Capital Goods Outlook 2021

The European capital goods credit outlook is negative. The lingering impact of Covid-19 and the only modest economic recovery anticipated for 2021 are the main risks. Non-investment grade companies face rating pressure.

Capital Goods, Scope Ratings GmbH, 21 January 2021

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| Bloomberg: RESP SCOP

Executive summary

Scope Ratings revises the European capital goods sector credit outlook for 2021 to negative compared with the stable pre-pandemic outlook.

While we expect the sector to rebound from the pandemic-related downturn in 2020, uncertainties persist and the economic recovery will not be enough to fully compensate the sector for revenue losses last year. How the pandemic evolves – in particular, the duration of current lockdowns, delays in a vaccine rollout, the potential for another outbreak – remains the principal risk. Rating pressure on smaller non-investment grade capital goods companies remains high.

The main trends we expect for 2021 are:

Positive:

- The likely return to normal across industrial supply chains as health authorities worldwide roll out Covid-19 vaccines should underpin the capital goods sector’s partial recovery in 2021.
- Manufacturing PMI indexes in major economies have turned up, indicating a return to growth (above 50 indicates expansion) after months of contraction.
- Bonds worth around EUR 14bn from capital-goods issuers mature this year. Rolling over debt should be manageable for investment-grade firms given the investor appetite for yield amid prevailing low interest rates.

Negative

- The strength of the recovery is unclear, given persisting uncertainties regarding the duration of current Covid-19-related lockdowns, delays in vaccine rollouts and the potential for another outbreak. Another potential risk is the development of US-China trade under the new US government.
- The expected recovery may not be enough to fully compensate for 2020 losses.
- Given the capital goods sector’s diversity of business models and end-markets, the pace of recovery will vary widely among the subsectors.
- Rating pressure for small, non-investment grade companies will continue in 2021.
- Deal-making could be credit-negative. Unlike in previous economic crises, valuations did not collapse in 2020. Potential deal multiples remain high. Ambitious, largescale M&A could strain balance sheets.

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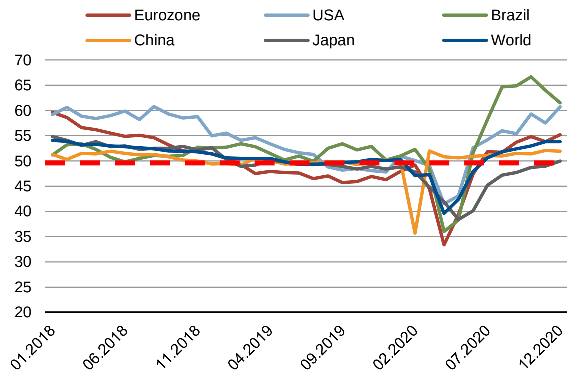
Key trends for 2021

The European capital goods sector is set to rebound from the pandemic-related downturn in 2020, but uncertainties persist, and the recovery may be too mild to fully compensate for last year's revenue losses. Revenue declined by an estimated 10% on average, while EBITDA[1] fell by 18%.

Economic indicators have been improving. For instance, manufacturing sentiment indexes (PMIs) in major economies are indicating a return to growth (above 50 indicates expansion) after several months of contraction. This gives reason to hope for growth in incoming orders for capital goods firms.

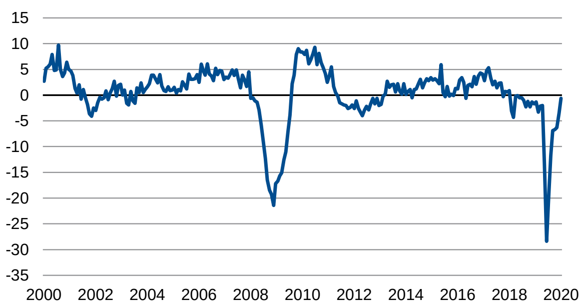
Figure 1: Manufacturing PMIs in major regions



Source: Bloomberg, Scope Ratings

Furthermore, we believe that the Covid-19 crisis created a supply rather than a demand shock. This explains the rapid recovery of manufacturing output in the euro area and US from lockdowns in Q2 2020, in particular compared with the rebounds in 2009 in the aftermath of the global financial crisis.

Figure 2: Euroarea industrial output



Source: Bloomberg, Scope Ratings

Provided we see normalisation of industrial activity across supply chains as the rollout of Covid-19 vaccines gains momentum, the capital goods sector recovery may be similar in strength to that in 2010: European large-cap capital goods companies recorded revenue growth of about 10%, compared with an average decline in revenue of 13% in 2009, and, aided by aggressive cost cuts, succeeded in expanding profit margins by even more.

Today's low interest rates and government support – in December, the US Congress passed a USD 900bn aid package; the incoming US government is reportedly considering massive additional spending of USD 1.9trn – provide a good backdrop for a recovery.

Persisting uncertainties make the strength of recovery unclear

Having said that, persisting uncertainties regarding the duration of current Covid-19-related lockdowns, delays in the vaccine rollout and the potential for another outbreak make the strength of the recovery unclear, with the danger that it might stall in the near term. Another potential risk is the future of US-China relations and their impact on global trade under the Biden administration. All in all, we believe that the recovery in 2021 will not be enough to fully compensate for 2020 revenue losses. For 2020, we expect average declines of 10% for revenue and 18% for EBITDA compared with the previous year.

Pace of recovery should vary widely among different subsectors

The capital goods sector also has an array of different business models and end-markets, so the pace of recovery should vary widely among the different subsectors. Companies with commercial aerospace exposures such as General Electric Co., UK engine-maker Rolls-Royce PLC, French aero-defence firm Safran SA and Germany's MTU Aero Engines AG may continue to suffer from the severe reduction in demand for air transport induced by the pandemic, with airlines cancelling and deferring orders to conserve cash. Capacity cuts, retirement of older planes and a slow return to pre-crisis air traffic could have a lasting adverse effect on lucrative aftermarket business. By contrast, companies with exposure to mining, for example, should show above-average performance given the stable market fundamentals and above-average commodity prices.

Pressure on non-investment grade ratings to continue in 2021, but less pressure on large-cap ratings

Leverage ratios at European capital goods suppliers rose in 2020, mostly due to steep declines in EBITDA, putting some pressure on the ratings.

Large European capital goods companies such as Schneider Electric SE and Alfa Laval AB were relatively well placed to cushion balance sheets with careful management of working capital, capital spending and cash pay-outs to shareholders as reduced profitability crimped cash flow.

By contrast, leverage ratios of smaller, cyclical capital goods companies such as printing-machine maker Heidelberger Druckmaschinen AG have increased

[1] Earnings before interest, taxes, depreciation and amortisation

disproportionately. This was also true for companies which made sizeable and expensive acquisitions in 2020 such as German mechanical-engineering firm Voith GmbH & Co. KGaA.

Capital goods companies, like other corporate borrowers in Europe, were spared a liquidity crunch, partly because of prudent financial policies pre-dating the pandemic and partly through the assurance of easy borrowing conditions by central banks as the Covid-19 crisis struck. Treasurers of large, investment-grade capital goods companies had, in particular, stretched out debt maturities over recent years, using the low interest-rate environment and established sizeable revolving credit facilities in proportion to their debt. Most industrials were also able to cover interest costs comfortably.

The expected recovery in 2021 may stabilise the ratings of large investment-grade European capital goods companies in particular. It should take more time for smaller, non-investment grade companies such as Heidelberger Druckmaschinen AG to return to their 2019 leverage ratios and we expect the rating pressure for these companies to continue in 2021.

Expect higher shareholder pay-outs

To save cash and to manage through a global downturn of unknown duration, European capital goods companies tended in 2020 to use less cash for share buybacks and dividends compared with in 2019. Companies such as Assa Abloy AB, AB SKF, Sandvik AB, Smiths Group PLC and Alfa Laval AB have cut or cancelled their dividends. Other companies such as Schneider Electric have suspended their share-repurchase programmes.

What is more, in Europe, share buybacks continued to play a subordinated role in capital allocation. This instrument is used by and large only by large caps such as Siemens AG, Schneider Electric and Koninklijke Philips NV.

The 2020 year provided further evidence of differences between the financial policies of US and European capital goods companies. We note generally that US-based capital goods companies were more reluctant to make share buybacks and pay dividends: while share buybacks reduced slightly, dividends remained stable between 2019 and 2020. We also note that on average in the past four years, US-based capital goods companies used around 70% of their operating cash flows for share buybacks versus around 45% in Europe.

European and US-based capital goods companies reined back spending on M&A in 2020 compared with the previous year (see **Figure 3**).

Figure 3: Three-year average capital allocation (as % of operating cash flow)

Capital allocation, last 12 months 2020				
	CapEx, net	Acquisitions, net	Dividends	Buybacks, net
US companies	20%	9%	39%	23%
European companies	22%	18%	28%	7%
Capital allocation 2019				
	CapEx, net	Acquisitions, net	Dividends	Buybacks, net
US companies	18%	19%	35%	27%
European companies	26%	18%	39%	8%
Capital allocation 2016-19 average				
	CapEx, net	Acquisitions, net	Dividends	Buybacks, net
US companies	20%	26%	37%	36%
European companies	25%	16%	35%	9%

Source: Bloomberg, Scope Ratings

European capital goods companies' readiness to pay dividends and buybacks should increase in 2021 but remain below pre-pandemic levels given the lingering uncertainty about order growth, cash flow and the strength of the economic recovery.

Modest deal-making likely in 2021

Similarly, the lack of business visibility will likely deter transformative M&A activity in 2021, with more of a focus on bolt-on acquisitions to gain technology or software assets amid the growing digitalisation of end-markets. The size of deals may be small, but they could prove more expensive given the higher multiples typical for technology-sector transactions.

Another focus of M&A in the sector could be on strengthening companies' core businesses and supply chains, given the risk that trade disputes could again escalate in 2021. Bond yields, hovering near all-time lows, provide a favourable backdrop for M&A. We anticipate that Siemens AG, Schneider Electric SE and Swedish lock-maker Assa Abloy AB will be among the consolidators in their respective subsectors.

Deal-making, however, could be credit-negative. Unlike in previous economic crises, including the global financial crisis in 2008-09, valuations did not collapse last year as the crisis struck. Deal multiples continue to be very high, posing risks to the finances of companies which go after largescale acquisitions.

Companies in the European capital goods sector undertook significant asset sales in 2020, partly under pressure from activist shareholders. Several diversified European capital goods firms such as ABB (power grids), Siemens (energy), Thyssenkrupp (lifts), and Metso Oyj (mining) reduced their exposure to underperforming units and streamlined operations to realign activities towards key markets or customer segments.

Mainly depending on the evolution of Covid-19, further asset sales are possible in 2021. These include the sale of Smiths Group PLC's medical unit, Sandvik AB's materials technology business, and Philips NV's domestic appliances business. Siemens could also sell its logistics unit and Thyssenkrupp could sell its industrial solutions unit and/or its steelmaking arm.

French train-maker Alstom is expected to close its acquisition of Canada's Bombardier Transportation in 2021.

Selling assets, as Siemens and Switzerland's ABB Ltd. did in 2020, often leads management to make capital allocation decisions that can test financial policies. The credit-rating impact largely depends on the importance of the divested assets in terms of their contribution to revenue and profitability, how the sale proceeds are used, and the structure of the individual deals. ABB, for instance, plans to distribute all proceeds from the sale of its power grids unit of around USD 7.7bn to shareholders.

Figure 4: Possible asset sales in European capital goods sector in 2020

Companies	Unit	Type of transaction	Unit's sales	Group's total sales
Siemens	Logistics	Sale	na	~EUR 57bn
Thyssenkrupp	Industrial Solutions	Sale	~EUR 3bn	EUR 29bn
Thyssenkrupp	Steel Division	IPO/Sale	~EUR 7bn	EUR 29bn
Sandvik	Materials Technology	Sale	~SEK 15bn	~SEK 100bn
Smiths Group	Medical	Sale	~GBP 900m	~GBP 3bn
Philips	Domestic Appliances	Sale	~EUR 2bn	~EUR 19bn

Source: Annual reports, press releases, Scope Ratings

Some funding pressure in 2021

European capital goods companies face around EUR 14bn in maturing bonds through 2021. With around EUR 5bn of upcoming maturities, funding pressure is the highest for Siemens, followed by Airbus Group SE (around EUR 1.2bn), Rolls-Royce (around EUR 1bn), Thales SA (around EUR 900m), BAE Systems PLC (around EUR 850m) and Schneider Electric (around EUR 800m).

Figure 5: Issuers with largest bond maturities through 2021

Company name	Total (EUR bn)
Total volume outstanding	**13.6**
Siemens Financieringsmaatschappij NV	5.0
Airbus SE	1.2
Rolls-Royce PLC	1.0
Thales SA	0.9
Schneider Electric SE	0.8
Other	4.7

Source: Bloomberg, Scope Ratings

The maturities should remain manageable, notably for investment-grade issuers, in view of the investor appetite for yield amid the low prevailing interest rates.

European capital goods companies are well placed to issue debt to refinance short-term maturities and improve their liquidity given the lingering Covid-19 related uncertainties this year.

Annex I: Related research

"Automotive credit outlook swings to stable: 2020 slump less severe than expected; rebound underway", published Jan 2021 available here

"European corporates: creditors, taxpayers bear Covid-19 financial burden; will shareholders in 2021?", published Dec 2020, available here

"Sovereign Outlook 2021: global growth recovers amid high debt; changing fiscal, monetary frameworks", published Dec 2020, available here

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