Capex quandaries divide European industry: Utilities spending contrasts with oil & gas, chemicals; telecoms investment steady

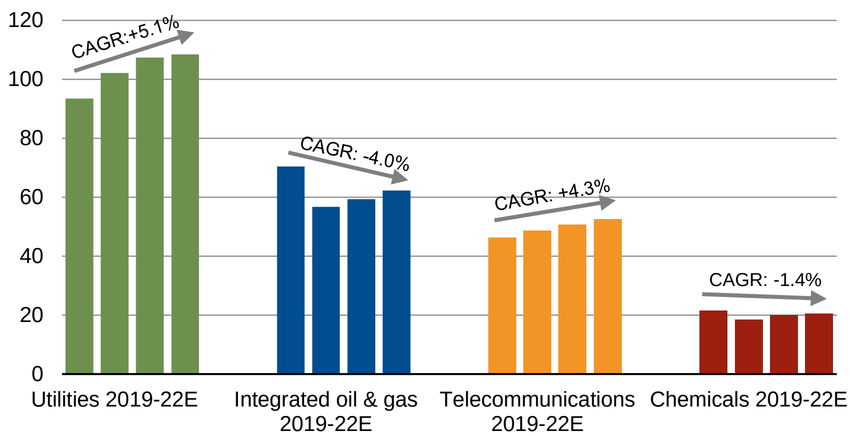
The combined effect of the pandemic and tougher environmental regulations is pulling capital expenditure in some of Europe's main industrial sectors in different directions – with implications for corporate funding and credit quality. One consequence is corporate treasurers' increasing recourse to hybrid and green debt.

In Europe, the utilities sector is seeing a steady rise in capex, estimated to reach EUR 108.5bn next year, 16% above the pre-pandemic level in 2019. In contrast, integrated oil and gas companies (IOCs) are confronted with secular and cyclical constraints that are preventing a return to pre-pandemic spending in the near-to-medium term. Chemicals companies will also take some time to return to pre-pandemic capex, though the shifts in their investment spending are more cyclical in nature. Telecommunications is again the outlier as an increasingly mature industry, committed to modestly increasing capex throughout the Covid-19 crisis and beyond.

Utilities, chemical producers, IOCs and telecoms operators usually have the heaviest industrial capex commitments in Europe. Think of the investment needed for oil exploration, the building, maintenance and upgrade of refineries and gas pipelines, the addition of cleaner power-generation capacity, and the extension and upgrade of electricity and telecoms networks. From the perspective of investors in long-term industrial projects, companies in these sectors have complex financing strategies that rely heavily on bank loans and debt markets.

Today, each sector is confronted with quite different investment contexts. Utilities face the heaviest capex burden (expected at a steady CAGR of 5.1% between 2019 and 2022), not least because of the accelerated energy transition. The generation, transmission and distribution of less carbon-intensive electricity are absorbing the greatest share of new investment. Utilities have also earmarked capex for innovative technologies like storage, e-mobility, metering, carbon capture and hydrogen.

Figure 1: European industrial capex spending (EUR bn) by sector, 2019-22E



Source: Scope Ratings

IOCs, in contrast, are in a quandary, facing the risk of billions of dollars' worth of stranded assets, through a combination of lower oil prices, growing investor concerns about the longevity of fossil-fuel production, and tougher environmental regulations. Spending on legacy assets has fallen sharply and looks unlikely to recover soon, if ever.

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IOCs seeking new paths for growth

For IOCs, overall capex will reduce to around 12% in 2022 from EUR 62.3bn from 2019. More capex will also be directed towards new technologies and deal-making, with chief executives seeking new sources of low-carbon growth such as from renewables generation and supply.

Telecoms looks like a mature industry in Europe

In contrast, telecoms operators are entering a mature spending phase for mobile, though overall capex is rising at an expected CAGR of 4.3% between 2019 and 2022E. The rise is driven more by investment in fixed-line infrastructure, principally fibre-to-the-home.

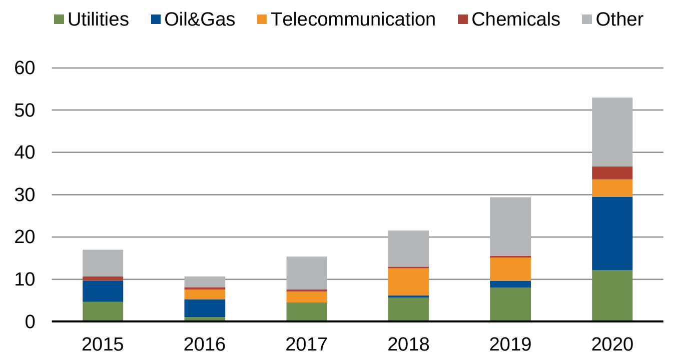
Prudence the watchword in more cyclical chemicals sector

Europe's chemicals producers look set to continue with prudent financial and capex policies, which are generally more tuned to the business cycle than in other sectors, particularly for suppliers of bulk chemicals than specialty chemicals. Capex next year is estimated at EUR 20.6bn, which will be a relatively modest 4.2% below the 2019 level.

Capital-intensive issuers active in Europe's bond markets

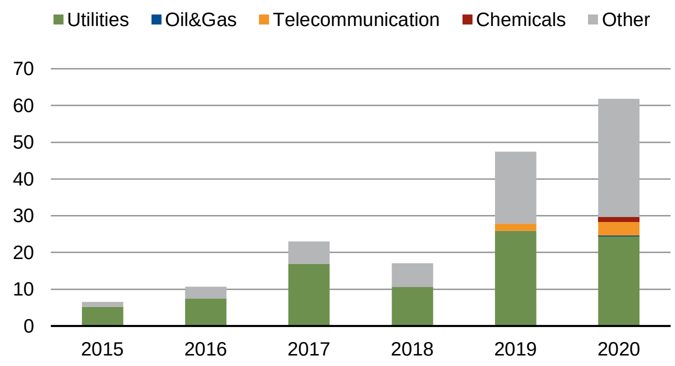
For Europe's financial markets, challenging conditions linked to the pandemic as well as to capital demands, particularly on utilities, oil and gas, and telecoms sectors, have led to a surge in debt issuances. These include hybrid bonds, increasingly in favour among IOCs, and green bonds, with European utilities particularly active.

Figure 2: Hybrid debt issuance of European non-financial corporates (in EUR bn)



Source: Bloomberg, Scope Ratings

Figure 3: Green/ESG debt issuance of European non-financial corporates (in EUR bn)



Source: Bloomberg, Scope Ratings

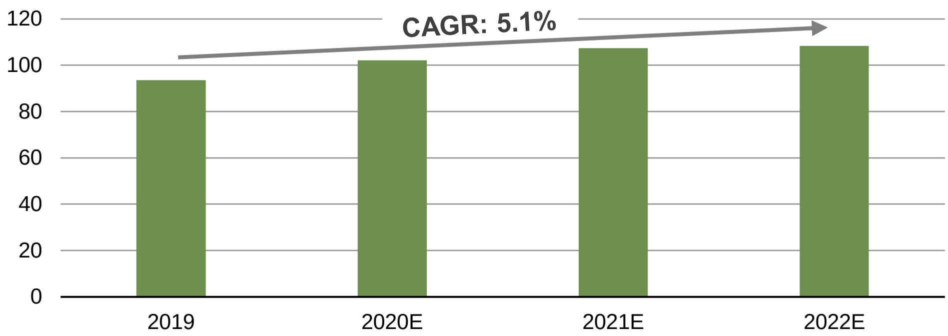
Utilities: taking up the cost of Europe's energy transition

Capex exceeds EUR 100bn a year

Capex from Europe's grid operators and integrated utilities crossed the EUR 100bn mark last year and is likely to keep rising in the short to medium term, not least because the sector bears the burden of Europe's commitment to achieving carbon-neutrality by 2050.

More than EUR 107bn of capex is scheduled this year, led by France's Electricité de France SA, Paris-based Engie SA, Italy's Enel SpA, Spain's Iberdrola SA, and the UK's National Grid. About 20% of the total is earmarked for power grids. Investment in generating capacity and other utility segments makes up much of the rest earmarked for asset rotation towards a greener generation portfolio.

Figure 4: European utilities capex 2019-22E (EUR bn)



Source: Bloomberg, company reports and presentations, Scope Ratings

Integrated players seek greener portfolios, defend market share

Integrated utilities are raising capex to defend their position in electricity generation and distribution against the encroachment of financial investors and IOCs. They are looking for new sources of long-term cash flow as environmental regulations bite.

Grid operators have hefty investment plans

Europe's grid operators face particularly heavy capex from upgrading and expanding power corridors and integrating the increase in renewable-energy capacity, notably for offshore wind. This will constrain free operating cash flow for years. Delaying necessary investment is no longer an option if European countries are going to keep the lights on. Largely debt-funded capex and the resulting pressure on free operating cash flow is not only limiting discretionary spending (such as on dividends) but reducing headroom for protecting credit ratings as improvements in operating cash flow are delayed.

Energy sector central to EU's 'green deal'

The regulatory climate remains crucial for the utilities sector. The European Commission is proceeding with its 'green deal' and aim of making Europe carbon-neutral by 2050. Environmental projects will be an important part of the EUR 750bn Next Generation EU post-pandemic recovery plan, with 25% of funds earmarked for climate-change mitigation.

While the EU will make a significant contribution towards a post-Covid 'green recovery' through loans and grants, much of the investment will come from the private sector. Governments are therefore keen for utilities to fund much of their capex issuing bonds with a green or ESG label. Such stimulus could provide strong backing for scheduled investments for renewables and grid assets in Western Europe. It could also trigger new investment, predominantly in Central and Eastern Europe where green energy investment has fallen behind that in Western Europe.

Green-bond issuance set to grow

Green bonds issued by utilities are no longer the main source of ESG-related debt instruments, but still make up around 40% of the total. European utilities placed about EUR 25bn of green and ESG-linked capital market debt in 2020, more than one-third of the newly issued green and ESG-labelled capital market debt in Europe. The biggest issuers were EDF SA, TenneT Holding BV, Alliander NV, EnBW AG, Engie SA, EDP SA, E.ON SE, Terna SpA and Vattenfall AB. We are seeing a clear tendency for companies to use sustainable finance as a way to signal strong ESG credentials. Utilities that come with a 'normal bond', i.e. without a transition strategy, will find it harder to entice creditors, regardless of whether such creditors are dedicated to ESG topics or not.

Premium on flexible funding policies

Utilities' treasurers will also need to use all available funding tools to ensure credit ratings are protected, which can be hard during a phase of debt-funded investment growth. In addition to a greater use of equity-linked funding like hybrid debt, we expect increased asset rotation and more conservative shareholder remuneration. Take grid operators as an example: the Netherlands' TenneT NV has turned to hybrid bonds and is requesting equity injections to minimise the impact of rising capex on leverage. Enexis, another Dutch firm, took out a subordinated loan from its sub-sovereign shareholders. Italy's Terna SpA may consider a first-time hybrid issue as part of its updated investment ramp-up.

Hybrid bonds in favour

We expect utilities to be remain big users of hybrid bonds, given their aim of keeping leverage under control. This source made up 16% of the sector's debt funding in 2020, with large issues from EDF, Enel, EnBW, Engie, Iberdrola and Energias de Portugal SA.

Overall, the sector can withstand temporary pressures on free operating cash flow and indebtedness during the current capex phase. These pressures will be offset by the likely recovery of investments through enhanced and stabilised operating cash flow in the medium term, with its favourable effects on business risk profiles and ESG footprints. As such, assuming no further economic shocks, negative rating actions on utilities in 2021 will be the exception.

Integrated oil & gas: grappling with Covid-19 and CO2

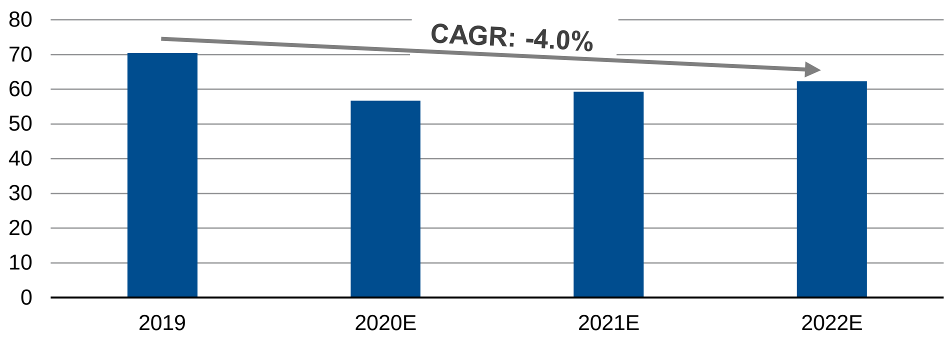
Challenging times for IOCs

The capex equation for Europe's oil and gas sector is different. IOCs face testing cyclical and secular trends that are forcing them to reassess investment and financial plans, with capital spending estimated for 2022 at EUR 62.3bn, well below the 2019 amount of more than EUR 70bn.

Sector hard hit by coronavirus fallout

For one thing, the Covid-19 crisis hit the sector hard in 2020 due to the sharp falls in oil prices, refining margins and demand. Financial leverage in 2020, measured by Scope adjusted debt/Scope-adjusted EBITDA, rose to levels not seen since 2016 for supermajors and exceeded them for large and medium-sized European IOCs, which are more downstream-focused on average.

Figure 5: Integrated oil & gas capex 2019-22E (EUR bn)



Source: Company reports, Bloomberg, Scope Ratings

IOCs rein in capex to protect finances

The industry avoided the worst through decisive measures to protect balance sheets, notably by cutting back capex, down on average by around 25% compared with initial budgets for 2020 and by 20% than in 2019. IOCs also made significant opex savings, through redundancies and price negotiations with suppliers of equipment and services. IOCs also suspended share buybacks and, in some cases, cut dividends.

As a result, IOCs have become more resilient in the face of low oil prices than before the Covid-19 crisis. The sector's organic free-cash-flow break-even point, after dividends, has fallen to around USD 50 a barrel as result of the drastic cost reductions. IOCs tapped bond markets actively in 2020 to shore up finances, including the hybrid debt market, sometimes for the first time as BP did with a EUR 12bn issue.

Trimming leverage remains a priority

The companies will focus on further deleveraging in 2021 – helped for now by better oil prices – though they will be ready to tap debt markets again if prices and margins do not live up to expectations.

The big challenge for the fossil-fuel sector is how to fund the transition to a more sustainable business as regulatory and investor pressures and the prospect of peak oil demand transform the sector. More IOCs will set ambitious greenhouse gas targets. For those that already pledged to reduce greenhouse gas emissions, we expect stronger and deeper commitments, with binding net zero targets replacing vaguer ambitions, focused throughout the industry value chain.

Environmental priorities require new investment

IOCs are pursuing different strategies to reduce their greenhouse gas footprint, all requiring some measure of capital investment. Some companies are focusing on low-carbon power and fuels, such as BP, Total and Repsol; others on chemicals (MOL, OMV) and carbon dioxide removal (Equinor). We expect a significant scaling-up of technologies that are already commercially viable such as wind and solar power. Some companies will also invest more in frontier technologies such as CO2 capture projects. Some IOCs have dedicated an ever larger share of investment budgets to low-carbon technologies (Repsol, Total). At Shell, an energy transition plan is up for a vote at the shareholder meeting in May 2021.

European telecommunications: mature sector shows resilience

Little upward pressure on mobile capex despite 5G rollout

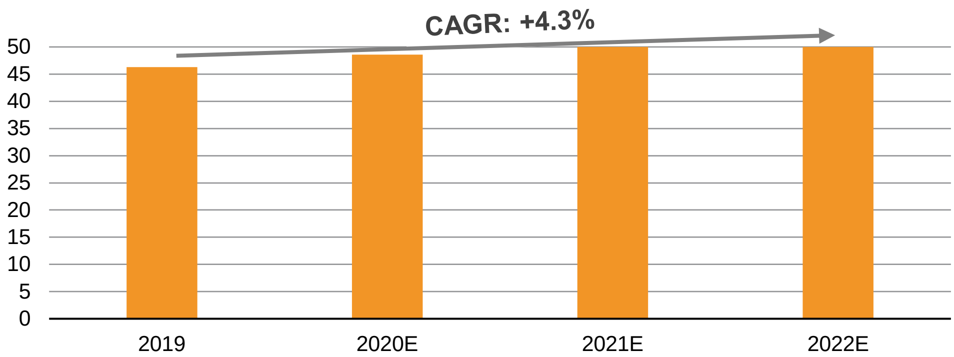
The outlook for capex for the resilient telecoms sector is again different to those of the other three sectors despite the roll-out of new 5G mobile technology. We expect growth in capex to average 4.3% a year between 2019 and 2022.

The European telecoms sector is mature and has none of the regulatory and environmental pressures faced by utilities and IOCs. The sector has been demonstrating its fundamental stability during the Covid-19 crisis. Latest revenue figures show little change from 2019 levels, particularly compared with the scale of economic recession in Europe. The sector faces the uncertainty of the pandemic’s lingering impact on the economy and its own revenues but is aware that the accelerated digital transformation of many businesses may largely compensate.

Investment in 5G replaces spending on older technology

European operators’ mobile capex is unlikely to increase. The 5G investment replaces spending on older technologies (2G, 3G and the diminishing investment in 4G), involves the re-use a significant part of existing infrastructure including masts and backbone networks, and benefits from lower equipment prices as the technology matures. Most operators have stopped reporting separate spending on mobile and fixed segments. Therefore, the best way to illustrate the trend is reported mobile capex excluding spectrum; in France, this has been disclosed by the French regulator (Arcep) over the past 15 years. In this period, mobile capex has remained stable at EUR 2.5bn a year on average – with a low of EUR 2bn in 2010 and a peak of EUR 3.3bn in 2006. Such levels were even achieved through the roll-out of various technologies (including 3G, 3G+, 4G, 4G+), a significant traffic increase, and the entry of a fourth mobile operator.

Figure 6: European telecommunications sector capex 2019-22E (EUR bn)



Source: ITU (EU without Malta and the UK), Scope Ratings

Spectrum spending risk looks modest

The main 5G-related spending issue will relate to spectrum auctions in the coming quarters. As anticipated a year ago, 5G auctions have not led to fierce bidding and exorbitant prices as initially was the case in Italy in 2018 and in Germany in 2019. France's 5G auction raised EUR 2.8bn last year with bids from four established operators – Altice SA, Bouygues Telecom SA, Iliad SA, and Orange SA – whereas EUR 6.5bn was raised in Germany. New bidders were the main reason for the elevated auction prices (such as 1&1 Telecommunication SE in Germany), a trend more recently seen in the US. This year, we expect no new entrants to compete for spectrum in any major European market: the industry is mature with mobile penetration of around 130%.

Extending fibre networks will require some extra capex

Any sustained increase in capex will be rather driven by fixed-line spending through a modest investment in fibre-to-the-home (FTTH). To move to high-speed broadband, some operators have either rolled out intermediate technologies (such as VDSL, G-fast, and vectoring) using existing copper networks, or relied on a limited fibre roll-out (fibre-to-the-node or fibre-to-the-curb), allowing them to limit capex. The fibre-lite approach is now under consumer and political pressure. In countries where operators have pursued it, more FTTH spending was belatedly announced, suggesting capex will rise.

With telecoms operators still keeping a close eye on liquidity and credit quality, we expect more infrastructure assets, such as mobile towers and fibre networks, to be sold or listed, either in part and as a whole, to raise funds amid the active issuance of corporate and hybrid debt.

European chemicals: caution remains the watchword in cyclical sector

Cyclical sector's slow capex rebound after 14% fall in 2020

We expect chemicals-sector capital spending in this year and the next to recover towards 2019 levels after the 14% decline in 2020 as companies tightened their belts in the wake of the Covid-19 crisis.

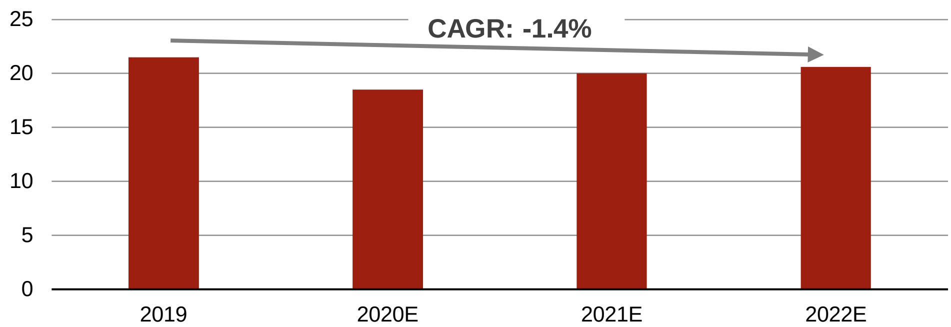
The biggest cutbacks were inevitably among the more cyclically exposed and capital-intensive bulk chemicals companies, which are more sensitive to changes in raw material prices. Among European chemicals companies, Covestro AG put its planned EUR 1.5bn methylene diphenyl diisocyanate (MDI) plant in Baytown in Texas on ice. Also on hold was BASF SE's plan to build a USD 4bn petrochemical complex in India. Though growth capex suffered, we saw little evidence of companies cutting back on maintenance capex to ensure the long-term quality and competitiveness of their production assets.

Capex is now set to recover as economic visibility improves and prices for major products start to rebound, such as for commodity polymers. Integrated companies are likely to restart projects or look at greenfield projects – with environmental aspects increasingly considered – particularly as underlying demand remains robust across many products.

Cautious approach from specialty sector

Most specialty companies that serve a variety of customer segments have decided to delay or prolong construction for major expansion projects, given the economic uncertainty related to the pandemic.

Figure 7: European chemicals sector capex 2019-22E (EUR bn)



Source: Bloomberg, Scope Ratings

Overall, we expect a modest increase in capex in 2021 and 2022E as chemicals companies adjust spending in line with an uneven economic recovery partly to ensure that they avoid driving product prices downwards by bringing on excess supply. Pre-pandemic capex in the sector is only likely to return in 2023-24.

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