Combined with dividend allocations, many investment grade companies are distributing all or even more than free cash flow generated while productive investment in research and development continues to fall.

Acquisitions is another area in which US companies are less conservative than their European counterparts. Even so, transaction multiples in both the US and Europe have increased (Figure 1) and are again at pre-crisis levels. While current cash flows are robust enough to support more aggressive financial policies, such activity could lay the foundations for negative rating actions and defaults if economies head into a recession.

Figure 1: EBITDA multiples – all industries



Source: Bloomberg, Scope

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Related Research

Methodologies:

Corporate Rating Methodology, 9 Jan 2017

European Automotive and Commercial Vehicle Manufacturers, 14 Feb 2017

European Utilities, 12 Jan 2017

European Real Estate Corporates, 11 Jan 2017

European Construction Corporates, 11 Jan 2017

European Automotive Suppliers, 11 Jan 2017

European Pharmaceuticals, 10 Jan 2017

European Renewable Energy Corporates, 10 Jan 2017

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Corporate outlook 2018 by industry

Scope's 2018 outlook for the healthcare sector overall, and the pharmaceutical segment in particular, is stable. Innovation is a major driver for growth, and the financial policies of European pharma producers are more conservative than those of US counterparts, which acts as a protection against potential rating downgrades.

For 2018, Scope has a stable outlook for the chemicals industry. Credit metrics are expected to deteriorate slightly, especially profits among integrated chemical companies. Moreover, ongoing industry changes combined with low interest rates make higher debt levels more likely.

The 2018 outlook for real estate is stable, supported by still-lively demand among tenants and investors. Financial risk profiles have been enhanced via the ECB's ultra-loose monetary policy. However, we highlight the heightening sensitivity to political and economic conditions, as well as interest rates.

Scope's 2018 outlook for European construction is stable. Demand looks set to increase further, boosted by the real estate industry and EU-funded civil engineering projects. Low interest rates and good capital-market access also improve debt protection while maintaining leverage. Even so, growth and profits are burdened by supply chain pressures in domestic markets.

Scope's outlook for European airlines in 2018 is slightly negative. Sector fundamentals have peaked; key credit metrics are likely to deteriorate slightly. Although sector fundamentals are set to remain intact while demand grows further, overcapacity and lower passenger growth will lead to weaker credit metrics. More industry consolidation is likely.

We expect positive developments for container shipping in 2018, thanks to solid supply and demand fundamentals. Oversupply in new vessels should continue to decrease, whereas robust growth in global trade volumes is likely to support freight rates on major global trades. Nevertheless, volatility and leverage are expected to stay high. We expect industry consolidation to continue.

Scope's 2018 outlook for postal services is stable. The major drivers will again be the continued decline in classic letter mail volumes, offset by the ongoing surge in parcel volumes driven by e-commerce growth. We also expect average operating leverage to remain low and all major European players to maintain a strong financial risk profile.

We see the 2018 outlook for the automotive sector as broadly stable. For automakers, we expect limited support on revenues and earnings from light-vehicle sales growth, given our base-case growth for 2018E of less than 1%. Selected auto suppliers should continue to benefit from rising fitment rates and content per vehicle should achieve organic sales growth above our projections for light-vehicle growth.

Scope's 2018 outlook for European utilities is positive, bolstered by rebounding commodity prices and portfolio restructuring effects. Political headwinds fade as supply security through well-maintained grids and reserve capacity systems gain importance. Reduced returns on grid assets will not significantly harm regulated utilities' credit metrics. M&A is coming back on the agenda.

The overall outlook for retail in Europe is stable for 2018. While the need to finance necessary business transitions is likely to degrade credit quality slightly, it will also lead to more robust business risk profiles. The sector will continue to grow in 2018, driven by e-commerce and m-commerce (tablets and mobile phones).

Healthcare industry outlook 2018: Outlook supported by growth and innovation

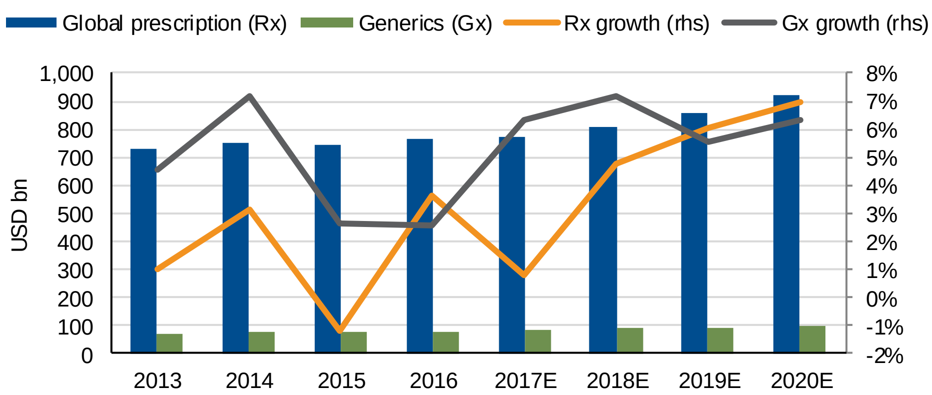
Healthcare industry outlook: stable

Scope's 2018 outlook for the healthcare sector overall, and the pharmaceutical segment in particular, is stable. This reflects a combination of favourable business-risk and financial-risk aspects which constitute Scope's corporate ratings. In our opinion, most pharma producers in Europe appear to be well cushioned against potential rating downgrades, as they employ more conservative financial policies than their US counterparts.

No macroeconomic dependence

Disease patterns are driven by different factors than GDP. This healthcare paradigm still holds true, as demonstrated by Figure 2 below. Healthcare demand across the globe continues to be driven by demographic and lifestyle-related factors as well as by emerging countries' ability and ambition to provide better coverage for their populations. We therefore predict compound annual growth of 6.5% for the global pharmaceutical industry between 2017 and 2022.

Figure 2: Global pharmaceutical market to continue growing faster than GDP



Source: Evaluate Pharma, Scope

Innovation and patent expiry costs

Our pharmaceutical company assessment features another important driver: the likely 'net effect' of innovation and patent expiry in the future, denoting the ability of a company to 're-invent' itself or generate sales growth at group level despite parallel patent expiry. The latter can be achieved either by a capable management anticipating upcoming patent expiration, and/or by lessening dependence on single drug patent expiry in the case of a diversified healthcare group, which is more often the case in Europe (Figure 3). With the exception of Johnson & Johnson (consumer healthcare products, medical devices), all large US pharma companies focus strongly on innovative products.

Figure 3: European pharmaceuticals more diversified than in the United States

	Innovative pharma*, weight in	
	Group sales	Group EBITDA
AstraZeneca plc	100%	100%
Bayer AG	40%	53%
GSK plc	60%	85%
Merck KGaA	45%	47%
Novartis AG	75%	90%
Novo Nordisk AS	100%	100%
Roche Holding AG	77%	93%
Sanofi SA	65%	80%e
Pfizer Inc	75%	90%e
Johnson & Johnson Inc	47%	65%e
BristolMyers Squibb Co	100%	100%
Celgene Corp	100%	100%
Merck & Co Inc	89%	95%e

*Defined as patent-protected drugs and vaccines, excluding generics and mature drugs, as well as OTC or animal health activities

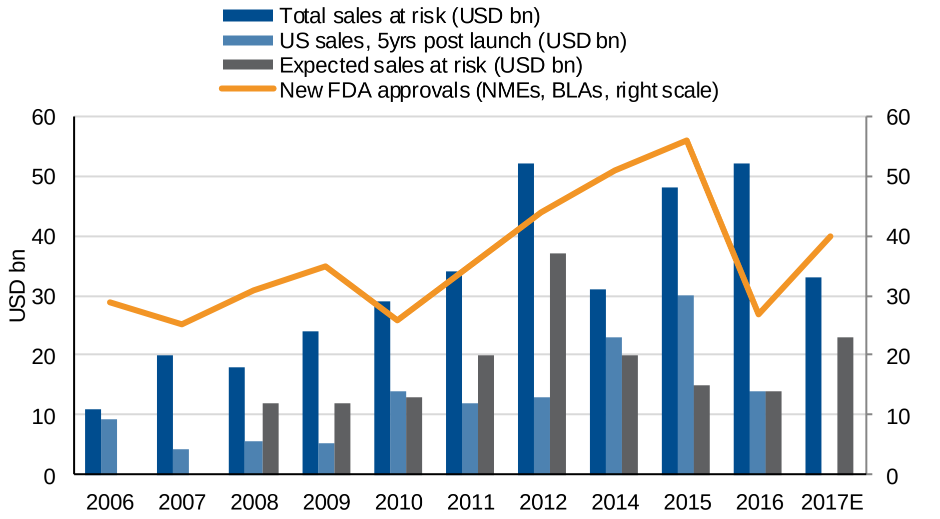
Source: Annual reports, Scope estimates

Industry dynamics continue to be favourable

Against this basic backdrop, and supported by ageing and lifestyle factors, most large European pharmaceutical companies appear in good shape for the future. Besides the above-mentioned advantages of diversification, limiting patent expiry threats, this is first and foremost due to progress in innovation. We have a favourable view of the industry's efforts over the past decade or so, which have generated significant medical benefits for patients (as demonstrated by the emergence of targeted therapies vs chemotherapy in oncology; immuno-oncology; a cure for hepatitis C; oral MS treatments).

This strong focus on R&D and innovation has also led to an increase in the number of new drug approvals in recent years. As shown in Figure 4, the industry sailed past the patent cliff remarkably swiftly in 2012. Relatively drastic worst-case scenarios for risk in 2015 and 2016 (assuming the complete loss of formerly protected drug sales) led to significantly lower expected sales at risk. This is explained by many large expiring blockbusters continuing to be relatively protected after expiry, due to either their biological nature or rare disease focus (resulting in few competitors). As a consequence, the industry has, over recent years, managed to reduce group profit-dependency on large blockbusters. Scope therefore believes that the global pharmaceuticals markets do not face a major patent problem at present.

Figure 4: Favourable risk-reward balance expected



Source: Pharm, Scope

Business risk profiles: no significant change drivers expected for 2018

We do not foresee significant negative change drivers for most pharmaceutical companies' business risk profiles in 2018. This reflects the main arguments detailed above and that regulatory pressure/adverse pricing is not new to the industry and has been well integrated into most business models. Scope believes that as long as individual companies can stay innovative when it comes to addressing the population's ever-increasing health issues they can generate comparatively high sales growth (Figure 5), operating margins and cash flow in future. Recent adverse pricing effects in the US from large payors such as Express Scripts or CVS Caremark are clearly negative, but appear to be limited to large, more crowded treatment areas such as diabetes and respiratory medicine – thereby opening up large savings potential for payors. The effects on globally active companies like Sanofi or Novo Nordisk are likely limited from a ratings perspective.

Figure 5: Positive growth scenario prevailing in the first nine months of 2017

'Like for like' growth rates, year-on-year	H1 2017	Q3 2017
(excluding currency effects, M&A)		
AstraZeneca plc	-9.0%	10.0%
Bayer AG	5.8%	4.6%
GSK plc	4.0%	2%
Merck KGaA	3.5%	2.7%
Novartis AG	2.0%	2%
Novo Nordisk AS	3.0%	3%
Roche Holding AG	5.0%	5%
Sanofi SA	0.6%	0%
Pfizer Inc	8.0%	11%
Johnson & Johnson Inc	1.2%	5.3%
BristolMyers Squibb Co	7.0%	6%
Celgene Corp	19.0%	10%
Merck & Co Inc	1.0%	1%

Source: Annual reports, Scope estimates

We believe most European pharma companies' financial risk profiles continue to be strong, as a consequence of comparatively high profit margins and cash flow generation. This is the case for most large, diversified pharma companies in Europe, with the exception of AstraZeneca and GSK, which did not sufficiently mitigate large-scale patent expiry with new products in recent years, bearing lower cash generation and higher leverage as a result (Figure 6).

Figure 6: Key financial policy indicators Europe vs United States

	Payout ratio	Share buybacks	Leverage*	
		2017 in USD m	2009	2016
AstraZeneca plc	100%	0	0.0	1.9
Bayer AG	50%	0	1.6	1.6
GSK plc	90%	0	1.1	3.2
Merck KGaA	37%	0	0.3	2.6
Novartis AG	80%	1,398	1.8	1.1
Novo Nordisk AS	50%	1,952	net cash	net cash
Roche Holding AG	73%	0	1.4	0.8
Sanofi SA	70%	2,497	0.4	0.1
Pfizer Inc	62%	5,000	1.4	1.4
Johnson & Johnson Inc	117%	5,232	net cash	net cash
BristolMyers Squibb Co	59%	2,220	net cash	0.4
Celgene Corp	0%	925	-	2.2
Merck & Co Inc	74%	2,153	0.1	1.1

*Net financial debt (reported)
Source: Annual reports, Scope estimates

As long as most large pharmaceutical companies' balance sheets continue to be strong, the only rating-relevant issue within their financial risk profiles is financial policy. Given robust cash generation, most large international companies – and most notably the US groups – have adopted a mix of high dividend payouts, share buybacks and bolt-on acquisitions. European companies, some of them family-owned, generally tend to follow a less aggressive shareholder value approach. With regard to M&A, we see the same picture in Europe as in the United States. Many companies in the past have taken advantage of their strong cash generation levels and low funding rates to acquire competitors. Although this has, in most cases, not resulted in large, transformational deals (Pfizer's attempts to take over AstraZeneca or Allergan were unsuccessful), the completion of larger transactions cannot be excluded and downgrades would almost inevitably follow.

Analyst: Olaf Tölke

Chemicals industry outlook 2018: Late phase in the cycle

Chemical industry outlook: stable

Our 2018 outlook for the chemicals industry is stable. Credit metrics are expected to be slightly lower in the coming year. In particular, we believe the profitability of integrated chemical companies will decrease next year. Moreover, due to ongoing changes in the chemicals landscape and the low interest rate environment, we consider the likelihood of increasing debt levels to be high.

Integrated players vs speciality companies

When assessing industry risk for the chemical industry, Scope groups companies into integrated chemicals and speciality chemicals. We define companies whose activities extend over various steps of the chemical value chain as integrated chemical companies. Petrochemicals (e.g. naphtha, ethane), base chemicals (e.g. olefins and aromatics), and speciality chemicals (e.g. performance materials for a unique application, industrial gases, agrochemicals) are typical steps in the chemical value chain.

Higher costs for feedstock expected in 2018

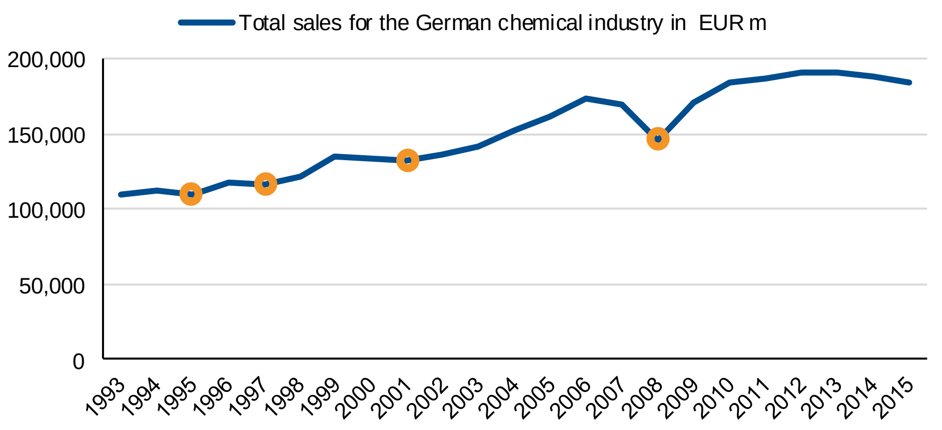
We believe that the positive momentum in profitability will slow in 2018. Integrated chemical companies in particular have improved profitability over recent years, due to lower prices for feedstock and positive demand-side effects. Consequently, we expect profitability to reach a peak of about 23% for the current year. In line with persistently solid economic perspectives, we expect crude oil prices in the range of USD 60-65. This will move feedstock costs up and place margins under pressure. Moreover, capacity expansions in base chemicals and intermediates will come online. On a granular level, lower product prices can lead to negative outcomes.

In general, we believe speciality chemical companies will continue to benefit from the positive development of their respective end-markets. Solid pricing power will keep profitability in line with prior-year levels. For instance, important end-markets such as pharmaceuticals, automotive and construction industries are expected to grow by rates in keeping with the previous year's level. With regard to maintaining market share in future, we consider the ongoing high levels of R&D spending to be positive.

Length of cycles in chemical industry three to seven years on average

We believe the chemicals sector in general has reached a later stage in its cycle. Measured by historical total sales for the German chemical industry, cycles have a length of three to seven years. As the current cycle began in 2010, there is potential risk of a downturn.

Figure 7: Total sales, German chemical industry



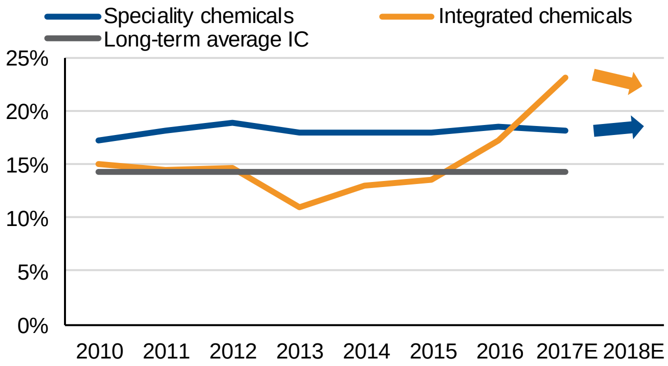
Source: VCI, Scope

Continuing changes in industry landscape

In addition to slower earnings momentum, we expect a slight increase in the financial leverage of integrated chemical companies. As financing costs will remain favourable in 2018 and financial leverage has decreased in the last few years, we anticipate that acquisitions will primarily be debt-financed. The Verband der Chemischen Industrie (VCI) estimates that speciality chemicals will outperform base chemicals within the next decade. We expect potential divestments, as a consequence of large M&A or pressure from activist investors (e.g. Bayer/Monsanto, AkzoNobel, Clariant) to lead to strong, selective portfolios, primarily for integrated chemical companies. In 2017, selective transactions were negotiated, such as the BASF purchase of Bayer's seeds and herbicide business.

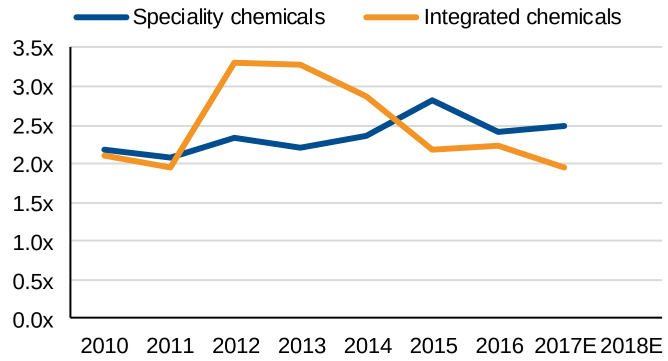
We consider these steps to be positive for business risk profile, because integrated chemical companies are able to balance more volatile base chemical revenue and benefit from synergies. Moreover, entrance into fast-growing regions is positive, for instance in the APAC region.

Figure 8: EBITDA margin



Source: Bloomberg, Scope

Figure 9: Financial leverages: speciality chemicals vs. integrated chemicals



Source: Bloomberg, Scope

Potential risk factors for chemical industry

Beyond our core scenario, we believe certain factors could cause the credit metrics of chemical companies to deteriorate:

- Decreasing economic perspectives in the APAC region (about 40% of global chemical revenues are generated in China)
- Temporary unfavourable price developments, due to natural disasters in important production areas for instance
- A sharp increase in feedstock and energy prices resulting in pressure on margins

Analyst: Klaus Kobold

European real estate outlook 2018: Super cycle drives credit quality, but risks increase

Real estate outlook: stable

Scope's 2018 outlook for the real estate sector is stable. Our view is based on still-lively investor and tenant demand positively influencing business risk profiles. In addition, companies have been able to make use of the ECB's ongoing ultra-loose monetary policy (with an all-time high of capital market debt issuance at very low interest rates) to enhance their financial risk profiles. However, our assessment emphasises the further heightening of sensitivity to changes in politics, economic conditions and interest rates.

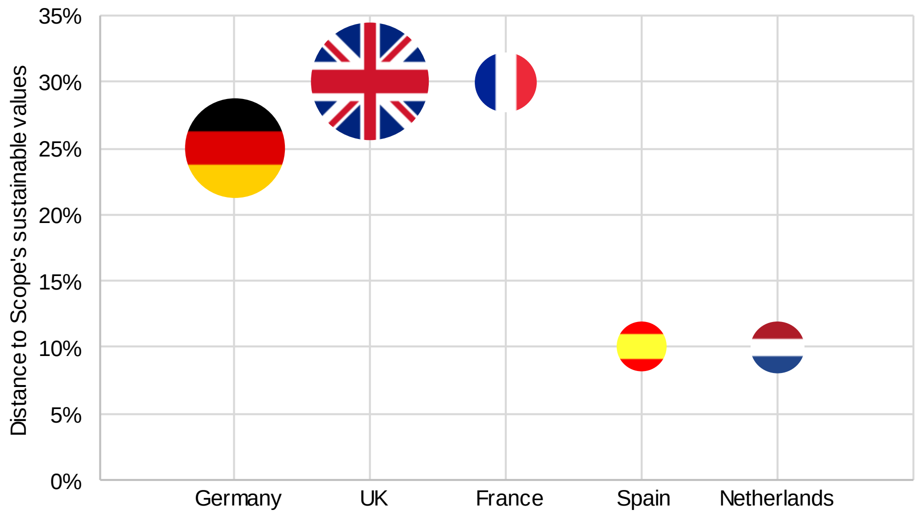
European real estate prices increased further in 2017, predominantly driven by: i) a shortage on the supply side; and ii) a sharp rise in rents. The performance of the latter has been driven by economic growth, resulting in strong fundamental demand for space and growth in rents, while new supply has been limited in most markets.

Rents expected to continue sharp upward climb, further boosting property values

We believe that rents across all property types (with the exception of shopping centres) will continue to see increases, supported by the good growth sentiment for the EU, which is expected to benefit from growth of around 2% for the fourth consecutive year. According to the European Commission (November 2017) EU GDP is forecasted to grow by a stronger-than-expected 2.3% in 2017 (compared to 1.9% in 2015), maintaining this momentum in 2018 (+2.1%) and 2019 (1.9%). More significantly, job creation has been robust, with the unemployment rate dipping to 7.8% in November 2017, down from its peak of 10.9% in 2013. Job creation will be sustained and labour market conditions are set to benefit from expansion driven by domestic demand and moderate wage growth. As a result, demand for space will not bottom out as long as the supply side continues to grow more slowly, as demonstrated by the fact that stock under development is below the long-term average for Europe's major markets of France, Germany, the United Kingdom, Spain, the Netherlands and Italy.

We anticipate that prices will increase in 2018, driven by the aforementioned developments. We do not forecast any further strong compression of real estate yields in Europe's core markets, as the ECB's ultra-loose monetary policy, and the resulting impact on real estate yields, has reached the end of the road for some markets. On the other hand, we do not foresee increasing yields for 2018 either, as the ECB is still liquefying credit markets despite a slight change in monetary policy, with the bank slowly tapering off its quantitative easing, as announced in October 2017. The adjustment of monetary policy is not expected to impact markets as the ECB is still reinvesting proceeds from maturing bonds, thus further increasing its balance sheet. Downside risk emerges due to Europe's core markets being overpriced, as indicated by the difference between current prices and sustainable price levels of between 10% to 30% (Figure 10).

Figure 10: Distance of property price index to Scope's sustainable value/ Bubble size = size of investment market in 2017



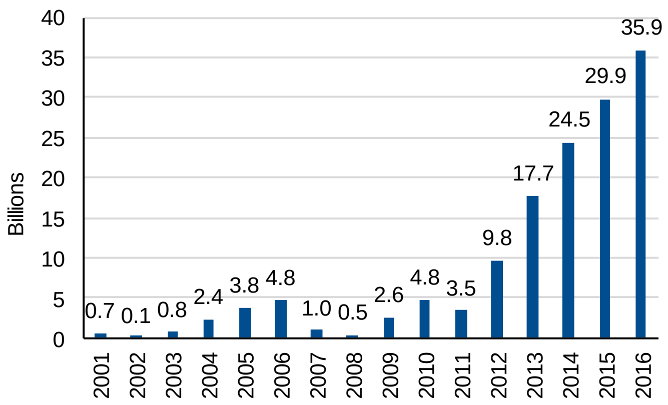
Source: Scope estimates

All-time high for capital market debt issuance as debt remains cheap

As yield curves remain flat for the time being and liquidity is flooding the markets, the hunt for yield and the strong appeal of real estate assets is placing further pressure on fixed-income yields (downwards) and, as a consequence, on asset prices (upwards). Real estate companies have made use of this continued access to equity and debt financing, with record lows in funding costs, by extensively tapping the capital markets with EUR 170bn (+EUR 39bn in between YE 2016 and Q3 2017) and EUR 120bn (+EUR 15bn) in debt and equity issuances, respectively, since 2009.

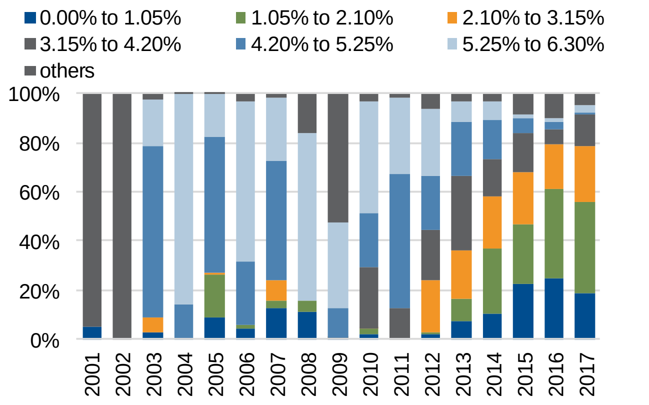
The aims of participants in this considerable cash call have remained unchanged since the spring of 2016 and include: i) the reduction of reliance on bank debt, illustrated by an all-time high for capital market debt issuance in the first three quarters of 2017 (Figure 11); and ii) taking advantage of decreasing financing costs (average coupons have fallen by 60% since 2009 – see also Figure 12).

Figure 11: Issuance activity European real estate corporates (capital market debt)



Source: Bloomberg, Scope

Figure 12: Distribution of coupon ranges for capital market debt of European real estate corporates



Source: Bloomberg, Scope

We expect stronger reliance on capital market debt versus equity going forward compared to the period from 2009 to 2017. This development will be driven by the availability of funds for equity investments flattening out, indicated by 'dry powder' available for investments in European real estate dropping by 13% compared to December 2016 (Preqin: Nov 2017). Consequently, we do not foresee a further deleveraging of European real estate corporates (which was primarily driven by value appreciation in the past) leaving them vulnerable should property values drop (see also mid- to long-term credit outlook).

More subdued M&A activity going forward as current price levels not justified by potential economies of scale

The third aim of participants in this cash call (financing growth via increased M&A or development activity) is expected to lose its significance in the next couple of years. In line with our previous year's forecast, European commercial real estate corporates have been leading mergers and acquisitions activity in 2017, with major deals including the Logicor Europe takeover by China Investment Group for EUR 12bn and the acquisition of 85% of shares in Eurosic SA by Gecina SA for EUR 6.5bn. However, consolidation on a large scale will be more subdued in 2018 going forward, as we anticipate real estate M&A to be on the decline given current price levels and limited economies of scale from potential consolidation for large- and mid-caps, according to the EPRA (source: Assessing Size Effects and Economies of Scale in European Real Estate Companies, 2016).

Stable credit outlook for 2018, but further heightening sensitivity to changes in politics, economic conditions and interest rates

Corporates with the ability to tap this flood of liquidity will use funds to either: i) improve business risk profiles, predominately via development, with gains in size improving economies of scale and/or diversification; or ii) improve financial risk profiles, with debt protection benefiting from low financing costs. However, we do not expect companies to use additional financial headroom to deleverage further; as a result, we expect limited positive credit impacts on investment grade peers. Instead we foresee higher rating volatility for sub-investment grade corporates, with positive rating adjustments for those using funds to enhance business risk profiles without impairing financial risk.

More volatile credit profiles among UK-focused corporates

Real estate corporates focusing on UK assets are expected to have a more volatile credit profile. Political risks in the UK have significantly increased after the Brexit referendum and have not been reduced through the ongoing negotiations between the EU and the UK. Rather, we see a growing sense of panic among UK companies. If a hard Brexit did come to pass – which we consider to be a rather remote scenario (see Scope's sovereign outlook) – we expect a decline in tenant demand, and, in turn, in UK property prices. Both of these could lead to a rise in commercial real estate loan defaults, weakening the credit profiles of the sponsors. However, we do not expect any long-term impact on tenant and investor demand as: i) companies aiming to maintain access to the EU market are likely to simply build beachheads in the EU rather than relocate their whole business; and ii) investor money will still pour into the UK once Brexit effects are quantifiable, following the current pattern with the majority of net investments coming from outside the UK and EU.

Mid- and long-term credit outlook more subdued

With the exception of companies able to tap the ECB market, Scope's mid- and long-term credit outlook is more subdued due to the heightened sensitivity of the European real estate market to changes in the political, economic and interest rate environments.

In view of the growing yields for sovereign debt, as well as the steepening interest rate swap curves, Scope anticipates greater refinancing risk for commercial real estate debt for the mid- to long term. Thus, we estimate that capital values for European commercial real estate stock will decline by 10-15% if interest rates rise by 100 bp and maintain this new level. This would impair key financial metrics, increasing leverage and weakening debt protection. Even this scenario will not, however, materialise in the short term; EUR 340bn of maturing European commercial real estate debt will face higher refinancing risk until 2020, with higher default rates anticipated for 2018 onwards.

Analyst: Philipp Wass

European construction outlook 2018: Increasing demand meets supply chain pressure

European construction outlook: stable

Scope's 2018 outlook for the European construction industry is stable. This view is substantiated by an anticipated further increase in demand spilling over from the real estate industry as well as civil engineering projects financed under programmes such as the Trans-European Transport Networks initiative, the European Structural and Investment Funds or the Connecting Europe Facility. Nonetheless, growth is burdened by supply chain pressure on domestic markets as increasing demand meets insufficient capacities, putting pressure on profitability. Financial risk profiles benefit from low interest rates and good access to capital markets. Consequently, companies should be able to improve debt protection, while leverage is expected to remain at current levels.

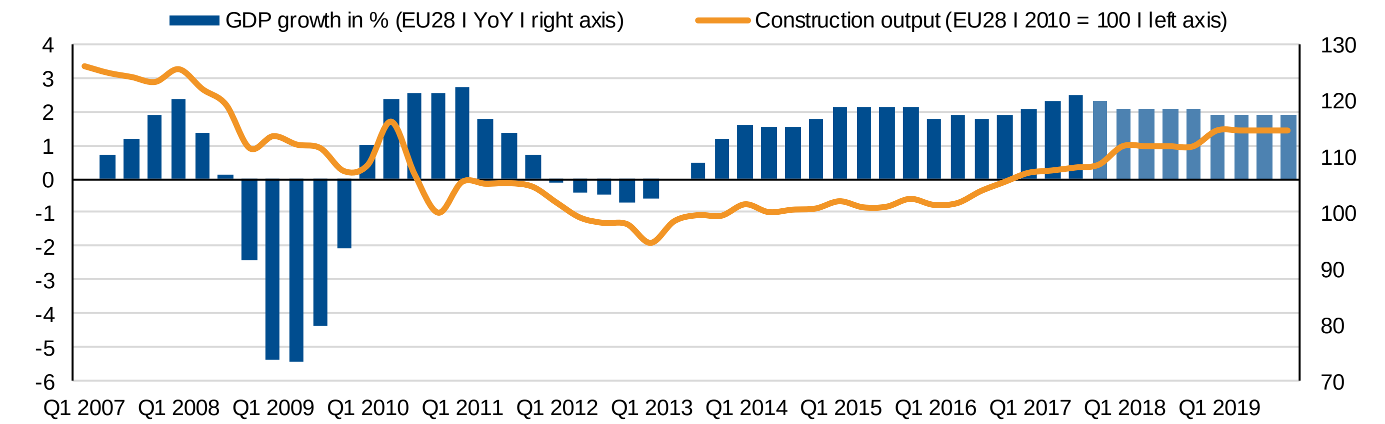
Further recovery of the sector in 2017

We believe that the European turnaround in construction output took place in 2013-2014, when the European Union and European Investment Bank provided support for infrastructure projects. The past two years showed significant recovery of market conditions on the European continent, with the pace of construction growth accelerating in 2017 and output for EU's 28 member states increasing by 1.9% for the first two quarters, according to EUROSTAT. This follows strong 2.9% YoY growth for 2016 and expands the period of steadily increasing construction output since 2013-2014. Growth is predominantly bolstered by residential development expanding by 5% in 2016 according to EUROCONSTRUCT. While we saw strong regional differences regarding growth in our previous year's outlook, almost all members of the EU experienced an expansion of construction output between Q3 2016 and Q2 2017. The strongest contributors to growth since Q4 2013 have been Spain (+18%), the Netherlands (+25%) and the Nordics (20-30%), while CEE caught up with close to double-digit growth rates in the twelve months between Q3 2016 and Q2 2017.

Ongoing expansion of construction output anticipated up to 2019

For the EU, we forecast construction output growth of 3.0% for 2018 and 2.5% for 2019 (see Figure 13). Scope's assumptions are driven by: i) stable residential construction output supported by demographic trends, an increase in household income and low mortgage rates; ii) a surge in non-residential output, as stock under development is still below the long-term average for Europe's major markets while meeting strong fundamental demand for space (see also real estate outlook); and iii) a rise in civil engineering output with projects that have been financed under programmes such as the Trans-European Transport Networks initiative, the European Structural and Investment Funds or the Connecting Europe Facility, which enter their implementation phase in 2017/18. Further support comes from the still-generous ECB policy. A loose monetary policy aids the flow of cheap credit to the private sector, especially for 'peripheral' economies still saddled with substantial debts; while governments will continue enjoying low funding costs induced by the ECB's quantitative easing programme in March 2015.

Figure 13: GDP YoY growth vs construction output (European Union) 2007-2019



Source: European Economic Forecast Autumn 2017, EUROSTAT, Scope

Supply chain pressure on domestic markets as increasing demand meets insufficient capacities

One of the main ongoing issues in the construction industry – the sourcing of new employees, with two-thirds of the labour force retiring by 2020 – is still not solved. While the need for skills has risen significantly in recent years, construction is generally unappealing to workers, despite recent strong wage growth per hour. The lack of a sufficient workforce is therefore expected to force out many regionally focused, micro and small companies in future. It will also result in supply chain pressure, with subcontractors charging sharply increased prices as rising demand on domestic markets meets insufficient capacities and capabilities. Ultimately, this will impair the profitability of construction corporates, even if they show strong top-line growth. The European Commission's 'Construction 2020 Action Plan', launched in 2013, has taken some initial steps to tackle these issues, which includes dealing with the low number of qualified workers.

M&A with focus on vertical integration to counter supply chain pressure

With smaller companies expected to exit the market, along with continued growth in the industry, we expect further consolidation in this sector, focusing on greater size to increase economies of scale and geographical diversification, as well as to strengthen the position of European constructors in worldwide bidding processes. M&A activity is forecasted to focus on: i) vertical integration to counter the supply chain pressure by increasing company-internal capacities; and ii) horizontal diversification to stabilise margin profiles.

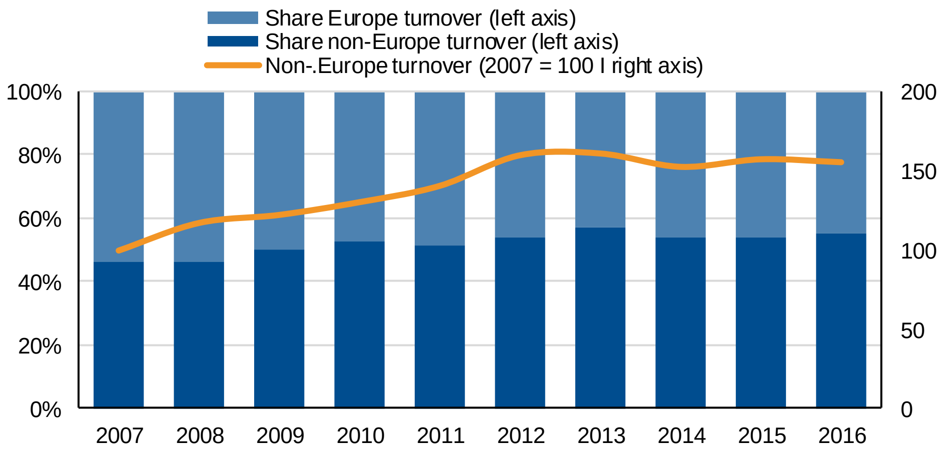
Consolidation will benefit from the relatively low cost of capital, empowering market participants to attain market leadership or diversification by means of M&A activity.

Credit outlook 2018 – large European construction companies benefit from growth outside of domestic markets

Even if growth gathers momentum, larger construction corporates have lost ground with a 5% YoY contraction of European revenues in 2016. However, top lines have not been impaired to the same extent thanks to the increasing share of turnover generated outside of Europe with a compound annual growth rate of 4.5% since 2007 (Figure 13). Scope believes that larger construction corporates are likely to further improve their business risk profiles, backed by diversifying activities across the globe, in addition to an ongoing recovery in their respective domestic markets. However, we highlight the negative contribution to profitability anticipated for these contractors due to: i) domestic markets becoming more expensive; and ii) their focus on mature markets with a low margin profile like North America. Both of these factors are expected to weaken credit metrics for highly levered corporates.

The business risk outlook for smaller competitors (revenue below EUR 1bn) is more subdued, as it will be harder for them to compete with larger constructors in domestic markets, and diversification into other regions is limited by: i) capital available; and ii) potential setbacks as achievable foothold is very low. This increases the risk of overly harsh exposure to the respective construction cycle. However, a further recovery or ongoing rebound of peripheral eurozone housing markets gives smaller construction companies some opportunity to develop. Smaller companies may also find protection within a larger group as a result of the anticipated vertical integration efforts of larger competitors.

Figure 14: Distribution of turnover from European construction companies 2007-2016



Source: EIC, Scope

Financial risk profiles are benefiting from low interest rates and good access to capital markets. Consequently, companies should be able to improve debt protection, while leverage is expected to remain at current levels. A further reduction of debt would, however, mitigate risks arising from a likely rebound of interest rates and still-fragile growth in the global economies, especially in light of an anticipated drop in profitability.

UK-focused companies face an increase in downside volatility

Corporates focusing on the UK will suffer from uncertainties with regard to Brexit negotiations and an increase in downside volatility. We observe that investment decisions have been postponed, as demonstrated by a steady reduction in construction output from January 2017 to September 2017. Housing is the only segment which has grown, driven by a double-digit expansion of public housing (source: Office for National Statistics).

Analyst: Philipp Wass

European airlines outlook 2018: Industry past its peak

Airlines outlook: negative

Scope's sector outlook for European airlines has turned slightly negative as we believe sector fundamentals have peaked, and average key credit metrics such as profitability and leverage measures are likely to deteriorate slightly. Although we expect sector fundamentals to remain intact and demand to grow further, we believe overcapacities in the sector will become more apparent with faster growth in passenger capacity (available seat kilometres – ASK) than passenger traffic (revenue passenger kilometres – RPK), particularly through the growth ambitions of low-cost carriers, and pricing pressure will increasingly translate into weaker credit metrics. After the defaults of three large European airlines in 2017, the sector is likely to see more consolidation as other smaller airlines will not be able to cope with sector challenges in the mid-term.

Industry past the peak

2017 has been a good year for major European airlines despite the insolvencies of three major carriers (Alitalia, Air Berlin and Monarch). On average, the market has seen unprecedented profit levels which have been bolstered by buoyant conditions for business and holiday travel, leading to peaking load factors as well as supportive jet fuel pricing. Recent airline defaults have been the result of individual company challenges and massive debt burdens. Nevertheless, we believe that supportive industry fundamentals, in terms of jet fuel prices and high load factors, have disguised persisting sector challenges and the necessity for structural cost adjustments in this still-fragmented market. With an estimated slowdown in demand in 2018 and beyond, the sector's major challenges such as looming overcapacity, continuous pricing pressure and increasing exposure to political developments are likely to become more visible.

We see key issues for the further development of European airlines' business risk and financial risk profiles to be driven by:

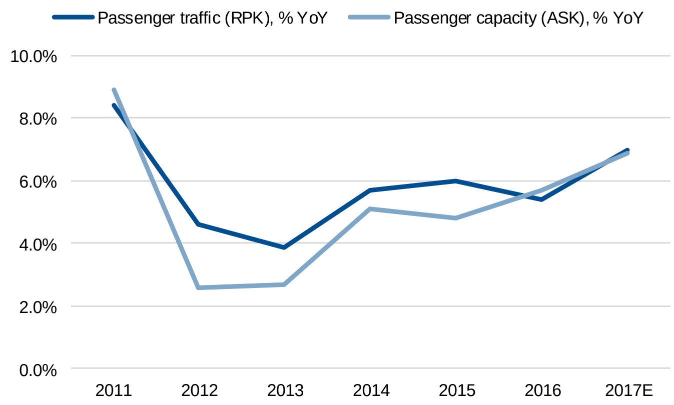
- RPK of an estimated 5% for 2018 likely to grow at a slower pace than ASK;
- Continuing pricing pressure from major low-cost carriers (LCCs) and stronger competition for legacy carriers on long-haul routes due to cooperation between LCCs;
- The strengthened dollar and its impact on jet fuel procurement;
- Peaking average credit metrics to deteriorate again;
- Continuous geopolitical and other external shocks;
- Passive rather than active sector consolidation.

Further capacity growth of LCCs to heighten pressure on the sector

Demand unlikely to keep pace with capacity growth

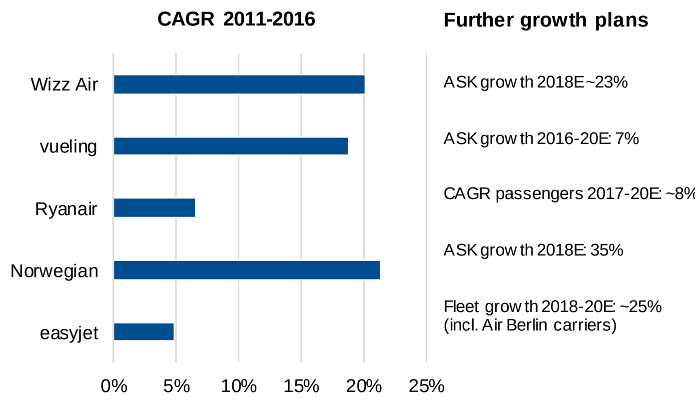
We believe the supply-demand balance as measured in ASK and RPK (see Figure 15) will widen again. The three recent defaults of Alitalia, Air Berlin and Monarch will not significantly take capacities out of the market as the majority of aircrafts have found or are likely to find a new European owner. An increased imbalance between supply and demand is likely to be triggered by the massive capacity ramp-ups of major European LCCs (see Figure 16) and a similarly aggressive capacity expansion of Middle Eastern carriers as well as the limitations of artificially stimulating demand by means of newly established LCC routes. As a result, we believe the sector's challenges from continued pricing pressure and growing overlap within the carriers' route networks will become more apparent in 2018. We note that major LCCs such as Ryanair, easyjet and WizzAir can largely afford further price cuts in light of their leading profitability profiles (EBITDA margins above 15%).

Figure 15: ASK vs RPK growth for European airlines



Source: Company reports, Scope

Figure 16: ASK growth rates for major LCCs (CAGR 2011-16)



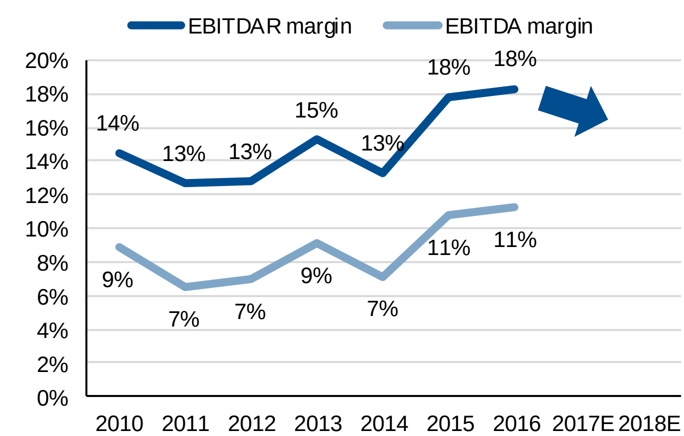
Source: IATA, Company presentations, Scope

Average industry leverage should have reached the floor

Average credit quality to deteriorate again

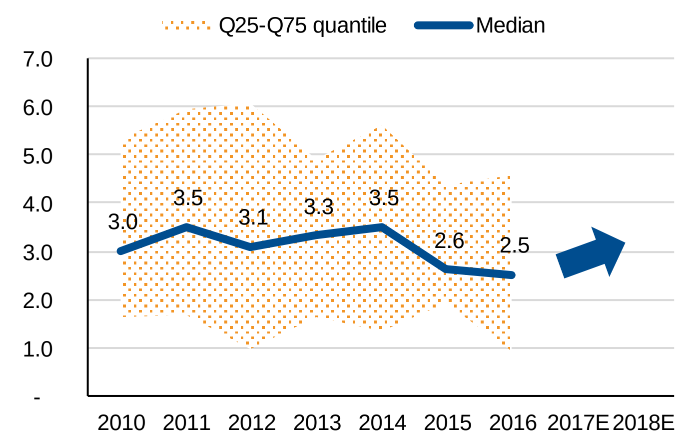
In light of the underlying industry cyclicality and low entry barriers, the average financial profile of European airlines has been comparatively strong, particularly from 2015-2017E. However, we highlight the fact that the significant improvement in average profitability seen in 2016, with an EBITDAR margin of almost 20% and an average industry leverage (Scope-adjusted debt/EBITDA) of around 2.5x, is unlikely to be repeated in 2018. We note that the industry's improved financial metrics are not the result of active deleveraging and cost cutting but rather of scaling effects and an advantageous cost base, i.e. comparatively low jet fuel prices. In general, European airlines have hiked debt levels (on-balance and off-balance sheet), taking advantage of the low interest rates and the growing popularity of operating aircraft leases (as displayed by the widening gap between the EBITDAR and EBITDA margin). Debt burdens of this magnitude are likely to backfire once market fundamentals deteriorate. Assuming that new capacities will not be absorbed as easily as over the past few years, credit metrics, and hence average credit quality, are likely to weaken again.

Figure 17: Margin profile



Source: Annual reports of 22 European airlines, Scope

Figure 18: Leverage profile



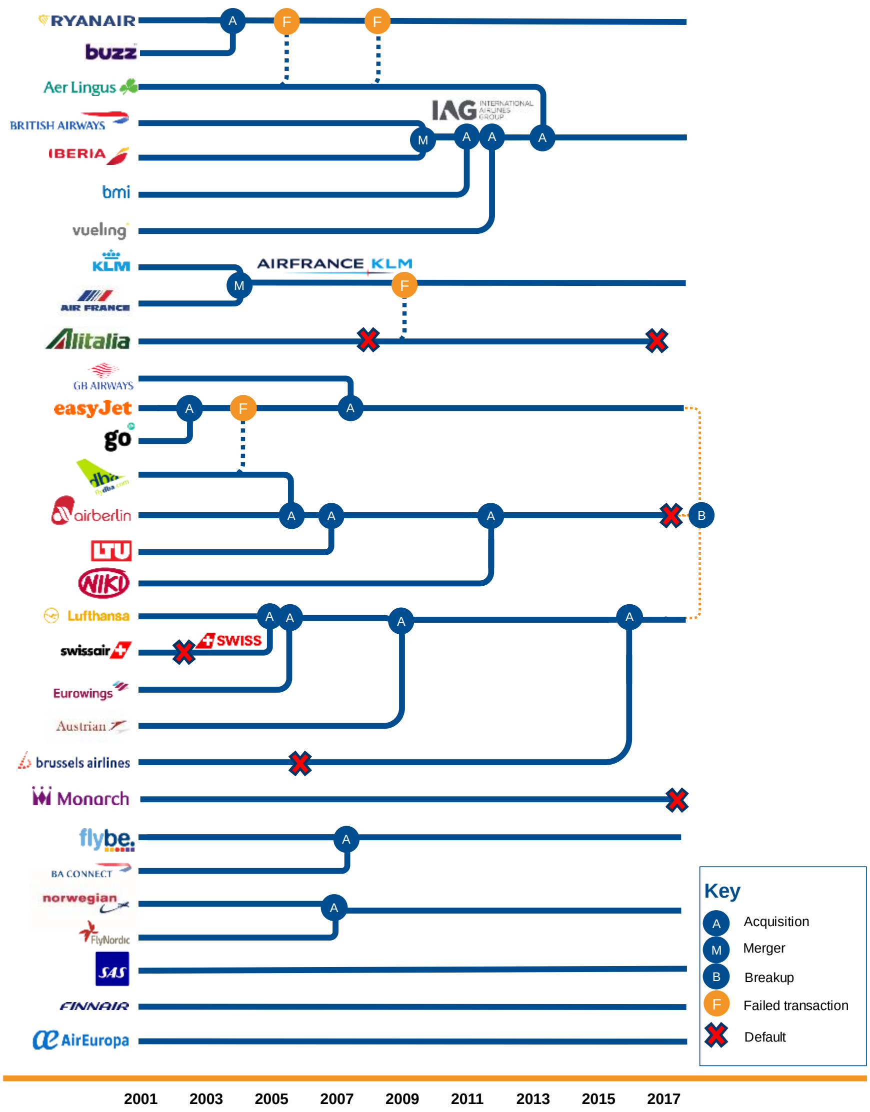
Source: Annual reports of 22 European airlines, Scope

Further passive consolidation ahead

Consolidation through acquisition of slots and assets

We expect consolidation among European airlines to grow: not, however, as an active market development but rather in a passive fashion, with larger airlines acquiring the assets and slots of troubled airlines (see also our study: European Airlines – Growing Need for Consolidation?). Troubled airlines will tend to be those carriers which are too small to compete effectively in the long-haul markets against the big players, and too expensive to compete effectively in the short-haul markets against the large LCCs. Scope also believes that low-cost carriers will participate in such consolidation more actively than in the past, as they have to contend with the limitation of growth through the artificial stimulation of demand and a growing overlap within their route networks. Eventually, accelerated industry consolidation is likely to help restore the industry's economic health in the longer term.

Figure 19: Major consolidation activities of European airlines



Source: Scope presentation

Analyst: Sebastian Zank

Container shipping outlook 2018: Sailing into calmer waters?

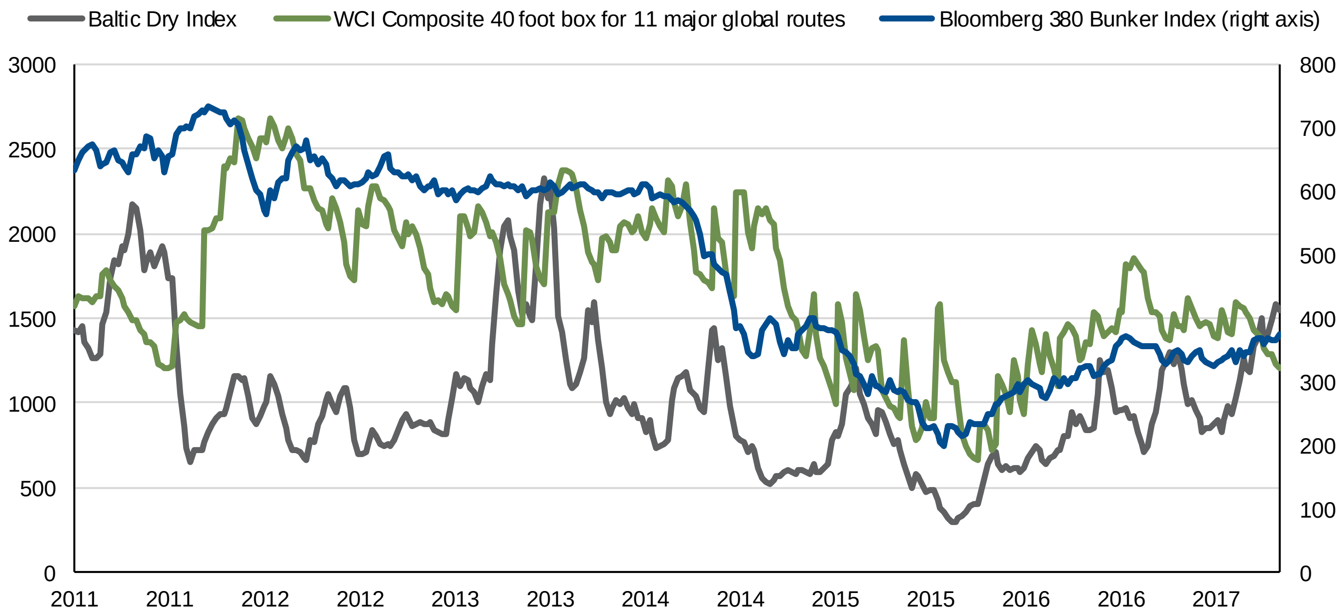
Container shipping outlook: positive

Scope's sector credit outlook for the container shipping industry is positive, as we see improved industry fundamentals for 2018 and expect a further recovery of profitability among issuers. Nevertheless, we hint at the imminent sector risks, in particular the high volatility of revenues and costs, as well as the dependency on external factors such as crude oil prices, global growth and trade volume.

Shipping rate development

As seen in Figure 20 below, global shipping rates (black and green lines) have recovered substantially from the lows in the first half of 2016. The WCI composite container price index (11 major global routes) has gained around 80% from March 2016 to November 2017, implying a significant rise in revenues for container shipping companies between 2017 and 2016. Bunker prices (blue line) have increased well, but were clearly offset by a stronger gain in rates.

Figure 20: Shipping rates vs bunker costs



Source: Bloomberg, Scope

Container shipping rate outlook backed by improving fundamentals

For 2018, overall container shipping rates are expected to increase, backed by two crucial supply and demand developments:

- slower capacity growth due to more scrapping and less deliveries
- robust global economic and trade-volume growth

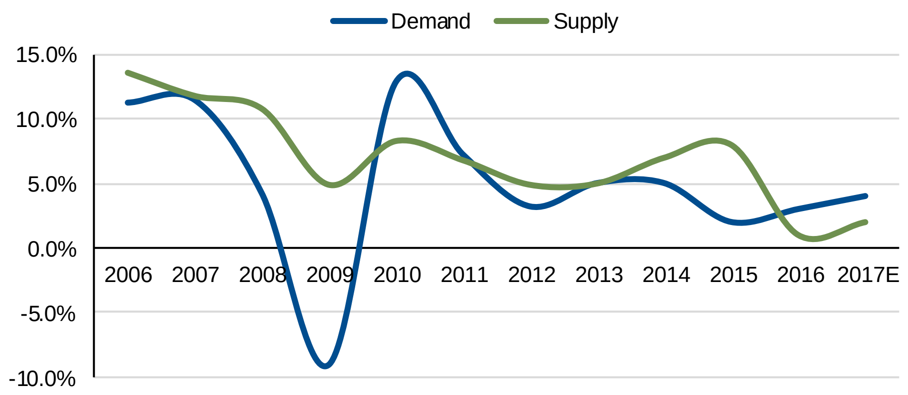
As bunker prices have increased in the past two years, container shipping companies have had to rely on fuel efficiency to bolster operating profits. 'Slow-steaming' should continue to play a role in reducing bunker costs, but the main way to improve fuel/cost efficiency will be by using more fuel-efficient and newer vessels and by reducing total costs per container transported by a larger capacity per vessel.

The ongoing pressure for efficiency will again lead to high volumes of vessel scrapping in 2018, which will help to limit global capacity growth.

Moderate new vessel deliveries likely to limit capacity growth

New vessel deliveries are also contributing to global capacity growth. After a massive rise in new deliveries of large container vessels in 2014 and 2015 put severe pressure on rates, we expect to see a significantly lower number in 2018 and 2019.

Figure 21: Growth of supply and demand in container shipping



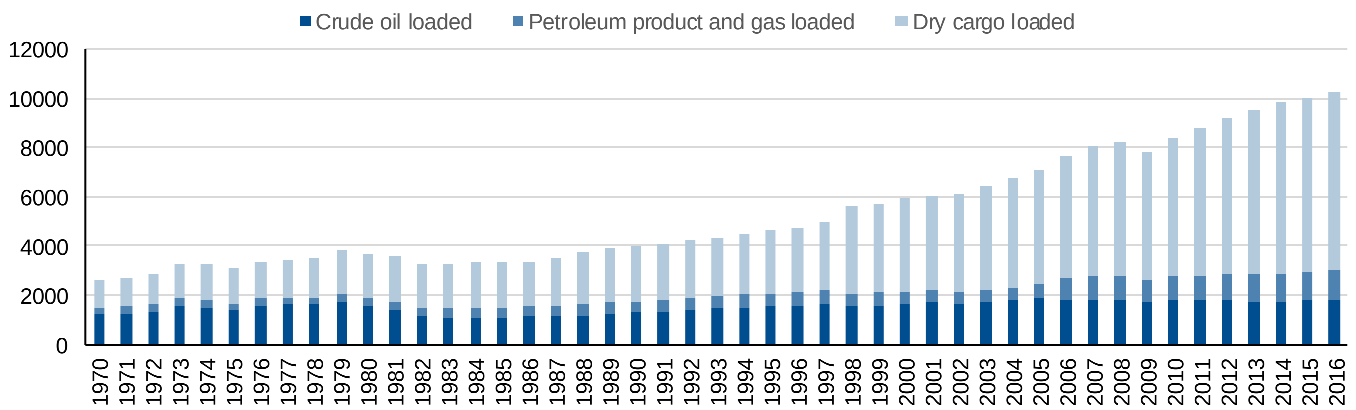
Source: UNCTAD secretariat calculations, Scope

On the demand side, global GDP is forecast to rise in 2018, by 3.1-3.7% (IMF, OECD and IHS Markit estimates). Global trade volume has been shown to rise 1-2% faster than GDP; therefore we expect to see global trade volume growth of about 3.5-4.5% next year.

Based on these industry fundamentals, profitability in the container shipping sector is likely to continue its recovery, in our opinion. However, two factors could hinder this development: i) global political uncertainties, which remain high and could lead to lower growth, and/or ii) a significant rise in crude-oil and bunker prices, which would negatively affect operating results.

As shown in Figure 22, dry cargo (including containers) has driven the long-term surge in global seaborne trade volumes.

Figure 22: World seaborne trade volumes by type of cargo



Source: UNCTAD Global Maritime Report 2017, Scope

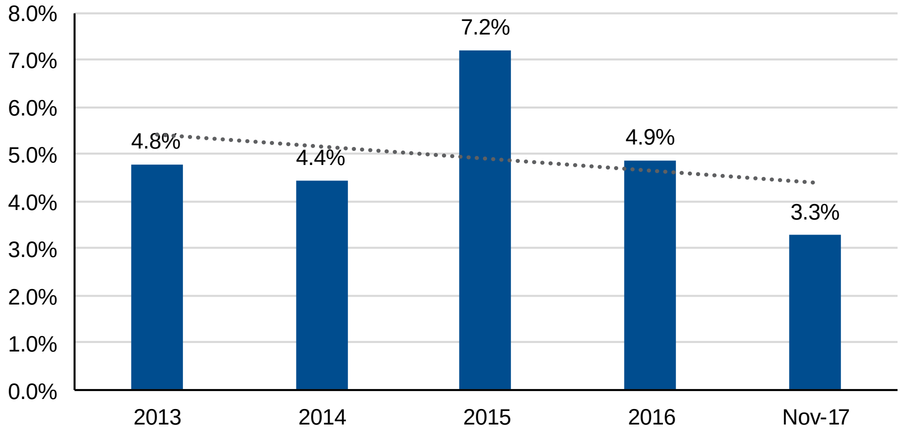
(Re-)financing conditions

Refinancing conditions attractive – Scope expects more issuers to tap the corporate bond market

Shipping companies have taken advantage of the extremely low interest rates and tapped the public debt markets. As sources of bank financing continue to shrink amid ever-stricter regulations, we expect more shipping companies to turn to capital market debt as a source of financing.

Over the last five years, there has been significant yield compression on major outstanding bond issues of large container shipping companies (Figure 23):

Figure 23: Yield comparison container shipping bonds*



*Average yields of outstanding bonds of APMM, CMA CGM, Hapag-Lloyd and GSL
Source: Bloomberg, Scope

As investor sentiment can have an immediate impact on capital market access, a well-diversified funding mix and balanced maturities will remain an important way to mitigate refinancing risks in the volatile shipping sector.

Industry consolidation

Scope expects industry consolidation to continue amid fierce cost competition

In 2017, the consolidation trend continued with large takeovers such as Hamburg Süd by AP Moeller Maersk or UASC by Hapag-Lloyd. We expect consolidation pressure to remain high, as profitability in the industry is still driven by cost efficiencies. There is little possibility for product differentiation and market rates, and bunker costs are exogenous, making container shipping companies price-takers. Hence, critical size remains key to achieve a low average cost per transported unit.

The high cost pressures have recently also led to several major defaults. Two notable examples were South Korea's Hanjin Shipping and Germany's Rickmers Group, which, in our view, defaulted because of high cost bases caused by an aged fleet, paired with a high debt burden. In this regard, we stress the importance of the asset/fleet quality to ensure financial health.

Debt levels expected to remain high, also due to M&A

We expect industry consolidation to affect issuers' financial strength in two ways: i) rising balance sheet debt due to M&A activity, and ii) improved operating cash profitability among the new larger players via cost reductions and synergies.

Summary

In conclusion, we expect the industry to continue its revenues and earnings recovery on the back of solid demand and supply fundamentals for shipping rates in 2018. Nevertheless, we hint at the high industry risk of the shipping industry in general due to its volatility. Moreover, we expect industry consolidation to continue as critical size remains key to achieving attractive operating margins.

Analyst: Denis Kuhn

Postal services outlook 2018: E-commerce to remain main volume driver

Postal services outlook: stable

We expect a stable sector development in the postal services industry for 2018. Major drivers should again be the two main opposing trends within the sector: continued decline in classic letter mail volumes throughout Europe as well as the ongoing surge in parcel volumes driven by e-commerce growth. We also expect the average operating leverage level of about 1.0x Scope-adjusted debt/EBITDA to remain low and all major European players in the sector to maintain a strong financial risk profile.

The sector's credit quality in 2018 and beyond is likely to be driven by the following:

- Letter and parcel volume development
- Pricing effects and competition
- Innovation/automation

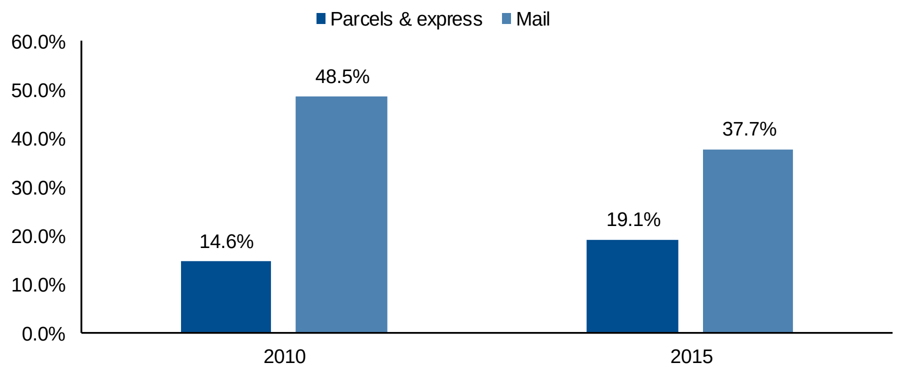
Letter and parcels volume development

Letter mail volumes have fallen markedly in Europe for about 10 years, substituted by electronic forms such as email. This trend has now peaked, and we expect letter mail volumes to decline at slower, single-digit rates.

Opposing trends in letter and parcel volumes continue

As volume declines have been constant, corporates have been able to adjust their cost bases and keep operating margins stable. We therefore expect stable operating cash results going forward in the letter mail sub-segment.

Figure 24: Five-year mail vs parcel revenue changes among European postal providers



Source: IPC, Scope

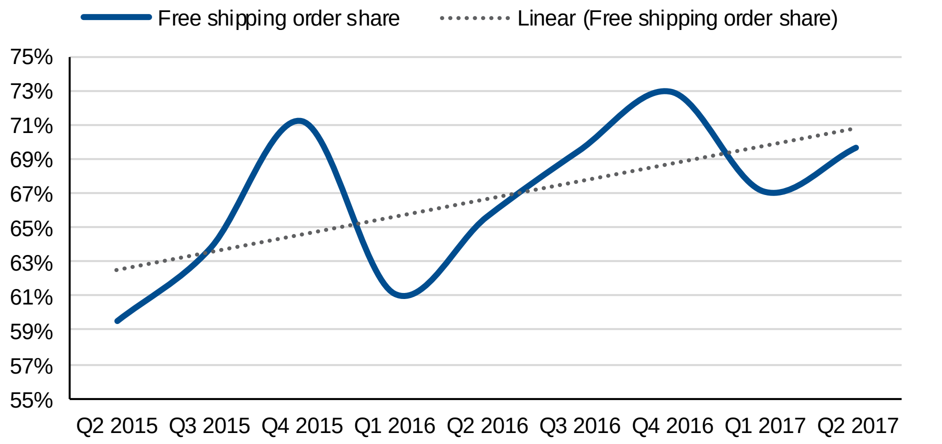
The parcel delivery segment paints an entirely different picture: the e-commerce boom has driven volumes to high, single-digit annual growth rates. While industrialised counties lost momentum in this area in 2017, still-strong absolute volume growth will benefit the sector for the years to come, in our view.

Pricing effects and competition

Increasing pricing power of large online retailers

Risks currently stem less from volumes, and more from increased price competition fuelled by large-scale e-tailers (e.g. Zalando), which use critical size to offer free shipping to retail clients. This has resulted in lower average prices per parcel delivered.

Figure 25: Share of free shipping orders in global online retailing



Source: eMarketer.com, Scope

New innovative players are also creating pricing pressures, although we do not expect this to have a significant impact in the short term.

Although the effects of pricing pressures will partially offset the growth in parcel volumes, operating results will continue to grow and remain a major credit-positive driver in our view.

Innovation and automation

Automation of sorting stations and access points gains momentum

As modern IT and robotics technology rapidly gain capabilities, we expect automation to play a crucial role in the future of postal services and logistics. This creates enormous scope for operational improvements – from a much higher degree of automation at sorting stations, fewer staff at branches/access points, to timed delivery and improved tracking services for retail customers. The trend for automation is in full swing, and we expect it to continue over the few next years.

Ultimately, the competitiveness of individual players will be determined by their innovativeness and level of technological improvement, both in terms of cost base and service quality (B2B and B2C). This will be a crucial credit driver for corporate issuers in the medium to long term, in our view, given the increasing price and quality competition generated by e-commerce players in the market.

Median leverage among Scope's observed peer group of 10 European players stands at 0.8x in terms of net debt/EBITDA, indicating a strong financial risk profile.

The industry in 2018

Robust margin development and ongoing investments in digitisation expected

Overall, we expect the industry's constant operating margins to continue into 2018, driven by the ongoing decline in mail volume, on the one hand, and the increase in parcel volume, on the other – although both trends have slowed recently. Even so, we expect the effects of the price/volume mix to partially offset the growth in parcel volumes. Also, while new smaller, highly digitised players are expected to enter the market, we do not regard them as a major threat to the market leaders and universal service providers, as the latter will most likely play an active role in consolidating the new market entrants. In addition, all major European issuers in the sector have sufficient financial headroom to engage in small- to medium-sized debt-financed acquisitions.

Analyst: Denis Kuhn

Automotive outlook 2018: Stable for 2018, but technological pressures to challenge margins

Automotive outlook 2018: stable

We see the outlook for the automotive sector as broadly stable. For automakers, we expect limited support on revenues and earnings from light-vehicle sales growth given our base case for 2018E of light-vehicle sales growth of less than 1%. Selected auto suppliers should continue to benefit from rising fitment rates and increased content per vehicle, with organic sales growth above the projected numbers for light-vehicle production.

Light-vehicle sales forecast for 2018E by region

For 2018E we expect global light-vehicle (passenger car and light truck) unit sales growth to moderate to levels of about 1%. A comparison with the expected growth rate of about 2% for 2017 indicates a levelling-off of demand following a decade of above-average growth, with growth rates averaging about 4% since 2007.

In our view, the decelerating growth rate is primarily driven by a slowdown of growth or decline in demand for light vehicles in the large volume markets of China, the United States and Europe, which is not being counterbalanced by the positive momentum we expect for smaller markets such as the Middle East, South America and South Asia.

China

China to remain key market

We expect this key growth engine for global light-vehicle sales in the past years to show further moderation of demand in 2018E. This development does not come as a surprise and is broadly in line with the viewpoint of most automakers and auto suppliers that a 'new normal' growth rate for China (i.e. low single-digit volume growth) is a reasonable expectation going forward. Over the past two years, volume developments in China have been influenced by tax incentives and government intervention that have led to some pre-buy effects. In 2016, customers brought forward purchases in anticipation of the tax rate on vehicles with a displacement of up to 1.6 litres being raised from 2.5% to 7.5% at the beginning of 2017. The pre-buy effect in 2016 could already be observed in the first half 2017 when the Chinese light-vehicle growth rate dropped to about 3%.

China broadly stable in 2018

General fundamental support in China, including low car penetration, economic growth, and the increasing availability of car financing for retail customers, principally remains supportive for the automotive market. Fundamentals point to stable market development in 2018E, a year that, in all likelihood, would be still influenced by the pre-buy effect for small passenger cars in 2016. Overall, we see the Chinese market for light vehicles almost unchanged in 2018E versus 2017.

North America/United States

North America weak in 2017

Despite high consumer confidence, a favourable labour market and manufacturer incentive programmes, the North American market was down by about 2% in the first half of 2017 compared with a strong prior-year period. Over the past years (2010-2016), volume growth in the United States was greatly boosted by a combination of low interest rates, availability of credit and replacement demand. The long-standing preference for light trucks (SUVs, pick-up trucks) has continued thanks to low oil and gasoline prices. Demand for sedans and compact cars already declined substantially in the first half 2017.

US market down by 4-5% in 2018

For the important US market, we expect a flat unit sales development in 2017 and a market decline of 4-5% in 2018E. This expectation is in line with our earlier projections and conviction that the US market has reached its cyclical peak. In 2017, unit volume sales in the United States will be supported by replacement demand for vehicles that have been destroyed by hurricanes Harvey, Irma and Maria. Without this hurricane-related effect, which we estimate should support sales of around 400,000-500,000 vehicles until the end of 2017, the US market would very likely have shown negative development already. Going forward, we see the following effects as having negative implications for volume development in 2018E:

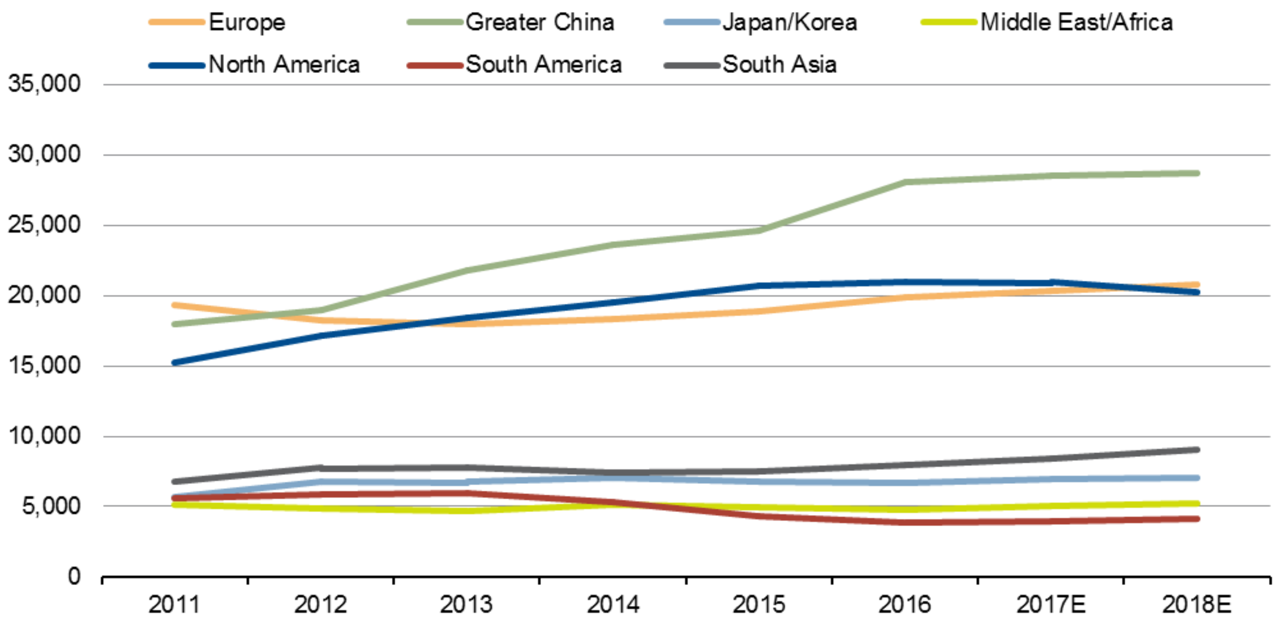
Rising financing costs in the US

Risk associated with gradually rising interest rates. The supportive financing conditions of the past few years (low auto loan interest rates, an appetite for risk on the part of car financial companies) are gradually coming to an end. More limited availability of consumer/auto credit, including tighter underwriting by car financing companies, combined with rising interest rates, should reduce the affordability of new car purchases.

Vehicles come off lease in 2018

Vehicles coming off lease. The US market has enjoyed high single-digit growth rates in the years 2013-2015, which peaked at a volume of 17.6m light vehicles in 2016. Consequently, and considering the typical duration of auto leases of three to four years, we see a significantly higher number of passenger cars and light trucks coming off lease in 2018-2019. We estimate an 'excess' supply of around 500,000 vehicles off lease in each 2018 and 2019, possibly dragging down used-car prices. This may, in turn, dampen demand for new light vehicles, especially in the absence of higher purchase incentives from carmakers.

Figure 26: Light-vehicle unit sales forecast by region



Source: IHS, Scope

Europe

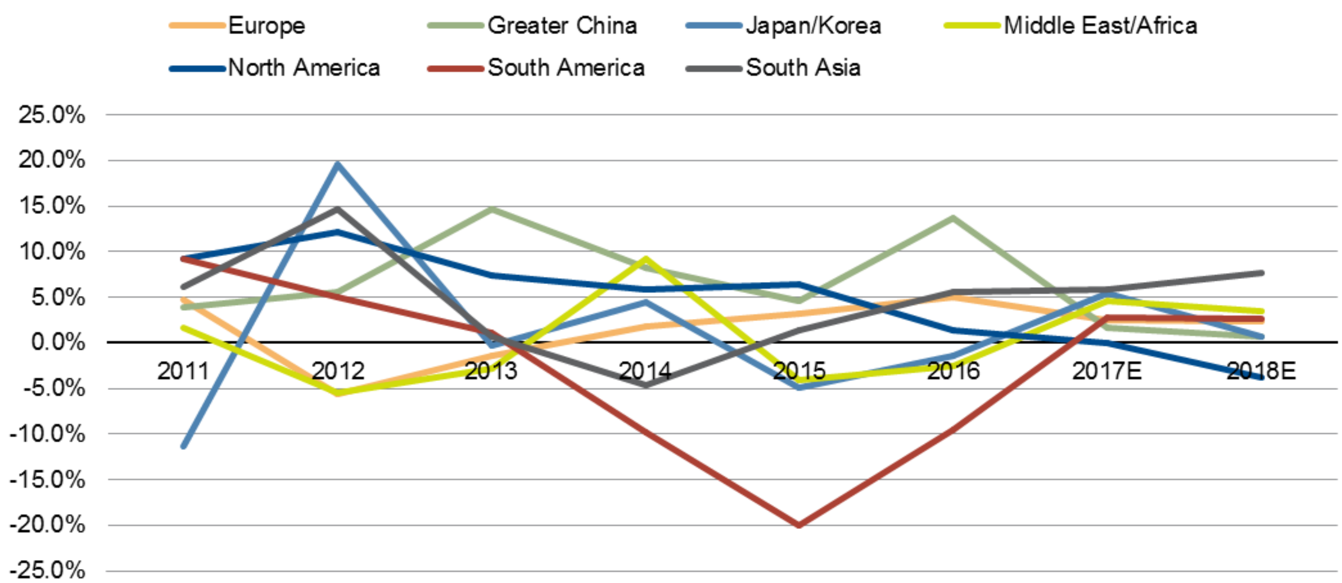
Western Europe to plateau in 2018

Following the strong revival of demand in recent years, the markets in Europe should continue to grow slightly in 2017. The ongoing economic recovery, favourable interest rates, and replacement demand in some countries (particularly in Italy, Spain and eastern Europe) have supported the European market since 2014. At the same time, the robust economic developments in key European markets (France and Germany), including low unemployment, have boosted unit volume sales beyond the unit volume sold during the financial crisis (which, at that time, was positively supported by scrappage schemes). For western Europe, we expect the markets to plateau at about 16m light vehicles in 2018E with some support from diesel-scrappage schemes offered by car manufacturers (replacement of older diesel cars with new diesel cars or petrol engines).

CEE: key volume driver in 2018

Tight labour markets, rising wages, and supportive fiscal policies (tax cuts) have buoyed up car sales in Central and Eastern Europe (CEE). Russia still accounts for about one-third of light-vehicles sales in this region. Thanks to rising consumption, government incentives for car park renewal, low interest rates and the Russian economy rebound, we see the CEE region as one of the key volume drivers for 2018E. Overall, we forecast a growth rate for Europe of slightly above 2% in 2018E.

Figure 27: Light-vehicle unit sales growth forecast by region



Source: IHS, Scope

Automotive electrification

China: largest electric vehicle market

Sales of battery-electric vehicles (BEVs) and plug-in hybrid electric vehicles (PHEVs) reached records in 2016 with over 750,000 electrified vehicles sold worldwide.

China has become the largest electric car market globally, accounting for almost half of electrified vehicles registered in 2016. Global unit volumes for electrified vehicles are, however, still at fairly low levels and represent less than 1% of global light-vehicle sales (2016). Consequently, there are still no implications for the credit quality of car manufacturers.

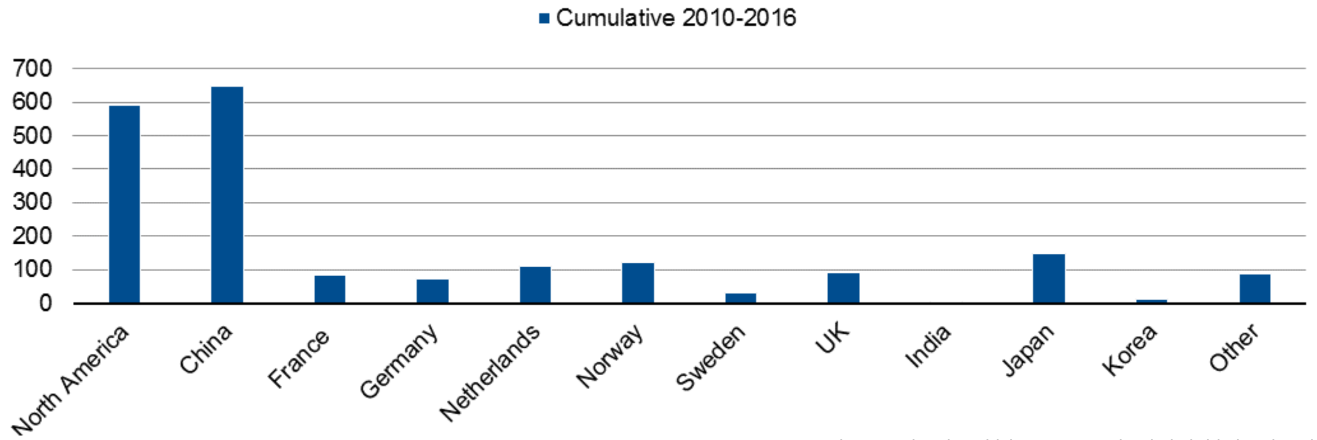
Subsidies to boost demand

Going forward, we see an increasing uptake of electrified vehicles driven by financial incentives, regulatory mandates, higher consumer acceptance and an improved charging infrastructure.

Electric vehicle targets in China

A key volume driver in this regard will once again be the Chinese market (as was the case for unit volume sales of combustion engines over the past decade). China has a regulation that requires automakers to sell a minimum number of ‘new-energy vehicles’ (these include BEVs and PHEVs) per year from 2019. In September 2017, China’s Ministry of Industry and Information Technology set out a policy that new-energy vehicles should reach 10% of volumes sold in 2019 followed by 12% in 2020. Failure to achieve these targets could result in fines for automakers but players in the industry can buy credits from competitors that exceed targets for the sale of electrified vehicles. Going by the numbers for 2017, a 10% share would represent more than 2.5m new-energy vehicles sold in China in 2019. This compares with about 2.0m electric cars (BEVs and PHEVs) sold worldwide over the period from 2010-2016.

Figure 28: Electric cars (BEVs and PHEVs) – cumulative new registrations by country



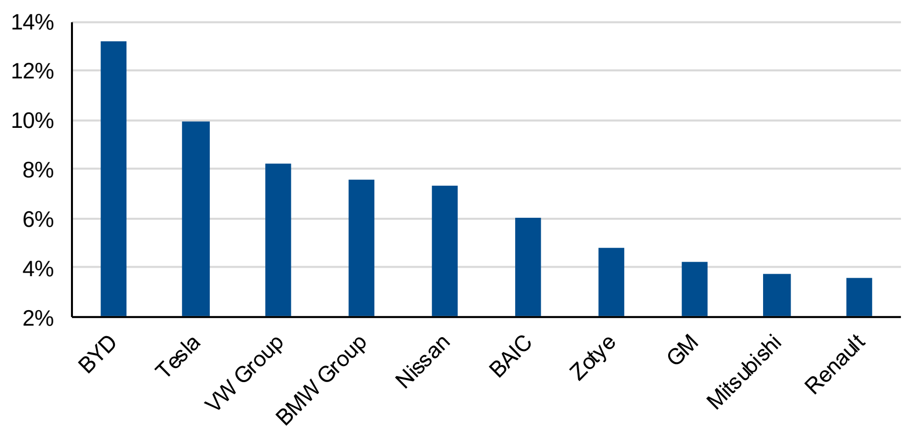
BEV = battery electric vehicle; PHEV = Plug-in hybrid electric vehicle
Source: International Energy Agency, Scope

Regulatory hurdles achievable

The regulatory targets for new-energy vehicles in China appear ambitious but achievable for original equipment manufacturers (OEMs) in our view. For instance, Volkswagen has announced a target unit volume for electrified vehicles in China of around 400,000 units by 2020.

Regulatory targets such as those in China and the continued need of car OEMs to reduce CO_2 fleet emissions may change the automotive landscape even though it is far from certain that the current leaders in electrified vehicles will remain so in the longer term.

Figure 29: BEVs – market shares of OEMs



BEV = Battery-electric vehicle; OEM = Original Equipment Manufacturer
Source: ev-volumes.com, Scope

Electric vehicles about 25% in 2025

OEMs have laid out different product and model strategies for the coming years (see Figure 30 below). Projections and plans by different OEMs point towards a share of about 25% of battery-powered vehicles by 2025. The largest share of vehicles on the way to achieving those targets will very likely be plug-in hybrids or hybrid vehicles, with only a gradually rising share of BEVs. The reasons for a slower take-up of pure BEVs are primarily:

Higher production/component costs: A key value-added component for BEVs is the cost of battery cells. Prices for battery cells are currently at EUR 200/KWh and only a further price decline for battery packs would reduce production costs for BEVs. Further investments by battery cell producers and learning-curve effects should lead to price falls for battery cells to levels of about EUR 100/KWh over the coming years.

Figure 30: Selected OEM announcements on electric car models

BMW	25 electrified vehicles by 2025 (announced at International Motor Show, IAA, in 2017)
Daimler	More than 10 pure electric vehicles by 2022; share of BEVs in a range of 15%-25% of unit volume sold by 2025
Volkswagen	Target of 80 electrified vehicles by 2025. 50 BEVs and 30 plug-in hybrids. Announced with Volkswagen 'RoadmapE' strategy in September 2017; share of BEVs in a range of 20%-25% of unit volume sold by 2025 (about 2m-3m electrified cars)
Jaguar and Land Rover	Production of only BEVs or hybrid electric vehicles from 2020
Volvo Cars	Production of only BEVs or hybrid electric vehicles from 2019
Ford	13 new electric vehicle models by 2020
Tesla	1m BEVs sold in 2020, 0.5m BEVs sold in 2018

Capacity limitations and capacity expansion for battery cell production

The electric car models announced by different OEMs implicitly assume sufficient availability of lithium-ion battery (cell) capacity over the coming years. As an example: if Volkswagen was to meet its target of up to 3m BEVs (50 new BEV models by 2025), this would require a lithium-ion battery capacity of over 150 GWh, the equivalent of four Tesla Gigafactories (Tesla's Gigafactory, a JV of Tesla and Panasonic, has a targeted capacity of 35 GWh per year). In view of the current production of battery cells, we believe substantial investment will be required in order to meet this increasing demand.

Analyst: Werner Stäblein

Utilities outlook 2018: Leaving behind the trough

Utilities outlook: positive

We believe that the 2018 outlook for European utilities is trending positive after years of depression bolstered by a rebound of commodity prices in major markets and the kick-in effects from portfolio restructurings. Moreover, we see fading political headwinds given the striking importance of supply security through well-maintained grids and reserve capacity systems. The negative cash flow effects from reduced returns on grid assets are unlikely to lead to significantly deteriorating credit metrics for regulated utilities. Ultimately, M&A is coming back on the agenda after business models and balance sheets have been restructured.

From contraction mode to expansion mode

Scope believes that the European utilities have left the trough behind, with pressure on the credit quality of major European utilities slowly easing, not only because of operational restructuring but also due to the rebound in commodity prices and greater clarity regarding the future setups of major utilities. Following depressed years of business contraction, major European utilities appear to be in expansion mode again: visibility of improving commodity prices has improved and political headwinds have lessened compared to the last few years.

Scope considers key issues for the further development of the business risk and financial risk profiles of utilities, including renewable energy corporates, to be:

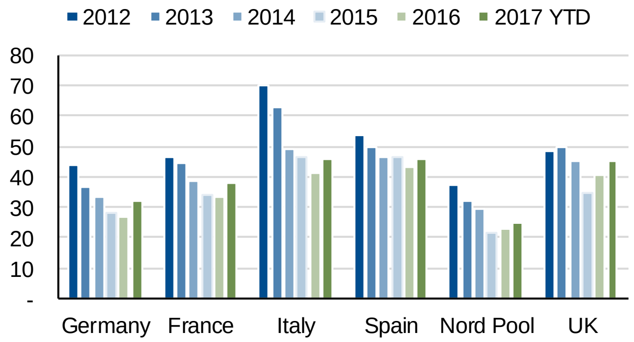
- Commodity price rebounds for spot and forward prices across European markets;
- More political support than headwinds;
- The start of new regulatory periods with lower returns on regulated grids as a result of the low interest rate environment;
- Increasing earnings contributions from capacity market systems;
- M&A back on the agenda: from demergers to M&A (Fortum-Uniper; SSE-npower);
- Renewed discussion of the European CO_2 Emission Trading Scheme;
- Slowing capacity ramp-up from renewables.

Rebound of commodity prices

Rebound of commodity prices stopping further margin erosion

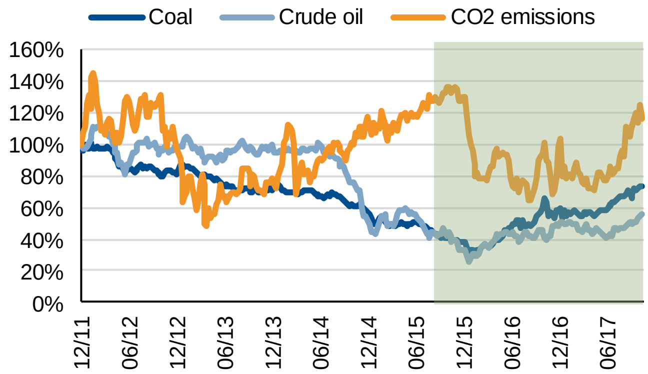
In light of the recent rebound in electricity wholesale prices across different European power markets and other relevant commodities (see Figures 31 and 32), Scope believes that unregulated power generators are likely to have emerged from the trough for power generation margins. Power generators in the German/Austrian and Nord Pool markets, whose power prices have been squeezed most over the past few years, are especially likely to benefit from this rebound (see also Scope's study: Commodity Rebound – Past the Trough). While for some conventional power generators 2018 will remain dispiriting, given the large share of hedged volumes at low prices, we expect margins in power generation to trend up on average, thereby easing the pressure on credit metrics.

Figure 31: Baseload prices 1Y forwards (EUR/MWh) in major markets



Source: Bloomberg, Scope

Figure 32: Rebound of commodity prices (crude oil, API coal, CO_2 certificates) 2012 = 100%



Source: Bloomberg, Scope

Easing political headwinds

From political headwinds to tailwinds

In general, we regard previous political headwinds for European utilities as fading, with positive stimulus being provided to major utilities. Given the phasing-out of incentive schemes for renewable energy across major European markets and growing political understanding on supply security, we believe the credit-positive effects from supportive political intervention such as: i) the strengthening of capacity schemes in additional European markets in 2018 (France, UK); or ii) the reduced production tax in Sweden for nuclear and hydro capacities, will create improved and less volatile margin profiles. Moreover, the French government has postponed a long-held target to reduce the share of nuclear energy in the country's power production after warnings on supply shortages after 2020 and the potential non-compliance with CO_2-reduction targets. The future regarding the phaseout of lignite power plants in Germany remains uncertain with currently no visibility on a future coalition. Ultimately, we expect movement from accelerating discussions of the European Emission Trading Scheme for phase 4 beyond 2020 to provide higher visibility on future capex allocations for new generation capacities (primarily gas-fired power plants).

Reduced returns on invested capital for regulated grids/networks not a major credit burden

Further adjustment of appropriate returns for grid operators not a threat to credit quality

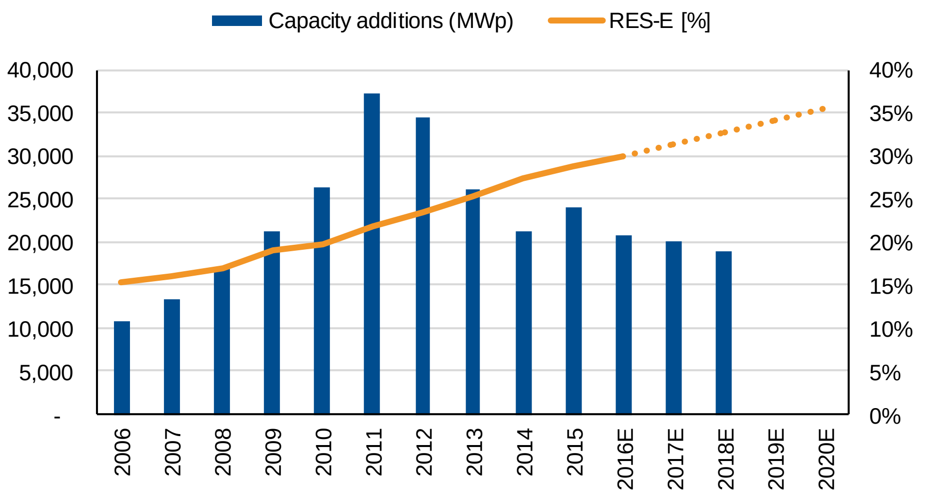
In a response to the persisting low interest rate environment, regulators across Europe are adjusting tariff levels for transmission and distribution. New regulatory periods are due to begin in 2018 with lower returns on invested capital for gas transmission and distribution in Germany and Austria. Nevertheless, tariff schemes for transmission and distribution are fully supportive of the heavy investment requirements made by Europe's energy transition. Consequently, Scope believes that the grid/network operators' credit quality will remain strong as companies can largely benefit from the excellent bankability and credit conditions for new assets. Scope expects no major credit threat to regulated TSOs and distributors.

Renewable energy: further slowdown in capacity additions

Phasing-out of renewable incentives supports further expansion of volatile wind capacities

The capacity ramp-up for renewable energy is expected to slow further, to below 20 GWp in 2018, following the introduction of new investment frameworks in major European markets without prioritised feed-in and fixed remuneration for renewable energy sources. Newly installed capacities are likely be dominated by on- and offshore wind, representing renewable energy sources which can compete in liberalised markets without subsidies. Overall, the EU 28 are pretty well on track to reaching the target share of about 36% of electricity generation from renewable sources (see Figure 33) (not considering the targets for renewable energy share in heat RES-H and transport fuels RES-T). While the slowdown in capacity expansion has reduced the pressure on conventional utilities, the increasing volatility of power generation emphasises the need for investment in transmission grids but also increases the likelihood of the further introduction of capacity market schemes in additional European markets, i.e. Germany.

Figure 33: Expansion of renewable energies in EU-28 countries (electricity generation – RES-E)



Source: Eurostat, NREAP, Scope

From demergers to M&A

M&A back on the agenda

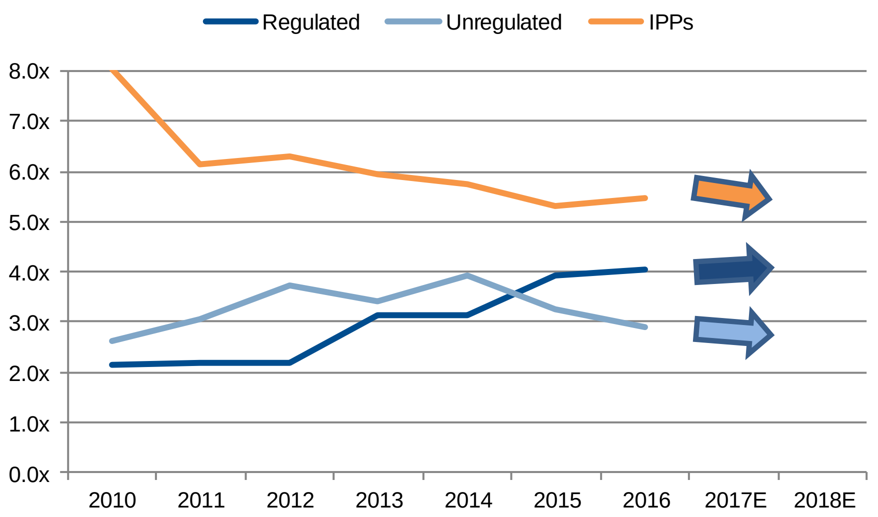
Following years in which major European utilities have concentrated on organic company developments with a strategic repositioning of activities and large asset disposal programmes, the industry is likely to see a return to increasing M&A activities. Balance sheets have been 'cleaned' and financing remains comparatively cheap. We believe that M&A activities are back on the agenda, as already indicated by the 'SSE-npower-innogy' and 'Fortum-Uniper-E.ON' transactions, given the higher visibility of sector developments over the next few years.

Credit quality stabilising further

Stable to improving leverage

Scope expects the average financial risk profiles of European utilities, as indicated by their leverage metrics, to stabilise further as the more defensive business mix adopted by major utilities and improved pricing conditions come to fruition. Average leverage metrics for unregulated power utilities of around 3x (Scope-adjusted debt/EBITDA) will probably remain lower than for regulated grid/network operators (at around 4x) which can, however, bear higher leverage for the same rating category given their well-protected business models. Leverage for renewable independent power producers (IPPs) is expected to come down further to around 5x on average, given the slowdown of capacity ramp-ups and stronger retention of earnings.

Figure 34: Leverage development of different utility sectors (Scope-adjusted debt/EBITDA)



Source: Company reports of 60 European utilities, Scope

Analyst: Sebastian Zank

Retail outlook 2018: A channel to stability?

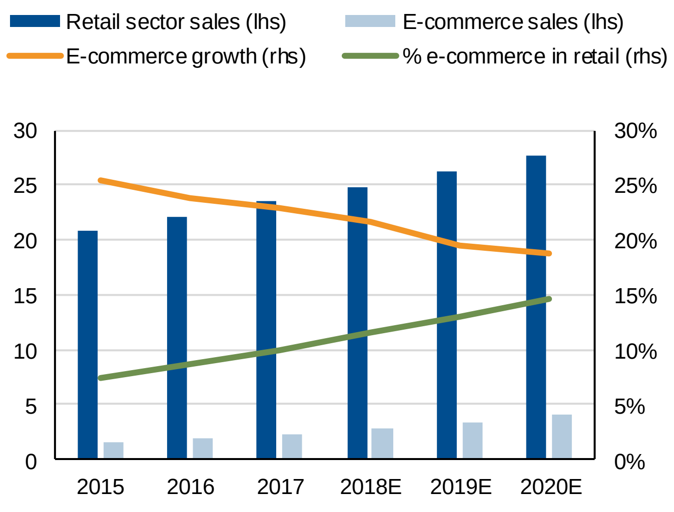
Retail industry outlook: stable

We view the overall sector outlook in Europe as stable. While the need to finance the transition to multi-channel retailer status (brick and mortar, e-commerce, m-commerce) will likely cause credit quality to deteriorate (due to a rise in capex), this will also lead to more robust business risk profiles.

A sector in evolution

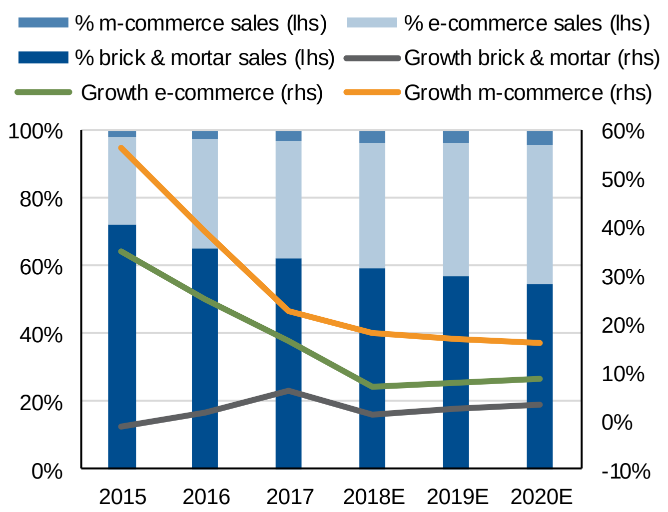
Despite household final consumption expenditure growth (at world level) stabilising at close to 2%, the retail sector continues to grow (Figure 35). This increase is mostly justified by the rise of e-commerce and m-commerce (mobile/tablet), which represented 10% of the whole retail sector in 2017, but is forecasted by e-marketer to reach 15% by 2020. This trend is continuing despite an overall slowdown of digital sales growth due to the ongoing market consolidation of e-tailers.

Figure 35: Worldwide evolution of retail and e-commerce sales (in USD trn)



Source: Emarketer, Scope

Figure 36: Erosion of market share of brick & mortar in the US, due to the fast growth of the mobile and e-commerce



Source: Emarketer, Scope

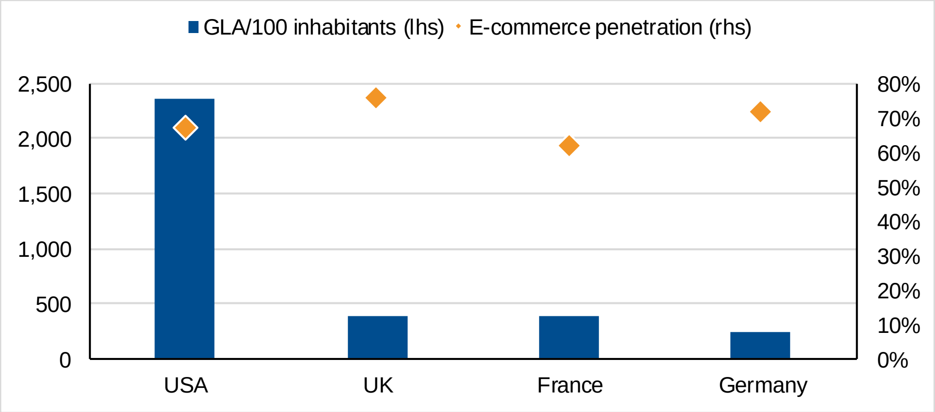
European retailers should not face a 'retail apocalypse'

On the other side of the Atlantic, 2017 was nicknamed the 'retail apocalypse': Toys"R"Us filed for bankruptcy; Macy's and Sears, among others, were forced to close stores. While the US retailers will continue to sell part of their brick-and-mortar assets (Figure 36), Credit Suisse expects a 20% reduction of the number of US shops within the coming five years), Scope does not expect a development of this amplitude to occur for European retailers in the foreseeable future.

Our predictions are based on the following reasons:

- On a business level, the US market is 'over-stored' (JLL), with six to 10 times more retail space (Figure 37) than in the European market. Despite US customers having a higher value of digital baskets, and thus a higher share of online revenues, Europe benefits from a relatively high e-commerce penetration (% of population using e-commerce), which is, in some cases, even higher than that of the US. We expect European retailers to gradually increase online basket sizes over the coming years (due to improved payment possibilities and delivery offers); nevertheless, this is restrained by geo-blocking in Europe, which should also give retailers enough time to adapt their offering.
- Higher debt levels for US retailers versus European firms. Many major US retailers have undertaken large leveraged buyouts (LBO), which has degraded credit quality. European retailers, by contrast, usually limit private-equity actions due to their stable and/or family-based shareholding structures.

Figure 37: Some features of the European retail market relative to the US market



Source: JLL, Scope

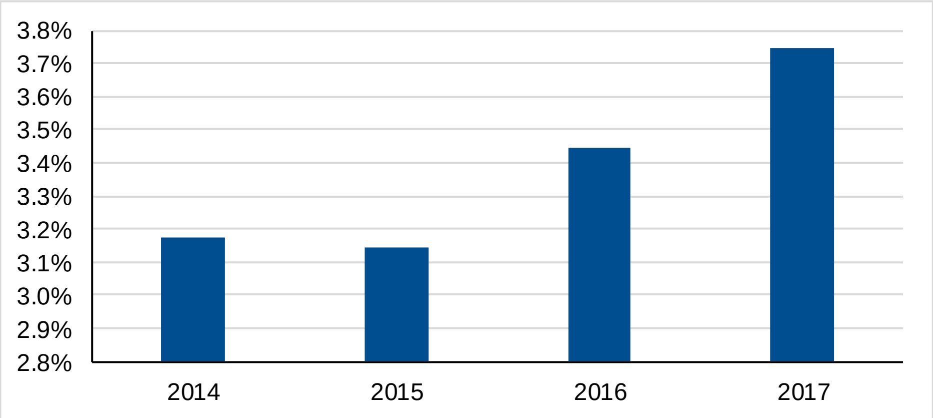
European retailers to continue investment process, but at different speeds

Investment is a necessity

After years of shrinking balance sheet sizes by exiting non-key markets/activities, many European retailers look set to increase capex by creating/reinforcing new sales channels, among other strategies.

Capex to sales among European retailers (combining brick-and-mortar and online retailers) has increased by nearly 20% over the last few years (Figure 38), and Scope expects this to continue in 2018 and beyond.

Figure 38: Evolution of the capex/sales median for European retailers



Source: Bloomberg, Scope

Despite a general increase in capex, investment targets differ widely.

- Brick-and-mortar retailers are spending capex on maintaining existing shops on top of investments in e-commerce (IT and logistics). Some brick-and-mortar retailers are benefiting from more than 10% of revenue from digital sales but on average such online shares remain marginal.
- E-tailers are developing a physical presence by either developing their own shops, acquiring shops or forging partnerships aimed at 'showcasing' products physically. Twenga, a market researcher, estimates that 40% of e-tailers had a physical store in Q2 2016.
- We consider m-commerce to continue to be a key investment target in 2018. While most retailers already offer online 'apps' for consumers, the development of m-commerce and 'smart purchases' (automatic purchases based on preferences/ recurring goods on multi-platforms) should become a major criterion for commercial differentiation in the coming years.

Increase of debt, but not in the same way for every retailer

Financing of capex differs among companies. Most large European retailers have successfully refocused on either key geographical markets or products via divestment/spin-offs to stabilise EBITDA margins. In our view, this modification of business models should increase chances of obtaining lower debt rates. On the other hand, retailers with sub-par EBITDA should face difficulties in financing their transition toward an omni-channel approach. We expect that in 2018 and beyond discrepancies in the ability of retailers to issue debt on financial markets will become more evident through an increase in interest rates.

Cash flows under pressure should deteriorate credit quality

We expect the reshuffling of portfolios (sale of less-profitable/non-key activities and shops) to continue from 2018 onwards. This should also pave the way for more M&A aiming at strategic expansion (such as Tesco's takeover of Bookers for GBP 3.7bn, or CEconomy's acquisition of Fnac for over EUR 0.5bn), or multi-format development (Amazon/Wholefoods at nearly USD14bn).

Along with our expectation on capex, working-capital management is expected to be a key criterion for the next few years. The growing requirement among customers for products to be permanently available will lead to higher inventory levels, only partly mitigated in the short term by the development of fulfilment centres.

To conclude, we expect major modifications to continue for the retail sector in 2018.

Positive view of industry's business risk profile

Negative financial profile counterbalanced by robust business profile

Regarding the business profile, retailers are forecasted to increase efforts in developing distribution channels. We expect a slow convergence toward an omni-channel retail business type. Nonetheless, retail sub-sectors will continue to transition at different speeds.

- The food brick-and-mortar business model is the most 'protected', as the investment required ex-nihilo by e-tailers to match speedy delivery while ensuring fresh products appears too high.
- Retailers dedicated to small/substitutable appliances (electric, apparel, cosmetics, entertainment) will evolve quickest due to the possibilities generated by online substitution. These sectors will make up the majority of future M&A activity, in our view.

Overall, we have a positive view of the industry's business risk profile, as retailers are becoming more diversified by products and channels.

Industry financial risk profile to deteriorate

Regarding the financial risk profile, we expect credit quality to deteriorate. The aforementioned modifications to business models will impact debt levels heavily and pressure cash flows. While European retailers are not expected to face conditions similar to those in the US, the range of interest rates at which retailers can borrow will widen in 2018.

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