

Research Update:

DRAFT: Truckmaker Scania Outlook Revised To Negative On Possible Integration With Traton; Ratings Affirmed At 'BBB+/A-2'

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Creditwire headline:

S&PGR Revises Scania Outlook To Negative On Traton Integration

Rating Action Overview

- Following the IPO by Scania's parent company, Traton, in June 2019, we believe Scania may be further integrated with Traton over the medium term, including a common treasury function. This could lead us to equalize our rating on Scania with the group credit profile of Traton.
- There is an increasing likelihood of weaker demand for the truck industry from 2020 due to a deterioration of global economic conditions, which might weigh on the group's potential to deploy synergies.
- We are therefore revising our outlook on Scania to negative, and affirming our 'BBB+' issuer credit rating.
- The negative outlook reflects the potential dilution of Scania's solid credit risk profile linked to its increasing integration with Traton and its other brands.

Rating Action Rationale

The affirmation and outlook revision reflect our view that we could equalize the rating on Scania with our assessment of Traton AG's group credit profile upon further integration of operating and group functions. Currently Scania enjoys higher profit margins and better free cash flow as well as somewhat lower leverage ratios than Traton. Although we expect some improvement of margins and free cash flow at Traton due to synergies, this could be more than offset by materially weaker demand for trucks in 2020, as we expect industry conditions to soften after 2019.

We still observe some degree of insulation between Scania and Traton, as important group functions are separated and the operating entities follow somewhat different strategies. However, with Traton's IPO in June 2019, we see a possibility of an autonomous treasury and captive finance business at Traton available to all the group's brands (akin to VW's centralized treasury and

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funding function for the passenger car brands). This would imply to us no isolation between the entities.

Scania accounts for about 53% of Traton's revenue, 75% of its operating profit, and an even higher share of free operating cash flow (FOCF). It also has somewhat better leverage ratios than its parent company. Traton fully owns and controls Scania. Traton's other brands have weaker profitability and generate lower cash flow than Scania. However, Scania is fully financed via its own treasury, and has a separate strategy. As Scania is the largest contributor to the group's profitability, we view Scania as important to Traton group.

Traton benefits from larger size, product offering, and geographic diversification compared with Scania on a stand-alone basis, but the group's profitability and FOCF are lower. We estimate Traton's adjusted EBITDA margin at just below 10%, compared with Scania's adjusted EBITDA of 13% for first-half 2019. We note that these ratios were achieved in a strong market, and expect a wider difference between the two in 2020 and 2021 when we foresee industry conditions will weaken. At the end of first-half 2019, Traton's order book was 6% lower than in same period last year, and Scania's order booking declined 7% during the same period. In total Traton (including the VW-controlled truck brands Scania, MAN, and Camionibus) sold 233,000 trucks last year (below Daimler's 517,335, on par with Volvo's 226,490, and ahead of Paccar's 189,100). Scania and MAN make up about 85% of the combined group's sold trucks and 91% of revenue.

For first-half 2019, Traton's funds from operations (FFO) to debt stood at about 95% and debt to EBITDA at about 1.0x, which is not materially weaker than Scania's stand-alone ratios of 100% and 0.7x. However, Traton's FOCF was substantially weaker than Scania's, with FOCF to debt in the around 15%, and negative cash flow after dividends.

We expect Scania's EBITDA margin to be about 12%-13% for full-year 2019, which should also have a positive impact at Traton. We believe the most immediate opportunity to cut costs could come from the sharing of research and development (R&D) expenses and from increased purchasing power. This could also lead to somewhat improved profitability within the next few years. However, Traton has stated that modularization of truck components and a joint power train is likely to improve profitability only from 2025, which is beyond our rating horizon. As investment is needed to meet more stringent environmental standards and mega trends in the heavy truck segment, such electrification and automation, we view the group's enlarged scale as an advantage in meeting these challenges. We believe Scania will contribute to the group's green expertise as it is well positioned to take advantage of the heavy truck industry's transition toward more energy-efficient engines, including electrical engines, which reduce emissions. We believe this will stimulate growth and further strengthen the company's position in the market.

Scania generated FOCF of SEK4.3 billion (€400 million) in 2018. For full-year 2019, we expect Scania to generate adjusted EBITDA of SEK16 billion-SEK20 billion and FOCF to improve to about SEK5 billion-SEK7 billion, which should strengthen credit ratios somewhat further. This is thanks to a strong cycle, with high volumes of trucks expected to be delivered in combination with our expectations of increased profitability. However, we believe that the industry cycle has peaked, and foresee a volume decline already in 2020.

Outlook

The negative outlook reflects the risk of a one-notch downgrade upon a further material integration of Scania into Traton and if, at the same time, Traton's operating margin and FOCF have not improved from current levels.

Downside scenario

We could downgrade Scania by one notch if further integration of Scania's group functions with the Traton group proceeds, particularly the treasury function, and if credit metrics at Traton do not improve, including the S&P Global Ratings-adjusted FOCF-to-debt ratio remaining well below 25% and prospects of limited discretionary cash flow.

In the absence of further integration of Scania into Traton, we could also lower our rating if Scania's EBITDA margin deteriorated to below 10% over a prolonged period, or if dividends were larger than expected, resulting in adjusted FFO to debt declining below 60%. We don't see this as a likely scenario, however.

We see rating downside as limited to one notch, since the ratings on both Traton and Scania continue to be tied to the rating on VW AG (BBB+/Stable/A-2) and since we view both Traton and Scania as highly strategic entities within that group.

Upside scenario

We could revise the outlook to stable if Traton's adjusted EBITDA margins improved to about 10% and its adjusted FOCF to debt improved to about 25%, coupled with Traton maintaining an adjusted FFO to debt ratio above 60% over the cycle.

Company Description

Based in Södertälje, Sweden, Scania is one of the world's leading heavy truck and bus manufacturers. Although it also produces buses, truck operations dominate the business. German original equipment manufacturer VW AG controls Scania.

Our Base-Case Scenario

In our base case, we assume:

- Moderate GDP growth of close to 1% in 2019 in the eurozone, where the group generates more than 60% of its revenues and 1.4% in Brazil. Typically, over the cycle we expect truck sales to correlate closely with economic growth, and slower-than-expected growth will likely depress sales volumes.
- A revenue increase of 9%-12% in 2019, in line with the 11% recorded in 2018, underpinned by a 10% increase in deliveries in first-half 2019. We believe volume growth is at the top of the cycle and project a decline of revenue in 2020 of 5%-10%. Scania's order book declined 7% in first-half 2019.
- A improvement in the EBITDA margin to 12%-13% in 2019 and 2020 from 10.5% in 2018 as ramp up cost for the new truck and also dual production cost decline.
- Capital expenditure of SEK6 billion-SEK7 billion annually (excluding the customer finance operations) in 2019-2020, broadly in line with 2018.
- Some working capital outflow in 2019, potentially up SEK5 billion, driven by volume growth.
- Annual cash dividend payment of 50% of net income, in accordance with Scania's financial policy.

- No material acquisitions or disposals.

Based on these assumptions, we arrive at the following credit measures for 2019 and 2020:

- Adjusted FFO to debt increasing toward 140%, compared with 100% in 2018.
- Adjusted debt to EBITDA at about 0.5x, compared with 0.7x in 2018.
- Adjusted discretionary cash flow of SEK1.5 billion–SEK3 billion, up from being neutral in 2018.

Liquidity

We expect Scania to maintain strong liquidity, with the ratio of sources to uses in the next 12 months for the industrial division staying at about 2.6x, and about 3x for the subsequent 12 months, mainly due to low debt at that division. Other supportive factors include Scania's generally high standing in credit markets and well-established bank relationships. There are no financial covenants or rating triggers in Scania's undrawn SEK31 billion of revolving credit facilities (RCFs).

On a consolidated basis, the group had substantial cash and marketable securities of SEK14 billion on June 30, 2019, as well as short-term financial liabilities totaling about SEK43 billion, predominantly relating to the captive finance operations. Captive finance debt is matched with underlying assets. The group continues to have resilient capital market access via diverse funding sources, such as medium-term notes and commercial paper programs.

As of June 30, 2019, the industrial division's liquidity sources included:

- Cash and marketable securities of about SEK14.2 billion.
- SEK28 billion of undrawn RCFs, of which €1.55 billion matures in 2021 and €1.25 billion in 2023. We deduct from the available RCF amount about SEK11 billion of outstanding commercial paper.
- Cash FFO of around SEK16 billion–SEK18 billion.

On the same date, liquidity uses comprised:

- Short-term debt at the vehicle and services division of about SEK1 billion.
- A dividend payment of 50% of the previous year's net income, in line with the company's financial policy, amounting to SEK4.3 billion paid in first-quarter 2019.
- Industrial capital expenditure of SEK7.0 billion–SEK8.0 billion annually (including capitalized development costs) over 2018–2019.
- Some volatility in working capital needs.

Environmental, Social, And Governance

Scania is focused to support fossil-free commercial transport solutions by 2050, and already has a portfolio of engines which cover all commercially available alternative fuels (biogas, bioethanol, biodiesel, biogas, compressed natural gas, and hydrogenated vegetable oils [HVO]). Scania's biogas engines reduce CO₂ emission by 90% compared with traditional diesel combustion engines. The company actively supports infrastructure development through a variety of partnerships. We view Scania as in a good position to manage tightening environmental

regulation, but this will continue to require substantial investments, and we expect R&D of about 6.0%-8.0% of sales with a focus on strategic automation, connectivity, and electrification. The company will be exposed to tightening environmental regulation in Europe mainly, albeit over a longer timescale than our rating horizon. As Scania is a relatively small manufacturer of heavy trucks, the required investment may somewhat constrain profitability in the near to medium term. However, given Scania's position as a premium truck manufacturer, we believe its high awareness and focus on lower emissions will continue to strengthen its competitive position over time. Social factors do not play a major role in our credit assessment. Although we are monitoring an ongoing investigation by the European Commission concerning inappropriate cooperation, we currently do not have any credit concern with regards to governance factors.

Issue Ratings - Subordination Risk Analysis

Scania's capital structure consists of senior unsecured debt issued at its financing subsidiary (Scania CV AB).

Analytical conclusions

The debt is rated 'BBB+', the same as the long-term issuer credit rating, since there are no significant elements of subordination risk in the capital structure. This is also supported by the company's low leverage.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Negative/A-2

Business risk: Satisfactory

Country risk: Low risk

Industry risk: Moderately high

Competitive position: Strong

Financial risk: Modest

Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers

Diversification/Portfolio effect: Neutral (no impact)

Capital structure: Neutral (no impact)

Liquidity: Strong (no impact)

Financial policy: Neutral (no impact)

Management and governance: Satisfactory (no impact)

Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb+

Group credit profile: bbb+

Entity status within group: Highly strategic

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Auto And Commercial Vehicle Manufacturing Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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