Corporate Outlook 2017: Still Stable but More Risks on the Horizon

Scope Ratings

Scope's corporate ratings team has assessed the credit outlooks for 2017 for the seven main industrial sectors (automotive manufacturing and supply, construction, real estate, pharmaceuticals, utilities and renewable energy). In general, we continue to see broadly stable credit quality for most sectors, although a start to a negative trend is likely, given the now more mature credit cycle. Scope's industry experts believe that while cash generation is still satisfactory for most companies we observe, the risks driving down credit quality have become more realistic. These include a weakened ability to realise growth (potentially leading to more M&A), increasing wages, and higher raw material prices – all of which will start to erode the solid cash flows that might result in lower capital expenditure.

Strong balance sheets support credit quality

In our view, the strong balance sheets and high liquidity positions that have built up in most companies over the last five years still bode well for stable credit trends, for at least the first six months of 2017. The utilities sector is the exception, for which we have a slightly more positive view than last year. While corporate credit quality has been supported by good demand in the past few years – helped by the 'triple positive' combination of low interest rates, low oil prices and low inflation –, we believe that risks in companies' operating environment, coupled with political factors and market sentiment, could become a turning point for the very mature credit cycle in Europe. In addition, the stronger divide of prospects between old and new economic sectors illustrates the likely need for more choice when it comes to investment in 2017. Additionally, business models of companies with high exports to the UK might see further pressure following the country's Brexit execution.

While Scope believes European default rates will not rise massively in 2017, historic lows might already have been reached.

Scope covers first DAX-listed companies in Germany

For Scope's corporate ratings division, 2016 was characterised by the first mandates from DAX-listed companies (BASF AG, Linde AG, Merck KGaA and Deutsche Lufthansa AG) plus Franz Haniel & Cie. GmbH, making Scope the first small rating agency in Europe to be hired by blue chips, formerly only the domain of large international agencies. This confirms our view of the quality of our product, as well as the markets' desire to see more competition in the ratings sector.

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Related Research

European Automotive Suppliers: Outlook & Application Study
March 2015

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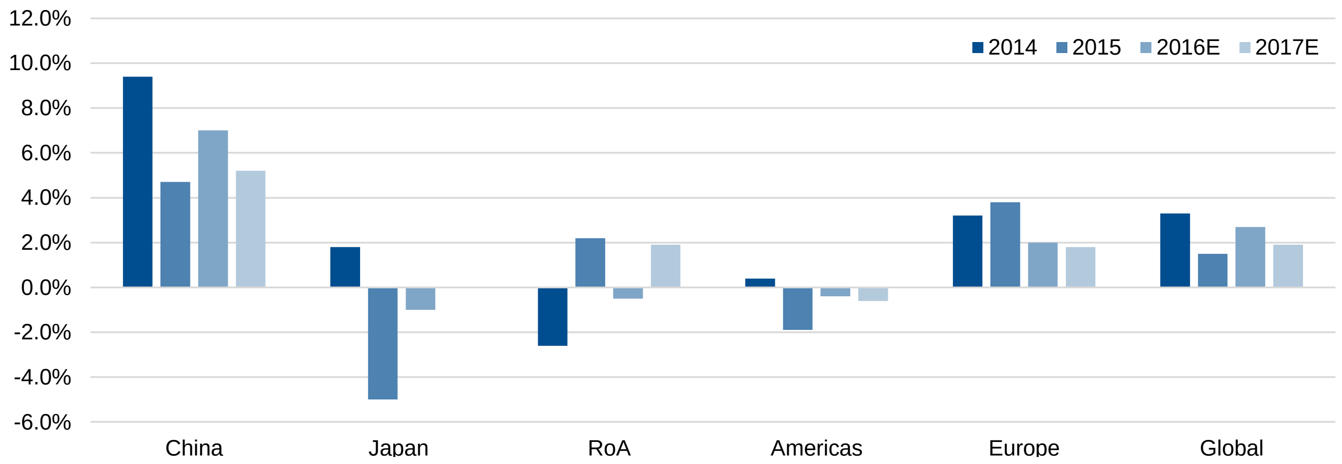
European automotive outlook 2017

Industry fundamentals weaken but outlook remains stable

Scope's credit outlook for the European automotive industry remains stable for FY 2017. We have observed increasingly clouding fundamentals in the industry in 2016, and our outlook for 2017 reflects the following key considerations:

- **The US, a key market, is reaching its peak**: Recent data on seasonally adjusted annual sales rates (SAAR) in the US suggest a flattish development of volumes going forward.
- **Short-term growth prospects for China remain intact:** Chinese car production was supported in 2016 by government incentives; however, car demand in 2017 will weaken and will be supported by the general economic environment rather than tax subsidies.
- **Connectivity, digitalisation and emission-related issues will drive up capex and R&D:** Changing customer behaviour and tighter regulatory scrutiny continue to require substantial investment from auto-makers and suppliers alike.

Figure 4: Light-vehicle production in key markets (YoY)



Source: Scope, IHS

Continued global light vehicles growth in 2017

Scope expects light-vehicle to growth globally by 1.9% in 2017, versus the 2.7% expected for 2016. In our view, growth will decelerate through the softening production in the key markets: Europe, North America, China, Japan, South Korea, and South America.

Steady recovery in Europe

For Europe, we expect light-vehicle production to continue on a steady recovery. We forecast that European car production will increase by 1.8% in 2017 versus the 2.0% expected for 2016 (Western and Eastern Europe). The slightly slower pace of expansion reflects our view of the intensifying macroeconomic uncertainty resulting from the Brexit vote and structural issues in Europe's banking system, which may impact consumer spending and hurt replacement/new demand for vehicles. We believe the European market will again be supported by favorable developments in Germany, France, and Spain.

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US market peaks – expected to be flattish 2017

The market in the US reached a new record in 2015, with sales of just under 17.5 million light vehicles (+3% YoY). However, volume growth decelerated in 2016. Over the past years, this positive momentum was powered by a combination of low interest rates, low gas prices and high replacement demand. Scope expects limited market upside in the US, as indicated by recent vehicle-sales figures. The seasonally adjusted annual rate of 17.7 million units (according to Ward's Auto Info Bank), was down slightly from nearly 18.0 million in September 2015, resulting in a three-month rolling average of negative 1.6%. In addition, despite sound economic fundamentals, we expect increasing headwinds from the higher interest rates for auto loans. We have also recently observed high inventory levels at US car dealers. As a consequence, we expect US production volumes to flatten.

Growth in China positively influenced by governmental intervention

In 2016, the Chinese market was supported by government intervention, through tax cuts for small-engine vehicles introduced at the end of 2015. According to the China Association of Automobile Manufacturers, total passenger-car sales rose by 15.4% to 19.1 million units in the first 10 months of 2016, which was largely supported by these tax incentives. Based on IHS data, total light-vehicle production is expected to grow by roughly 7% in 2016. Despite the phase-out of tax incentives by the end of 2016, Scope still has a positive outlook for the Chinese market. We forecast light-vehicle production to grow moderately by 5% in 2017. China's single-digit growth rates, a new norm for the industry, are supported by stabilising fundamentals, which indicate GDP growth of 6-7%. In addition, the greater availability of car financing for retail customers provides a further boost to the market, in our view.

Analysts: Timo Schilz, Werner Stäblein

European utilities outlook 2017

Stabilising sector fundamentals against further erosion of credit quality

Scope believes the pressure on credit quality for major European utilities is alleviating slowly, not only because of the accomplished operational restructurings, but also due to the rebound of commodity prices and greater clarity over major utilities' future setups. Nevertheless, the pressure on utilities' balance sheets remains, triggering an increasing demand for hybrid debt or even equity injections. While credit metrics remain under pressure in the short term, Scope already sees evidence that the strategy of substituting volatile margin business for more robust forms is finally coming to fruition.

In Scope's view, the further development of business- and financial-risk profiles of utilities (including renewables corporates) is driven by the following:

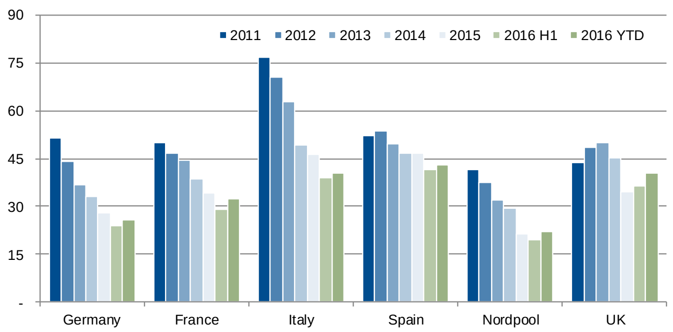
- A recovery of wholesale prices across European markets
- A stabilisation of integrated utilities, bolstered by corporate restructurings
- Better visibility on nuclear provisions (decommissioning and fuel disposal)
- Regulated grids/networks with lower remuneration
- Less regulatory support for new renewable energy capacities
- More usage of hybrids or equity measures

Stabilising sector developments

Rebound of commodity prices stops further margin erosion

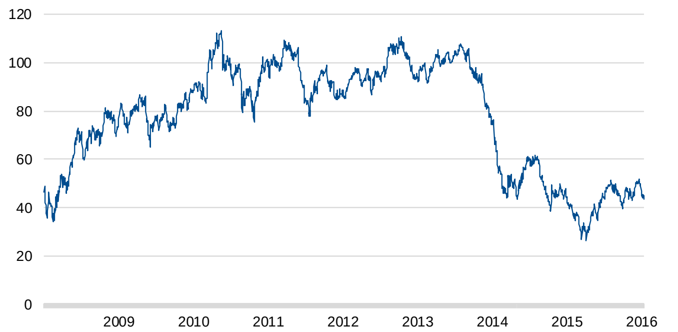
After years of dismal fundamentals in the sector – stemming from slow volume growth, the rise of renewables, and squeezed commodity prices –, wholesale prices have stabilised, particularly in the worst-hit markets, Germany and Scandinavia (Figure 1). Improved 'dark' and 'spark' spreads in power generation, as well as improved margins in the trading business, will stop the pressure on key credit metrics, such as leverage and debt coverage. Moreover, with the increasing share of renewables and the comparatively slow roll-out of adequate transmission resources, Scope believes that a strengthened system for capacity remuneration will come on the political agenda again.

Figure 1: Baseload prices 1Y forwards (EUR/MWh)



Source: Bloomberg, Scope

Figure 2: Oil prices (WTI crude oil in USD/barrel)

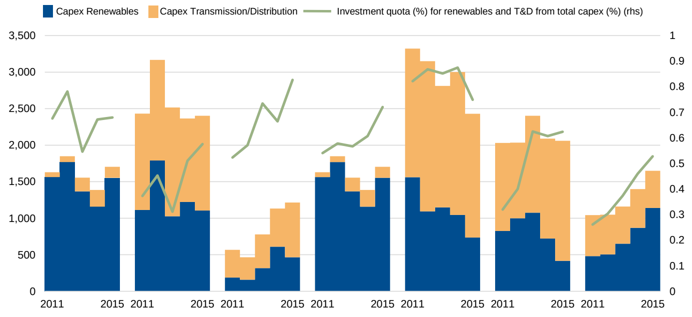


Source: Bloomberg, Scope

Strategies to come to fruition after the peak of the investment cycle

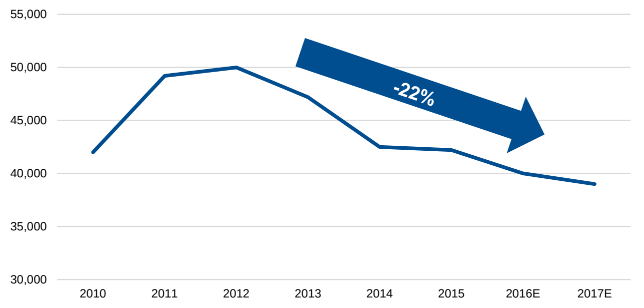
Scope believes that the corporate and portfolio restructurings by major European utilities will somewhat stabilise credit quality, if not even improve it. Heavy investment in the past few years, primarily in regulated assets and renewables (Figure 3), as well as increased activity in non-European markets, will likely have a stabilising effect on discretionary cash flows. While new assets are increasingly supporting operating cash flows, Scope believes free cash flows are likely to be less under pressure as the investment cycle has likely reached its peak (Figure 4) (see also Scope's study 'European Integrated Utilities: From Headwinds to Tailwinds').

Figure 3: Renewables capex for major utilities (EUR bn)



Source: Annual reports of utilities, Scope

Figure 4: Investment, 2010-2017E (EUR bn)



Source: Capgemini Consulting , Scope

Better visibility on nuclear power in Germany …

Although debt-like asset-retirement obligations for decommissioning nuclear plants form a significant portion of utilities' adjusted debt, Scope regards the new visibility on the funding of such obligations among German nuclear plant operators as a relief. The German parliament has broadly followed the recommendations of the German Nuclear Commission (see also Scope's report: 'German Nuclear Provisions: Proposed Risk Surcharge Digestible'). The draft law, which is likely to be enacted in 2017 within the current legislative period, requires the transfer of provisions for the disposal and storage of nuclear waste (EUR 17.4bn) plus a risk surcharge (EUR 6.2bn) to an independent foundation (similar to funding systems in Scandinavia or the UK); the funding of the power plants' decommissioning will remain with the utilities. Scope believes the attached credit risks will be manageable, in light of the granted payment schedules of the risk surcharges by year-end 2022 (or 2026 under certain conditions), as well as envisaged funding strategies i.e. potential capital hikes or increased usage of hybrid debt issuances.

… increasing nuclear risks in France

In contrast, uncertainties over nuclear provisions in France may rise because of: i) the European Commission's view that France might be underestimating its costs of nuclear decommissioning compared to other European countries (i.e. estimated clean-up costs of EUR 300m per GWp in France versus EUR 1.4bn per GWp in Germany), and ii) recent malfunctions that interrupted the operations of 12 French nuclear reactors in November 2016.

Lower remuneration offset by favourable (re-)financing

Reflecting the persistently low interest rate environment, regulators across Europe are adjusting tariffs for transmission and distribution. Moreover, the continuing pressure on cost efficiencies is tackling the creditworthiness of European-regulated grid and network operators. While heavy investments in electricity grids are strongly required in light of Europe's energy transition, Scope believes credit quality among grid/network operators will remain strong, as they can largely benefit from the excellent bankability and credit conditions of new assets. Consequently, Scope expects no major credit threat to regulated transmission system operators and distributors.

Renewable energy corporates: the game gets tougher

Fading regulatory support for new renewable energy capacities across Europe

Scope points to the fading support for new renewables capacities across Europe, which can be characterised by market-oriented remuneration and a controlled growth of capacities. In core markets such as Germany, France and the UK, the increased use of competitive bidding and a lack of guaranteed feed-in of generated clean energy will increase pressure on the utilisation and profitability of newly installed capacities. While the slower growth of clean energy sources can be credit-positive for utilities with a low renewables exposure (given fading competition within the merit-order system), this is clearly credit-negative for independent power producers of renewables, and particularly for project developers. Only large project developers with a strongly diversified project pipeline and exposure to different renewables markets are likely to survive in such conditions. In contrast, smaller project developers that rely strongly on the successful bid of single projects are likely to be squeezed out of the market.

Financial measures to maintain credit quality

Use of hybrids or requirement for equity increase

Scope highlights that major European utilities are not only adjusting their business models with the aim of stabilising creditworthiness, after years of negative rating migrations. Scope also sees clear signals to deleverage, through the increasing use of hybrid-debt issuances, indications on equity hikes, and the continuation of asset-rotation programmes. Overall, Scope assumes utilities will take full advantage of the low interest rates, diversified funding sources and ECB eligibility of utilities' corporate debt in order to keep leverage and debt protection measures commensurate with current ratings.

Analyst: Sebastian Zank

European construction outlook 2017

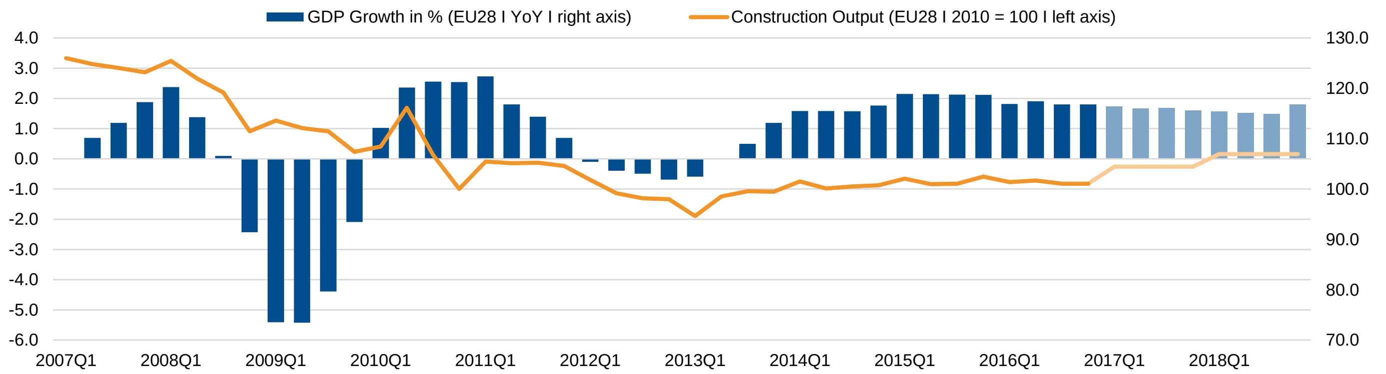
Further recovery of the sector, after growth catches its breath in 2016

Scope believes the European turnaround in construction output took place in 2013-2014, when the EU and European Investment Bank provided support for infrastructure projects. However, up to Q3 2016, European construction grew by just 2% since Q4 2013 (source: Eurostat). This was driven by strong growth in Spain (16%), the Netherlands (22%) and the Nordics (around 15%), but hampered by the sharp decline in Central and Eastern Europe (around negative 10%).

Further growth of construction output, as projects financed under European initiatives reach implementation phase

For the EU, Scope forecasts construction output to grow by 3.0% in 2017 and 2.5% in 2018 (Figure 5). Scope's assumptions are driven by i) the recent growth of house prices for most European economies, and ii) projects, financed under initiatives such as the Juncker Plan and 'TEN-T connecting Europe', which will be implemented between 2017 and 2018. Further support comes from the still-generous ECB policy. Loose monetary policy aids the flow of cheap credit into the private sector, especially for 'peripheral' economies still saddled with substantial debts; whereas governments will continue enjoying low funding costs, induced by the ECB's quantitative easing since March 2015. Downside volatility is set to increase due to uncertainties from i) the Brexit referendum, which accompanied a slowdown in UK construction investment (from 3.7% to 0.4% until Q2 2016), ii) the sharp decline in Polish construction output (negative 16% YoY as at end of Q2 2016) and iii) tapering[1] rumours due to the decrease of eligible assets for the ECB's asset purchase programme.

Figure 5: GDP YoY growth vs construction output (European Union) 2007–2018



Source: European Economic Forecast Autumn 2016, EUROSTAT

Staff shortages still hamper growth

At the end of 2015, one of the main issues in the construction industry remains unsolved: the sourcing of new employees, as two-thirds of the labour force will retire by 2020. While the need for skills has risen significantly in recent years, construction is generally unappealing to workers, despite the recent strong growth in hourly wages according to Eurostat. The lack of workforce is therefore expected to force out many regionally focused, micro and small companies. The European Commission's 'Construction 2020 Action Plan', launched in 2013, has taken first steps in tackling these issues, including the low number of qualified workers.

Consolidation should benefit from low costs of capital

With smaller companies expected to exit the market, along with continued growth in the industry, we expect further consolidation in a sector that aims for greater size in order to increase economies of scale and geographical diversification, and to strengthen the position of European constructors in worldwide-bidding processes.

[1] Tapering is the gradual winding down of central bank activities used to improve the conditions for economic growth.

Consolidation will benefit from the relatively low costs of capital, empowering market participants, through M&A to reach targets of market leadership or diversification.

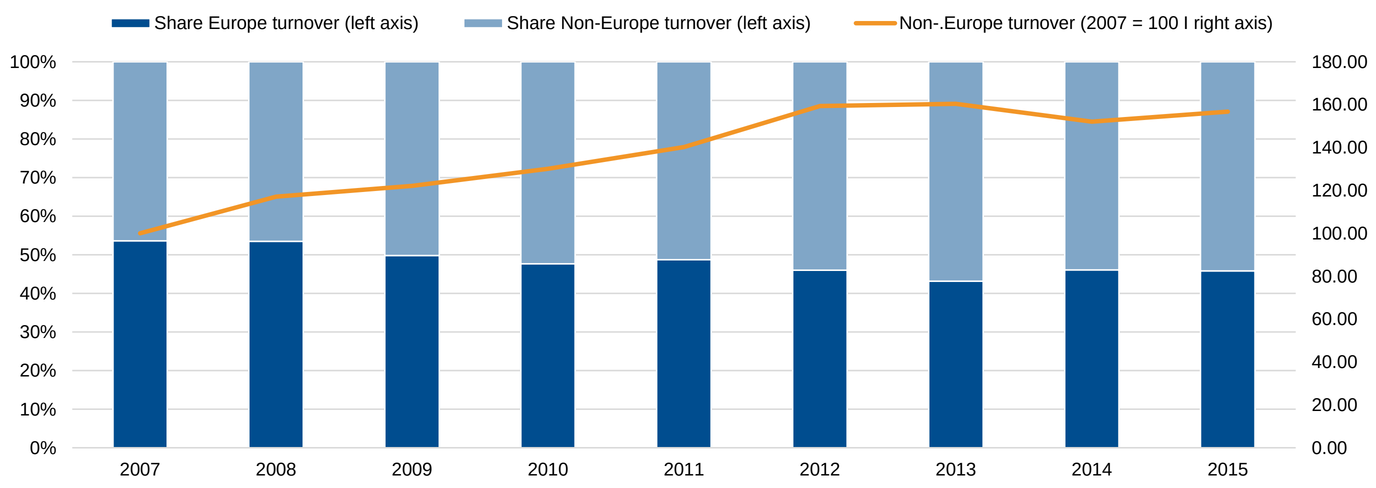
Large companies have benefited from growth outside Europe

Despite the still-subdued growth of European construction output since 2007 (CAGR of negative 2.0%, according to Eurostat), larger construction corporates have increased total turnover by 3.3% p.a. since 2007. This development is foremost driven by an increasing share of turnover generated outside Europe, at a CAGR of 5.0% since 2007 (Figure 6). In our view, larger construction corporates are likely to improve business risk profiles further, backed by diversification to global activities and the ongoing recovery in domestic markets. However, a recent focus on low-margin, mature markets, like North America, with the turnover of European construction corporates increasing by 16% YoY as at YE 2015, is likely to put pressure on profitability, thus weakening credit metrics for highly leveraged corporates.

Smaller contractors face stronger competition

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 companies on domestic markets. In addition, diversification into other regions is limited by i) capital available, and ii) potential setbacks because the achievable foothold is very small. These factors heighten the risk of harsh exposures to market-specific construction cycles. However, the ongoing rebound of peripheral-Eurozone housing markets also gives smaller construction companies the opportunity to improve.

Figure 6: Distribution of turnover from European construction companies, 2007-2015



Source: EIC

The financial risk profile benefits from low interest rates and good access to capital markets. Consequently, companies are expected to improve debt protection measures, whereas leverage should 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 global economies, especially in light of the anticipated reduction of profitability.

Analysts: Philipp Wass

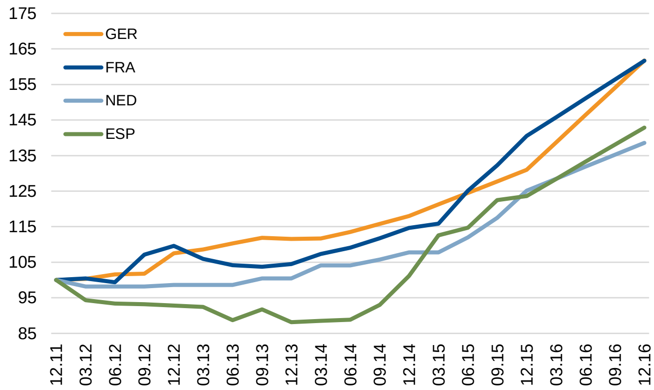
European real estate outlook 2017

Tenant demand fuels property prices; yield compression at the end of the road

European real estate prices are soaring in 2016 (Figure 7), despite the unstable economic environment caused by i) rising interest rates in the US and their effect on European markets, ii) a rise in populist politics worldwide, and its potential negative impact on growth, iii) the Brexit referendum, and iv) the ongoing threat of terrorism.

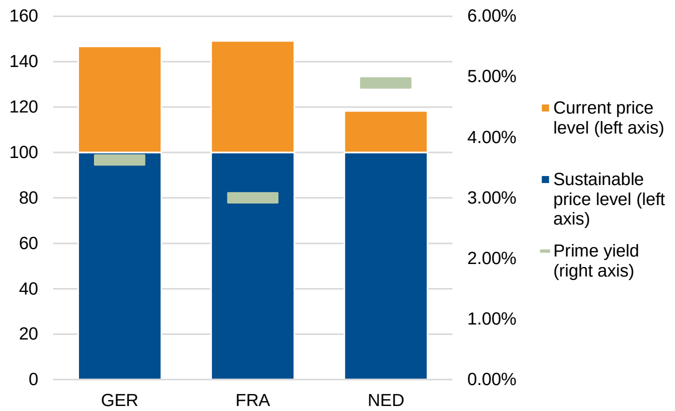
Scope expects prices to increase further, bolstered by rising tenant demand and supported by the recovery of European economies for a fourth consecutive year. Scope forecasts no further strong compression of real estate yields in Europe's core markets, as the ultra-loose monetary policy of the ECB, and the resulting impact on real estate yields, have reached the end of the road for some markets (Figure 8). Instead, Scope sees the risk that Europe's core markets are overpriced, as indicated by the difference between current prices and sustainable price levels of between 20% to 50% (Figure 7).

Figure 7: Prime-property price indices (PPI I 2012 = 100)



Source: Scope Ratings, Feri Euroratings, JLL, CBRE

Figure 8: Prime property price – sustainable vs current

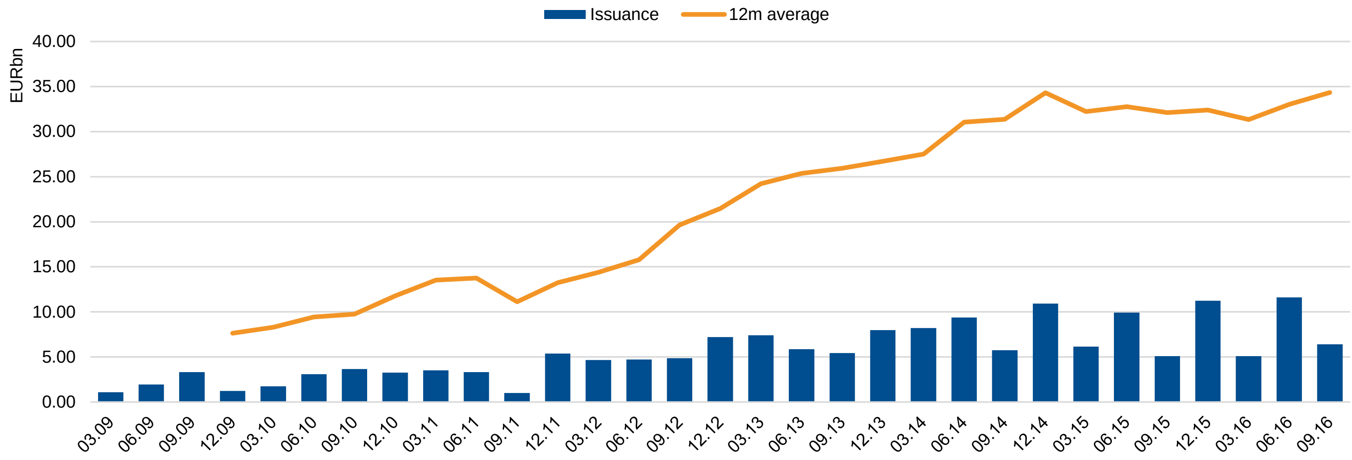


Source: Scope Ratings, Feri Euroratings, JLL, CBRE

EUR 240bn of cash calls since 2009 buoyed by cheap funding costs

As yield curves remain flat for the time being and liquidity floods the markets – indicated by +21% YoY growth of 'dry powder' (Prequin: June 2016) available for investments in European real estate – the hunt for yield and the strong attractiveness of real estate assets puts further pressure on fixed-income yields (down) and, as a consequence, on asset prices (up). Real estate companies have made use of this continued access to equity and debt financing and record lows in funding costs by extensively tapping the capital markets with EUR 170bn and EUR 71bn of debt and equity issuances, respectively, since 2009. Scope predicts additional pressures on the fixed-income yields, with the start of ECB's corporate-sector purchase programme (CSPP) in June 2016 buying EUR 7bn of corporate debt per month. Scope forecasts the ECB to become the major market participant in corporate debt, with a forecasted holding of EUR 130bn by October 2017 (+240% YoY). This is expected to skew the pricing of credit products to almost mirror the rates products under the covered bond and public-sector purchase programmes.

Figure 9: Issuance volume – European real estate corporates, 2009-2016 (EUR bn)



Source: Bloomberg

The aims of participants in this considerable cash call have remained unchanged since spring 2016:

1. Reducing reliance on bank debt
2. Decreasing financing costs (average coupons have reduced by 60% since 2009)
3. Financing growth via increased M&A or development activity

Scope has observed that consolidation efforts have remained unchanged in the industry, but the number of failed mergers has risen. This trend should change, as Scope expects consolidation to include European commercial real estate corporates in 2017, due to the cheap cost of capital, attractiveness of real estate assets, and valuations hitting pre-crisis peaks.

Positive credit outlook for 2017, but increasing sensitivity against changes in politics, economic conditions and interest rates

Corporates that can to tap this flood of liquidity will use funds to either i) improve business risk profiles via M&A or development activity, with size gains improving economies of scale and/or diversification or ii) improve financial risk profiles, with debt protection and leverage benefiting from low financing costs and the further increase in property prices. With companies using additional financial headroom to deleverage, Scope expects a positive impact on a number of credit ratings.

More-volatile credit profile 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. Scope expects several macroeconomic factors will challenge the growth of UK commercial real estate prices. UK economic growth is also forecasted to weaken because investment decisions have been postponed until the effects of Brexit are quantifiable.

Mid- and long-term credit outlook more subdued

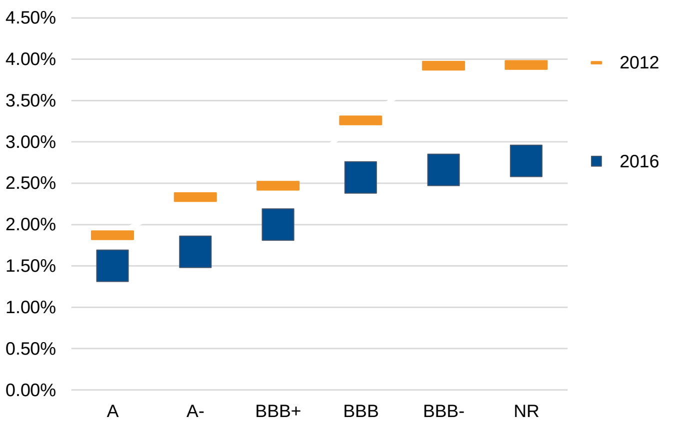
Aside from companies that can tap the ECB market, Scope's mid- and long-term credit outlook is more subdued through the heightened sensitivity of the European real estate market against changes of political, economic and interest rate environments.

Due to the recently growing yields of sovereign debt, as well as the steepening of the interest rate swap curves, Scope anticipates greater refinancing risk for commercial real estate debt for the mid- to long-term. Thus, Scope estimates that capital values of European commercial real estate stock will decline by 10-15% if interest rates rise by 100bp and maintain the new level. This would impair key financial metrics, which will increase leverage and weaken debt protection. Even this will not materialise in the short term; EUR 615bn of maturing European commercial real estate debt will face higher refinancing risk until 2020, with higher default rates anticipated for 2018 onwards.

Mispricing of credit expected to increase

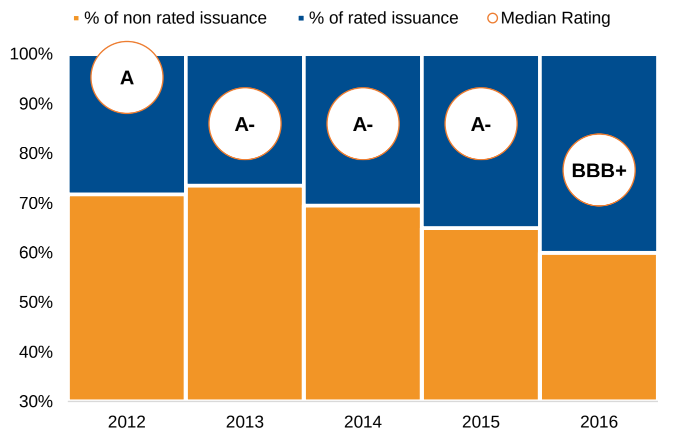
Lastly, mispricing of credit risk is expected to increase, with the ECB's CSPP putting further pressure on yields following the spread compression seen since 2012 (Figure 10) with a slight migration in credit quality (Figure 11).

Figure 10: Real estate bonds I spread vs 3-month Euribor at issuance



Source: Bloomberg, ECB, Scope Ratings

Figure 11: Real estate bonds – changes in median rating



Source: Bloomberg, ECB, Scope Ratings

Analyst: Philipp Wass

European pharmaceuticals outlook 2017

Scope believes credit trends in the European pharmaceutical market are likely to be largely stable in 2017. That said, we think there is a slightly less positive trend emerging for individual players – not necessarily for the whole industry – motivated by the following three factors:

- Growth is still available by sector but not overall
- Pricing and access are seen as more difficult factors for credit quality than before
- Large M&A is providing a basis for potential downgrades

Strong industry growth expected for next 5 years

While Evaluate Pharma and other experts still predict significant growth for the pharmaceutical industry (above 6% for global drug sales on a CAGR basis between 2016 and 2022), a number of companies are finding it more challenging to generate growth. This primarily relates to players like Sanofi or AstraZeneca, which are suffering from large drug-patent erosion, thereby highlighting our view of the pharma industry as a high-risk/high-reward sector. In contrast, pharma companies with an innovative-drug portfolio – like Roche or Bayer – could comfortably report significant organic growth in the first nine months of 2016 (Table 1).

Table 1: Growth rates for selected pharma companies

	Pharma like-for-like growth	
%, YoY	Q3 2016	Nine months 2016
AstraZeneca	-4.0%	-3.0%
Sanofi	0.5%	-0.9%
Bayer	7.6%	9.3%
Roche	2.0%	4.0%

Source: Quarterly reports

Pricing remains tough, at least in Europe

Price pressures and access to patients via reimbursement status have already slowed sales for a number of drugs in the last two years; while, in the US, this is usually triggered by large payors, like Express Scripts, that demand discounts for existing drugs on the market. This was felt prominently in the diabetes indication during 2015 and 2016. In Europe, health insurers' efforts to curb prices takes the form of coupling drug companies' willingness to grant price discounts to a new drug's eligibility for reimbursement. This was evidenced by Gilead's introduction of hepatitis drug Sovaldi onto the European market with regard to patient access, which was made reimbursable after Gilead allowed significant price discounts, of more than 20%, compared to the list price.

In general, we believe pricing pressures are stronger in Europe, as there can be virtually no price increases for existing drugs; as opposed to the US, where this can happen for even very mature products. Secondly, pricing efforts are driven by regulators in Europe while it appears to be a means of the payors in the US. Additionally, we believe the outcome of the recent US general elections is good news for the pharma industry, as the incoming government is unlikely to change regulatory pricing fundamentally. Price discounts will continue to be demanded in the US, in our view, but only in large competitive indications like diabetes, where a large number of effective drugs is available with partly small differences in effectiveness for the patient.

M&A fueled by available cash and low interest rates

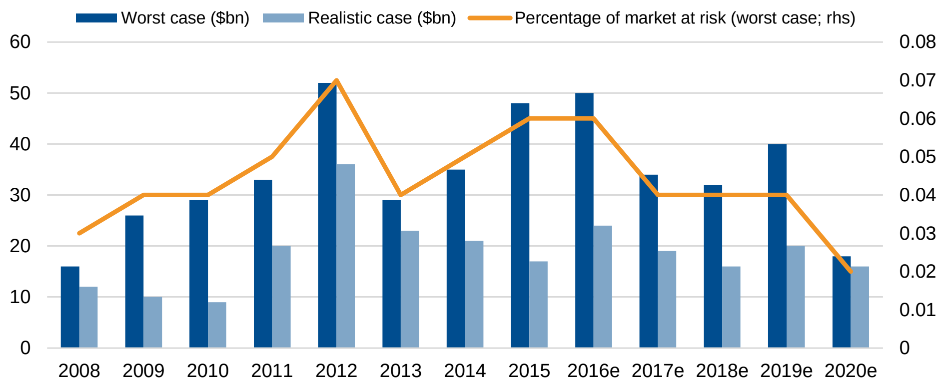
Generally, M&A in pharma is driven by the need to replace a non-performing pipeline in the event of larger-scale patent expiry. While we believe pipelines containing great innovations are broadly in place, some companies need time to bridge the gap until the next potential blockbuster from pipelines are ready to be commmercialised. This is the case right now. Adding to this, a huge amount of available cash – partly parked in Europe for US companies – generates interest in Big Pharma M&A (Pfizer's interest in AstraZeneca, for example). It remains to be seen whether the incoming US government will continue the currently hostile stance against using this partly tax-exempt overseas cash for motivating and funding 'big ticket' international acquisitions.

Industry fundamentals remain solid

Against this slightly more cautionary backdrop, there are still several supportive factors for the industry and the credit quality of its representatives, highlighted by the following points:

- Drug pricing in the US is still protected (incoming government is unlikely to focus on pricing)
- Approvals are up; pipelines are well filled
- Innovations and niche products generate and promise high growth (orphan drugs, immuno-oncology)
- Demographic and lifestyle-related factors are still supportive
- Patent expiry is past its 'cliff' (Figure 12)

Figure 12: Decreasing impact of patent expiries (in USD bn)



Source: Evaluate Pharma

After 2012, the peak of patent-expiry effects (Lipitor and others), there has been a significantly more positive development for the pharma industry, which is expected to continue until 2020. Compared to 2012, when more than USD 30bn of formerly high-margin blockbuster sales evaporated into generic product sales (equal to about 7% of the total market in terms of total product impact), 2015 and 2016 showed a significantly more benign picture (about USD 20bn of drug sales converted). The difference to the former peak also relates to the fact that patent-expired drugs are more protected today (less sales lost to generic challengers) than before. The greater protection is, in our view, due to the expiry of more orphan drugs, which do not face as many competing products, as well as the biotech drugs, which are more difficult to copy. This trend is likely to continue in the next four years. Evaluate Pharma predicts the economic impacts of patent expiry to be well off its peak until 2020, with only 2-4% of total market revenues expected to be wiped out by expiring patents.

Thus, future credit quality in pharma appears to be well supported, as industry fundamentals present a historic double-positive effect: a lower downside (patent expiry) and a higher upside (new product approvals) for innovative companies.

Analyst: Olaf Tölke

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