

Capital Goods

Megatrends and megaprojects ease a cyclical downturn

January 9, 2024

This report does not constitute a rating action.



What's changed?

Destocking: downturn or bullwhip? Inventory liquidation has been widespread in the industrial economy. Sometimes destocking has presaged an economic downturn, but inventories are returning to normal after a historic spike in working capital given disrupted supply chains.

Costs drop and supply chains ease, but bargains are scarce. Producer prices have dropped only moderately in 2023, even though commodity and energy costs are down sharply.

Execution eats strategy for breakfast. Megatrends and multiyear projects should support revenue growth, but credit quality will depend on the profitable conversion of investments in new products, research and development, and acquisitions.

What are the key assumptions for 2024?

S&P Global economic forecasts and Purchasing Managers Indexes (PMI) indicate slowing growth. We assume flat investment growth for a couple of years, coming off a two-year boom.

Lower input costs and softer demand should contain prices. The availability and cost of skilled labor appears to be limiting output growth in some sectors, which could sustain good price cost.

What are the key risks around the baseline?

Interest rates catch up with investment ambitions. Even if large projects provide a longer tail for demand, lower orders through 2024 could set up a longer, deeper downturn in this late-cycle industry. Also, discounts or incentives could erode margins if demand slackens further.

Refinancing pressure is rising in 2024 and 2025. Several low-rated issuers, mostly those from leveraged buyouts (LBO) in the U.S. and Europe, face large maturities after rising interest rates, uncertain valuations, and financial sponsor activity. For investment-grade issuers, higher interest rates will eat into free cash flow.

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Ratings Trends: Capital Goods

Chart 1
Ratings distribution

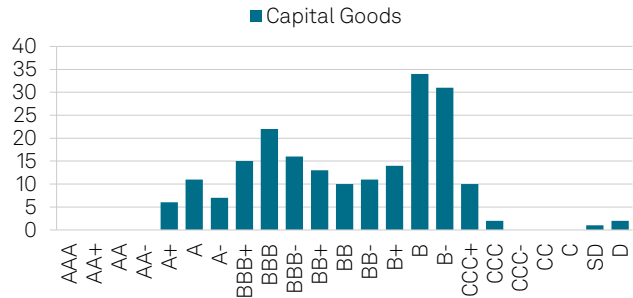


Chart 2
Ratings distribution by region

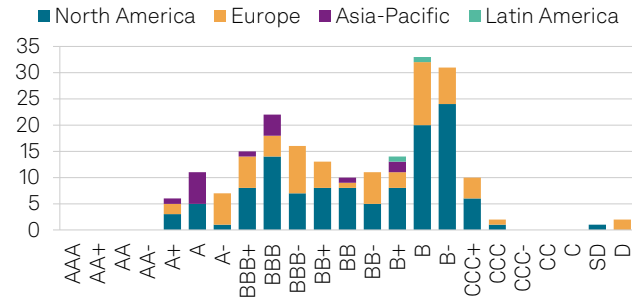


Chart 3
Ratings outlooks

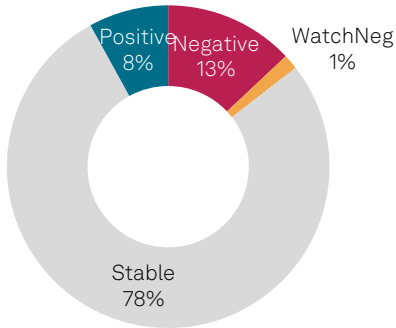


Chart 4
Ratings outlooks by region

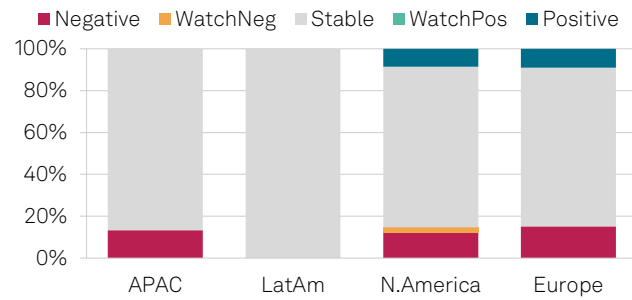


Chart 5
Ratings outlook net bias

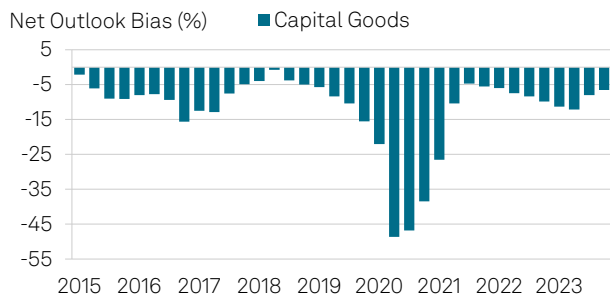
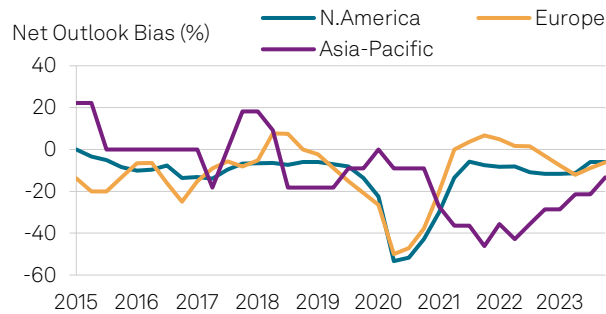


Chart 6
Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

Revenue and earnings in 2023 held up better than we expected, as global GDP and industrial activity defied what S&P Global's economists termed "the most anticipated recession in recent years" (Economic Outlook U.S. Q2 2023: Still Resilient, Downside Risks Rise, March 27, 2023). Our net outlook bias in global capital goods remained steady over the year, at a modestly negative 10%. Most of that is for deep speculative-grade issuers facing rising interest costs and large maturities in 2024 and 2025. Among issuers rated 'BB' and above, the negative outlooks are largely company-specific rather than indicating any particular segment of deteriorating credit ratios. Most companies with a negative outlook are working through unexpected earnings disruption, strategic change, upcoming refinancing, or elevated debt usage amid generally favorable industry conditions for several years.

Our credit outlooks are fairly consistent around the world, with a similar 8%-18% negative bias in North America; Europe, the Middle East, and Africa (EMEA); and Asia-Pacific (APAC). EMEA has net negative bias of 10%. The use of outlooks mainly relates to LBO firms for which we observe higher or lower than expected leverage and emerging refinancing risk. For investment-grade Siemens Energy AG, KION Group AG, and Sandvik AB, outlooks are negative because of operational challenges or elevated leverage following mergers and acquisitions (M&A). In APAC, our credit outlook remains decidedly negative, partly because demand remained sluggish, particularly in China. Because of the small portfolio of rated issuers in APAC, credit trends have been strongly affected by a few outliers and company-specific issues such as governance.

We downgraded a net 3%-5% of the portfolio in 2023. Many issuers rated 'BB' and higher built a buffer in credit ratios during 2023, so upgrades and downgrades were muted. In contrast, we moved about 10% of companies rated 'B-' into the distressed 'CCC' categories, highlighting the increasing risks in refinancing large maturities in 2024 and 2025. These companies are mostly sponsor-owned LBO firms with high leverage. Some have missed their profit targets and could soon face difficult refinancing. We rate about 40% of the global capital goods portfolio 'B' or lower and about 45% of issuers in the U.S. portfolio 'B' or lower.

The profit cycle may have peaked in this cyclical sector, with good pricing through 2023 and declining input costs. The industry's EBITDA margins have risen for three consecutive years, and return on capital was at a 15-year high. Good buffer in credit ratios indicates that ratings for most companies that we rate 'BB' and higher should withstand a normal cyclical downturn. Broad industry credit indicators such as debt to assets remain near decade lows below 30% despite the addition of numerous small, highly leveraged issuers over the last five to eight years. That said, many of those LBO firms have large intangible assets after some sponsor-to-sponsor transactions with progressively larger goodwill. The sector's median debt to EBITDA edged up to 3.4x in 2023 from 3.3x in 2022. By contrast, 'B' and 'B-' rated issuers had debt to EBITDA of about 6.5x in 2023, and many have even higher leverage as they look to refinance in 2024 and 2025.

Main assumptions about 2024 and beyond

1. Equipment investment growth slows.

Higher interest rates typically work with a lag for capital goods, so it appears some destocking in late 2023 is attributable to lower order intake and slowing demand. A two-year post-pandemic rebound in 2021 and 2022 contributed to high-single-digit percent volume growth. Tight supplies throughout supply chains enabled strong price-cost, so profits increased.

2. Lower input costs take pressure off pricing.

Most companies in capital goods demonstrated good pass-through of sharply higher costs in 2021 and 2022. We expect most will hold prices now that input costs are lower, but assume price gains as long as demand holds up.

3. Megatrends and large projects underpin several years of demand.

Large, multiyear investments for infrastructure, manufacturing facilities, and energy transition, supported by government stimulus, could moderate a cyclical downturn in this interest-sensitive sector. We believe higher interest rates typically work with a lag for capital goods, so it appears some destocking in late 2023 is because of lower order intake and slowing demand.

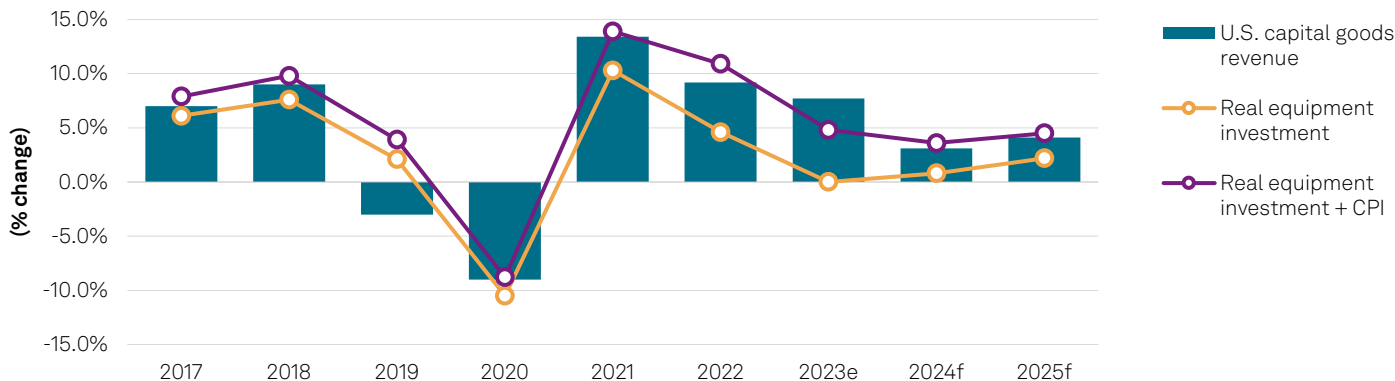
We expect a slowdown in revenue growth for global capital goods in 2024, as higher interest rates affect investment decisions around the world and catch-up demand following the COVID-19 pandemic fades. We assume generally flat volumes and cooling prices, which might yield low- to mid-single-digit percent revenue growth in the aggregate, with pockets of lower revenue in heavy equipment offset by solid service revenues and robust growth in equipment rental (see chart 7). Companies with a high share of services, as well as products aimed at improving energy efficiency, should better withstand any cyclical downturn in 2024.

U.S. manufacturing demand is decelerating, indicated by S&P Global’s Manufacturing PMI (compiled from responses to questionnaires sent to purchasing managers for about 800 manufacturers) in the U.S. hovering near or below 50. We believe this will likely translate to contracted equipment demand in 2024. Specifically, new order intake has declined the past several months (though there are variations in trends by end market), and the backlog of work is lower going into the year. Caution around the U.S. macroeconomic climate and reduction in inventory weigh on domestic demand. We also expect price growth will slow, in line with lower input cost inflation.

Chart 7

Demand and pricing power

Equipment investment and inflation drive capital goods revenue



e—Estimate. f—Forecast. Source: S&P Global Ratings.

Orders softened in the European industrial landscape during the third quarter of 2023, reflected in the results of major players. Despite a slight uptick to 44.2 in November 2023 from 43.1 in October--the highest since May 2023--the eurozone manufacturing index indicates a 17th consecutive month of contraction. Notably, the most significant declines were in Germany and France. This trend aligns with our previous view, indicating continuing destocking and normalization of inventories. Anticipating the continuation of subdued order intake through the first half of 2024, we remain cautious about the broader economic outlook. We note that order backlogs remain high and the pipeline strong, providing support for companies in 2024. However, we believe growth will moderate in 2024 compared to 2023 as the manufacturing sector bottoms out. We also foresee slower conversion rates in some end markets as clients postpone investment decisions due to higher interest rates.

Demand for the overall industrial sector in APAC will likely continue to be lackluster in 2024. China's countrywide weak PMI is the most significant indicator of concern. Government stimulus plans will only support moderate demand and earnings growth in some areas, such as power equipment and infrastructure related equipment. Destocking was widespread across industries in 2023. Access to materials and components has improved generally, many companies broadened their supply networks, and input costs dropped, all of which enables some inventory release. A return to more-normal inventories is slowing orders and has eaten into record backlogs from 2022. Meanwhile, sharply higher prices from 2021 and 2022 have eased with better product availability and lower costs.

Supply chains loosen and demand eases, so "just in case" inventories are being liquidated. In our view, 2024 could be characterized by more normalization after three years of high backlogs driven by the COVID-19 pandemic, supply chain disturbances, and geopolitical tensions. All in all, we anticipate a tighter control on working capital, especially on inventory management, which should support cash generation for 2023 and 2024. According to S&P Global Market Intelligence's Supply Chain Edge (Dec. 8, 2023), "Supply chains in 2024 face higher labor costs, which may hinder investments in resilience. Firms are returning to 'just in time' rather than 'just in case' inventory strategies, and diversification of suppliers is falling. Reshoring continues, however, as firms look to cut costs and risks even as corporate cash flows remain pressured." Further, the S&P Global Price and Supply Monitor (Dec. 6, 2023) notes that, "For the first time since the beginning of the COVID-19 pandemic, all 12 monitored commodities recorded below-trend supply shortages in November, highlighting that pandemic-driven supply constraints are a thing of the past. The improvement should help to keep prices settled and give manufacturers greater confidence that inputs will arrive as scheduled."

The construction outlook for 2024 looks flat. S&P Global Ratings' economists believe U.S. nonresidential structures investment growth will be 0.4% versus a strong 11.3% in 2023. Residential investment, meanwhile, is trending the other direction with our expectation of a miniscule 0.1% decline following an over-11% fall in 2023. The equipment manufacturers we rate tend to have more exposure to nonresidential construction. In our view, fiscal stimulus such as the U.S. Inflation Reduction Act, Creating Helpful Incentives To Produce Semiconductors and Science Act, and the infrastructure bill should provide support to these companies over the next few years. In Europe, we believe the manufacturing recession could recede. In 2023, construction stalled as high interest rates and high building costs weighed on demand. In APAC, we expect low demand, particularly in China. The rebound in China, however, has been slower than we anticipated. The property sector in the country is still struggling and confidence remains subdued. We expect demand in APAC in 2024 will remain weak. Demand for construction machinery in China continues to be subdued because of the stressed property sector, despite potential moderate growth in infrastructure investment. In the rest of Asia, we also anticipate sluggish demand for construction machineries in Association of Southeast Asian Nations

countries as higher interest rates slow the progress of construction projects. We believe demand for the mining sector in Asia remains solid, despite lower commodity prices, with prices higher than in previous downturns.

In Europe, we expect stronger headwinds in the new residential and nonresidential structures segments because of higher interest rates, construction material shortages, and higher costs. As a result, we estimate that output will shrink about 1.5% in 2024, when issuers that derive the highest portion of revenue from the new residential and residential renovation end markets will face the greatest volatility. Conversely, we expect tailwinds to continue for EU-funded infrastructure plans and projects aimed at renovating inefficient buildings with high emissions. We anticipate output to increase almost 3% in 2024 for the eurozone economy. Rental companies will therefore need to tackle the cyclical risks linked to some end markets such as construction, nonresidential construction, and oil and gas.

Automation, electrification, onshoring, and energy transition define strategic objectives. Most companies are pivoting strategies to benefit from high-profile megatrends in capital investment, often changing their business portfolios through M&A. Companies with exposure to these large trends have continued to enjoy favorable operating outcomes with the expectation of moderation in the next few years as backlogs are worked off, supply chains ease up, and orders start to decrease. Some recent examples include Emerson Electric Co.'s acquisition of National Instruments Corp., Honeywell International Inc.'s acquisition of Global Access Solutions Ltd., and Fortive Corp.'s acquisition of EA Elektro-Automatik GmbH & Co. KG. We expect M&A will continue into 2024 as companies embark on portfolio transformations and strategic objectives aligning with longer-term growth, stability, and profitability. Nonetheless, the challenges around labor availability--particularly skilled labor--have increased the urgency for many companies to automate their operations and increase the overall efficiency of their plants to remain competitive. Costs to automate have decreased over time. Despite these medium-term megatrends, earnings for APAC issuers engaged in automation as a core business will likely recover slower in some end markets, such as semiconductors.

Aerospace continues to support favorable operating trends going into 2024. The sector remains a bright spot for companies with a sizable presence in its end markets. Firms such as Honeywell and Eaton Corp. PLC have enjoyed these tailwinds over the past few years and expect them to continue, supported by increasing flight hours, continued strength in commercial aftermarket, and growth in defense and space investments. In addition, we expect longer-term increased international travel will continue to support uptrends for widebody aircraft.

A slowdown in automotive demand is likely in Europe and North America, while China returns to its 2019 sales volumes. Global demand for light vehicles unexpectedly surged 8% in the first half of 2023, largely outperforming our earlier 3%-5% forecast. For 2024 and 2025, we continue to expect very gradual volume recovery as demand aligns with subpar global economic growth resulting from higher-for-longer rates ahead. In our base case, only China is largely back to pre-pandemic sales this year despite weakness in domestic consumption. China's increasing gap between sales and production over 2023-2025 reflects its increasing status as a net global exporter of light vehicles. In Europe and the U.S., sales will rise moderately after the surge in 2023, not recovering to pre-pandemic levels even by 2025.

Manufacturers we rate are not heavily exposed to the transition to electric vehicles. Therefore, we do not expect issues in the automotive industry to put significant pressure on capital goods companies. In fact, we believe the pressures will delay the transition for heavy equipment somewhat, giving companies more time to prepare. However, it will also require persistently elevated investments in research and development. We anticipate Cummins Inc.'s new energy

business, which sustained significant losses in Accelera (its new power business), will approach break-even profitability toward the latter part of the decade.

Heavy equipment cycle slows, but fiscal stimulus measures could support demand. Following three years of growth after the COVID-19 pandemic, we expect lower demand globally, though we do not expect it to be a sharp correction. In our view, agriculture equipment manufacturers such as CNH Industrial N.V., Deere & Co., and AGCO Corp. could face the biggest decline as the industry trends back to the midcycle from a cyclical peak. Nonresidential structures investment in the U.S. should moderate to modestly positive while residential investment should be about flat following two years of significant declines. Price realization should moderate to historical levels after many companies we rate continued pushing through increases in 2023 while enjoying the benefit of lower manufacturing costs. Over the medium to long term, we think fiscal stimulus globally should support demand, which bodes well in the event of a broader economic downturn.

We expect farmer income to decline significantly following a strong 2021-2022 in North America and EMEA because of moderating commodity prices and dairy prices, elevated input costs for fuel and fertilizer, and higher interest costs. Therefore, we assume a pull-back toward midcycle volumes. In APAC, demand in Thailand and India is likely sluggish in 2024 because bad weather in 2023 slashed farmers' income. We expect demand in Japan to continue to be stable. Supply chain difficulties, however, left manufacturers unable to take advantage of market demand from 2021-2023. Therefore, farm equipment did not decline in age as much as in previous cycles, so we think the bottom of the cycle will be less severe.

Equipment rental faces slowing construction in Europe, while U.S. growth stays strong.

Following two years of robust demand amid new equipment shortages, we expect conditions in the U.S. equipment rental market will remain relatively favorable in 2024. We believe rental revenue and rate growth will decelerate as inflation falls and fleet utilization returns to more normal levels. We expect spending on infrastructure and manufacturing megaprojects in the U.S. to be partly offset by downside risks in the verticals for office and commercial construction. We believe larger equipment rental companies are well-positioned to serve megaprojects with their sizable fleets, which should support continued share capture from smaller players. If the industry encounters weaker demand, we believe equipment rental companies could preserve free operating cash flow by lowering discretionary growth capital expenditure (capex). The gradual shift in customers' preference toward asset-light, rental-focused operating models remains a longer-term driver of growth in equipment rental demand. Over the past decade, equipment rental penetration has increased, and we expect it will continue, fueled in part by high-growth specialty equipment product lines. Overall, we believe organic revenue for large equipment players could increase in the mid- to high-single-digit percents in 2024.

A decline in construction output in Europe weighs on prospects for rental equipment, albeit with specific end-market and geographic differences. In line with S&P Global Market Intelligence's latest Global Construction Outlook, we predict construction output to fall about 1.7% in 2023 and remain flat in 2024 because of a weakening macroeconomic environment. We view construction output as aligned with the economic cycle, demonstrated by a 4.4% decrease during the pandemic following a 6.5% contraction of the eurozone economy. In addition to the economic slowdown, interest-rate-sensitive segments such as residential construction are already suffering from the quick shift in monetary policy, with demand for new construction reduced.

Oil and mining spending slows. This trend is similar for companies exposed to the oil and gas and mining sectors, where organic order intake has moderated over the first nine months of 2023. Earnings and cash flow declines were sharp in 2023 from records in 2021 and 2022. S&P Global Ratings forecasts steady capital spending for these extractive industries in 2024 and 2025 after a cyclical jump in 2023.

Heating, ventilation, and air conditioning (HVAC) manufacturers are riding a cool breeze. We rate four HVAC makers in the U.S. Several Japanese manufacturers we rate also produce HVAC systems. For the U.S. firms, we forecast mid- to high-single-digit percent organic revenue growth in 2023, decelerating somewhat in 2024, driven by demand in nonresidential end markets and pricing, and supported by the conversion of solid backlogs. We estimate a similar trend for Japanese companies such as Mitsubishi Electric Corp. Changing regulations and government programs for energy-saving products should support outsize revenue growth relative to GDP for HVAC products and services in the next few years, with good longer-term growth of about or modestly above GDP, supported by a growing installed base and price increases. Of the U.S. rated manufacturers we rate, Johnson Controls International PLC and Carrier Global Corp. have the greatest exposure outside of the Americas market, of which we believe EMEA will prove to offer the greatest opportunities for growth, particularly around heat pumps, given the EU's 2030 decarbonization targets. Longer term, Japanese companies appear well-positioned because their products are equipped with inverters as standard, which is advantageous for energy conservation. We expect they will maintain or build in sufficient cushion in credit metrics over the next 12-24 months to withstand a potential, unexpected, modest decline in EBITDA.

HVAC manufacturers have been an outlier among capital goods companies, increasing backlogs as most order rates fall in other end markets. Changing regulations are generally a tailwind, in our view, but these companies are not immune to risk. In 2023 for instance, shipments of heat pumps (which are electric and more environmentally friendly) in Europe decelerated due to changing regulations, a lower gas/electricity price spread, and a softer macroeconomic environment.

Credit metrics and financial policy

Steady credit ratios to close out 2023, a good cash flow outlook, and better visibility into capital markets should enable several capital decisions in 2024, including continued M&A (and spin-offs) for corporate development. We estimate almost three-quarters of capital goods companies around the world generated some discretionary cash flow (free cash after shareholder returns) in 2023, but elevated acquisitions pushed cash to assets down for a fourth consecutive year. As such, our revenue growth assumptions typically incorporate measured acquisitions for most companies.

We expect many issuers to generate cash from working capital release in 2024, even as earnings potentially weaken. More stable capital markets and potential private equity exits could make for more attractive transactions. M&A have been particularly active as companies execute strategic plans to position themselves for long-term growth, increase profitability, enhance stability, and add to product and geographic diversification and overall scale. Despite decent M&A, we have seen a trend toward larger companies transforming their portfolio mixes or adding complementary businesses that align with automation, electrification, and the longer-term objectives of the energy transition trends. While some transactions have been initially leveraging to an extent, they are highly accretive and incorporate higher growth rates and stability.

Reflecting the higher cost of debt with higher differentiation across ratings, crossover credits are committing to more-conservative financial policies to raise credit standing, lower funding costs, and improve terms with its suppliers and customers.

Key risks or opportunities around the baseline

1. Higher interest rates worsen a cyclical downturn.

Our revenue forecasts imply an end to destocking (which began in 2023) by the middle of 2024. If interest rates hold higher for longer, however, revenue growth in this interest-sensitive, late-cycle industry could turn negative if volumes drop more than 2%-3%. Order intake dropped double-digit percents in several segments in late 2023, which could be early signs of a demand chill or just destocking record inventories throughout the supply chain.

2. About 40 leveraged issuers in the U.S. and EMEA face higher interest costs and unsustainable capital structures.

Credit conditions remain tough for mostly LBO issuers. About 10% of this group of companies migrated lower to 'B-' and the 'CCC' category during generally good industry conditions.

3. Strong tailwinds from the energy transition imbed operations, earnings, and credit risks.

Demand for large corporate or infrastructure projects will remain high. Evolving and new technologies for renewable energy present a wide array of unexpected surprises, including overruns and warranty liabilities.

Another year of higher interest rates could pressure global capex and business spending. Our economists forecast sluggish economic growth in 2024 and 2025, with flat real equipment investment growth and declining inflation to support prices. If interest rates bite harder in 2024, revenue growth could turn negative by mid-2024 as destocking becomes a deeper slowdown in demand. Input costs have stabilized lower, so cost relief should abate in the first couple of quarters of 2024 while labor costs remain elevated. In that scenario, single-digit-percent lower revenue could translate into a gentle cyclical downturn of 10% lower EBITDA. In this case, we'd expect rising distress among the lowest-rated issuers facing maturities but stable credit ratings for issuers that we rate 'BB' and higher. Considering the generally good buffer in credit ratios for higher-rated issuers, we believe an unusually deep and protracted downturn would be needed to pressure those ratings.

Highly leveraged credits face higher interest costs and big maturities. On average, this group of companies is on track to improve leverage to about 6.5x in 2023, but five out of about 50 in the U.S. that we rate 'B' or below defaulted in 2023. Even if credit ratios are improving on average, almost 20 companies have leverage above 7x as maturities loom and industry conditions weaken. We still assume they will improve leverage to 6x in 2024 and enhance refinancing prospects.

Climate transition remains one of the key supportive trends for the capital goods industry, providing a baseload of orders. However, while it is one profit-and-growth driver for companies such as Schneider Electric S.E., it poses substantial risks for companies that offer long-term projects. While producers of conventional gas power plants and grid networks suffered due to overcapacity and sluggish investments in the past, the tables have turned. The still-evolving wind turbine industry has been constrained heavily by unfavorable terms, supply chain bottlenecks, and cost inflation over the past two years. We believe the nascent industry is beginning its maturation, trending toward break-even profitability at some major renewables equipment manufacturers following recent losses. We expect Siemens Energy's wind turbine subsidiary Siemens Gamesa, plagued by component failures in its onshore business and ramp-up challenges offshore, to return to break-even EBITDA in 2025. General Electric Co. (GE), following a significant warranty charge in 2022, has made good headway in simplifying its products and realigning its cost structure. Therefore, we expect GE's renewables business to reach profitability in 2024. GE's order book has benefited significantly from the Inflation Reduction Act, which extended the production tax credits for renewable sources of energy and removed a degree of

uncertainty. Still, we expect it to face pressure in its offshore business, signaled by significant cancellations in the industry.

Related Research

- [Siemens Energy AG 'BBB-' Rating Affirmed On Asset Sales And Expected Recovery Of SGRE: Off CreditWatch; Outlook Negative](#), Nov. 30, 2023
- [U.S. HVAC Manufacturers Riding A Cool Breeze](#), Nov. 29, 2023
- [Japan Corporate Credit Spotlight: Scant Room For Improvement](#), Oct. 17, 2023
- [European Equipment Rental Firms Are Flourishing, Despite Some End-Market Slowdown](#), Oct. 16, 2023
- [Heavy Lift: U.S. Capital Goods Companies Leverage A Big Backlog To Defend Credit In 2023](#), Feb. 3, 2023

Industry Forecasts: Capital Goods

Chart 8
Revenue growth (local currency)

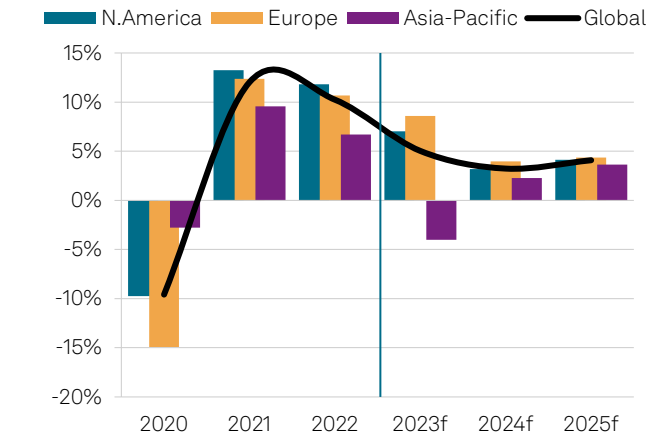


Chart 9
EBITDA margin (adjusted)

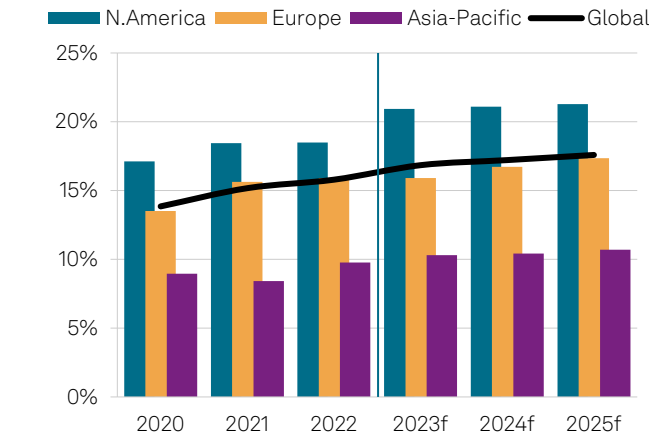


Chart 10
Debt / EBITDA (median, adjusted)

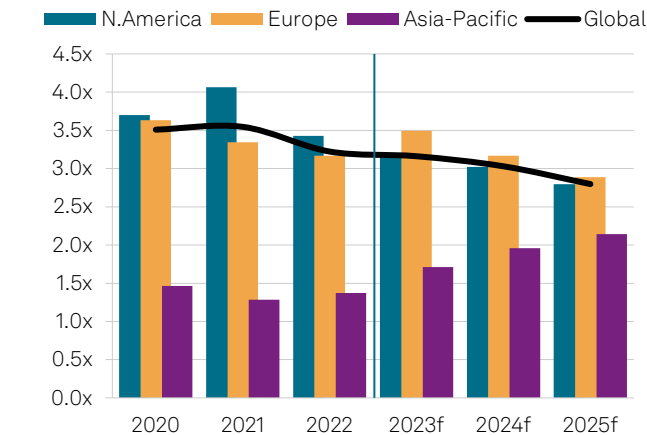
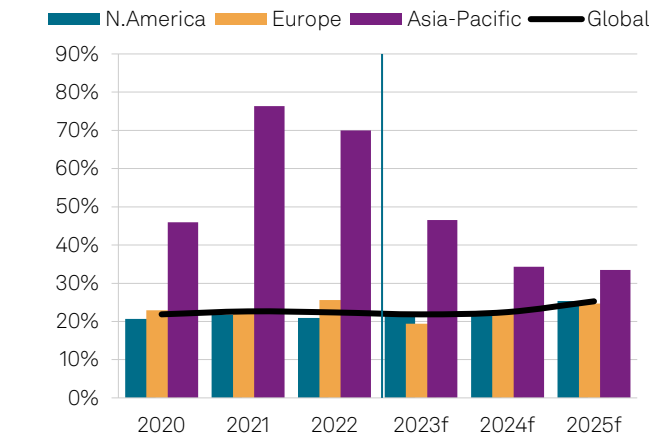


Chart 11
FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Capital Goods

Chart 12

Cash flow and primary uses

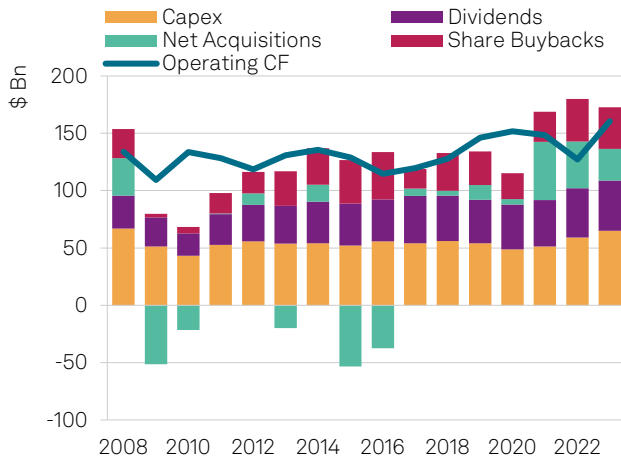


Chart 13

Return on capital employed

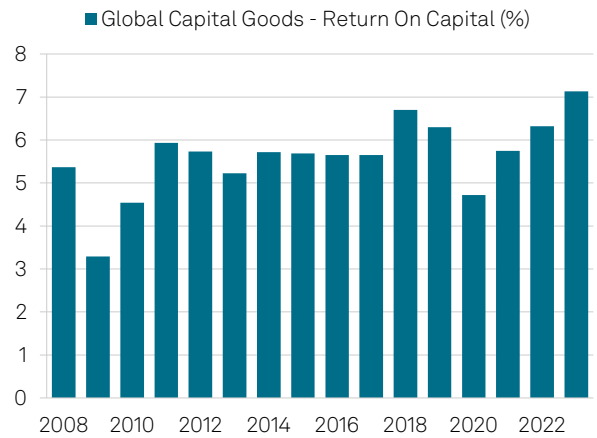


Chart 14

Fixed- versus variable-rate exposure

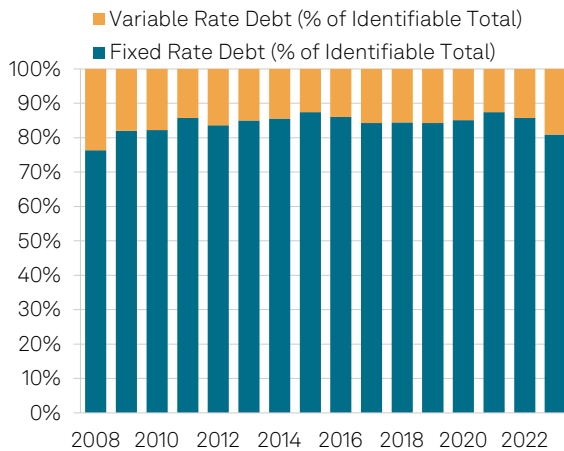


Chart 15

Long-term debt term structure

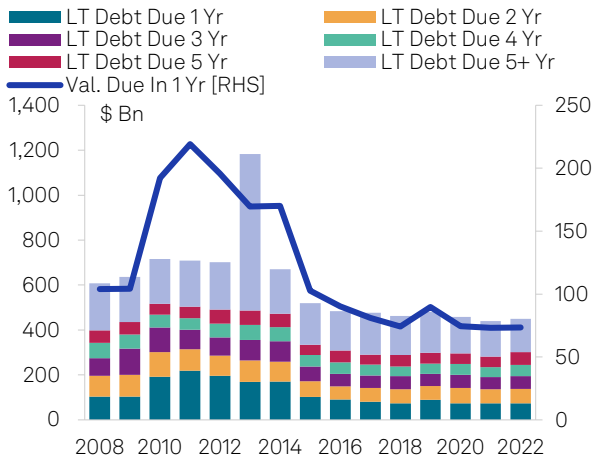


Chart 16

Cash and equivalents / Total assets

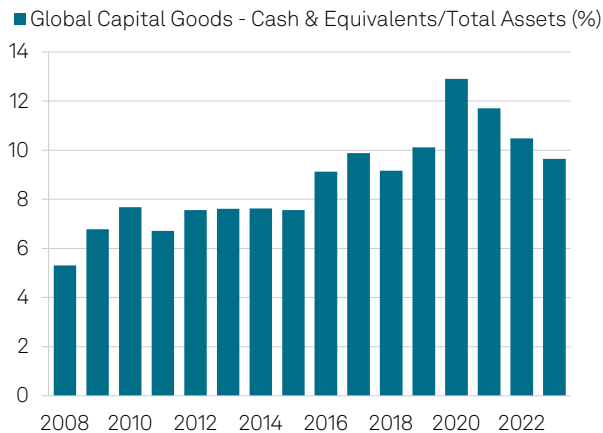
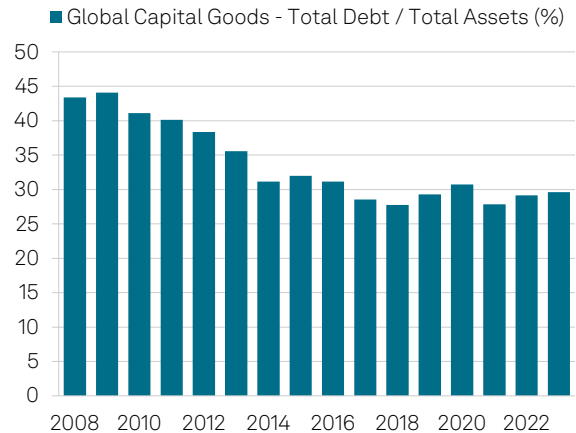


Chart 17

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2023) figures use the last 12 months' data.

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