European Corporate Credit Outlook
Mid-Year 2019
A Switch In Time?

S&P Global Ratings
European Corporate Credit Mid-Year Outlook 2019: A Switch In Time?

July 25, 2019

Key Takeaways

**Policy switch:** Amid growing signs of an economic slowdown, central banks have once again signaled a return to the tried and tested analgesic of monetary stimulus.

**Corporate credit quality under pressure:** Our base case remains that stimulus will avert recession, but systemic fragilities and ebbing corporate credit quality give cause for concern.

**Industry Top Trends update:** We provide single-page updates of our key industry reports that focus on what’s changed in the year to date, what to look out for, and key credit drivers.

As Yogi Berra memorably said, it’s déjà vu, all over again. Global economic growth is stuttering (see chart 1) and has been met with a clear switch in monetary policy direction from the U.S. Federal Reserve and European Central Bank (ECB) that S&P Global Ratings expects will bring lower interest rates in the U.S. and renewed unorthodox stimulus efforts in the eurozone. Our concerns that credit market risk premiums would rise this year in the face of gradual monetary policy tightening and a barrage of political risks (trade, Brexit, Middle East tensions) have proved unfounded for now as the balm offered by central banks has once again soothed financial market confidence and underpinned the availability of liquidity.

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Source: Markit, Refinitiv, S&P Global Ratings

Our base case remains that a European recession is unlikely in the next few years, but we remain concerned at the underlying fragility of economies and banking systems wrestling with flattening yield curves and, in many European countries, negative interest rates (see charts 2 and 3). Europe’s long quest to restore inflation to target levels remains elusive and the argument that many developed economies are at risk of following Japan’s path of high debt, low growth, and deflation is increasingly compelling.
Inflation expectations and government bond yields have slumped lower again

Eurozone Banks Have Lowered Their Interest Rate On Overnight Deposits Close To 0% As Interest Rates Have Turned Negative

For the nonfinancial corporate sector, this environment has remained relatively comfortable given ample and cheap liquidity that has helped keep default rates historically low. Signs of financial excess have crept in—in the form of eroded covenants and less stringent documentation. The ECB’s low-for-longer policy stance may encourage larger, more aggressively structured leveraged buyouts (LBOs) to capitalize on cheap and available financing. This would raise the risk of higher defaults and lower recoveries down the road when the cycle turns. However, for the next 12 months, we anticipate the European speculative-grade default rate will rise slowly toward 2.6% as debt service is low and debt maturities are extended. M&A also remains a credit concern, with surging acquisitions and high debt levels by speculative-grade entities in sectors such as healthcare. In aggregate, though, there is little immediate sign of deterioration, with profit margins holding up (see chart 4) and, in Europe at least if not globally, a continuation of positive if modest capex growth (see chart 5).

EBITDA Margins Are Holding Up For Now… …and Western Europe Non-Financial Corporate Capex Growth Is Still Expected To Expand In 2019, Albeit Modestly

Nevertheless, the combination of slowing global growth and risks surrounding M&A, disruption, and intensifying capital spending requirements is apparent in credit quality. The net outlook bias—the percentage of ratings with positive outlooks less the percentage with negative outlooks—is continuing to deteriorate globally and in Europe (see charts 6 and 7).
An industry breakdown of the net outlook bias (see chart 8) highlights that those with the greatest credit pressures currently include aerospace and defense, autos, retailing, and consumer products. Within these sectors, many of the challenges are structural—internet disruption, electrification, modest consumption growth in developed economies—rather than harbingers of cyclical problems. That said, in the Industry Top Trends updates that follow, deteriorating growth conditions feature significantly as part of "what’s changed" for each industry in the year to date.
Table 1 provides the current assessment of the top risks for European credit conditions as a whole made by S&P Global Ratings’ EMEA Credit Conditions Committee. Inevitably, many of these relate to the political situation both in terms of trade tensions—the risks to European automakers of higher tariffs being imposed by the U.S. remains a particular credit concern—and event risk surrounding Brexit and the deteriorating political cohesion apparent across Europe. A key structural concern remains Italy, where fiscal imbalances and political differences with the EU present a potent risk that could escalate further if the economic slowdown gains traction.

### Table 1

**Top European Risks**

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#### Global trade

The risk trend for global trade has taken a turn for the worse as the U.S. moves to target key strategic industries in China. While Europe is not (yet) directly involved in this bilateral negotiation, the threat of U.S. auto tariffs, deferred for six months, would have serious financial repercussions for the auto industry in Europe if deployed.

#### Disruptive Brexit

Our base case remains that the U.K. will not leave the EU without a deal. However, we see a high and growing risk of a disruptive no-deal Brexit. This follows the resignation of the U.K. prime minister, the emergence of the Brexit Party, and the likely policy direction of the new prime minister putting a no-deal Brexit back on the table as a negotiating tool.

#### Fiscal imbalances in Italy

Although Italy benefits from substantial balance-of-payments surpluses and high private-sector savings, the sovereign has material vulnerability to downside risks over our rating horizon due to the combination of political risk, high government debt, and a weak economy.

#### Weakening European political cohesion

Populists continue to undermine support for established centrist parties, creating a more fragmented and divisive political landscape with the risk that multilateral institutions lose support, policy becomes less predictable, and governments become less willing to respond in a timely basis to emerging crises.

### Top Middle East and Africa Risks

#### Dependence on external debt

This risk is relevant for Turkish banks and to a lesser extent for Qatari banks. The stock of external debt of Turkish banks has been on a downward trend, pointing to lower rollover rates and a higher cost of refinancing.

#### Geopolitical risk

This risk remains elevated and closely monitored by investors. Regional tensions have increased over the past quarter because of tighter U.S. sanctions and accusations of retaliation against GCC-based infrastructure and shipping vessels.

#### Unexpected U.S. Federal Reserve interest rate increase

The Fed interest rate pause is creating some breathing space to countries that depend highly on external debt. However, the underlying reasons for the pause, and particularly concerns over global growth, are creating new risks.
Issuance: ECB’s Policy Shift Has Resuscitated Market Conditions

In contrast to expectations at the start of the year, investment-grade (IG) corporate issuance has surprised on the upside, while leveraged finance supply remains slow paced after a busy 2018. Arguably, financing conditions have been the best since the height of ECB’s quantitative easing, as corporate yields, particularly for the upper end of the rated spectrum, remain anchored close to record lows. Markets are likely to remain borrower-friendly for the rest of the year, supported by accommodative measures by the ECB and diminishing sensitivity to credit risk. We expect the central bank to cut the deposit rate by 10 basis points and potentially resume net asset purchases by €15 billion per month in October. It remains to be seen if this restarts corporate bond purchases, which has been a catalyst for the recent buying frenzy.

High-grade non-financial corporates latched on to the favorable issuance environment, raising €181 billion in H1 2019, about 37% higher from the same period last year. As expected, the sub-zero yields on European sovereign debt pushed IG borrowers to tap the longer end of the curve. Top-rated names have deftly used the window to lock in lower funding costs for longer periods. Overseas borrowers, too, have been enticed by the conditions in Europe. U.S.-based issuers have raised over €42 billion, already more than twice the levels issued in the full year 2018. Issuers looking to diversify their investor base for their large M&A trades, or corporates capitalizing on their cash flows in euros are driving this.

The leveraged finance market, too, is displaying similar signs, as conditions have recovered after a rocky start to 2019. Spreads are extremely tight, while brief periods of volatility in the capital markets have failed to derail investor optimism. However, unlike the high-grade market, lack of issuance has left the buy-side frustrated. European leveraged loan syndication is down 35% YoY, according to LCD, an offering of S&P Global Market Intelligence. Overall M&A-related issuance stood at €24.8 billion, down 45% compared to the same period of the prior year. Issuers have preferred loans over bonds given the access to a larger investor base with good appetite. HY volumes have declined 41% in H1 2019 versus the same period in 2018. Supply in the leveraged finance market has been dominated by opportunistic refinancing trades, while the absence of big-ticket acquisition-related financing seen last year has pushed volumes lower in H1 2019.

Supportive monetary policy and quest for yields will continue to aid cheaper refinancing. More longer-dated supply seems inevitable. However, new IG supply will be curtailed in the absence of large M&A financing deals. Meanwhile, the leveraged finance market is expected to see a pick-up in new supply, amid a growing pipeline for larger LBOs and jumbo cross-border deals. But the list of companies with refinancing needs has diminished—a sign that investors would continue to operate in an environment where there would be little to choose from.
M&A: Political Concerns Derail European M&A Activity

European M&A deal activity has been lackluster since H2 2018, with corporates unwilling to pursue acquisitions amid elevated economic and political risks. Deal volumes in Europe stood at €228 billion as of H1 2019, down 30% from the comparable period last year. The volatile domestic political landscape is pushing European firms to pursue bolt-on acquisitions overseas, particularly in the U.S. Overseas purchases accounted for about 54% of total acquisitions undertaken by firms from EU31 countries in H1 2019, the highest share since H2 2016.

The dearth of big-ticket deals illustrates the pessimism that prevails. There was just one deal worth more than €10 billion in 2019, compared to six in 2018 and 2017. Deals are unlikely to match these levels this year given the cautious mood in corporate boardrooms. The sharp slump in deal activity in the U.K. reflects the wariness among overseas buyers to prospects of no-deal Brexit and broader political concerns in Europe. The U.K. has been the laggard in the EU, with deal volumes down 58% YoY in H1 2019 (see chart 11). Volumes are likely to remain depressed, with Brexit-related uncertainty expected to linger for a few months, after which, overseas firms could be enticed to bid for established businesses. Weaker currency could be an added advantage: Softbank’s purchase of ARM Holdings occurred in a similar environment.

Chart 11
M&A Activity in Europe

Private Equity players were relatively active, aided by strong fundraising during 2019. Sponsors accounted for 21% of acquisition volumes in Europe during H1 2019, the highest share since 2013. We expect Private Equity firms to up the ante in the coming months amid mounting pressure on them to put money to work.

European corporates are expected to remain conservative for the rest of the year. However, anemic growth in Europe over the next few quarters will gradually push European corporations to look for inorganic growth opportunities. With interest rates expected to stay low, weaker exchange rates or lower valuations could accelerate this process. For now, though, the current political environment remains a deterrent and corporates would prefer to stay on the sidelines if Brexit and trade-related uncertainty drags on.

Leveraged Finance: Issuance And Recovery Trends

Broadly speaking, issuers in health care, consumer, TMT, and business services sectors account for approximately two-thirds of total rated first-lien issuance. These sectors dominate year-to-date first-lien new issuance volumes and therefore have the most meaningful impact on average recovery rates. Highest expected recoveries can be seen in companies with relatively low leverage and physical assets with long-term enduring value, such as real estate, oil, and mining & minerals.
However, companies in the capital goods sector, particularly small and midsize issuers exposed to the U.K., have seen adverse top-line headwinds putting pressure on liquidity and their overall capital structure.

Chart 13

European S&P Rated First Lien New Issuance Volume and Average Expected Recoveries by Industry

The health care sector's average is brought down by several large 'B' and 'B+' rated tranches with estimated recoveries between 30%-45%, such as Synlab, Rossini, and Nidda Healthcare, which account for one-fifth of new issuance rated by S&P Global Ratings since 2018. Otherwise, average expected first-lien recoveries in this sector typically emerge in the area of 55%.

Expected restaurants and retail debt recovery averages were around 55%. However, it is worth noting that over two-thirds of the new issuance in this sector since 2018 is contributed by two issuers, EG Group and Motor Fuel (CD&R Firefly), with average estimated recovery of 65%. Both issuers operate petrol stations, with above-average recoveries supported by a benign competitive dynamic, a captive and stable end consumer market, and asset-heavy business models.

Related Research

- Economic Research: ECB: Back To The Future?, July 18, 2019
- Global Corporate Capex Survey, June 19, 2019
- Credit Conditions EMEA: Double, Double Toil And Trouble, June 27, 2019
- The ESG Risk Atlas: Sector And Regional Rationales And Scores, May 13, 2019
- Credit FAQ: When The Cycle Turns: ‘BBB’ Downgrade Risks In EMEA, April 15, 2019

This report does not constitute a rating action
Aerospace and Defense

Still ascending, with a chance of turbulence

What’s changed?

New aircraft model gives Airbus a lift. Airbus launched the A320XLR at the Paris Airshow, gaining 226 orders. These, along with additional committed orders for the A320NEO, will support the supply chain, but may need increased capital expenditure and temporarily cut operating efficiency, as some suppliers retool.

The 737 MAX remains grounded, but Boeing keeps building (at a slower rate). The supply chain is coping, but if the 737 MAX stays grounded beyond fall or Boeing cuts production further, smaller suppliers' earnings, cash flow, and liquidity will be strained.

Rising geopolitical tensions increase defense demand. European demand for fighter jets, missile defenses, and UAVs is growing fast amid heightened EU-Russia tensions and saber-rattling between the U.S. and Iran. European defense players like BAe, Thales and Leonardo are looking to EU certification requirements for UAVs while aiming to capture future demand with the Tempest and F4 Rafale programs.

What to look for

A no-deal Brexit. While still not our base case, a no-deal Brexit could lead to delays all along the supply chain as issuers grapple with potential new customs, logistics, and certification requirements. Large manufacturers like Rolls Royce have already taken action by moving design facilities to the continent. Most of our issuers have taken mitigating steps with regard to regulation, and are stockpiling inventory. However, any disruption lasting more than one month is likely to cause short-term shocks, followed by long-term consequences as alternative suppliers are identified.

Supplier consolidation. Suppliers are looking to consolidate to improve cost efficiencies and increase diversification among platforms. Technological advancements by aircraft manufacturers and engine producers, along with increasing use of new composite materials, are pressuring suppliers to keep up.

Emissions reduction is a key focus for OEMs as customers demand greater efficiency given the IACO Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA), which requires airlines to offset the growth of their emissions after 2020. Projects such as the E-Fan X (spearheaded by Airbus, Rolls Royce, and Siemens) are due to take first flight in 2020. We expect continued capital and R&D expenditure.

What are the key credit drivers?

Individual performance. The negative outlook bias largely reflects specific product and execution challenges faced by specific issuers. But the overall environment is very supportive. Cost reduction initiatives are under way, although it remains to be seen if they can be successfully executed.

Modernization. European states continue to modernize and digitize their militaries. Issuers like Thales and BAES Systems are well placed to benefit, given their cyber and communications focus. Military spending should support revenues in this political environment and as governments target NATO commitments of 2% of GDP.

Latest Related Research

- Rolls-Royce PLC Jul 03, 2019
- ESG Industry Report Card: Transportation, Aerospace, And Defense May 13, 2019
Industry Top Trends Update

Autos

Negative rating bias is building in EMEA

What’s changed?

The global car industry has lost its main growth engine. Contrary to initial expectations that the setback in the Chinese market would be temporary, sales volumes have now been declining for almost a full year (passenger car sales -12.4% YOY in H1 2019). Prospects of a recovery in the second half of the year are dim.

Overall, 2019 looks gloomy for revenues and margins. A healthy product pipeline and intensifying cost cutting might not be sufficient for many Europe-based auto manufacturers to offset negative trends. These include the impact of punitive CO2 regulation, reticence from consumers waiting for new products and more aggressive purchase-incentive schemes by governments, and exceptional negative items for some OEMs such as litigation and recalls.

Unpredictable geopolitical developments. European automakers face the risk that trade conflicts may escalate, specifically the Trump administration’s considering plans to impose tariffs on EU-sourced vehicles and parts, and to increase tariffs on goods imported from Mexico.

What to look for

Nowhere to grow in 2019–2020. Volume growth in the second half of the year (after a very weak H2 2018) is unlikely to be sufficient to rescue a relatively somber 2019. The Chinese car market, the only relevant market area with residual growth potential, essentially linked to low penetration, remains subdued.

A drive for cost structure flexibility. Automakers will seek flexibility measures to rapidly align production capacity to slower demand. These are likely to include high capacity utilization at manufacturing plants, capacity to improve the mix of temporary versus permanent employees, outsourcing of R&D teams, partnerships to share R&D costs, and rationalization of model portfolios. Restructuring will likely become the norm.

Diesel developments. Any further decline of the diesel share in new vehicles below 30% in Europe, particularly if offset by petrol as recent statistics suggest, would jeopardize automakers’ CO2-related strategy around the mix of high- and low-emitting vehicles needed as early as 2020 and 2021.

What are the key credit drivers?

Free cash flow after capex and dividends. Increased financial discipline will be necessary to preserve financial flexibility amid the challenging market conditions, as we see little available headroom for curtailing capex and R&D.

A possible increase in M&A. The quest for cost synergies is likely to trigger consolidation in the industry, whether in the form of tight partnerships or full mergers.

Latest Related Research

− In Europe’s Auto Market It’s All About Curbing CO2 Emissions, June 17, 2019
− Questions Over Electric Vehicle Residual Values In European Auto ABS, May 31, 2019
− ESG Industry Report Card: Autos And Auto Parts, May 13, 2019
− Worldwide Auto Sales Will Slump More Than Expected In 2019, May 6, 2019
Industry Top Trends Update

Building Materials

Business conditions weaker but still supportive

What’s changed?

Business confidence has weakened. Heightened near-term (mainly geopolitical) risks are feeding uncertainty and weighing on economic fundamentals, notwithstanding the ECB’s easing bias that is helping funding conditions.

Lower energy prices than in 2018 are easing margin pressure in 2019. On current forward prices, most building materials players should benefit from tailwinds both in fuel and power costs for the remainder of 2019. This should limit cost inflation and help companies preserve their EBITDA margins at around 14% on average.

The 2018 earnings season did not bring any surprises. Most companies reported results in line with our expectations. The implementation of IFRS 16 should not materially change our credit metrics, based on companies’ preliminary data.

What to look for

Outlooks are mainly stable. The rating trend is mostly stable, with an overall neutral bias. Rating upside remains limited, notwithstanding still-supportive sector fundamentals, due to highly leveraged issuers owned by private-equity firms and generous shareholder remuneration at investment-grade companies.

Rating headroom remains limited in the case of a downturn. Building materials companies’ credit metrics have not fully recovered since the financial crisis, on average. As this is a cyclical industry, and companies have usually exhibited a rapid EBITDA decline when the market has taken a downturn, tight credit metrics leave less room to maneuver when under stress.

Profit reliance on the U.S. market is high. The increased exposure of the large European companies to the U.S. has enabled them to improve their results in past decade. However, this adds concentration risk in the case of a sudden downturn of the U.S. construction cycle.

What are the key credit drivers?

Construction output remains supportive. The construction sector in Europe should grow further in 2019-2020, continuing the recovery that started in 2014. Infrastructure works are the primary driver of growth. However, we expect a slowing path compared with 2017-2018. Structural factors, like demographic pressure, limit growth upside over the medium term.

Eased financial discipline remains a key risk. Although some large investment-grade players have moderated acquisition spending and share buybacks, relaxed financial policies remain a major driver of rating downside. For financial sponsor-owned companies, we expect an increase in leverage, because these companies should continue to either seek out acquisitions or eventually pay dividends.

Strict investment criteria are not reducing capital expenditure (capex). Most players have trimmed expansion capex but we expect capex to remain almost unchanged, sustained by compliance to more stringent environmental regulations.

Latest Related Research
- Credit Conditions EMEA: Double, Double, Toil And Trouble, June 27, 2019
- ESG Industry Report Card: Building Materials, June 3, 2019
- ITT Building Materials, Nov. 14, 2018
Industry Top Trends Update

Capital Goods

Spin-offs are accelerating

What’s changed?

The global economy is cooling down faster than we expected. Trade tensions—in particular the tariff dispute between the U.S. and China—are casting a shadow on the global economy and financing conditions in all regions. This is already affecting order intake and is likely to affect both production volumes and investments in capacity. We therefore expect 2020 to be a more difficult year for capital goods companies than the start of 2019.

Declining investment levels threaten top-lines and margins. We are seeing declining levels of industrial investment globally. The picture is dominated by trends in North America, where growth has slumped, and in Asia-Pacific (excluding Japan), where we expect overall capex to shrink again. A sharp downturn in IT spending in Asia-Pacific and cuts to oil capex in the U.S. are key contributory factors. As of the year to April 2019, manufacturing-related investments in China only grew by around 3%, compared to year-on-year growth of nearly 10% in 2018. For most European capital goods companies, China is the most important geographic market next to the U.S., and we expect stagnating market demand to put pressure on prices and margins.

What to look for

M&A will dominate the headlines in the investment-grade and crossover ('BB' to 'BBB') categories. We expect divestments and acquisitions to continue to remodel the sector landscape as European capital goods companies seek simplified structures, growth, and shareholder returns. For larger sector participants in particular, a focus on digitalization, software, technology content, and higher margins is likely to transactions to follow.

Risk lies at the highly leveraged end of the speculative-grade category. Slowing demand, in combination with highly geared balance sheets, have already left their mark in the low speculative-grade space during the first half of 2019. The defaults of Senvion and Galapagos Holding, as well as multiple rating transitions to the 'B-' and 'CCC' categories, have underlined the risk of high leverage for margin-weak or capital-intensive manufacturing businesses when economies are weakening.

What are the key credit drivers?

Operational and financial challenges ahead. We expect companies with less favorable business models, weaker operational capabilities, and more concentrated market or product exposure to experience more operational and financial challenges, including access to liquidity and feasible refinancing options. Our outlook distribution in the 'B' and 'CCC' categories has a heavy negative bias, with 30% of the ratings on a negative outlook.

Latest Related Research

- ESG Industry Report Card: Capital Goods, June 3, 2019
- Bulletin: German Steel Producer thyssenkrupp’s Back To The Drawing Board After Calling Off Tata Merger And Materials Spin-Off, May 10, 2019
- Bulletin: Siemens’ Planned Gas & Power Spin-Off Will Strengthen Profitability And Growth, May 8, 2019

Outlook Distribution

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Sector Forecasts (2019)

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Tougher times ahead for EMEA chemical producers

What’s changed?

The global economic slowdown is faster than anticipated. The cool-down in global economic growth and rising trade tensions, specifically the tariff conflict between the U.S. and China, have weighed on business confidence and investment in key chemical industry markets. The German IFO chemical business climate assessment is at its lowest point in a decade and business expectations fell to the lowest level since 2012. Accordingly, we expect headwinds for chemical producers, particularly those exposed to cyclical end-markets, such as Automotive.

Weakness in automotive. Global auto production, a key end market for the chemical industry, declined about 6% in the first half of 2019 and twice as much in China, the world’s biggest market. Lower volumes were a key reason for the severe profit warning from BASF, one of the world’s largest chemical companies, which pointed to weaker-than-expected global industrial production, specifically in China, which represents more than one-third of the global chemical market.

European chemical production is moving sideways. Global chemical production expanded modestly YTD May 2019, but at a slower pace and led by the U.S. and China. But European chemical production is stagnating (-0.8% vs YTD May 2018), with limited likelihood for an acceleration in H2 2019.

What to look for

Potential margin pressure from lower utilization rates. The subdued demand situation coincides with ongoing global capacity additions in petrochemicals, mainly in the U.S. and in China, which could result in lower utilization rates and pressure on global prices and margins in certain value chains. This is contrary to our previous expectations and, due the lower growth environment, it could take longer than anticipated for the market to absorb the additional production capacity, putting pressure particularly on high cost producers.

Financial policies need to adjust to operational weakness. Following record-high operating cash flows and dividend payouts in 2018 in the Chemical industry, we assume that chemical companies will adjust key elements of their financial policies, such as dividends and shareholder rewards, to the deteriorating economic conditions. Although favorable conditions for chemical companies in the past few years have resulted in moderate rating headroom for many issuers, we would view a similar amount of payouts, especially for players exposed to a more challenging operating environment, as a reflection of a more aggressive financial policy than we currently factor in our ratings and therefore as a credit risk.

Rating outlooks are stable for now. The rating outlooks in EMEA are largely stable as of July 2019 (86%), with the remainder equally balanced between positive and negative outlooks. As a share of total rating actions we saw net downgrades for speculative-grade chemical issuers and balanced actions in investment-grade chemical issuers over the past 12 months.

Latest Related Research

- BASF’s Profit Warning Will Have Only A Moderate Impact On Its Credit Metrics, Pending Second-Quarter Results, July 12, 2019
- ESG Industry Report Card: Chemicals, June 3, 2019
- Industry Top Trends 2019: Chemicals, Nov. 13, 2018
Industry Top Trends Update

Consumer Products

No mega M&A, as embattled retailers pose risks to growth

What’s changed?

Growth prospects lie with omni-channel and emerging market strategies.
 Companies will have to continue developing these strategies in the face of tighter consumer spending on basic goods and the declining credit standing of traditional retailers.

Currency volatility and local competition keep multinationals’ growth ambitions in emerging markets in check. Disproportionate exposure to China is becoming a specific risk for a number of consumer industry sub-sectors. With Latin American demand still fragile, the investment focus has again moved to the more populous markets of South-East Asia, such as Malaysia, Indonesia, and Vietnam.

EMEA multinationals are unlikely to engage in mega mergers and acquisitions over the medium term. The largest companies continue to focus their strategies on in-fill acquisitions and spin-offs of non-core activities.

What to look for

Growth in China. The luxury goods sector continues to post very strong results, but is highly exposed to Chinese consumers, both in mainland China, and across major travel destinations. Infant and specialist nutrition sales are experiencing acute competitive rivalry.

Beer. Mainstream lagers are under pressure from pricing rivalry and slowing demand in mature markets.

Tobacco regulation. The tobacco industry is awaiting an FDA ruling on premarket tobacco application in the U.S. to develop new generation (reduced risk) product strategies for the market.

What are the key credit drivers?

Raw material pricing. Upward pressure is likely to continue in pulp and paper, packaging, as well as in a wide range of agricultural commodities, including sugar. Current low green coffee prices may result in supply disruption over the medium term.

Digital retail. Omni-channel success relies on careful product and service management as customer acquisition costs continue rising. Direct-to-consumer and social media-enabled sales are gaining prominence, especially for luxury and prestige brands.

Sustainability. The social and environmental agenda is increasingly prominent in consumer discourse, focusing on health and nutrition, as well as the use of plastics in packaging and fabrics.

Latest Related Research

- Global Skincare Player Sunshine Luxembourg VII (Galderma) Rated Prelim. ‘B’; Outlook Negative, July 1, 2019
- France-Based Luxury Goods Group Kering Upgraded To ‘A-‘ After Strong Results; Outlook Stable, April 18, 2019
- LVMH Group’s Strong Operating Performance Further Reinforces Its Position In The Luxury Goods Market, Jan. 30, 2019
Health Care
SG companies max out on debt while IG rationalize costs

What’s changed?

Big pharma has posted positive organic growth and margin improvements. Results have exceeded our expectations, despite increasing generic competition for blockbuster drugs and ongoing high research and development costs. This is thanks to successful launches of innovative products offsetting losses of exclusivity on patent expiry, coupled with geographical and product diversification and cost-rationalization programs.

EMEA companies have no patent cliff driving a need to buy big. European pharma companies have abstained from large mergers and acquisitions (M&A) since the beginning of 2019, in sharp contrast to the M&A frenzy among U.S. players Bristol-Myers Squibb, Pfizer, and AbbVie. The focus is on bolt-on acquisitions and collaborations to gain new technologies or late-stage products.

The reimbursement environment for medical devices and services remains mixed. Some markets, such as France, are benefiting from an improved stance on reimbursement tariffs. Rising costs across all markets make it imperative for service players to grow volumes to maintain profitability. Emerging markets are driving growth in medical devices despite currency headwinds.

What to look for

Potential drug price executive order in the U.S. signals uncertainty over returns on new launches. The U.S. administration has signaled that it might request that U.S. prescription drug prices are brought in line with those in other countries. Although potentially negative across the board, this is unlikely to tamper the success of new launches of drugs with a clear clinical edge.

Health care services need to optimize cost structures. Shortages of qualified medical staff, changing legislation, and low unemployment in Europe are pushing staffing costs up, amid limited scope for fee and tariff increases.

Medical equipment companies face higher M&A multiples. Driven by technical innovation, this segment faces rising costs for external acquisition growth.

What are the key credit drivers?

Big pharma seeks to protect ROC. Companies are entering collaboration agreements with milestone payments on results (GSK and Merck, AstraZeneca and Daiichi Sankyo), or combining contingent payments with equity issuance.

High yield signals a credit bubble. Fueled by a combination of favorable funding, high multiples, and rapid consolidation, starting leverage has exceeded 7x.

No scope for high-yield companies deleveraging in the near term. The sector is pushing ahead with acquisition growth, despite material integration risks.

Latest Related Research

- How Business Strength Varies Across The Top 15 Branded Pharmaceutical Companies, June 10, 2019
- Bayer ‘BBB/A-’ Ratings Affirmed On Projected Debt Repayment Offsetting Potential Litigation Costs, May 23, 2019
- Big Pharma’s Renewed Appetite For M&A Will Put Pressure On Ratings, Feb. 1, 2019

Outlook Distribution

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Rating Distribution

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Capital Expenditure Trends

- Energy
- Healthcare Equipment IG
- Healthcare Equipment SG
- Healthcare Services IG
- Healthcare Services SG
- Infrastructure
- Non-Core
- Private
- Transportation
- Utilities

S&P Global Ratings July 25, 2019 15

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Paris
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+33 1 44 20 66 72
Industry Top Trends Update

Hotels, Gaming, And Leisure

Watch out for tighter regulation and weather risks

What’s changed?

New gaming regulation in the U.K., Germany, and Italy has weighed heavily on gaming operators’ performance. Reduction of the maximum bet on fixed odds betting terminals to £2 from £100 in the U.K., and gaming ordinance changes in Germany brought real change with the full effects still to be realized.

Weak booking trends across the European tour operator market, particularly in U.K., are weighing on tour operators’ performance. U.K. and North European customers, historically early bookers of summer holidays, were slower to buy tour packages than in previous years.

The 2018 earnings season was in line with our expectations. Solid performance for lodging (due to good diversification) and gaming (World Cup year) supported good growth in 2018. While regulation weighed on performance in some areas, improvements in other areas overcame most of the negative effect.

What to look for

The challenging market environment will force tour operators to discount during the peak summer season June-September to fill committed capacity, leading to weaker results for the year. Slow bookings are also adding pressure on companies’ working capital dynamics, as they have to rely more on bank financing to pay their suppliers for the summer season. As a result, liquidity could become a concern.

Gaming shop closures in the U.K. could change the face of the industry. New regulations in effect since April 1, 2019, are forcing bookmakers to close a large portion of shops. William Hill has said it will close up to 700 shops before end-2019, while GVC is expected to close up to 1,000. This will likely drive some gamblers online and negatively affect EBITDA of all U.K. retail-based gaming operators.

Indirect effects of a no-deal Brexit are still not clear. We do not anticipate significant disruption. However, a sharp decline in consumer confidence, should it occur, would reduce spending on leisure-related activities including lodging, visits to amusement parks, and gaming activities.

What are the key credit drivers?

Social risks of gaming regulation. Europe’s gambling industry is under considerable political pressure to reduce the social harm of gambling addiction. Despite recent self-regulation by operators, we expect regulators will continue to seek tighter regulation, leading to earnings’ volatility and an uncertain outlook.

Weather-related risks are creating earnings’ volatility for the travel industry (lodging, theme parks). Performance could suffer under extreme weather, as people travel less. Tour operators could face oversupply and lack of demand, leading to increasing competition for customers and tour package price declines.

Debt-financed acquisitions and dividend recaps will continue to weigh on the financial risk profiles of leisure companies we rate, as the past few years of market consolidation and LBOs has shown. Business divestments could be material in several industries (tour operators, gaming) and bring significant industry changes.

Latest Related Research

- ESG Industry Report Card: Leisure, May 21, 2019
- German Arcade Operators Face A Challenging 2019 As Gaming Ordinance Effects Are Worse Than Anticipated, Jan 25, 2019
Industry Top Trends Update

Media And Entertainment

Declining earnings and cash flow due to investments in TV programming and VOD

What’s changed?

A move to direct-to-consumer (DTC). European broadcasters and pay-TV players are offering streaming services in response to cord-cutting, competition from over-the-top (OTT) platforms such as Netflix, and pressure on TV advertising spending.

Creation of European partnerships to protect local competitive positions. These include, for example, ITV and BBC bundling some of their U.K. content for the new Britbox offering in the U.K., or the European Media Alliance that includes TF1 (France), ProSieben (Italy), Mediaset (Spain), Channel 4 (U.K.), and CME (Central and Eastern Europe).

More flexibility and sophistication in content rights. With broadcasters going DTC and local content being key to retain local audiences that have been inundated with U.S. programs in recent years, content producers have been focusing on better managing their intellectual property rights. For example, global OTT platforms are now less likely to get unlimited and unrestricted global rights to exclusive content, thereby creating additional windows of opportunity for content owners, but also forcing global OTT platforms to adapt their models.

What to look for

Cross-border consolidation. Consolidation of the media sector could continue, be it cross-Atlantic (such as the Comcast/Sky transaction), or across Europe, such as France-based Vivendi’s recent acquisition of European broadcaster M7.

Evolving regulation. We will closely monitor the changes in the European and local regulations. In particular, OTT platforms such as Netflix or Amazon will have to comply with European content quotas by September 2020, whereby video-streaming companies that operate in the EU must ensure that 30% of their catalog is made up of European works.

What are the key credit drivers?

Effective reach. While the industry standard measurement for audience reach has not been able to keep pace with the changes in TV viewing, effective reach remains critical for broadcasters to attract advertisers. We believe that successful broadcasters will be those with a multi-platform strategy and increased audience engagement, with both being very attractive to advertisers.

Pressure on free cash flow generation. We anticipate pressure on earnings and free operating cash flows for most broadcasters, reflecting DTC strategies and investments in exclusive content (such as live sports rights or scripted drama), compounded by the loss of syndication and licensing revenues. This could pressure credit ratings.

Diversification of revenues streams. Due to advertising spending’s high correlation with GDP, broadcasters less exposed to advertising will likely perform better during recessions. Similarly, content producers with wide offerings and diversified clients will be in a better position to withstand pressure from broadcasters delaying expensive shows in anticipation of weaker advertising revenues.

Latest Related Research

- Bertelsmann SE & Co. KGaA, June 11, 2019
- ITV PLC, June 3, 2019
What’s changed?

Supply matters. Supply constraints in iron ore are contributing to sharply higher earnings for these miners at the expense of steel producers amid weaker steel demand. A similar margin squeeze is affecting aluminum producers, with high alumina input costs and low primary aluminum prices.

But so does demand. Copper prices have dropped again in response to global growth concerns, not least in China. Our base case assumes continued global growth in 2019 of 3.4%, with 6.2% in China. For ratings, the financial headroom will be critical for the next recession or cyclical downturn.

Tariffs are playing a minor role. Tariffs on steel imports into the EU and U.S. haven’t prevented a sharp downturn year-to-date in 2019. Concerns about more tariffs, for example on U.S imports of EU cars, and the “weaponization” of tariffs beyond specific sectors are crimping growth expectations.

What to look for

Lower U.S. dollar and interest rates will support metal prices— if China holds up. Gold miner profits should get a boost as prices respond favorably to geopolitical risks and lower U.S. interest rates. Producers of base metals like copper and nickel could also get a boost, but only if demand from the world’s largest consumer holds up through trade friction.

Competitive positions are being recast in the gold sector. We believe that recent M&A among gold miners will trigger a reshuffling of assets among issuers. Large producers are selling to boost asset and capital efficiency and smaller companies are buying to shore up reserves to sustain production.

Imports and margins signal weakness. Apparent steel consumption in the EU28 was down 2.5% in Q1 2019, with domestic deliveries down more than imports and LME aluminum inventories appear remarkably tight, but prices for both metals have dropped 20%-30% over that same period.

What are the key credit drivers?

Miners are plotting their next moves after cleaning up balance sheets. Robust cash flow is providing options for investment or shareholder returns. We expect that mining companies will use ample cash balances to bolster reserve lives amid steady demand, but these multi-year investments are increasingly difficult and risky.

Country risks and social issues, especially unions and strikes impact production. From South Africa to Chile and beyond, strikes have taken their toll. Exposures vary by company, as their financial flexibility varies, but for smaller players the impacts can be material.

Latest Related Research

– S&P Global Ratings Lifts Metal Price Assumptions For Iron Ore, Makes Modest Revisions For Gold, Aluminum, Copper, And Zinc, July 8, 2019
– The Top Five Global Miners Remain Sensitive To Environmental And Social Risks Jun.19, 2019
– Issuer Ranking: Global Metals And Mining Companies, Jan.29, 2019
Industry Top Trends Update

Oil and Gas

Benchmark prices aren’t the only credit driver

What’s changed?

Crude prices are supportive for many producers, but gas prices are weaker. Oil prices have oscillated between $50 and $74, averaging $65/bbl as production surprised to the upside and then growth concerns moderated demand. Gas markets remain more globally correlated, but have been moving lower in 2019.

Drillers and oilfield services are under pressure. Some restructurings and defaults are continuing. Margins are still under pressure from producers in spite of years of cost retrenchment at producers and providers and limited cost inflation in some sub-segments.

Refining margins are likely to strengthen in H2 2019. First-half 2019 margins have been depressed and below our base case. Several fundamental drivers point to cracks recovering in the second half and into 2020, not least with IMO 2020.

What to look for

Change in OPEC and production discipline. Compliance with cuts has been over 100% (mostly Saudi Arabia). The extended nine-month cuts will remain important to underpin crude prices, absent tightening supply-demand balances.

Actual realisations, differentials and product prices. At the company level, sustainability depends on all-in break evens after capex, interest, and dividends for producers. More complex refiners should benefit from IMO-related diesel demand, but feedstocks and full product slates will differentiate performance.

Restructuring risks. Smaller and lower rated OFS and E&P companies may elect to lower their fixed costs, namely interest, by restructuring financial obligations or buying back debt below par. Adequate or inadequate liquidity can be less important than management opportunism.

What are the key credit drivers?

Brent above $55, WTI above $50 on average. Most producers and OFS issuers can cope with dips, but sustainable earnings for many imply prices above these levels.

Financial discipline. For majors and shale players alike, effective capex spending, and contained shareholder returns and M&A may be credit differentiators.

Moderating leverage and debt. Cost control remains a key focus, and this entrenches resilience to lower prices. Companies that reduce debt further will have additional rating and strategic headroom to address future volatility.

Latest Related Research

- S&P Global Ratings Lowers U.S. Natural Gas Price Assumption For 2019 and 2020; Long-Term U.S. Natural Gas, Canadian AECO, And Crude Oil Price Assumptions Unchanged, Jun 11, 2019
- Reports Rank Global Oil And Gas Companies’ Relative Risks, May 15, 2019
- Oil Majors Are Back On The Front Foot, March 19, 2019

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Rating Distribution

Sector Forecasts (2019)

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Oil and Gas Price Dynamics

- Brent $/BBL
- TTF $/MMBtu (RHS)
- Brent Crack Ref. Mgn US$/BBL [RHS]
Industry Top Trends Update

Real Estate

Rising risks despite healthy operating fundamentals

What’s changed?

Retail owners are starting to witness the effects of e-commerce. Most companies see tenants’ turnover stabilizing or even declining, especially in matured Western and Nordic markets, where e-commerce penetration is higher. Rents remain supported by a stronger inflation, but uplifts on renewals could be more subdued.

Social protests are putting residential landlords at risk in Germany. The senate of Berlin reacted to social events by proposing a five-year freeze on in-place residential rents. Such tightening regulation on rental growth will likely hinder like-for-like rent increases and valuation upsides in those respective locations.

Brexit uncertainties are beginning to affect the U.K. market more acutely. Investments in the London office market sank to the lowest since 2010, implying negative revaluations and growing yields in CBD. House prices in London continue to decline modestly, mainly driven by falls in luxury homes in prime central locations.

Flexible office operators are boosting leasing markets. They still take long leases to traditional REITs but push them to follow the trend of shorter flexible contracts.

What to look for

Despite still positive operating trends, watch out for access to funding. Market fundamentals for real estate landlords remain strong. However, financial markets continue to discount REITs. This could be an issue if refinancing becomes harder.

Where retail space is nearing saturation. We see a risk for companies that operate in markets showing a combination of high shopping center density, low barriers to entry, and excessive supply. Presence of non-food hypermarkets is also a negative.

Political risks and possible evolution of regulatory frameworks, not only in Germany. Rising concerns on cost of living may prompt governments to adopt measures to limit rent increases and, as a result, landlords’ profitability.

Share buybacks may be back. Most REITs continue to see their share price trading at a deep discount to NAV, especially those related to Retail. If no acquisition opportunities arise, some of them may proceed with shares buy-back.

What are the key credit drivers?

Retail is about detail. Micro location and tenant mix will likely differentiate winners and losers among shopping center owners. We see a sweet spot for food and leisure-oriented, centrally located, dominant centers in area with low retail density.

Interest coverage will remain strong, if not strengthen. Lower coupons on recent debt issuances and growing revenues will keep interest coverage high.

Debt leverage will land, but valuation uplifts should be more limited. The low interest environment should prevent rising capitalization rates. On other hand, M&A activity has tempered in 2019. So debt-to-debt plus equity ratios should not rise.

Latest Related Research

- Berlin’s Proposed Rent Freeze Would Likely Limit Landlords’ Growth And Hinder Investments June 7, 2019
- Real Estate Disruption: Can Traditional Office Landlords Co-Work With Flexible Office Space Players? April 9, 2019
Industry Top Trends Update

Retail and Restaurants

Disruption continues and the worst is not yet over

What’s changed?

Retail is still trending negative. The high street remains under pressure, with pockets of improvement on a name-by-name basis only. Apparel and departmental stores have faced negative pressure for the past two years, with various defaults, especially in the U.K. Value-added segments, both food and non-food, show resilience and positive momentum.

Changing consumer behavior is forcing structural change in retail. E-commerce is gaining momentum but remains a small fraction of overall sales and EBITDA.

Full-year 2018 Retail results were weaker than anticipated. Overall, the sector is showing flat to marginally declining trends. Food retailers, which were expected to show modest resilience, continued to face pressure from top lines as well cost implications. French food retailers in particular surprised on the downside.

What to look for

Continued disruption. 43% of high-grade issuers are on negative outlook. French food retailers and the U.K. non-food segment in particular face continued downward pressure, as do apparel and departmental stores.

Capital expenditure will continue to rise: Large corporates with financial flexibility continue to invest in supply chains, faster checkouts, improving the efficiency of their e-commerce platforms, and use of AI to move into “experience shopping”.

More consolidation, more regulation: Retail is continuing its consolidation trend, with regular partnerships and joint ventures. But regulators are keeping a close eye, and businesses focused on pure online retailing could also come under closer scrutiny. ESG factors are gaining traction, with regulations on single-use plastic, supply-chain traceability, a drive for more environment-friendly policies and usage.

What are the key credit drivers?

The development of omni-channel capabilities across the eurozone: Retailers in France and the U.K. are focusing on omni-channel capabilities to maintain and increase market share. Partnerships are being formed on both the supply side as well as delivery solutions to the end consumer.

Discounters are ahead of the game. To combat discounters, traditional food retailers are increasing private label penetration to improve EBITDA margins and provide value to the end consumer. Food retailers are experimenting with entry-level price points and exclusive and premium ranges, with a focus on fresh, organic, and environment-friendly ranges to win customer loyalty.

Convenience stores are gaining popularity across urban centers, where they are being used as top-up shops. This format now represents about 5%-7% of the total grocery market across Europe. It is even gaining ground in France, where the map is dense with hypermarkets, and Germany, where discounters dominate.

Latest Related Research

- ESG Industry Report Card: Retail, May 21, 2019
Telecommunications

**What’s changed?**

**Weak growth prospects push asset sales and cost-cutting up on the agenda.** With our telecoms growth forecast near breakeven, some companies are exploring asset sales, including network spins, to increase balance sheet flexibility, and aggressive cost-cutting to grow EBITDA through margin improvement. We expect incremental growth in ratings headroom will result, but little will come from topline growth.

**5G auction results show spectrum is hard to value.** Auctions have yielded valuations ranging from less than 5 cents per MHz POP in Finland to over 35 cents in Italy. This highlights the difficulty operators have in valuing spectrum, with revenue prospects highly speculative, and magnifies other considerations like auction structure. We expect remaining auctions to trend downward to 10-20 cents.

**Huawei restrictions.** Risk of higher network equipment spending and project interruptions flared with U.S.-led Huawei restrictions. We think operators will pursue a multi-sourcing equipment approach to mitigate risks, and remain cautious on Huawei handsets and use in core networks.

**What to look for**

**Network spins could provide attractive valuations, but come with business risks.** Tower and fixed-line assets can yield mid-teens multiples, double that of integrated telecoms. This is attracting interest from telecoms operators looking to deleveraging, and from hedge funds and infrastructure buyers. But operating lease adjustments temper the financial benefit, and in the asset-heavy sector, potential loss of differentiation can have negative consequences for business profiles.

**5G rollouts.** A steady stream of 5G launch announcements belies the fact that current use cases and compatible devices are sparse, and consumer plan pricing shows little to no 5G premium. We think the real 5G opportunity is mid-decade unless enterprise customers can accelerate the arrival of a 5G “killer app”.

**European Commission and M&A.** With new EC leadership, we’re looking for signs of any rebalancing between consumer protection and infrastructure investment priorities. Consumer protection has largely reigned, but the pendulum is swinging back as 5G readiness becomes a national competitiveness issue. We expect incremental change, but in-market consolidation M&A could be back on the table.

**What are the key credit drivers?**

**Competition.** Competition remains fierce in most European markets, keeping a lid on pricing and presenting a challenge to networks upgrades and credit ratios. We think premium segmentation through strong networks and convergence will provide a better defense than expensive content or net adds via aggressive pricing.

**Financial discipline.** Equity performance has been disappointing, with Europe’s telecoms underperforming the broader index by over 20% the last three years. Financial discipline in the face of shareholder demands will be critical to maintaining ratings given relatively tight ratings headroom.

**Latest Related Research**

- U.K.-Based Vodafone Group PLC ’BBB+’ Rating Placed On CreditWatch Negative, Jul 16, 2019
- Bans On Huawei Will Hit Tech Harder Than Telecom, But Not Enough To Move The Ratings, June 12, 2019
Industry Top Trends Update

Transportation

May be in for a bumpier ride as risks accelerate

What’s changed?

Dry bulk shipping rates have collapsed. The Vale dam accident and subsequent closure of mines and suspension of iron-ore production in Brazil, resulted in major disruptions to trade volumes. This, exacerbated by weather-related supply issues in Australia, has put significant pressure on dry bulk charter rates.

Scraping has gathered speed. Demolition of old ships, in particular drybulkers and containerships, has accelerated ahead of IMO 2020 regulations. Positively, this has reduced supply growth and positioned shippers better to cope with sluggish demand trends, most notably stemming from the ongoing U.S.-China trade dispute. Additional trade tariffs could impede the rebalancing of demand-supply conditions.

Fuel prices have risen. Most European airlines are adequately hedged, which offers some protection, but they are finding it challenging to pass through escalating costs via higher ticket prices amid sustained and intense industry pricing pressure.

What to look for

New International Maritime Organization (IMO) regulation. Shipping companies will face higher operating and capital costs to comply with stringent regulations to cut sulfur emissions to 0.5% as of January 2020. Most will need to switch to more expensive, cleaner fuel, as few have yet installed the exhaust gas cleaning systems ("scrubbers") necessary to capture and dispose of sulfur emissions.

Orders for new ships. Assuming a typical lead-time from ship ordering to delivery of 18-24 months, we expect a slowdown in vessel supply growth for at least the next few quarters, regardless of new ordering activity.

Will passenger yields improve on European airlines’ short-haul routes? Industry-wide network adjustments and Boeing’s 737MAX grounding could help to improve persistent overcapacity issues and low-ticket fare growth.

What are the key credit drivers?

Political and economic uncertainties continue to threaten demand. While most airlines are confident that they will comply with EU and U.K. ownership and control rules post-Brexit, increased costs could stem from challenges in border management, labor shortages, and regulatory changes.

The new low-sulfur regulation will likely boost crude oil- and oil-product shipping demand and tanker charter rates. Notwithstanding any further such geopolitically driven challenges, we should see a recovery in container freight rates in H2 2019, supported by the supply-side, including accelerating scrapping volumes, which year-to-date have nearly exceeded the 2018 level.

Management commitment to prudent financials provides headroom in credit metrics for operational setbacks typical in this principally highly cyclical sector, despite persistent political and economic headwinds.

Latest Related Research

- Boeing 737 MAX Accidents Leave A Trail Of Uncertainty For Airlines And Aircraft Leasing Companies, March 14, 2019
European Corporate Credit Mid-Year Outlook 2019

Industry Top Trends Update

Transportation Infrastructure

M&A, regulation, and politics pose risks to stable outlook

What’s changed?

The sector remains resilient. The outlook for business conditions and the credit quality of most airports, railways, and toll roads are broadly stable, despite macroeconomic and geopolitical uncertainty.

Traffic is slowing. European passenger and road traffic growth is slowing. We expect traffic growth volume multiples of GDP to fall to 1.0x-1.5x from 2x-3x.

Revenues and profitability are holding up. Earnings have remained strong. Some airports’ earnings should be challenged in the medium term amid the prospect of cuts in aeronautical charges. Meanwhile, operating expenditure on customer services has increased and is placing pressure on the rail sector’s profitability.

What to look for

Regulatory returns are being revised downward for airports. Low interest rates and strong operating performance will likely weigh on regulatory returns in the next regulatory periods. This may result in a material drop in aeronautical charges for some airports under regulatory review. We expect airports’ currently healthy credit metrics to deteriorate and therefore reduce headroom in the ratings.

Brexit. The heightened short-term uncertainty around transport policies and the potential for weaker macroeconomic conditions under different Brexit scenarios may weigh on U.K. transportation companies’ performance and credit quality.

Consequences of the Genoa bridge collapse. The Genoa tragedy raised reputational, regulatory, and political considerations, as well as an uncertain financial impact. Uncertainty over the possible revocation of the motorway concession managed by Atlantia’s subsidiary Autostrade per l’Italia has triggered our CreditWatch negative placement on Atlantia.

Rail liberalization challenges operating models. The sector is preparing for the start of competition in EU domestic rail passenger markets from 2020. Rail companies are ramping up investments and operating expenditure, which will add pressure to their already leveraged credit profiles, as well as their low profitability.

What are the key credit drivers?

M&A will continue. Depending on the nature and structure of such transactions, M&A activity is likely to be the main reason for rating actions.

Growing capex needs. Increased capex to address capacity constraints, tightening emissions regulations, and digitalization is likely to hamper companies’ ability to generate free operating cash and cause them to increase leverage to finance their needs at a time when we foresee pressure on tariffs.

Leverage could tighten rating headroom. High leverage for transportation infrastructure companies stemming from M&A, rigid shareholder distributions, and capex could exacerbate the effects of a slowdown in traffic performance and tariff cuts, resulting in negative rating actions.

Latest Related Research

- Research Update: Atlantia Ratings Placed On CreditWatch Negative On Heightened Downside Risk From ASPI Concession, July 11, 2019
- Research Update: Irish Airport Operator daa PLC Outlook Revised To Stable On Expected Lower Tariffs; 'A-' Rating Affirmed, July 3, 2019

Outlook Distribution

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Average S&P Adjusted EBITDA Margin by Subsector

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Utilities

Regulated companies are the most at risk

What’s changed?

Business positions have improved. In recent years, large integrated utility companies have divested volatile merchant power business in favor of more stable regulated networks, long-term contracts, or subsidized renewable generation.

Balance sheets are stronger. Given their capital intensity and high debt, utilities have cut dividends, sold assets, and reduced debt to reinforce their capital bases.

The 2018 earnings season brought few surprises. Most European utilities’ reported results were as we expected, and prospects of improved earnings and greater rating headroom support increased investment plans and dividends.

What to look for

Regulatory returns are being revised downwards across Europe. We anticipate increasing cuts to regulatory remuneration, due to operators’ reduced debt costs and operating efficiencies, with the U.K., Sweden, and Spain on the radar. The remuneration reform proposed by Spain’s National Authority for Markets and Competition in July 2019 may erode rating headroom for Spanish gas distribution and transmission companies. The Swedish regulator announced in June a WACC figure of only 2.16% against market expectations of around 3%. Still, diversification helps offset the impact on most rated companies operating in Sweden.

Negative outlooks are mainly in the U.K. Political pressure to make energy more affordable and the U.K. regulator’s call for a steeper cut in returns could reduce cash flows and therefore credit quality.

Government support remains an important rating consideration. Many utilities are government owned and benefit from government support, providing an additional degree of credit stability. However, some ratings on Italian utilities are currently under pressure due to the negative outlook on the 'BBB' sovereign rating.

What are the key credit drivers?

Power prices are recovering slowly. After a sharp fall in 2016, due to weak coal and gas prices, combined with historical low CO2 allowance prices and oversupply, prices are inching upward. We expect power generators will start benefiting from this upswing from 2019 as previously low hedges mature. Currently low European gas prices may impact electricity markets and foster more coal-to-gas switching.

Energy transition is driving investment. The EU’s demanding CO2 emissions reduction targets imply significant investments—notably in renewables and networks—to transform the energy mix. Politics expects hydrogen and other green gas to play an important role in the decarbonization of the energy sector.

Political pressure. With the rise of populism across Europe and governments’ focus on purchasing power of populations, the energy sector has been under significant scrutiny. Politicians are increasingly pushing for lower allowed margins.

Latest Related Research

– Credit FAQ: U.K. Utilities Are Feeling The Heat, June 14, 2019
– A Trio Of "Special Situations" M&A In European Utilities And Their Rating Implications, 18/04/2019
– E.ON After 2020: Bigger, Stronger, And More Flexible, 16/01/2019

Outlook Distribution

Ratings Statistics (Last 12 months)

Rating Distribution

Sector Forecasts (2019)

European Electricity Prices