Industry Credit Outlook 2024

January 31, 2024

This report does not constitute a rating action.

Foreword

Dear reader,

We recently published our Industry Credit Outlook 2024 reports (formerly Industry Top Trends) for corporate and infrastructure industries globally to communicate our credit views on rated companies and industries. It is the ninth annual edition, and this publication brings the individual reports together in a single volume along with our assessment of the common themes that emerge.

If our baseline economic assumptions are broadly correct, the year ahead will likely see a soft landing for the global economy, a remarkable outcome given the scale of interest rate rises already seen and indicative of the uncertainty engendered by the profound transformation for the global economy and financial markets ushered in by the COVID-19 pandemic. This scenario suggests that revenues and profits will recover after only a modest downturn, with the corporate sector in relatively good health outside of the weaker parts of the credit spectrum. Even so, recession and refinancing risks remain front and center, and labor cost, inventory, and supply-chain constraints are lingering concerns.

These reports outline S&P Global Ratings' key industry assumptions for 2024, as well as our views on key risks and opportunities that may affect sector trends. They draw on the assessments of more than 5,500 corporate and infrastructure entities that we rate globally. By presenting our assumptions, risks, and ratings trends in a consistent format, we hope to aid understanding of our analytical assessment of industry trends.

Best wishes

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Contents

Infrastructure

Industry Credit Outlook 2024

Key Themes

- A soft landing for the global economy suggests revenues and cash flow will see a modest rebound and draw a line under a remarkably mild earnings recession.
- Dwindling cost inflation should boost margins, but labor costs remain a concern and supply-chain worries could deepen if Middle East conflict and trade tensions escalate.
- Credit risks are mostly concentrated in the weaker parts of the credit spectrum where stretched capital structures create vulnerabilities to refinancing and rate pressure.

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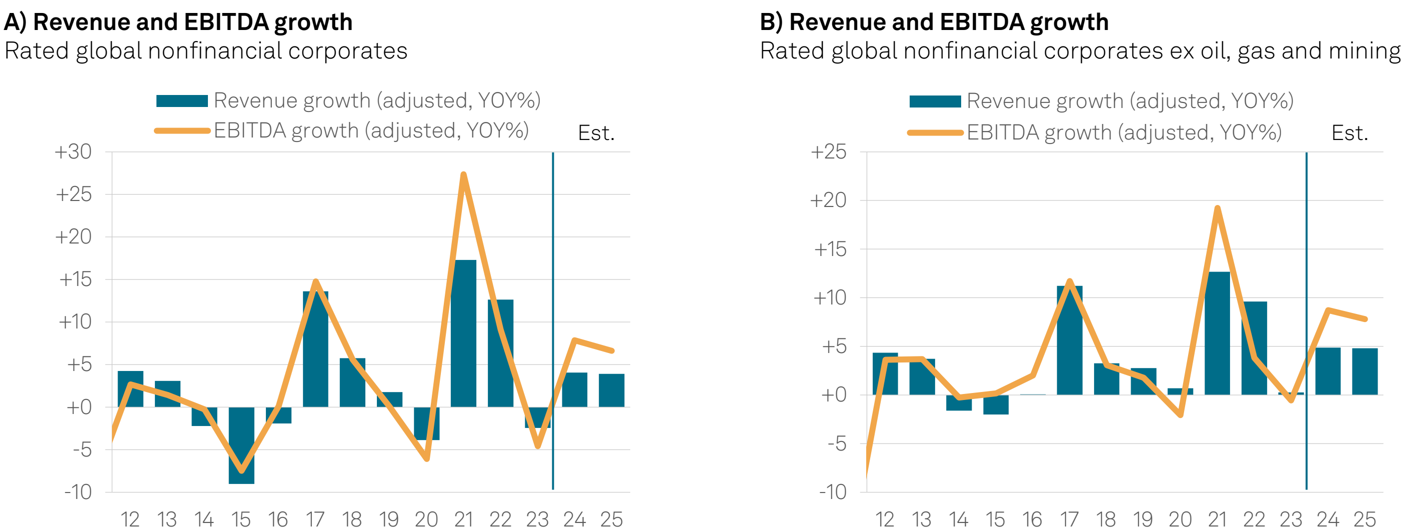
Soft landing to bring an earnings rebound

An anticipated soft landing for the global economy suggests a rebound in revenues and profits. Our analysts expect adjusted revenues for global nonfinancial companies rated by S&P Global Ratings to rise 4.1% in 2024, after declining 2.4% last year (see chart 1). We anticipate adjusted EBITDA growth is will rebound from a 4.6% decline in 2023, growing 7.9% this year. Excluding the relatively volatile oil, gas, and mining sectors suggests an even better picture, with revenues and EBITDA flat in 2023, and rising 4.9% and 8.7% respectively in 2024. If our baseline economic assumptions of a soft landing are correct and this anticipated recovery in revenues and profits is borne out, the earnings recession of 2023 will have been remarkably modest by historical standards, particularly in light of the scale of policy rate tightening seen since 2022.

Chart 1

Soft landing suggests a return to modest growth and margin expansion



Source: S&P Global Ratings. Includes nonfinancial corporations currently rated by S&P Global Ratings. Expressed in U.S. dollar terms. YOY--year over year.

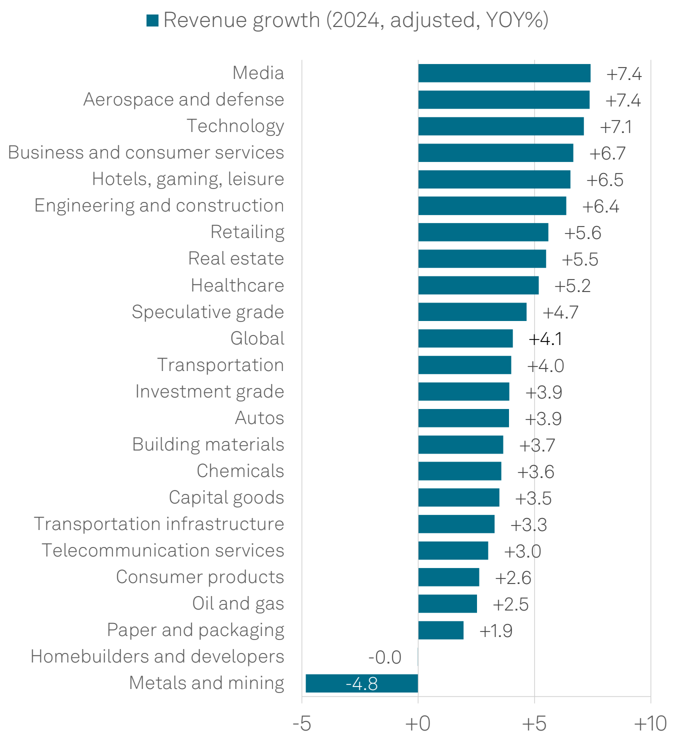
The turnaround is expected to bring positive growth in nearly all industries. Chart 2 shows aggregate adjusted revenue and EBITDA growth assumptions by industry; only metals and mining entities are expected to see revenues and EBITDA decline. Drivers of strong relative revenue performance include areas of secular strength, such as technology spending (online media -

where Alibaba and Meta Platforms have much weight - and the technology sector) and defense spending (aerospace and defense). The resilience of the consumer is apparent in relatively healthy growth expectations for retail, and persistent latent demand strength for hotels and leisure. We see weaker prospects in heavy industries and slower growth sectors such as telecoms.

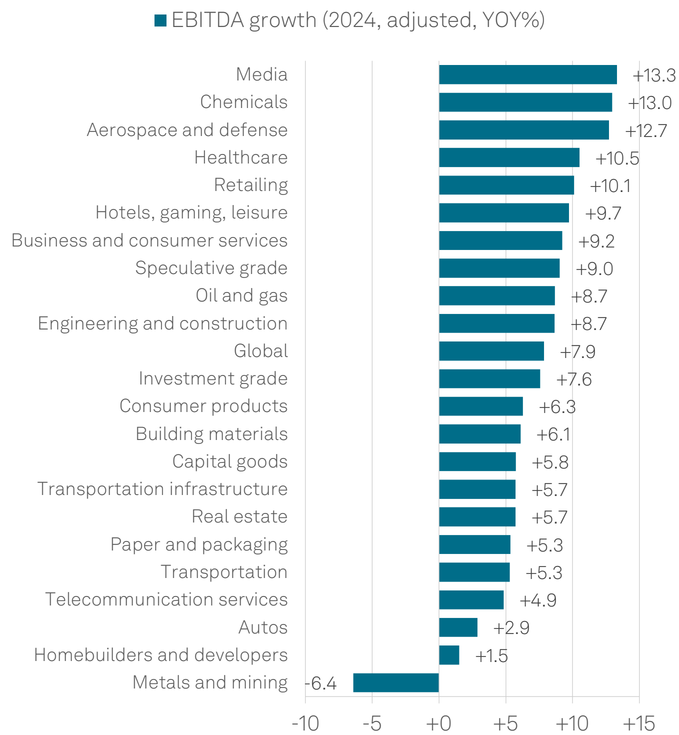
Chart 2

Nearly all industries should return to positive revenue and EBITDA growth...

A) Estimated 2024 revenue growth by industry
Rated global nonfinancial corporates



B) Estimated 2024 EBITDA growth by industry
Rated global nonfinancial corporates



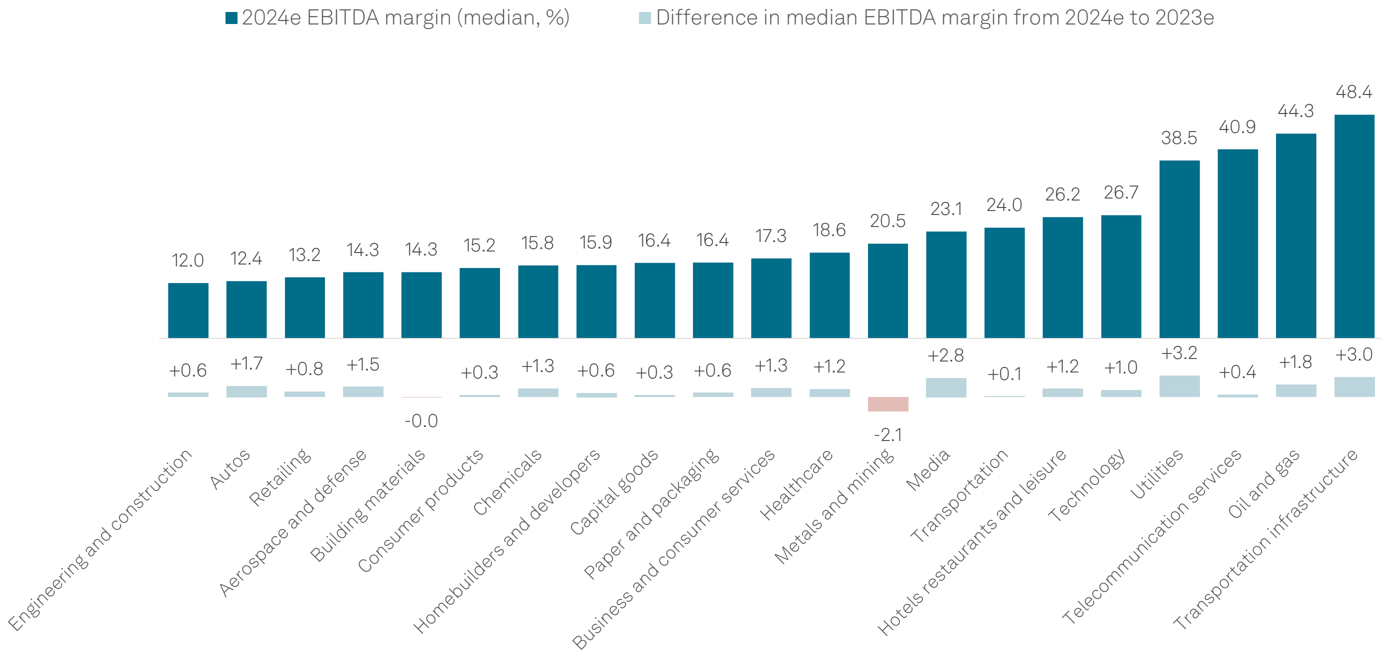
Source: S&P Global Ratings. Includes nonfinancial corporations currently rated by S&P Global Ratings. Expressed in U.S. dollar terms. YOY--year over year.

Profit margins appear set for a broad-based rebound. For the most part, we expect EBITDA growth to outpace revenues, as margins bounce back from a decline last year. The pickup in profitability appears to be widespread. Chart 3 shows the estimated median 2024 EBITDA margin for speculative-grade rated entities by industry, and the implied change from 2023 margins. We project 20 out of 22 industries will see margins expand, with building materials flat and metals and mining declining after a period of strong financial performance.

Chart 3

...and median speculative-grade EBITDA margins are expected to increase in almost all industries

Global nonfinancial speculative-grade rated corporates



Source: S&P Global Ratings. Includes non-financial corporations currently rated speculative grade by S&P Global Ratings. Expressed in U.S. dollar terms.

Cost inflation trends favorable, but labor is still a concern

Waning inflationary pressures underpin the improvement in margins, although the risk of renewed pressure is still elevated. Nonlabor cost pressures have eased considerably (see chart 4) following the initial impact of war in Ukraine, which amplified pandemic-related supply pressures. Prices have fallen or been unchanged over the last year across a swathe of commodity and energy input costs: industrial and battery grade lithium is 42% cheaper, spot ethanol prices 25% lower, and jet kerosene prices down 30%, for example. Oil and electricity prices are mostly flat or lower.

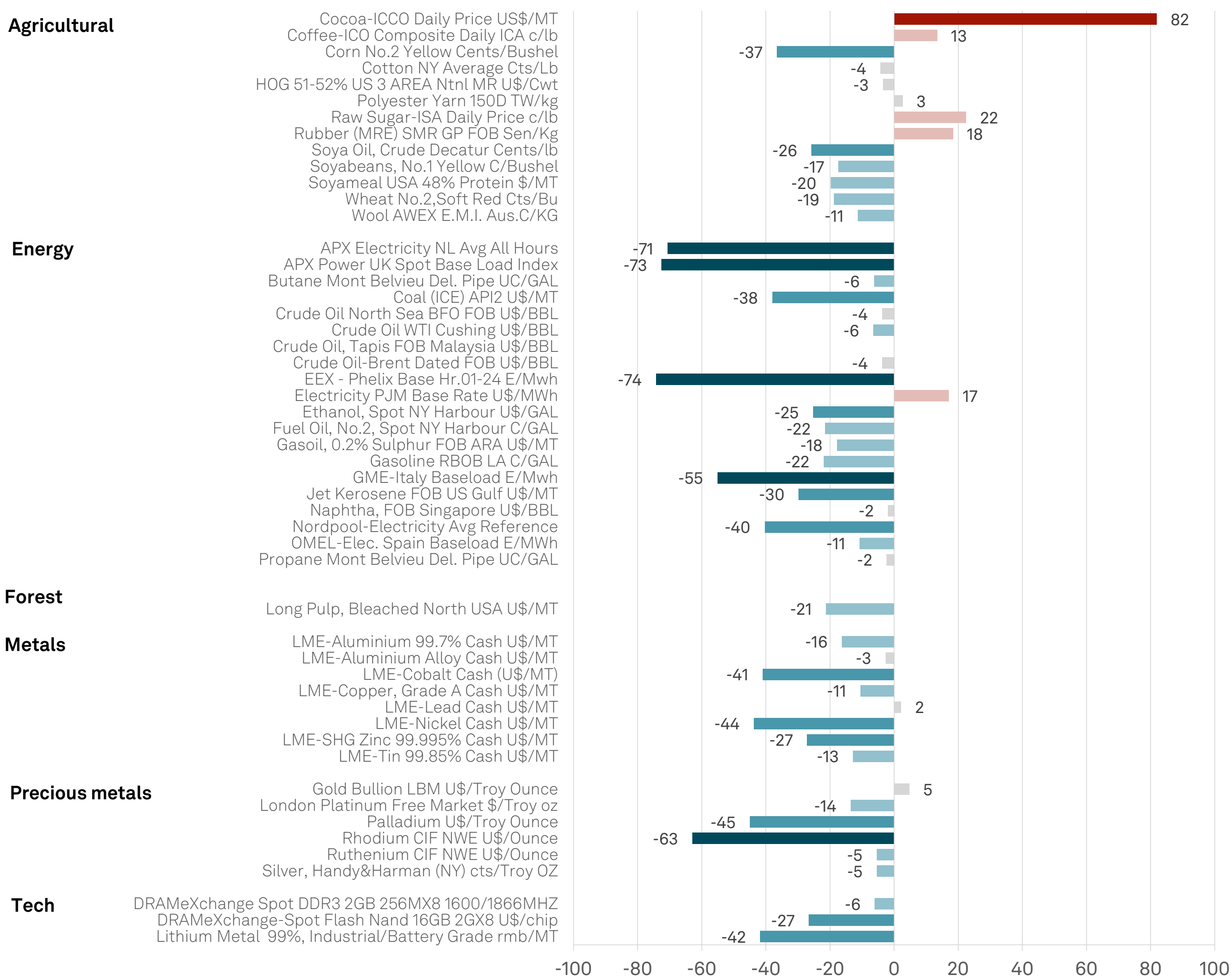
Even so, risks of a rapid reversal in these favorable trends remain considerable given their susceptibility to geopolitical events in Ukraine, the Middle East, and elsewhere. Softer demand from China - the world's leading consumer of many commodities - has helped ease pressures here, but this could easily reverse and is not the case for commodities such as copper where Chinese demand remains strong given its importance for electric vehicles and solar power.

Climate change and regulatory responses to it are also now important shaping factors for nonlabor costs. Notable instances of rising prices over the last year - cocoa and sugar - are consequences of poor weather conditions, and food shortages and price volatility may become more widespread over time. Decarbonization efforts are also affecting costs by design. For example, European Building materials producers face cost pressures because the EU’s "Fit for 55" program will increase carbon costs significantly. Annual carbon costs could account for, on average, 75% of EU cement companies' EBITDA, assuming a complete phase-out of allowances.

Chart 4

Corporate nonlabor costs have mostly fallen over the past 12 months

Price changes Jan. 24, 2023 to Jan. 24, 2024

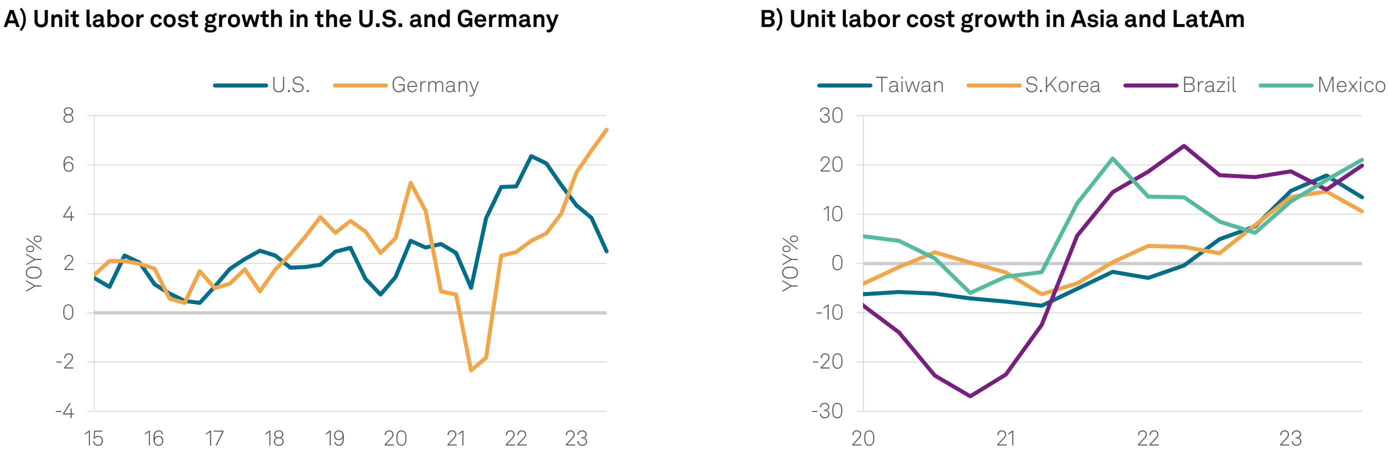


Source: LSEG Datastream, S&P Global Ratings

Labor cost pressures have been slower to ease and, while the direction of travel is encouraging in the U.S., Taiwan, and Korea for example (see chart 5), Germany, Brazil, and Mexico continue to see significant labor cost inflation. Our analysts remain concerned that labor costs could pose downside risks to profit margins, both cyclically and structurally. In health care for instance, we see labor costs as a long-term risk given strong demand and continuing labor shortages. In telecoms, labor costs are moving front-and-center in cost structures with industry wage growth running ahead of consumer inflation indices that guide regulatory pricing. Labor hoarding is also still an issue for some sectors. Many consumer product businesses have reduced opening hours to save labor costs but retain staff to avoid repeating the difficulties finding workers post-pandemic. These ongoing strains suggest that while a soft landing will drive a revenue recovery it may also see labor cost pressures build up again.

Chart 5

Unit labor cost inflation is easing in the U.S. and east Asia but still rising sharply in Germany, Brazil, and Mexico



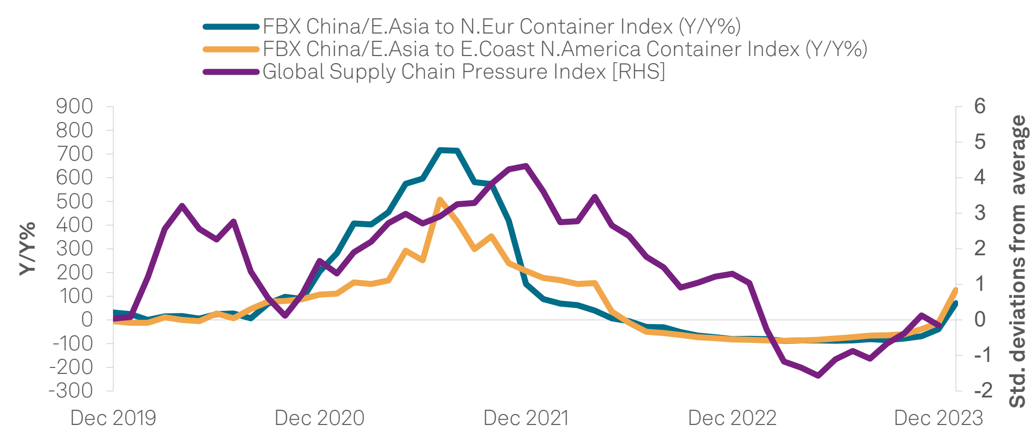
Source: LSEG Datastream, S&P Global Ratings. Rates shown are for business (U.S.), whole economy (Germany, Brazil), or manufacturing (Taiwan, S.Korea, Mexico)

Positive supply chain and inventory outlook if risks are avoided

Supply-chain disruptions have largely dissipated but risks of further supply shocks remain. Most industry sectors report a normalization of supply chains after the disruption wrought by the pandemic and political trade tensions. There remain notable pockets of supply chain pressure. In commercial aerospace, supply-chain constraints and related inefficiencies will likely persist beyond 2024 and limit margin improvements. This is having knock-on effects on air transportation. In defense, issuers expect logistical challenges to persist, specifically some lingering bottlenecks in some parts of the supply chain and exacerbated by shortages of skilled labor. For solar power, an important part of the energy transition, supply challenges are still acute. Broader supply chain disruption is still a significant downside risk, with attacks on shipping in the Red Sea causing affected freight rates to surge (see chart 6) and the ongoing threat of wider regional escalation. The U.S. election later in the year could also rekindle trade tensions.

Chart 6

Supply chains have normalized but Red Sea shipping disruptions pose renewed threat

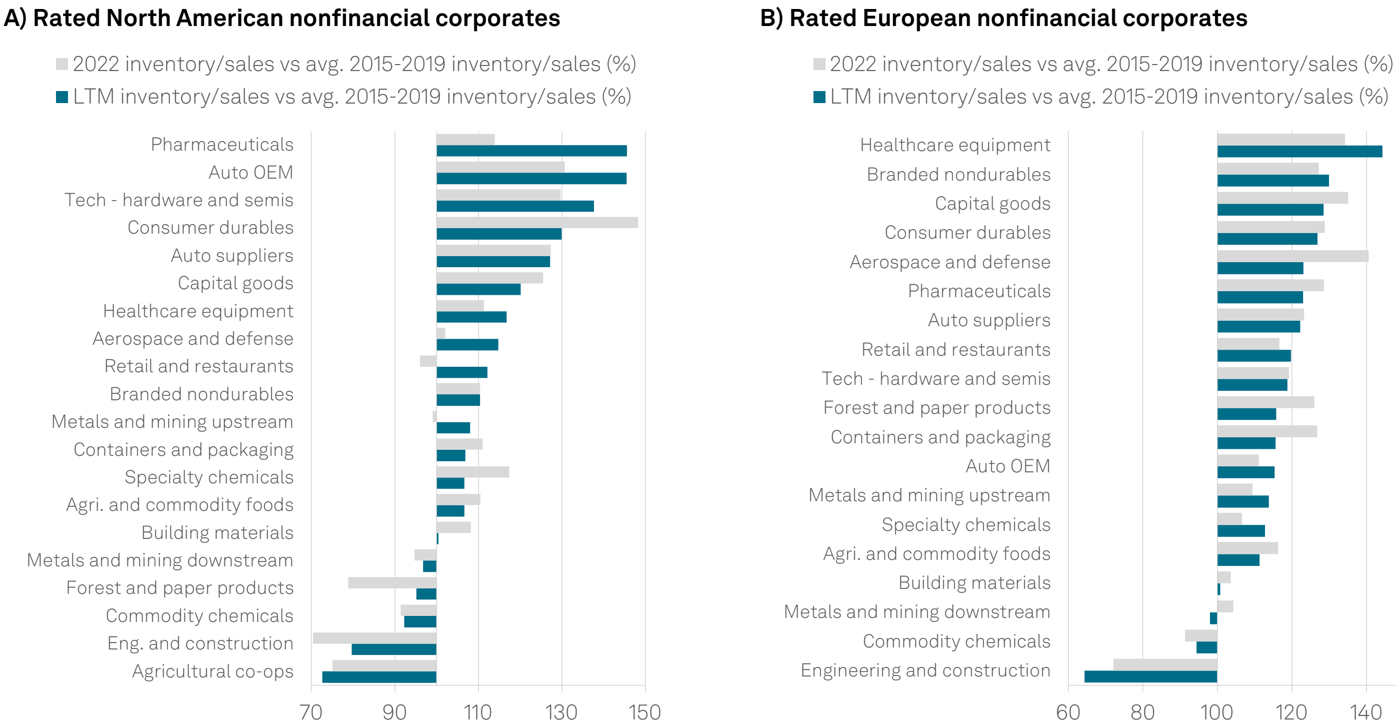


Source: S&P Global Ratings, Freightos Baltic, FRBNY, LSEG Datastream

Inventory and working capital management still poses problems and may offer a credit upside. The combination of supply-chain disruption, the vulnerabilities of "just in time" delivery, and "friend-shoring", and reshoring has brought higher inventory levels and associated working capital risk. Chart 7 shows median inventory-to-sales ratios for inventory-heavy sectors in North America and Europe relative to their 2015-2019 average. Last-12-month data shows that inventory levels remain elevated for most, and while some have managed to lower inventories versus the prior year (consumer durables, capital goods) others have not yet (health care, auto OEMS). Expectations for 2024 are for positive however, with many industries anticipating further normalization of inventory levels and destocking boosting free cash flow.

Chart 7

Median inventory levels remain above pre-pandemic averages for many sectors



Source: S&P Capital IQ, S&P Global Ratings. Shows median inventory sales by sub industry group for sectors with significant inventory. LTM--last 12 months.

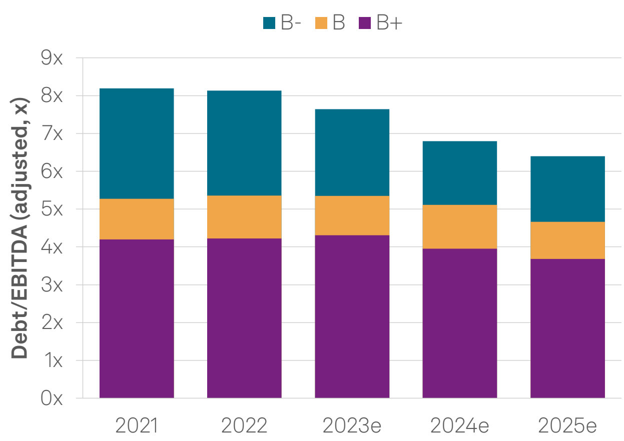
Leverage falling but weak credits vulnerable to rates and refinancing

The rebound in EBITDA will likely further improve aggregate debt metrics. Median leverage for 'B' rated nonfinancial corporates in North America and Europe is expected to fall in 2024 (see chart 8). The decline is particularly notable for 'B-' rated credits where the median prospective adjusted debt/EBITDA multiple is projected to fall to 6.8x in North America, versus a 2021 peak of 8.2x, and also to 6.8x in Europe versus a 9.1x peak. The anticipated decline in leverage is broad-based: we project median speculative-grade leverage for 2024 to be lower than in 2022 (when the rate-tightening cycle began) for 18 out of 22 industry sectors (see chart 9), and three out of the six sectors with rising leverage have relatively low gearing. Sectors with still elevated leverage globally are real estate, technology, and health care.

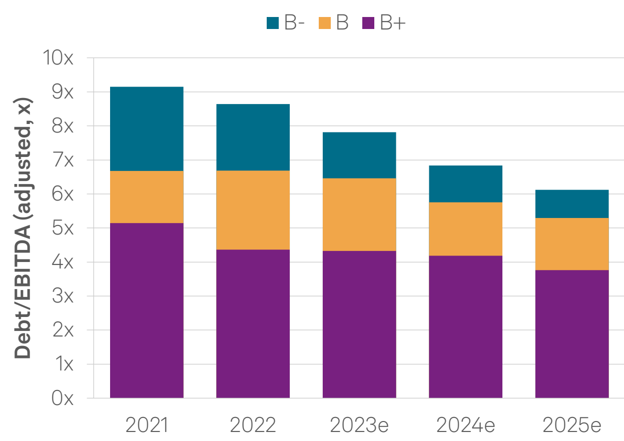
Chart 8

Median leverage for 'B'-rated nonfinancial corporates is expected to drop in 2024-2025, particularly for 'B-' rated entities

A) Rated North American nonfinancial corporates



B) Rated European nonfinancial corporates

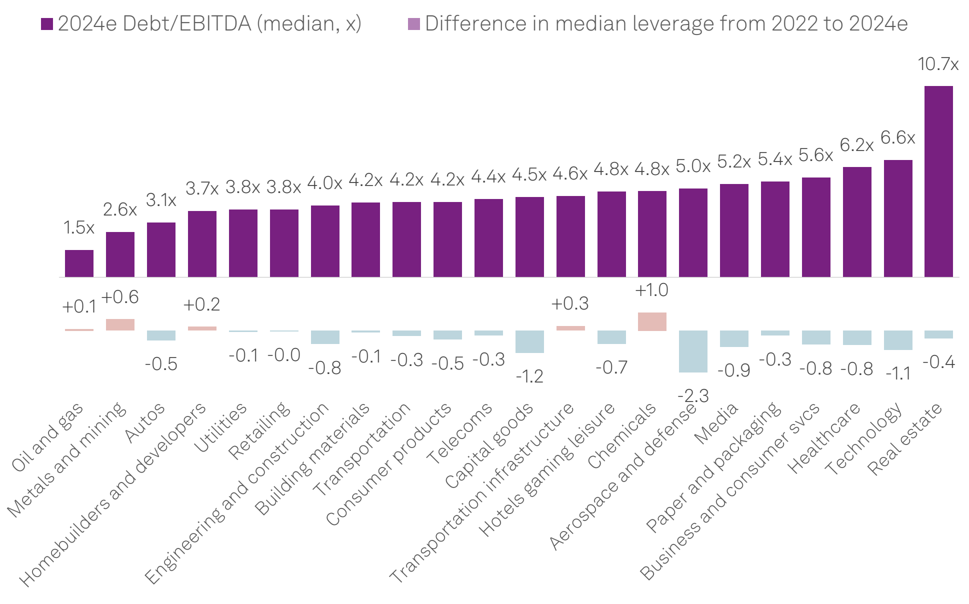


Source: S&P Global Ratings. Reflects current rated universe. e--estimate.

Chart 9

Median speculative leverage should continue falling for most industries

Speculative-grade rated global nonfinancial corporates



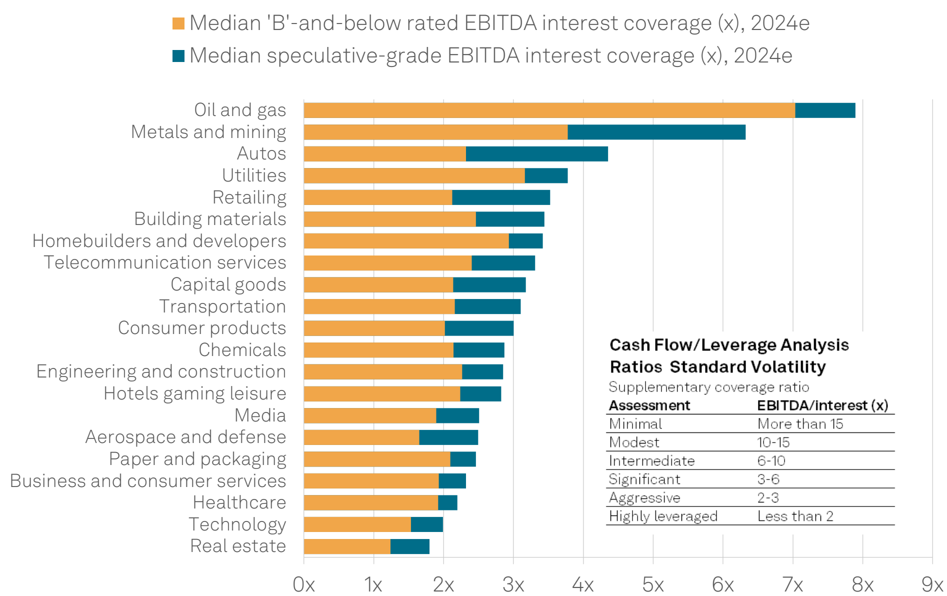
Source: S&P Global Ratings. Reflects current rated universe.

Interest rate and refinancing pressures will bear down on the weakest credits. The existing fixed-rate debt of many speculative-grade issuers is priced at historically low interest rates, and effective interest rates will continue to rise as cheaper debt is refinanced. As of third-quarter 2023 results, interest payments for rated speculative-grade borrowers were up 25% at an annual rate. Financing pressures are consequently acute for entities with vulnerable capital structures where interest coverage is weak (see chart 10) both in terms of servicing existing debt and in securing refinancing, particularly for 2025-2026 maturities. Although debt capital markets have enjoyed a robust start to the year, weaker credits remain vulnerable to market volatility particularly if recession fears re-emerge or if inflationary pressures prove persistent and necessitate higher-for-longer interest rates contrary to current market expectations.

Chart 10

Weaker credits are vulnerable to interest cost and refinancing pressures

Rated global nonfinancial corporates



Source: S&P Global Ratings. Reflects current rated universe.

U.S. stimulus measures drive diverging capex trends

Capital expenditure (capex) for rated entities was relatively resilient last year, expanding 4% in nominal terms, even as revenues and EBITDA fell. In real terms, however, capex was marginally lower, shrinking 0.6% (see chart 11), and there were sharp regional differences. North American corporate capex expanded in real terms, in contrast to a sharp decline in Europe and even more so in Asia-Pacific. The continuing outperformance of the U.S. economy will be part of the explanation, but it seems likely that this also reflects the impact of fiscal stimulus such as the U.S. Inflation Reduction Act, Creating Helpful Incentives To Produce Semiconductors and Science Act (CHIPS), and the infrastructure bill.

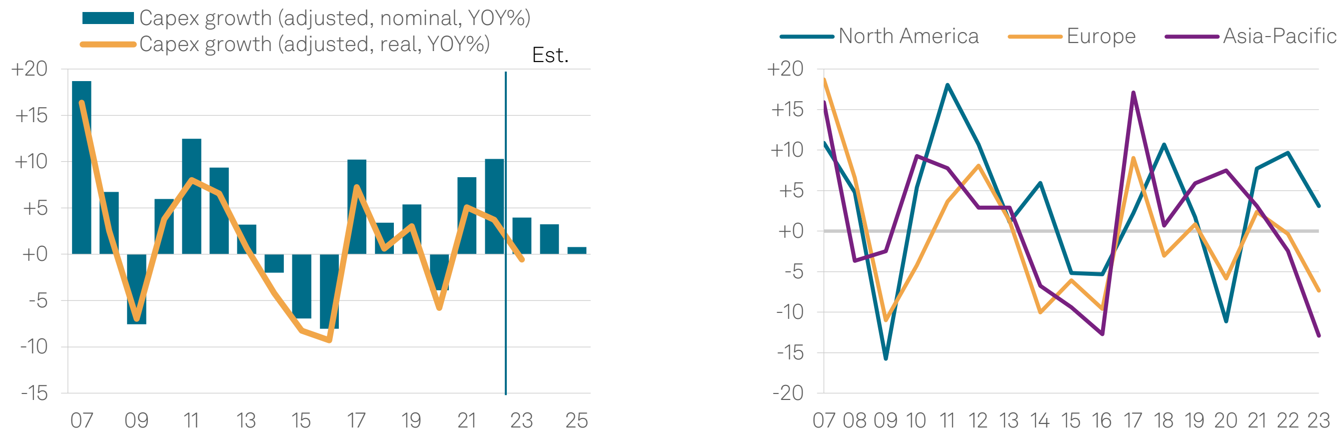
We expect capex growth to slow in 2024, rising just over 3% in nominal terms. Even so, most sectors are likely to increase spending (see chart 12), with a strong core of spending driven by energy transition (autos, utilities), and strong transportation demand (transport, transport infrastructure). Of the other big capex spenders, for oil and gas we anticipate low-single-digit percent global capex growth, and telecoms spending is slowing as the pace of 5G network development diminishes. Investments in generative artificial intelligence (AI), while a blip in overall information technology (IT) budget today, has the chance to be a significant driver of overall IT growth in three to five years, and is already a significant part of R&D spending in defense. The sharp slump in hotels, leisure and gaming investment reflects a slowdown in cruise where capex has been high post pandemic. Media's strong capex is heavily influenced by increased spending by Meta Platforms, Alibaba, and Disney; excluding those growth is more subdued.

Chart 11

Corporate capex growth has turned negative in real terms, but there are sharp regional differences

A) Real and nominal capex growth (adjusted)
Rated global nonfinancial corporates

B) Real capex growth (adjusted, YOY%)
Rated nonfinancial corporates

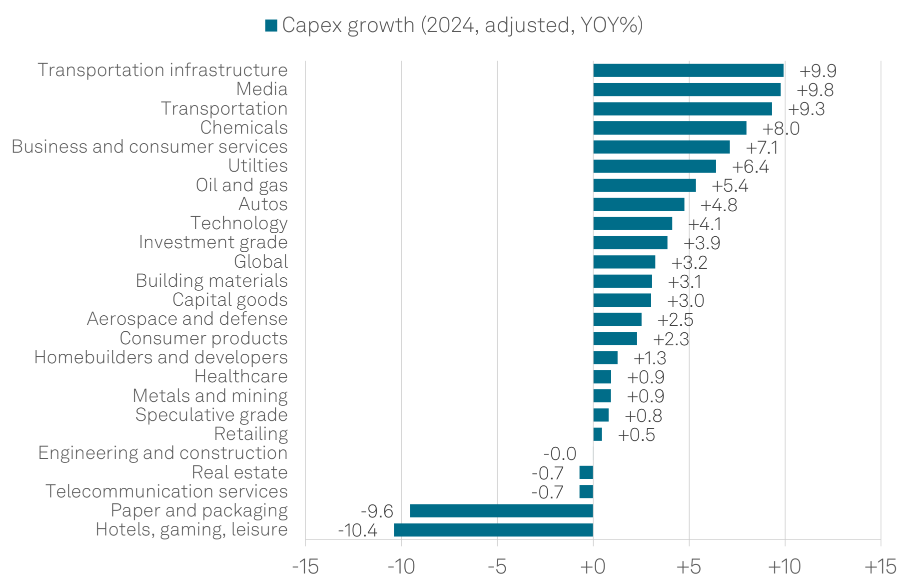


Source: S&P Global Ratings, IMF, LSEG Datastream. Real-terms adjustment made on a per entity basis using IMF inflation data for country of domicile. YOY--year over year.

Chart 12

Nominal capex likely to grow modestly for most sectors in 2024

Rated global nonfinancial corporates



Source: S&P Global Ratings. Includes non-financial corporations currently rated by S&P Global Ratings. Expressed in U.S. dollar terms. YOY--year over year.

M&A activity is likely to pick up

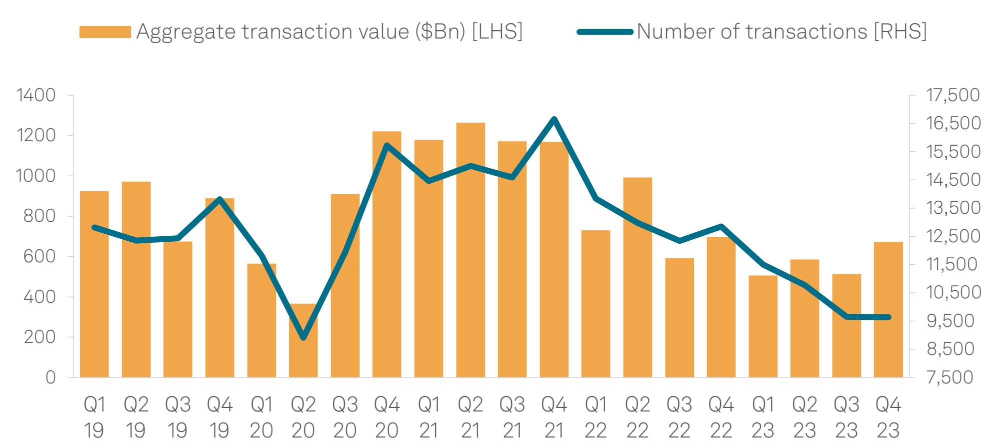
M&A seems likely to increase after a subdued period, but in a measured way unlikely to threaten credit metrics. The number of M&A transactions globally has fallen steadily since its Q4 2021 peak (see chart 13) to not far above the low seen at the height of pandemic uncertainty. This downtrend will likely see a partial reversal, with our analysts expecting M&A to pick up over the year ahead in a number of industries. Some illustrations:

- The **European aerospace and defense industry** is ripe for consolidation, and we believe 2024 will see further sizeable M&A activity
- In **capital goods**, most companies are pivoting strategies to benefit from high-profile megatrends in capital investment, often changing their business portfolios through M&A.
- In **health care**, M&A has returned to pharma, and we expect to see this in services too.
- In **leisure**, the hotel sector remains fragmented, cyclical, and highly competitive, which leads to potential consolidation opportunities.
- In **technology**, we believe there is pent-up demand for deal making after two quiet years. An end to the rate hikes removes some uncertainties and will likely boost M&A activity through 2024. A wildcard is how AI will impact tech M&A in 2024 and beyond.

Chart 13

M&A activity has been subdued

Global M&A (completed and announced)



Source: S&P Capital IQ Pro. Includes private equity deals. Value as at agreement date.

Risks and opportunities versus the baseline

Financing conditions, macroeconomic conditions, and supply chain and cost pressures loom largest. Tables 1 and 2 show the three main risks or opportunities identified by S&P Global Ratings' analysts for their industries in the year ahead, for corporates and infrastructure respectively.

Table 1

Corporate sector risk and opportunity map

Sector	Subsector/region	Risk/opportunity '1'	Risk/opportunity '2'	Risk/opportunity '3'
Aerospace and defense	Commercial aerospace	Supply chain constraints	Technical challenges	Aggressive financial policies
	U.S. defense	Defense spending declines	Supply chain constraints	Aggressive financial policies
	European defense	Aggressive financial policies	Escalating conflicts	Strategic pivot to APAC
Autos		Geopolitical tensions	M&A in the suppliers space	Price war among OEMs
Building materials	North America	Cost inflation	Refinancing risk	Sharper demand decline
	EMEA	Sharper demand decline	Long-term megatrends	Aggressive financial policies
	Latin America	Macro/(geo)political risks	Adverse weather conditions	Decarbonization
	Asia-Pacific	Property crisis in China	Easing input costs	Environmental regulations
Capital goods		Worse cyclical downturn	Higher interest rates	Energy transition
Chemicals		Lower demand	Tighter financing	Headwinds in Europe
Consumer products		Robust labor market	Higher interest rates	Digitalization/cyberattacks
Health care		Margin/cash-flow pressure	M&A scrutiny	Legislative risk
Homebuilders	U.S.	Cost inflation	More resale competition	Higher incentives
	Europe	Tighter financing	Environmental regulations	Government support
	Asia-Pacific	China: more policy easing	Hong Kong: solid demand	Indonesia: refinancing risk
	Latin America	Macro/political risks	Longer-term growth drivers	
Hotels, gaming, leisure	Gaming	Projects add leverage	Digital gaming	Tighter regulation in Europe
	Hotels	M&A drives up leverage	Cost (wage) inflation	Macro weakness
	Cruise, Recreation	Cruise: deleverage	RV: macro weakness	Fitness: pullback in capex
Media	Content	Smaller studios' profits	Higher cost of sports rights	Studio consolidation
	Distribution	Streaming profitability	The Disney/Charter deal	Streamers' sports rights
	Advertising	Macro weakness	Little forward visibility	Privacy/regulation changes
Metals and mining		Supply-demand imbalance	Project execution problems	Aggressive financial policies
Oil and gas		Supply-demand imbalance	Policies; energy transition	Aggressive financial policies
Real estate	U.S. REITs	Refinancing risk	More credit metrics erosion	Rental/industrial assets
	European REITs	Distressed asset sales	Refinancing risk	Better market sentiment
	Asia-Pacific REITs	Negative office revaluations	Office supply/demand	Retail, logistics, hospitality
	Latin America	Macro weakness	Nearshoring	Political risks
Retail and restaurants		Consumer resilience	Reignited inflation	Tighter financing
Technology		Supply chain diversification	Higher interest rates	Improving M&A activity
Telecommunications	Global	Higher interest rates	Macro weakness	Aggressive financial policies
	North America	Higher interest rates	More shareholder returns	FWA/FTTH competition
	Europe	Renewed competition	Higher interest rates	Transaction risks
	Latin America	Stiff competition	More capex needs	Interest rates/inflation
	Asia-Pacific	Competition, inflation risks	More capex needs	New-growth investments
Transportation	Airlines	Macro weakness	Geopolitical tensions	Decarbonization
	Container Shipping	Slower growth in trade	Sharper freight rates drop	Counterparty risks
	Rail Roads	Stalled service betterment	Regulatory/political risks	Macro weakness
	Equipment Leasing	Higher interest rates	Macro weakness	Supply chain constraints
Most prevalent themes		Financing/interest rates	Macroeconomic conditions	Supply chain/cost inflation

Source: S&P Global Ratings. Risks and opportunities have been simplified and standardized relative to the originals for cross-sectional clarity. No rank ordering is implied between the risks/opportunities. FWA—Fixed wireless access. FTTH—Fiber to the home.

Table 2

Infrastructure sector risk and opportunity map

Sector	Sub-sector/region	Risk/opportunity '1'	Risk/opportunity '2'	Risk/opportunity '3'
Midstream energy		Macro weakness	Tighter financing	Climate change regulation
Utilities	APAC	Macro weakness	More volatile fuel prices	Overaggressive expansion of unregulated businesses
	EMEA	Price volatility/event risks	Political/regulatory risks	Poorer energy-transition economics
	Latin America	Macro weakness/higher interest rates	Political/regulatory risks	El Niño/geopolitical risks
	N.America Merchant Power	Excess cash on growth	Higher interest rates	Supply chain constraints
	N.America Regulated	Climate change	Sales growth returns	Complex projects
Transportation infrastructure	Airports	Macro weakness	Geopolitical risks	Growing capex and costs
	Ports	Macro weakness	Geopolitical risks	Emerging risks
	Roads	Affordability/regulations	Macro weakness	Interest rates/cost inflation
	Rail and Mass Transit	Margin pressure	Large capex programs	Subsidy and affordability

Source: S&P Global Ratings. Risks and opportunities have been simplified and standardized relative to the originals for cross-sectional clarity. No rank ordering is implied between the risks/opportunities.

Aerospace and Defense

The only way is up (supply chain permitting)

January 9, 2024

This report does not constitute a rating action.

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What's changed?

Demand is outpacing supply in commercial aerospace. Customers are expanding fleets to meet strong demand. Supply-chain and labor constraints and manufacturing defects persist.

New engine durability is a challenge. Some new engines are seeing lower time-on-wing performance, reflecting the tradeoffs and diminishing returns of engineering advances.

U.S. defense spending growth is likely to slow. Europe's will rise. Europe's defense spending is driving higher backlogs for many players and growing revenues, EBITDA, and cash flows.

What are the key assumptions for 2024?

Global airline capacity is likely to remain stretched. Demand is strong but equipment downtime, maintenance constraints, and new aircraft supply lagging demand will test system reliance.

Aircraft production and deliveries will increase. Boeing will increase MAX production and deliver its inventory of finished planes. Airbus will keep increasing production of its A320 family.

Defense companies will exhibit robust earnings. Global tensions will support high defense spending, and current backlogs will grow. Supply-chain and capacity constraints will persist.

What are the key risks around the baseline?

Air travel growth might falter. Recession could weaken long-haul international travel demand.

Production problems could hinder aircraft makers' delivery rates. Productivity might not improve, or manufacturing flaws could persist, causing delivery delays and lost revenue.

Equipment durability limitations could constrain air travel capacity. Lower-than-expected time-on-wing performance of new engine models could limit airline capacity, and remediation efforts might exacerbate the strain on maintenance networks.

Ratings Trends: Aerospace and Defense

Chart 1

Ratings distribution

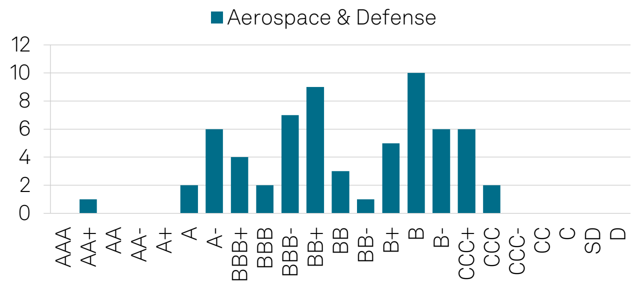


Chart 2

Ratings distribution by region

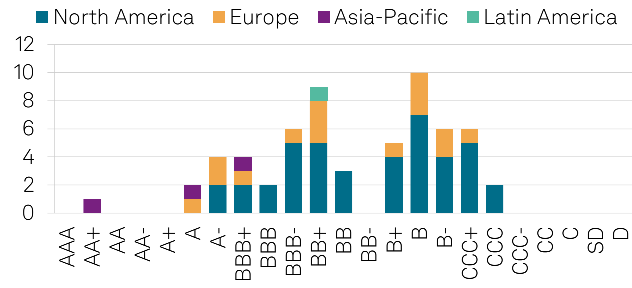


Chart 3

Ratings outlooks

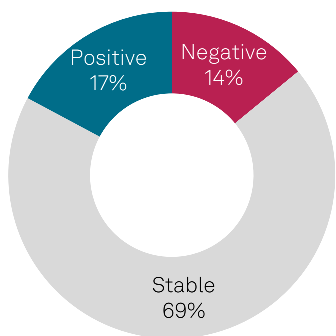


Chart 4

Ratings outlooks by region

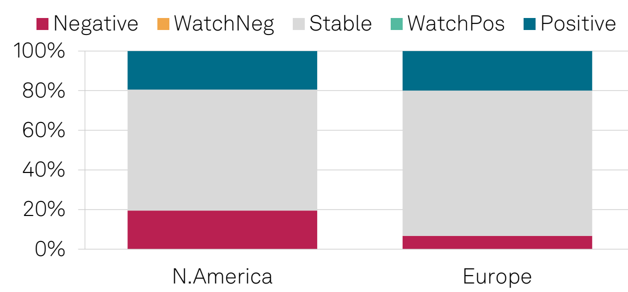


Chart 5

Ratings outlook net bias

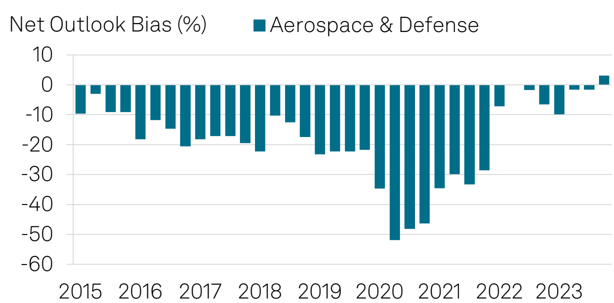
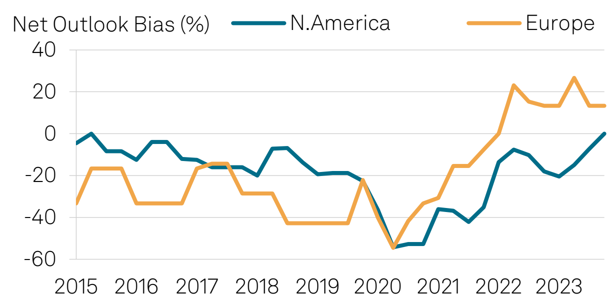


Chart 6

Ratings net outlook bias by region



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

Ratings are largely stable, and those not on a stable outlook are balanced between positive and negative. The positive outlooks include aircraft component makers benefiting from a long-delayed increase in original equipment manufacturer (OEM) production rates. They also include companies taking advantage of strong cash flows to reduce debt, especially with higher interest rates making refinancing less attractive. The negative outlooks include aerospace suppliers dealing with the effects of manufacturing flaws and labor disruptions, as well as aggressive financial policies. More negative outlooks in North America, compared with Europe, reflects the prevalence of suppliers to Boeing and financial sponsor-owned issuers in the U.S. Sponsor-owned companies typically have high debt levels and are very sensitive to rising interest rates.

In Europe, rating changes have largely been positive in the past 12-18 months, but this will level off. Gradually improving revenues, profitability, cash flows, and credit metrics will likely be at least partly offset by increased mergers and acquisitions (M&A), dividends, and share buybacks, particularly among the primes. Smaller players are a mixed bag; fortunes depend on product and service offerings and the aerospace and defense (A&D) platforms they're on. For example, suppliers with significant exposures to narrowbody will benefit more than those highly exposed to widebody, and on the defense side suppliers with a heavy leaning toward battlefield equipment, radar, communications, unmanned aerial vehicles (UAVs), and munitions will benefit more in the short term.

Industry Outlook: Commercial Aerospace

Ratings trends and outlook

The overall rating trend is modestly positive. Several issuers should benefit from continuing strong demand for commercial aircraft and improving (though still constrained) build rates. Our ratings on most issuers are linked to underlying OEMs, and some are well positioned to materially improve cash flows and credit measures via growth in parts sales and services. OEMs are navigating industrywide supply constraints, but long-dated backlogs could boost cash flow growth. We expect narrowbody production to ramp up in 2024 as Boeing addresses manufacturing flaws and, along with Airbus, achieves supply-chain efficiencies. Widebody aircraft production, while a smaller, slower-growing proportion of the overall market, incorporates high-value components and is important for OEM and supplier returns. Aside from already documented durability challenges, large engine makers will benefit from rising production rates on the OEM side, coupled with higher engine flying hours and increasing engine shop visits. We expect demand to remain strong even if economic conditions slow. As such, shareholder returns and higher interest rates (namely for lower-rated issuers, which account for most of the negative outlooks in the commercial aerospace sector) pose greater potential risk to ratings.

Main assumptions about 2024 and beyond

1. Airbus and Boeing continue to increase narrowbody rates toward record levels.

We assume production rates for Airbus and Boeing broadly in line with their own targets. Airbus targets 65 A320 aircraft per month by the end of 2024 and 75 by 2026; four A330s through 2024; and nine A350s by the end of 2025. Boeing targets 50 737 MAXs and 10 787s in 2025-2026. We assume a gradual production uptick, reflecting previous challenges and lingering supply-chain issues.

2. Engine durability remains a hot topic.

Remediation of a manufacturing flaw in Pratt & Whitney's (P&W) geared turbofan (GTF) engine will cause much equipment downtime in 2024. New engine models were already experiencing elevated downtime before the flaw emerged, thereby reducing fleet availability. All large engine makers continue to explore next-generation technology in the drive toward greater efficiency.

3. MRO demand is strong, buoyed by reliance on older equipment.

Companies that provide parts used in repairs and perform maintenance will likely see their operating results further improve, benefiting from air traffic growth, engine reliability issues, and tight industrywide capacity. However, the retirement of older planes, which add some usable parts to the market, could limit the pace of expected improvement.

Airbus is keeping to its production rate guidance despite the RTX recall, and 2024 looks bright. Airbus delivered 488 commercial aircraft in the year ended Sept. 30, 2023, and announced 800 new orders at the Paris Airshow, including a record 500-plane deal with Indian airline IndiGo. The group's order backlog is now a record 7,992 aircraft as of Sept. 30. Management guides for 720 commercial aircraft deliveries in 2023. RTX Corp. has announced it will remove about 3,000 PW1100 GTF engines from service for inspection and repairs to the high-pressure turbine discs between now and 2026, resulting in 600-700 incremental shop visits mostly in 2023-2024. P&W's engines power a significant proportion of Airbus' narrowbody A320 and A220 planes. Despite this, Airbus does not expect 2023 deliveries or 2024 ramp-up plans to be affected. This recall will primarily be felt in the aftermarket and therefore by airlines (not Airbus). Airbus continues to work on bringing its A321XLR and A350F aircraft into service. The A321XLR is a long-range version of the A320 family and is undergoing test flights. The A350F--a freighter version of its flagship A350 widebody--has first deliveries slated for 2026. The A220 program will gradually move toward breakeven. We note positively Turkish Airlines' recent order for 220 aircraft from Airbus, including 150 Airbus A321neo aircraft, and 70 A350s, including five freighters. Turkish Airlines has also ordered 100 Trent XWB-84 and 40 Trent XWB-97 engines from Rolls-Royce Plc, to be delivered between 2025 and 2033.

Boeing aims to increase aircraft production and deliveries, moving past manufacturing flaws. In October, Boeing lowered its 2023 guidance for 737 MAX deliveries, reflecting the operational impact of production defects uncovered earlier in the year. The company disclosed a flaw in a fuselage fitting supplied by Spirit Aerosystems in April and a subsequent flaw in an aft bulkhead also made by Spirit in August. Boeing had to pause production and implement remediation plans for in-progress and completed aircraft. As a result, it reduced expected MAX deliveries to 375-400 planes from 400-450 previously for the year and slowed the pace of increased production to 38 planes per month from 31 earlier in the year. Boeing remains on target to deliver 70-80 widebody 787 aircraft. Meanwhile, it received net 841 new orders in 2023. It remains committed to raising MAX production above 50 planes per month by 2025-2026 and expects to increase its 787 rate to five per month by year end (from about four currently) and to 10 by 2025-2026. Both targets are vulnerable to labor and supply chain constraints. Component makers are poised to meet higher rates but are hesitant to outpace the OEMs until they demonstrate stability.

Boeing is also addressing the manufacturing flaws in a number of its completed aircraft, including 250 737 MAXs and 75 787s as of the end of the third quarter. Boeing plans to deliver most of these planes by the end of 2024 or early 2025. The MAX inventory includes 85 MAX planes ordered by Chinese airline customers that Boeing has not yet received approval to deliver. Preparing planes from inventory for delivery is tying up its manufacturing resources and reducing its operating efficiency. Once Boeing has worked though this inventory and can again increase production, we believe profitability and cash flows will improve, as will its ability to meet demand for new aircraft.

Limitations in new engine model durability will result in reduced airline capacity. RTX Corp. has reported that it will remove certain GTF aircraft engines made by P&W from service to inspect them for a potential manufacturing flaw. RTX expects the number of planes affected will peak in early 2024, when we estimate about 20% of Airbus' A320neo aircraft powered by GTF engines could be grounded. GTF engines power a significant proportion of Airbus' narrowbody A320 and A220 planes, which serve the faster-recovering domestic and regional air travel segments. That said, its GTF engines were experiencing durability constraints before the company disclosed the turbine disc issue, especially in harsh environments featuring sand, pollution, and high temperatures. Rolls-Royce's technical challenges with the Trent 1000 are well documented but now largely remediated, and the group's newer generation XWB engines are performing relatively well. CFM-made LEAP engines have also experienced lower-than-expected durability, though much less so than GTF engines. All these issues are likely to limit the availability of in-service planes at a time when OEMs are struggling to meet demand for new aircraft. They are also increasing the reliance on older aircraft that, in turn, run on earlier, less fuel-efficient engine technology.

Demand for aerospace maintenance repair and overhaul (MRO) is strong given high travel volumes, the delayed delivery of new assets, and grounded aircraft. The underperformance of popular engine models is also contributing to the extended use of aging aircraft. Following significant supply-chain problems in 2023, build rates for major commercial platforms started to improve toward the end of the year. We expect OEM supply chain constraints to ease in 2024, though airframe MRO demand will likely stay strong until new aircraft delivery rates return to closer to pre-COVID-19 pandemic levels. We expect engine MRO capacity to remain stretched. Repair turnaround time nearly tripled during 2023, with the waiting period for an engine to enter overhaul now up to one year. We expect spare parts to also be in high demand because older engines remain in use. The normal evolution of aircraft platforms will also naturally drive MRO demand most notably for the Boeing 787 fleet, which is approaching its 10-year maintenance cycle. MRO services for military and defense platforms will also likely remain in high demand in 2024 given activity in Ukraine and Israel. Overall, we expect the MRO market to grow modestly over the next 24 months.

Though business aircraft demand has been slightly down from its 2022 peak, orders for planes remain strong in the U.S., the largest market for business aviation. We expect the production of business jets to increase modestly over the next two years and for deliveries in 2024 to increase by about 10%. Operators are eager to expand their active fleets and replace older planes with more fuel-efficient models. Major U.S.-based OEMs' orderbooks have reached record highs, resulting in wait times for new plane deliveries of roughly one year. Pricing remains favorable despite extended delivery schedules. While lightweight business jets remain popular with new buyers, larger long-range and ultra-long-range aircraft are expected to make up more than half of spending on new jets over the medium term. Supply-chain constraints, largely related to components, remain a headwind while the industry itself is vulnerable to economic downturns.

Credit metrics and financial policy

Credit measures should modestly improve in 2024 for most commercial aerospace issuers. Continuing strong demand fundamentals are expected to translate into higher revenues across much of the sector. Supply-chain constraints and related inefficiencies will likely persist beyond 2024 and limit margin improvements, but we estimate higher average earnings and cash flow across the sector. As such, we forecast lower leverage and stronger cash flow coverage ratios--in some cases, to an extent that could support higher ratings. For lower-rated companies, liquidity pressures and reduced capacity to withstand sharply higher interest rates are key risks this year. Overall, we do not anticipate material changes to financial policies. Shareholder returns for most have been well broadcast, and M&A activity in the commercial aerospace supply chain is likely to be subdued based on high regulatory scrutiny, which we expect will persist. However, higher-than-expected share repurchases contributed to negative rating actions in 2023 and remain a risk if not curtailed in the event of deteriorating business conditions.

Key risks or opportunities around the baseline

1. The supply chain can't keep up.

For Airbus, this could dent production of the popular A320 family, which was 80% of deliveries in the year ended September 2023. For Boeing, this could mean backtracking on 737 MAX production growth, which was uneven in much of 2023 but appeared to stabilize at the end of the year.

2. Unforeseen technical/engineering challenges that are costly to fix.

Manufacturing defects discovered on components from one of Boeing's key suppliers in 2023 showed how disruptive unexpected problems can be. Any new issues could lead to higher costs and delays for OEMs and their suppliers. Remediation of previously identified problems, including those on GTF engines, could also prove more costly than currently anticipated.

3. Aggressive financial policies.

Several commercial aerospace companies are using a material portion of their discretionary cash flow for share repurchases. We believe most will proceed with share buybacks in a manner that limits negative effects on credit measures and ratings. However, as we have seen previously, unexpected increases in cash outflows for discretionary uses--particularly amid weaker-than-expected operating results--is a notable downside rating risk.

Industry Outlook: U.S. Defense

Ratings trends and outlook

Our ratings on U.S. defense companies should remain mostly stable amid continued robust government spending. While the pace of spending is expected to slow in 2024, this follows a material increase last year. Generally steady improvement in earnings and cash flows should follow, particularly for the larger, higher-rated issuers. However, these companies tend to prioritize shareholder returns as a use of discretionary cash flows, and we expect this will continue, therefore limiting improvements in credit measures and ratings. On the other hand, several smaller, lower-rated companies will continue to face cash flow challenges stemming from high leverage and sharply rising interest rates. These issuers mostly account for the higher share of negative versus positive outlooks in the sector.

Main assumptions about 2024 and beyond

1. Defense spending will remain strong, while growth flattens.

Broad-based consensus around strategic risks is supporting defense spending. However, delays in passing budgets are creating uncertainty, tempering our growth expectations for defense companies. Those with a large installed base of long-dated programs are afforded revenue stability, but supply-chain challenges will likely persist and limit margin accretion.

2. Near-peer threats will drive spending priorities.

Heightened conflicts in the Middle East, Russia's invasion of Ukraine, and continued tensions with China underpin strategic focuses and defense spending priorities. As such, we expect limited material downside risk to defense spending in the U.S.

3. Companies will emphasize shareholder returns.

Cash flows are likely to remain high, even after factoring in cost pressures. Large firms face limited M&A opportunities and may prioritize share repurchases or dividends, limiting improvements to credit metrics.

The fiscal 2024 budget of $841 billion is up 3% from last year. The budget focuses on enhanced readiness and modernization efforts, artificial intelligence research and development (R&D), and nuclear deterrence in response to more recent conflicts in the Middle East and Ukraine, as well as continued perceived threats from China. Major aircraft programs receiving funding include the F-35 made by Lockheed Martin, the B-21 made by Northrop Grumman, and unmanned aircraft systems. Funds are also going to the construction of two Virginia class submarines built by Huntington Ingalls and General Dynamics, one Columbia class submarine built by General Dynamics, and two Arleigh Burke class destroyers built by Huntington Ingalls. International sales growth is supported by allies' commitments to increase spending in response to heightened security concerns. Foreign sales comprise less than 20% of the largest defense contractor’s revenue but generally contribute higher margins than domestic sales.

Despite what seems like broad support for robust defense spending, the government delayed passing the 2024 budget until the tail end of last year, and even threatened to shut down. Continuing resolutions allowed the Department of Defense to keep operating without major interruptions, although the impasse created uncertainty and delayed new contract awards. A request for supplemental funding for Ukraine and Israel failed to pass Congress at the end of 2023, but some form of additional support could eventually succeed later this year.

Credit metrics and financial policy

Financial policies are a key driver of credit quality. While U.S. defense budget growth has flattened from very strong 2023 levels, spending remains robust and we expect most companies in the sector to generate ample free cash flow. Cash flow will benefit from the tapering effect of a 2022 tax rule that requires companies to capitalize rather than expense R&D spending. Large-scale strategic acquisitions that increase industry consolidation are unlikely given the Biden administration's concerns about maintaining competition. Prioritization of cash flow, whether for debt reduction or shareholder returns through dividends and share repurchases, will drive the direction of credit ratios for larger U.S. defense companies. Smaller companies with higher debt burdens will focus on rebuilding financial strength as they face higher borrowing costs and debt maturities.

Key risks or opportunities around the baseline

1. U.S. defense spending might decline.

The recent elevated pace of spending growth will likely be difficult to maintain, especially in the context of high deficits and increased borrowing costs. Political will to support Ukraine in an extended conflict appears to be tepid, resulting in lower spending.

2. Supply-chain constraints could get in the way of delivering on orders.

Shortages or delays in sourcing components and labor productivity limitations could impede translating orders into sales. Defense companies also face production capacity constraints.

3. Financial policies might become more aggressive.

Slowing defense spending growth and few M&A opportunities may push large U.S. defense contractors to increase share repurchases to boost equity returns. As a result, pressure on credit measures and ratings could follow if not accompanied by rising earnings and cash flows that mitigate the impact of higher adjusted debt levels.

Supply chain and labor constraints may increase costs and impede companies' ability to deliver orders. Higher costs are a key risk for companies with fixed-price contracts. Development contracts for major new aircraft or weapons systems require investment over several years to develop and produce initial units. Programs signed when inflation was minimal could result in losses due to cost overruns or production delays if the company isn't able to fully pass the excess on to the customer. Defense contractors might also hesitate to invest in expanding capacity for munitions or missiles without long-term contracts or other support.

Industry Outlook: European Defense

Ratings trends and outlook

For many European defense manufacturers, soaring backlogs, rising revenues and EBITDA, and stronger cash flows are almost a given through 2024. Rising defense budgets should underpin solid industry prospects over the medium to long term, and European defense issuers will likely continue seeing robust demand for their products and services. Ratings changes have largely been positive in the past 12-18 months, but we expect this trend will level off as issuers now prioritize (potentially debt-funded) M&A and share buybacks.

Main assumptions about 2023 and beyond

1. The Israel-Hamas and Russia-Ukraine wars are fueling strong operating performances for many European defense issuers.

It takes time for political decisions to translate into orders, but some issuers have been winning very large contracts off European countries that have been hiking defense budgets in reaction to conflict on their borders. Demand for some battlefield products and services is at a record high.

2. M&A activity is picking up, and shareholder returns will rise.

Balance-sheet headroom and liquidity is already being deployed for opportunistic M&A. A few larger issuers have share buyback programs underway, and some are accelerating the pace of return.

3. Parts of the supply chain and production lines will remain stretched through 2024.

Our issuers expect logistical challenges to persist, specifically some lingering bottlenecks in some parts of the supply chain. Some smaller players are still struggling to attract and retain highly skilled engineers. Some issuers' production headcount has been directly affected by military drafting (for example, the call up of 360,000 Israel Defense Forces [IDF] reservists in Israel).

Even before the Russia-Ukraine conflict, European NATO members' defense budgets were increasing, and defense expenditure as a percentage of national GDP was rising for most large members. The Israel-Hamas war has added further momentum to many European governments' appetite for such spending. Leading NATO members are urging their counterparts to increase defense spending toward 2% of national budgets, and European countries including Germany and France are planning for expansion. Others, such as Poland, have increased their targets even more.

The European defense industry is also benefiting from political action beyond Europe's borders. Since the start of the two recent wars, nearly $100 billion in military funding has been committed to Ukraine. The Biden administration has committed nearly half of this--about $45 billion. The U.S. has also just increased its annual provision to Israel ($3.8 billion for defense) by an additional $14.0 billion. European defense manufacturers, who tend to be more global (U.S. peers are more domestically focused), are winning large contracts, and several of our issuers have revised up their financial guidance. The main beneficiaries in our rated portfolio are BAE Systems, Babcock, Israel Aerospace, Leonardo, Rafael, and Thales. We also see benefits for defense players such as Rolls-Royce and Safran. The need for battlefield equipment--radar, communications, and munitions--has resulted in large spikes in demand for certain products and services for some issuers. Defense contracts tend to be long term and so are likely to provide support for revenues and profitability for many years to come. Any previously anticipated pressure on defense budgets due to post-pandemic bean counting has abated.

Larger issuers will likely use their strong balance sheets to prioritize M&A and share buybacks. This will somewhat erode ratings headroom. Some notable M&A is currently underway, including BAE Systems' $5.6 billion acquisition of Ball Aerospace, and Thales' $3.6 billion acquisition of Imperva and $1.1 billion acquisition of Cobham's Aero Communications business. Safran plans to acquire Collins Aerospace's actuation and flight control business for $1.8 billion (although Italy could still block this deal by using its "golden power" option). Collins is currently a subsidiary of U.S.-based Raytheon Technologies, now known as RTX. The European aerospace and defense industry is ripe for consolidation, and we believe 2024 will see further sizeable M&A activity. However, we don't think opportunistic M&A or shifts in financial policy will lead to material ratings downside. Instead, any downside might come from financial underperformance or operational challenges.

Many aerospace and defense issuers seized opportunities to cut production and costs during and after the pandemic. They did this by reducing headcount, tightening working capital practices, and strengthening balance sheets. Most defense issuers are managing persistent inflation, with margins generally holding up quite well. We expect this to continue through 2024. Where we could see some pressure is not on raw materials or energy, but on the salaries of a workforce that is generally highly skilled and experienced. Our Israeli issuers are experiencing some direct effects of the IDF's call up of 360,000 reservists, but our base case is for the war to remain centered in Gaza and to last no more than three to six months.

The question mark over defense has clearly moved from the shape and timing of a demand-led rebound to whether the supply chain can keep up. Issuers expect logistical challenges to persist, specifically some lingering bottlenecks in forgings and castings. Some smaller players are still struggling to attract and retain highly skilled engineers. Despite this, the effects of peak-pandemic are fading for the industry.

Credit metrics and financial policy

Pure-play defense issuers should continue to experience good backlog, revenue, and cash flow visibility, with stable credit metrics. Gradually improving credit metrics will likely be at least partly offset by increased M&A, dividends, and share buybacks, particularly among large defense contractors. Smaller, weaker contractors will continue to focus on rebuilding financial strength, although many of these are owned by private-equity firms. We expect recent positive ratings momentum will level off.

Key risks or opportunities around the baseline

1. Poorly executed M&A and/or overly aggressive financial policies remain a risk.

Overly ambitious shareholder returns could also soften ratings headroom for some issuers.

2. Conflicts escalating/spilling over into the wider region could further strain production.

Any further demand on production could lead to shortages or supply bottlenecks.

3. A shift in strategic priorities might affect contracts and platforms.

The pivot to Asia-Pacific will result in opportunities for some and losses for others.

Poorly executed M&A and/or overly aggressive financial policies remain a risk. Although many of the M&A transactions we are seeing make strategic sense, there is always the risk of poor integration. Overly ambitious shareholder returns could also soften ratings headroom for some issuers.

Conflicts escalating/spilling over into the wider region could further strain production. Some defense players are producing as fast as they can (specifically those making radar and communications equipment, munitions, and other gear used on the battlefield). Any further demand on production could lead to shortages or supply bottlenecks.

A shift in strategic priorities might affect contracts and platforms. The strategic pivot to Asia-Pacific will result in new contract and platform opportunities for some and losses for others. This might also affect existing contract platforms.

Related Research

- Israel Aerospace Industries Ltd. Upgraded To 'A-'; Outlook Stable, Dec. 28, 2023
- Engineering Services Company Babcock International Upgraded To 'BBB+' On Sustained Lower Leverage; Outlook Stable, Dec. 20, 2023
- Howmet Aerospace Inc. Upgraded To 'BBB-' From 'BB+' On Improved Credit Metrics; Outlook Stable, Dec. 15, 2023
- Triumph Group Inc. Outlook Revised To Positive On Expected Improved Cash Flow And Leverage; 'CCC+' Rating Affirmed, Dec. 6, 2023
- RTX Corp. Outlook Revised To Negative From Stable On Share Repurchase Announcement; 'BBB+' And 'A-2' Ratings Affirmed, Oct. 27, 2023
- General Dynamics Corp. Outlook Revised To Positive From Stable On Improving Credit Metrics; Ratings Affirmed, Oct. 18, 2023
- EMEA A&D Credit Quality Gains Altitude As Supply Chain Turbulence Persists, Oct 16, 2023
- Bulletin: BAE Systems' Credit Metrics Can Accommodate Ball Aerospace Acquisition, Aug. 18, 2023
- Tear Sheet: Rolls-Royce PLC, Aug. 15, 2023
- Leonardo SpA Upgraded To 'BBB-/A-3' On Solid Operating Performance And Improving Credit Metrics; Outlook Stable, Aug. 4, 2023
- RTX Corp. Downgraded To 'BBB+/A-2' On Expectation For Negative Free Cash Flow Generation, Outlook Stable, Aug. 3, 2023
- Tear Sheet: Thales SA, Aug. 2, 2023
- Israel-Based Rafael Advanced Defense Systems Ltd. Affirmed At 'A-/A-2'; Outlook Stable, July 31, 2023
- Tear Sheet: Safran SA, July 28, 2023
- Boeing Co. 'BBB-/A-3' Issuer Credit Ratings Affirmed On Improving Deliveries And Increasing Production, Outlook Stable, July 27, 2023
- Industry Top Trends Update Europe: Aerospace and Defense, July 18, 2023
- Industry Top Trends Update North America: Aerospace and Defense, July 18, 2023

Industry Forecasts: Aerospace and Defense

Chart 7

Revenue growth (local currency)

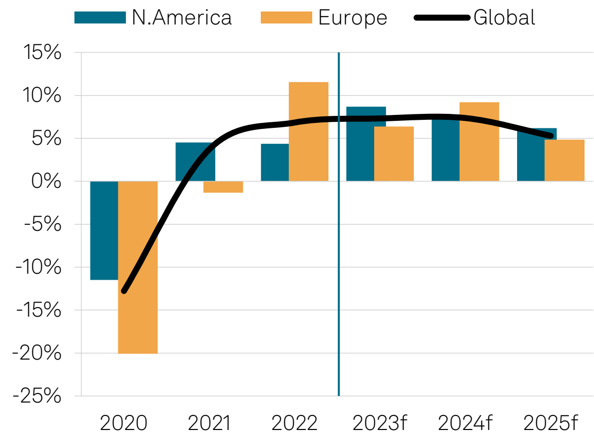


Chart 8

EBITDA margin (adjusted)

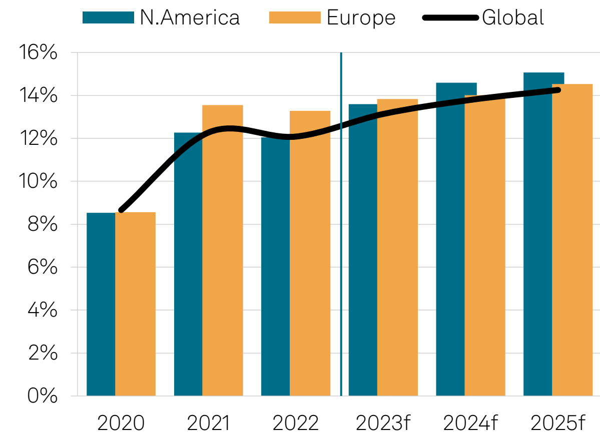


Chart 9

Debt / EBITDA (median, adjusted)

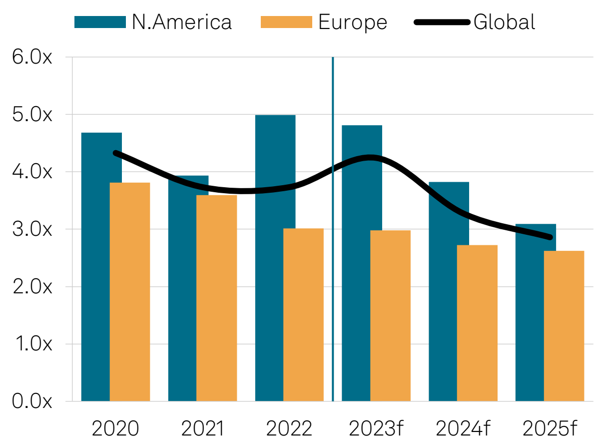
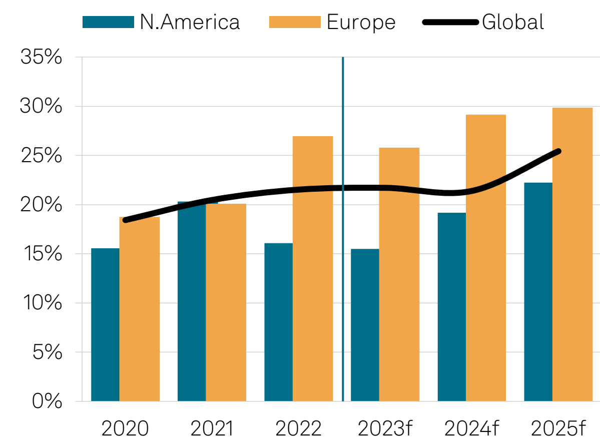


Chart 10

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: Aerospace and Defense

Chart 11

Cash flow and primary uses

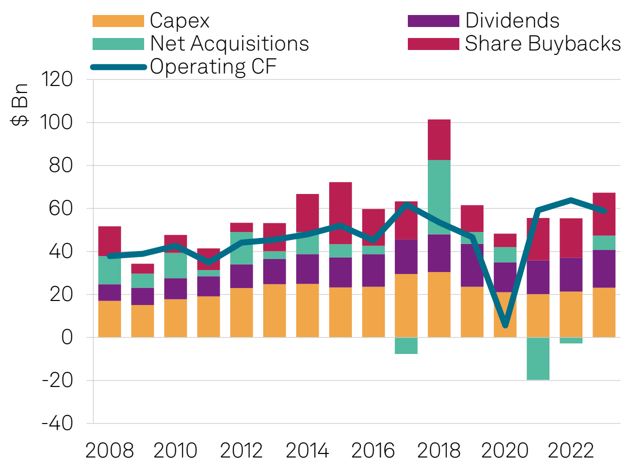


Chart 12

Return on capital employed

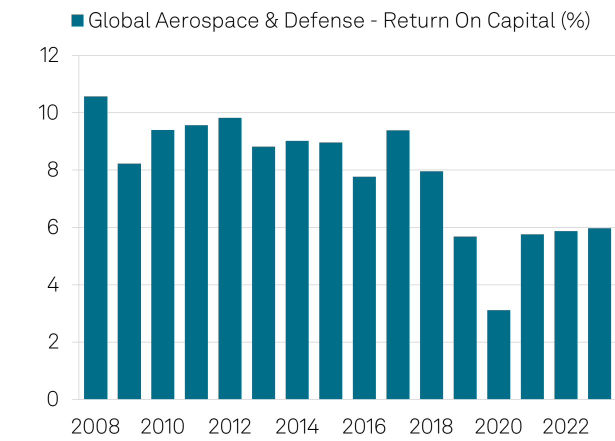


Chart 13

Fixed- versus variable-rate exposure

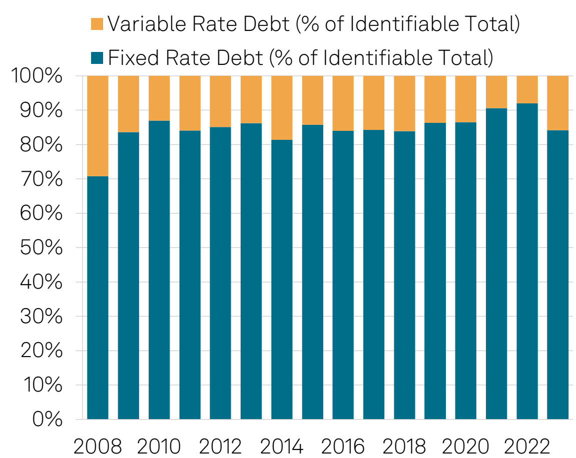


Chart 14

Long-term debt term structure

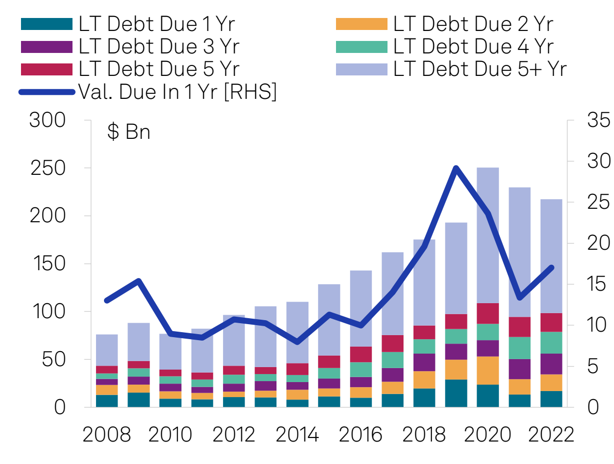


Chart 15

Cash and equivalents / Total assets

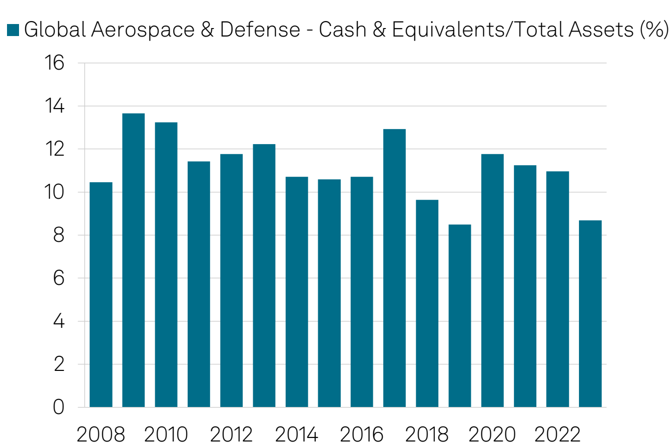
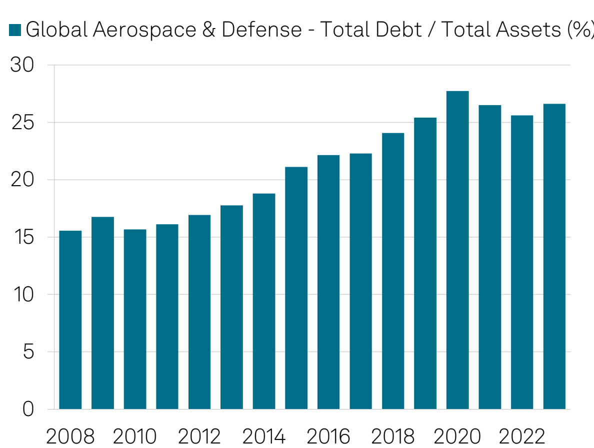


Chart 16

Total debt / Total assets



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

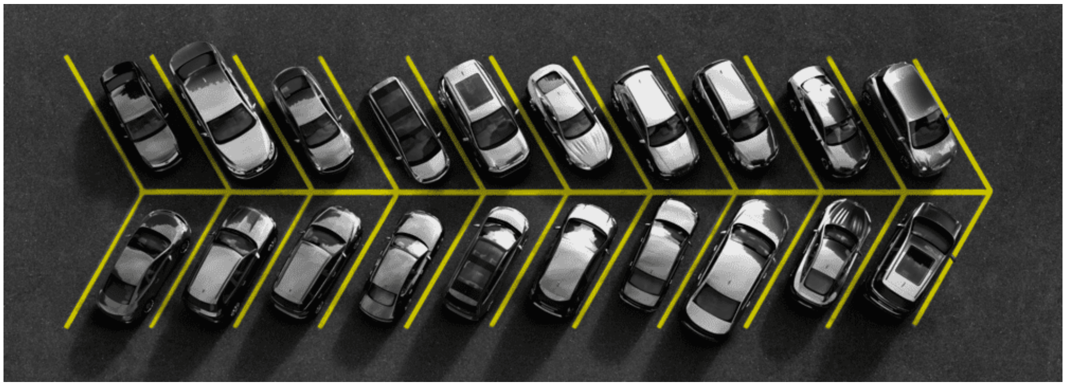
S&P Global Ratings

Autos

Pricing pressure adds to slow volume recovery

January 9, 2024

This report does not constitute a rating action.



What's changed?

A muted Chinese auto market. We see the market's underlying weakness continuing through 2025 and constraining global demand growth to 1%-3% in 2024 and 2%-4% in 2025.

Softer electric vehicle (EV) momentum to affect pricing and capex strategies. Slightly slower adoption in North America and Europe will lead some (not all) to pull back on 2024 investments.

Declining prices of raw material. Moderation in prices for steel and key battery components will be one of the few tailwinds supporting auto margins.

What are the key assumptions for 2024?

Pre-pandemic volumes recovery far off in Europe and the U.S. Growth in China will be slow.

Flattening original equipment manufacturers' (OEMs') margins owing to less-favorable pricing, supplier payments, higher labor costs, sticky R&D costs, and EV-linked profitability dilution.

Recovering supplier margins thanks to better fixed-cost absorption and moderating raw material and freight inflation, but cash conversion will be pressured by ongoing capital expenditures (capex), restructuring expense, and high borrowing costs.

What are the key risks around the baseline?

Geopolitical tension and protectionism. Europe's failure to respond to the U.S. and China's moves in EV value chains heighten stress on regional legacy OEMs and suppliers.

Mergers and acquisitions (M&A) in the supplier space continuing to cloud visibility on ratings, and could lengthen the time needed for integration and restructuring to fully pay off.

Intensifying price pressure, especially if light vehicle demand recovery stalls.

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Ratings Trends: Autos

Chart 1
Ratings distribution

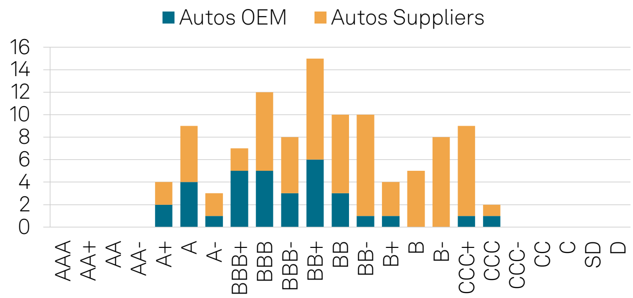


Chart 2
Ratings distribution by region

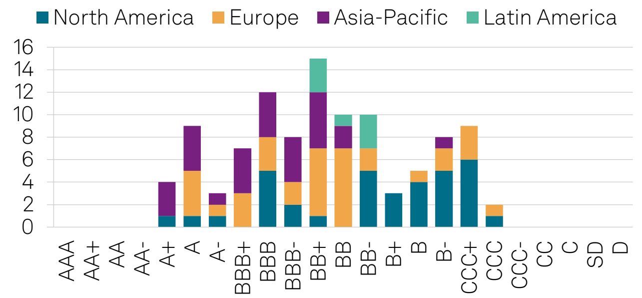


Chart 3
Ratings outlooks

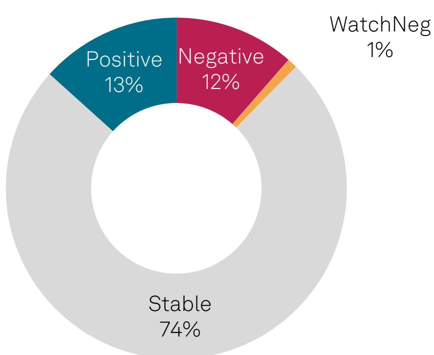


Chart 4
Ratings outlooks by region

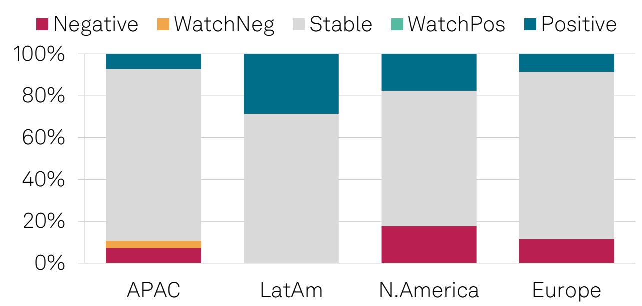


Chart 5
Ratings outlook net bias

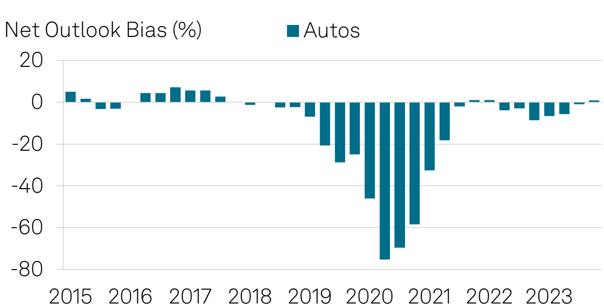
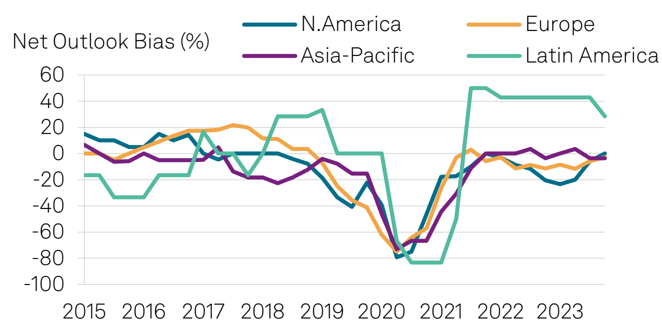


Chart 6
Ratings net outlook bias by region



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

Industry Outlook

Ratings trends and outlook

We expect relatively resilient ratings in 2024 and 2025 for OEMs where we anticipate credit metrics will absorb a weak recovery of volumes and less supportive pricing conditions that will affect the volume segment more than the market's premium segment. Refinancing at higher interest rates should have a relatively minor impact for investment-grade OEMs because part of it could be absorbed by large and comfortable cash positions built in the post-pandemic phase thanks to healthy cash conversion and tight cost management. In addition, slower momentum in EV penetration could boost some OEMs in 2024 and 2025, and delay the dilutive impact associated with electrification. Over the next few years, we expect the industry to transition to more cost-effective vehicle platforms and cheaper cell chemistries at scale with a higher degree of insourcing. We think this transition will take time and is unlikely to deliver consistent profits within EV segments before 2027.

The picture is more mixed for auto supplier ratings. Rated suppliers are extremely diversified in terms of product offering (from extensive software solution to typically undiversified hardware skewed products mix) or market positioning (exposure to OEMs versus aftermarkets). Suppliers' margins and free cash flow will continue to improve as raw material and freight inflation remain more moderate, volumes improve, and less supply chain uncertainty decreases operating volatility at OEM customers. However, labor availability and wage inflation, along with overall higher energy prices, limit margin upside. Higher research and development, capex, and working capital in the form of tooling support the launch of new products geared to support EVs. While there is the potential for greater revenue opportunities from newer electrification-related products, initially this transition will drag on supplier margins and free cash flow. The impact on credit quality will depend on each suppliers' product portfolio and how they navigate the product transition.

Higher interest rates are a bigger credit risk for auto suppliers compared to automakers, which tend to have better ratings and stronger liquidity, to need to cope with refinancing risks while protecting their capacity to acquire assets that are key for the energy transition.

Main assumptions about 2024 and beyond

1. The post-pandemic volume recovery remaining moderate in the U.S. and Europe.

The stronger-than-expected rebound in 2023 is short lived, in our view, as higher interest rates in the U.S. and Europe will eventually take their toll on big ticket purchases. China is no longer seen as driving global auto demand growth in 2024 and 2025.

2. OEMs' topline growth and margins moderate, but cash conversion remains resilient.

Moderate recovery of volumes and less favorable pricing will feed 2%-5% revenue growth. Margins will be flat at best for most, linked to sticky cost items such as R&D, labor, and logistics costs. This is partially offset by declines in raw material costs, mix improvement, and the absence of large restructuring, one-time charges from 2023 for some automakers.

3. Suppliers improving on profitability, but less so on cash conversion.

After a plunge in 2021 and 2022, suppliers will improve margins thanks to compensation from OEMs but continue to lag on cash conversion as R&D, capex, refinancing, and restructuring costs all take their toll.

Volume growth will be moderate in 2024 and 2025. Our forecast is linked to the expectation of depressed private and retail sales in Europe and, in the U.S., a share of the market (approximately 40%) likely to be more affected by higher-for-longer interest rates than fleet sales to corporates rental companies and governments, that largely supported demand in the post-pandemic phase. While the U.S. economy remains overheated, economic prospects in Europe over the next couple of years could improve with inflation curbing from second-half 2024. The scenario of shallow recession in Europe remains dominant, which is why we are not revising our demand forecasts for the two regions.

Consistent with our previous expectations, 2023's muted growth in the Chinese auto markets was mainly due to the distortions from auto demand being partially pulled forward to 2022 by stimulus policies (the central government's restoration of the full purchase tax on internal combustion engine [ICE] vehicles, and removal of the EV purchase subsidy from January 2023). Growth in the first 10 months was in line with our forecast of 0%-2%, but the last two months of 2023 could have been stronger than expected as carmakers strive to deliver annual sales goals by slashing prices.

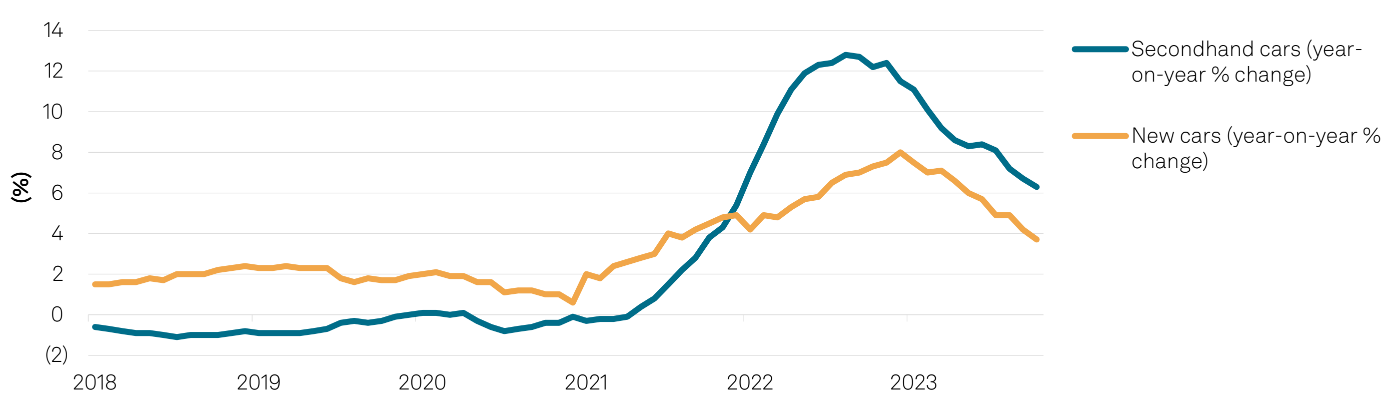
Chinas' property weakness continues to weigh on the economy. We expect the country's real GDP growth to slow in 2024 (to 4.6% down from 5.4% this year), so economic slack and fragile consumer sentiment will persist in 2024, which leads us to maintain our prudent forecast on light vehicles demand in China (0%-2% growth).

Pricing and labor cost pressure will intensify. Pricing patterns differ substantially among regions, depending on the structure of local markets combined with the strategy of disruptors and new entrants. Overall, we expect weaker pricing in 2024 and 2025 from the strong performance in 2021 and 2022. Pricing remains particularly competitive in China, owing to a multitude of car manufacturers trying to boost a quick ramp-up of volumes, hence failing to earn decent returns on capital invested. This trend should favor incremental market consolidation in China, although it will take time to materialize.

In Europe, Chinese players like BYD and SAIC appear unlikely to trigger a price war and retain stronger profit margins on low-but-increasing volumes, for EVs in particular. In the eurozone, pricing trends remain positive (according to the Eurostat Eurozone Car Price Index) despite a clear inflection of them, which is more pronounced for secondhand cars but also affects new ones (see chart 7). The average manufacturer's suggested retail price for passenger cars has steadily risen since 2019 (by 40%) and is at an all-time high in Europe.

Chart 7

Eurozone car prices

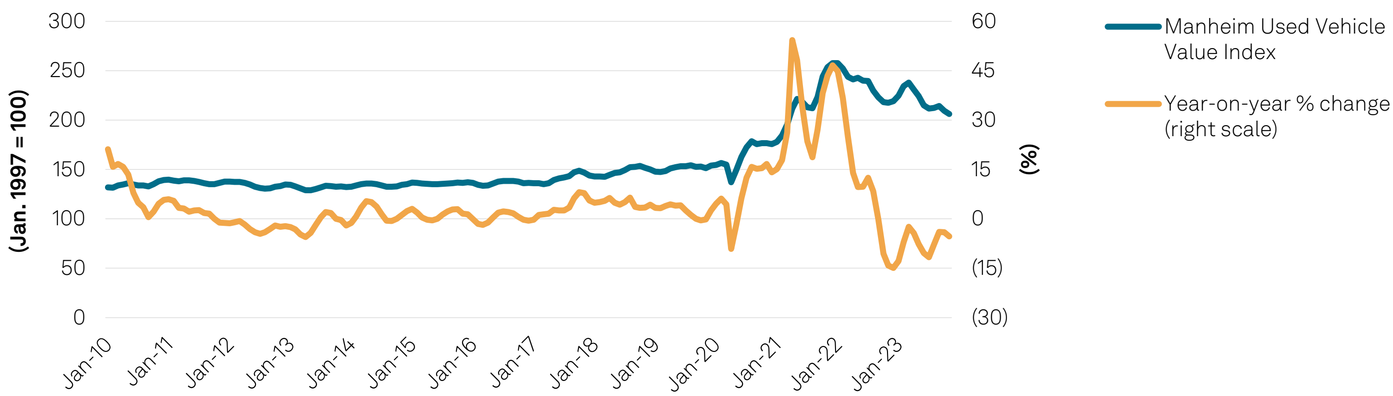


Sources: Eurostat, S&P Global Ratings.

New vehicle prices remain about 30% above pre-pandemic levels in the U.S. so far in 2023 (with average transaction prices over $45,000 in August, according to J.D. Power, see chart 8), but we expect about a 10% decline over the next 24 months in the U.S. as used vehicle prices fall (with potentially higher supply) and the product mix trends toward lower-trim versions and more entry-level segments.

Chart 8

Manheim Used Vehicle Value Index: U.S



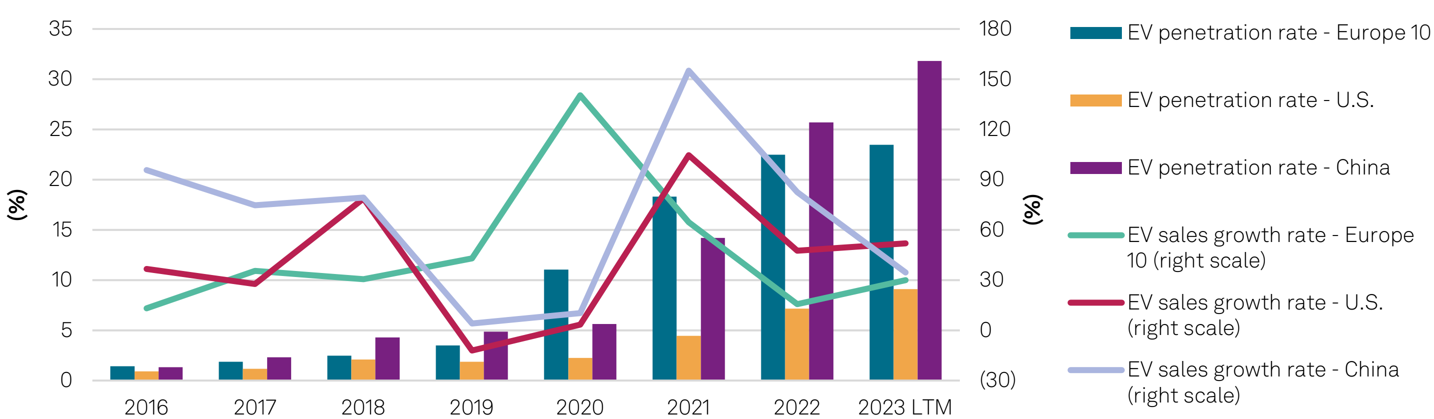
Sources: Manheim, S&P Global Ratings.

We expect a significant portion of the price decline in the U.S. to affect auto dealers that have been pricing vehicles at record high-levels in recent years. For U.S. automakers, following the recent ratified agreement reached with the United Auto Workers, higher labor-related expense will lead to multi-billion-dollar annual incremental costs, which will lead to even-higher reliance on ongoing cost-reduction efforts and lower spending on self-driving related businesses to avoid a large margin decline in 2024 and 2025.

The transition to electrification remains a key risk for most global automakers. A key credit risk for legacy automakers is managing the transition to EVs, which we estimate could be cash-flow-dilutive until at least 2026. Most legacy automakers will not pursue market share gains but will remain largely focused on improving cost competitiveness and repositioning themselves on the new value chains. Aggressive steps to vertically integrate battery technology business (by building own cells mostly with joint venture partners), will likely dilute EV business models' profitability for the next year.

Chart 9

EV sales growth and penetration rate



LTM—Latest twelve months to Nov. 2023. Source: S&P Global Ratings.

Given the recent slowdown in growth for EVs (see chart 9), we view plans to temporarily scale back capacity and balance growth with profitability (partly through sale of hybrid options) as a slight credit positive over the next 12-24 months. This trend could be more likely in North America, a market that remains largely dominated by Tesla, rather than in Europe, considering the latter's exposure to Chinese competition (see chart 10).

Chart 10

Segment structure of BEV market by region and bestseller by category

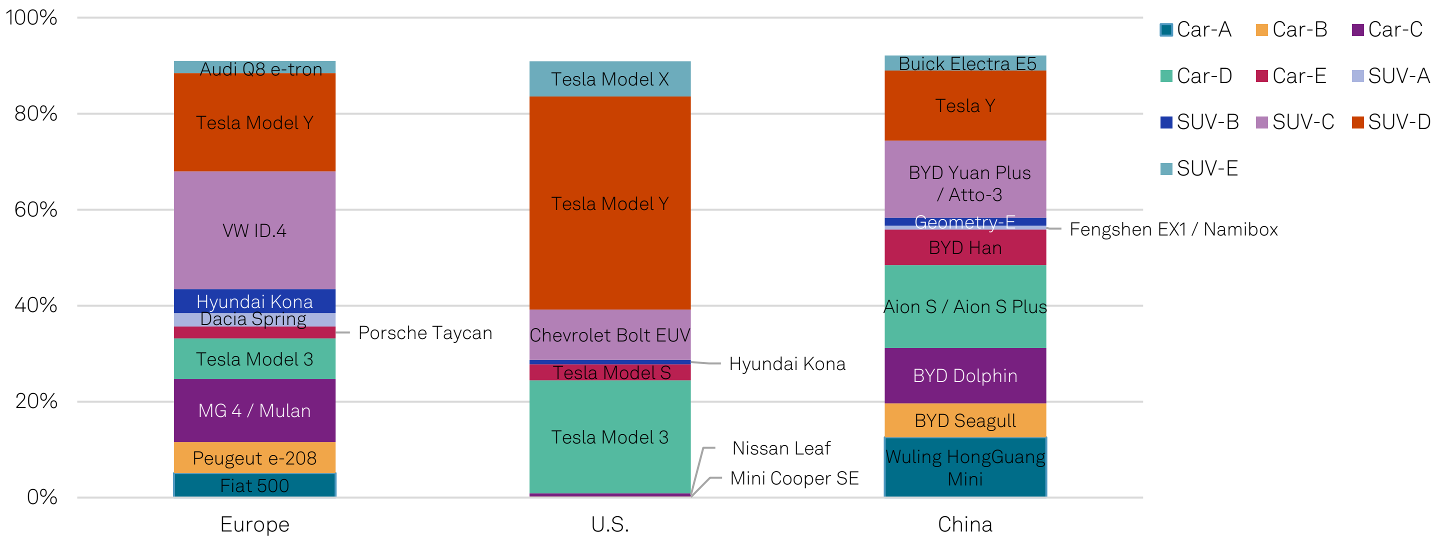


Chart shows 2023 data to October. Sources: EV Volumes, S&P Global Ratings.

Our 2025 electrification scenario remains broadly unchanged, however. Despite the likelihood of a bumpier trajectory, essentially due to an average global price gap of more than 20% between battery electric and traditional vehicles (close to 40% in Europe), we see electrification as an irreversible long-term trend. We expect that by 2025, more than 20% of global vehicle sales will be electrified. By then, we expect EV penetration to be highest in China (close to 40% versus 32% for the latest 12 months [LTM] to November 2023), followed by Europe (about 30% from 23% for LTM November 2023) and the U.S. (towards 15% from 9% in that time). By that time electric models on offer will have almost doubled in the U.S. and Europe only.

Table 1

Global light vehicle (LV) forecast (as of Oct. 2023)

	Actual		New projections (as of Oct. 2023)			Previous projections (as of April 2023)		
	2022	2022	2023e	2024e	2025e	2023e	2024e	2025e
	Mil. units	YOY%	YOY%	YOY%	YOY%	YOY%	YOY%	YOY%
Global LV sales	78.9	(1.7)	5-7	1-3	2-4	3-5	3-5	3-5
China (mainland)	24.1	0.9	0-2	0-2	1-3	0-2	2-4	1-3
U.S.	13.9	(7.9)	9-11	0-1	1-3	5-7	5-7	4-5
Europe	15.0	(11.2)	9-11	0-2	1-3	3-5	3-6	4-6
South Korea	1.7	(2.3)	0-2	0-2	0-2	0-2	0-3	0-4
Japan	4.1	(5.1)	5-7	1-3	1-3	5-7	1-3	1-3
Rest of the world	20.1	9.0	6-8	5-7	4-6	4-6	4-7	4-8
Global LV production	82.4	6.7	3-5	0-2	1-3	2-3	3-5	3-5

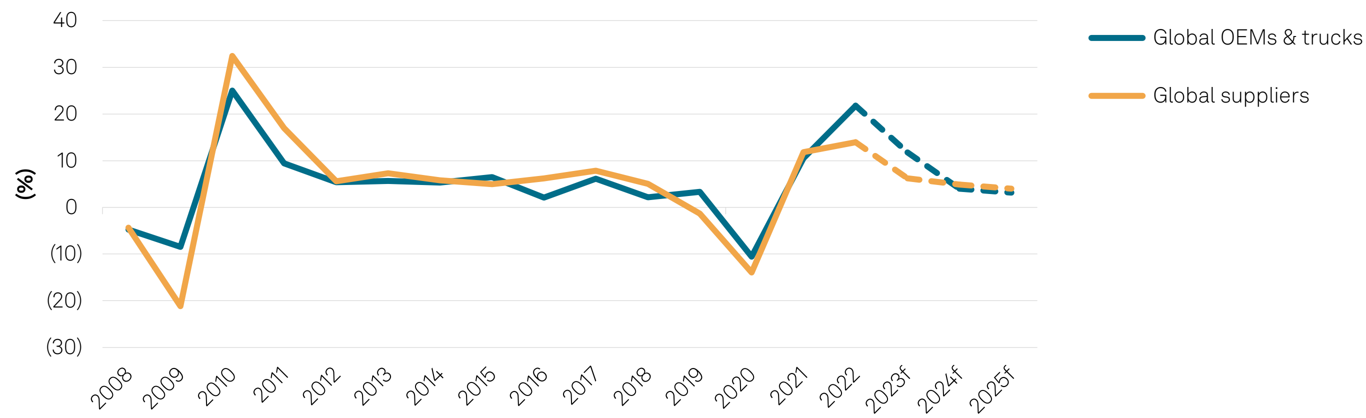
YOY—Year on year. e—Estimate. All percentages are year-on-year changes. Sources: Actuals from S&P Global Mobility, forecasts by S&P Global Ratings.

Credit metrics and financial policy

We expect 1%-5% organic revenue growth for both OEMs and suppliers, whose results will start converging again as from 2024 after the pricing party for OEMs gradually subsides (see chart 11).

Chart 11

Year-on-year revenue growth (median)

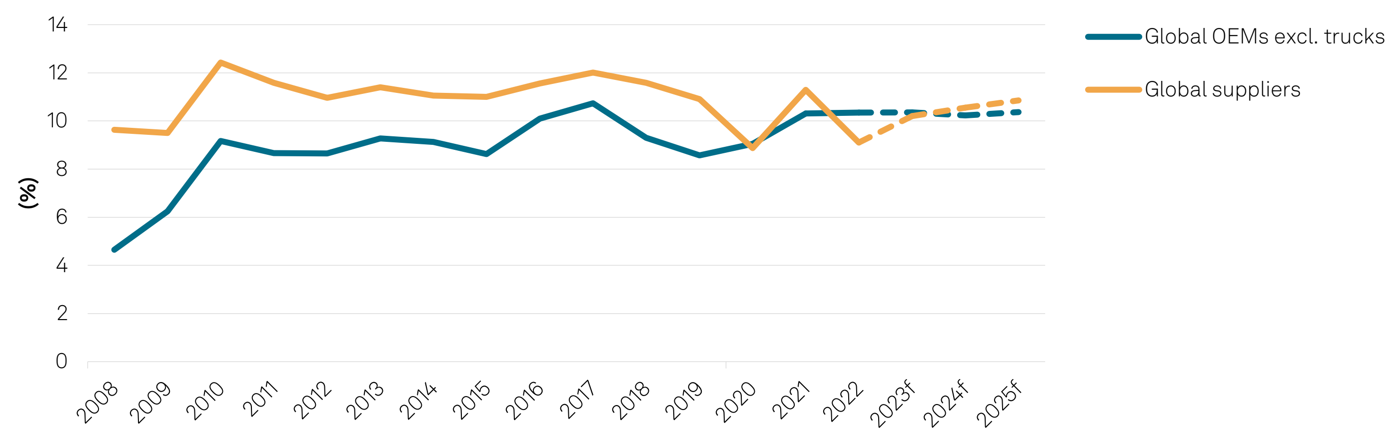


f—Forecast. Source: S&P Global Ratings.

The profitability gap between manufacturers and suppliers will also gradually decrease as margin flatten out at most car manufacturers while supplier margins improve as raw material and freight inflation remain more moderate, volumes improve, and less supply chain uncertainty lowers operating volatility at their automaker customers (see chart 12). However, labor availability, wage inflation, and overall higher energy prices limit margin upside.

Chart 12

EBITDA margin, % (median)



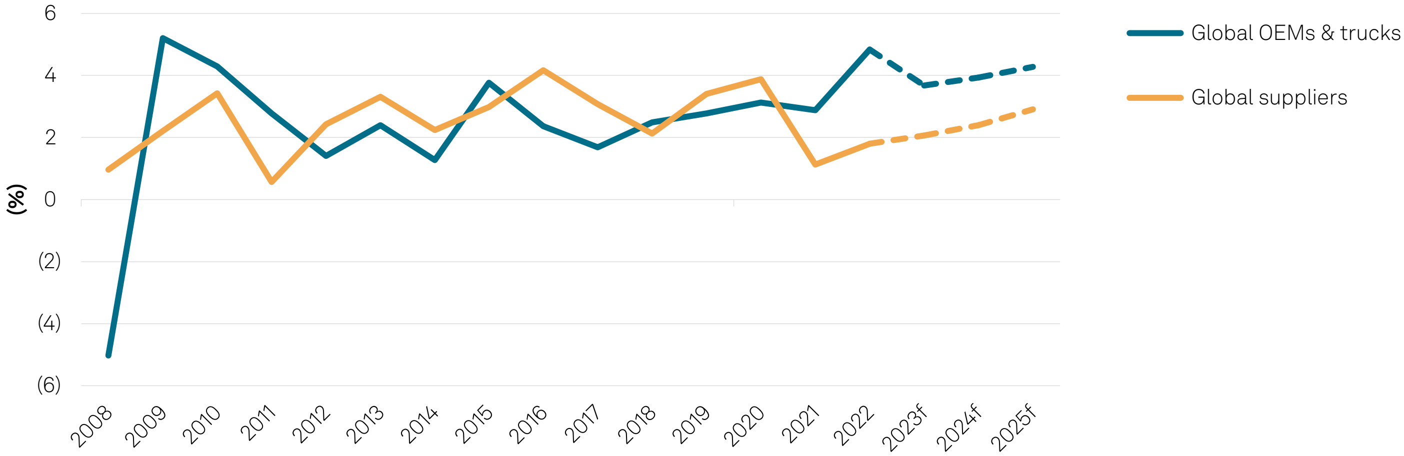
f—Forecast. Source: S&P Global Ratings.

Investment intensity is unchanged with R&D and capex representing 8%-10% of adjusted sales (median value) at car manufacturers, which compares with a lower range at global suppliers (6%-8% of adjusted sales). The gap reflects our view of the effort towards a more pronounced verticalization of OEMs' business models associated with the transition to electric mobility. The pressure on R&D and capex is linked to the effort on new products, architecture, and platforms at OEMs aiming to reduce their time to market. Our definition of capex doesn't capture investment in equity, which allows OEMs to enter partnerships on nontraditional businesses like raw material sourcing, battery production, and software development in an effort to share risk and optimize capital allocation. As a result, the capex gap between OEMs and suppliers could be higher if we were to account for those partnerships that we deem key for manufacturers' competitive advantage.

Given the accounting differences on these investments, absolute free operating cash to sales at car manufacturers appear inflated, at 4%-5%, compared with suppliers (in the 2% range), plagued with high refinancing costs and ongoing restructuring efforts (see chart 13).

Chart 13

Free operating cash flow to sales, % (median)



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

In the post-pandemic phase, financial policies have been inspired by great prudence, resulting in cash accumulation, in particular at OEMs. As capital allocation becomes more selective and energy transition bumpier, some OEMs have undertaken share buybacks. We don't take this as evidence of more aggressive financial policies, but rather as the redistribution of gains from the exceptional pricing situation OEMs have enjoyed over the past two years. We expect financial policies at suppliers to be more conservative considering the multitude of challenges they could face given very gradual volume recovery and constantly adapting their portfolio to market needs.

Key risks or opportunities around the baseline

1. Geopolitical tension and protectionism could compound competition. Europe's failure to respond to the U.S. and China's moves in EV value chains heightens pressure on regional legacy OEMs and suppliers.

2. M&A in the supplier space will continue to cloud visibility on ratings and lengthen the time needed for integration and restructuring to fully pay off.

3. Price war among OEMs in North America and Europe are unlikely, but could be triggered by automakers with high inventory in internal combustion-engine segments or by dominant disruptors like Tesla in the EV segment, which would weaken the industry credit outlook.

Geopolitical tensions are far from resolved and both OEMs and suppliers have responded with increasingly local-for-local market-based approaches, which is consistent with the Western bloc's ambition to reduce dependence from Chinese dominance of value chains. The rapid increase in exports from China into markets where competitive pressure is more sustainable and profits per unit higher, mostly in Europe but also Southeast Asia and South America. As a result, major auto players in Europe are directly exposed to the risk of being challenged in their home markets by cost-competitive Chinese battery EV (BEV) companies (such as BYD Auto and SAIC Motor). Due to a cost advantage that legacy OEMs estimate in the 20%-30% range (for EV production), protectionist policies could be less effective if they didn't establish the principle of a regional sourcing, like the Inflation Reduction Act (IRA) in the U.S. does, and could feed into negative sentiment towards foreign players in the Chinese market, which remains a key market for the bulk of rated OEMs. In the U.S., new guidelines on restrictions embedded within the IRA's consumer purchase credit for EVs (related to component sourcing from China, Russia, Iran, and North Korea) will further limit the eligibility for the full consumer tax credits. Even before the new guidelines, only 16 of 50 BEV models were eligible for the full $7,500 tax credit.

With a transformation in business models triggered by the energy transition, M&A risk remains high and unpredictable as to the impact on credit quality. We see this as risk material for auto suppliers but less so for OEMs, as the former strive to adapt their portfolio of products to a bumpy transition towards electric mobility, while the latter appear less exposed to risks of transformative transaction with material credit implications.

A price war is a remote risk at this stage (except in China) and could emerge only with protracted market weakness, which we deem unlikely. We think Europe could remain a sweet spot for pricing (also due to the high share of premium sales), but the U.S. could be a more challenging region, and China faces the highest price tensions.

Related Research

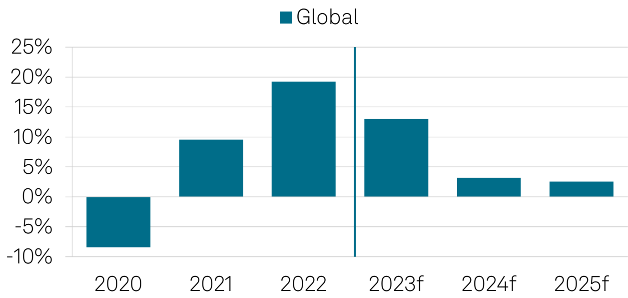
- Autoflash EMEA: OEMs Can Navigate Choppy Waters Better Than Suppliers, Dec. 12, 2023
- Credit Outlook: Global Autos, Oct. 31, 2023
- Most Rated Asian Automakers Should Steer Through Demand Volatility, EV Strains, Oct. 12, 2023
- U.S. Auto Sector Ratings Could Remain Resilient Despite Slowing Macro Conditions And Rising Pricing Pressure, Oct. 11, 2023
- China Auto: Soft Demand Heightens Competition, Oct. 10, 2023
- Global Auto Sales Forecasts: The Pricing Party Is Coming To An End, Oct. 9, 2023
- Asian Battery Makers Are Shifting Strategies To Hold Onto Global Lead, Oct. 5, 2023

Industry Forecasts

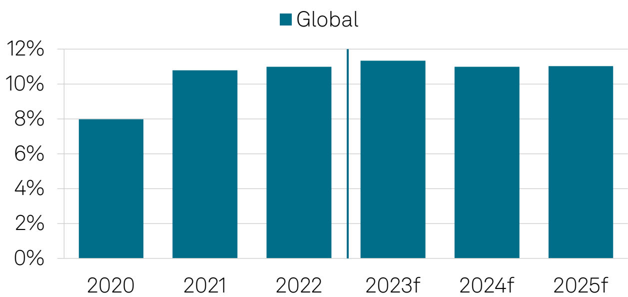
Auto OEMs

Chart 14

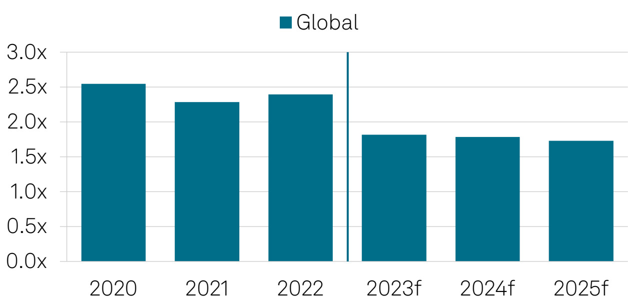
a) Revenue growth (local currency)



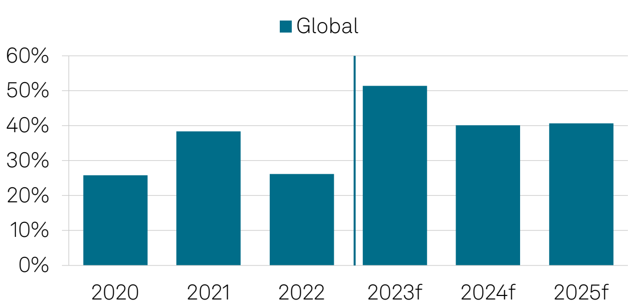
b) EBITDA margin (adjusted)



c) Debt / EBITDA (median, adjusted)



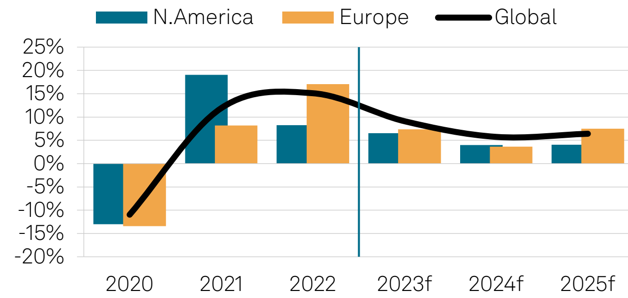
d) FFO / Debt (median, adjusted)



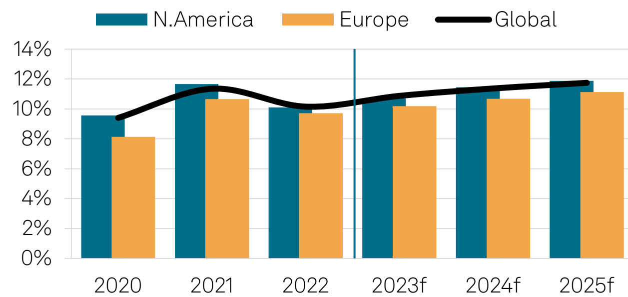
Auto Suppliers

Chart 15

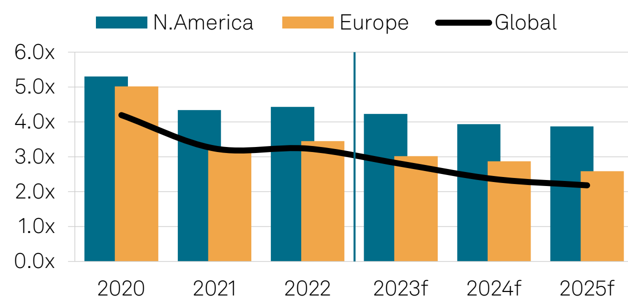
a) Revenue growth (local currency)



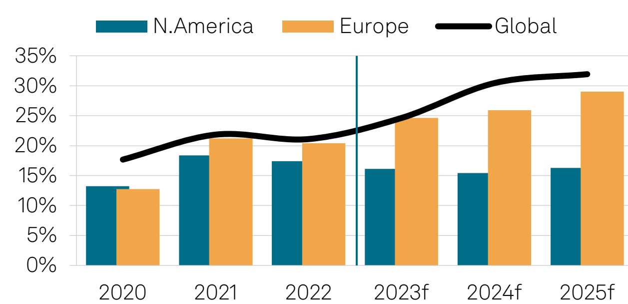
b) EBITDA margin (adjusted)



c) Debt / EBITDA (median, adjusted)



d) FFO / Debt (median, adjusted)



Source: S&P Global Ratings.
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. OEMs--Original equipment manufacturers. FFO--Funds from operations.

Cash, Debt, And Returns: Autos

Chart 16

Cash flow and primary uses

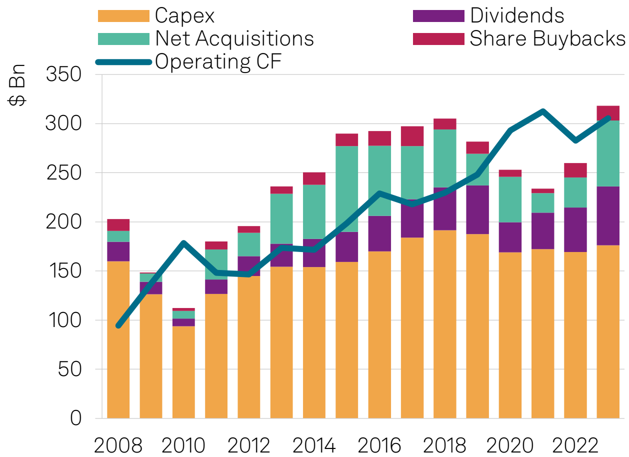


Chart 17

Return on capital employed

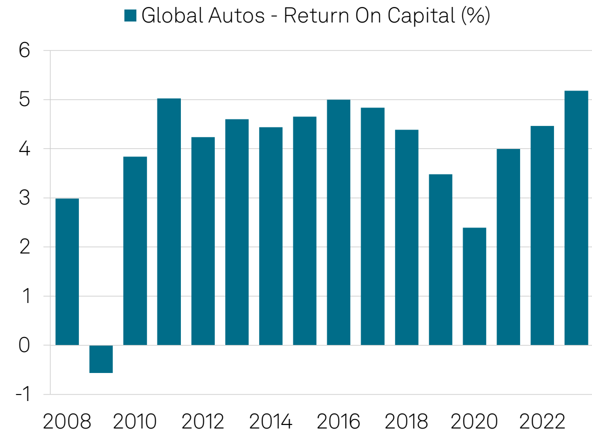


Chart 18

Fixed- versus variable-rate exposure

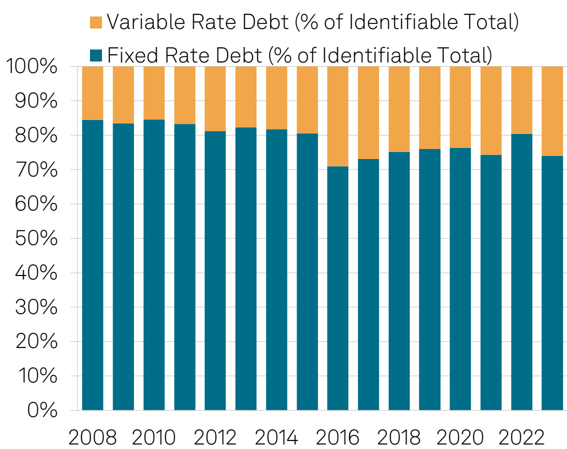


Chart 19

Long-term debt term structure

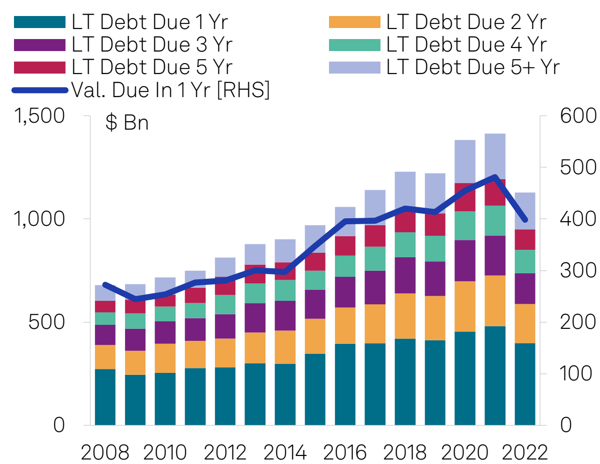


Chart 20

Cash and equivalents / Total assets

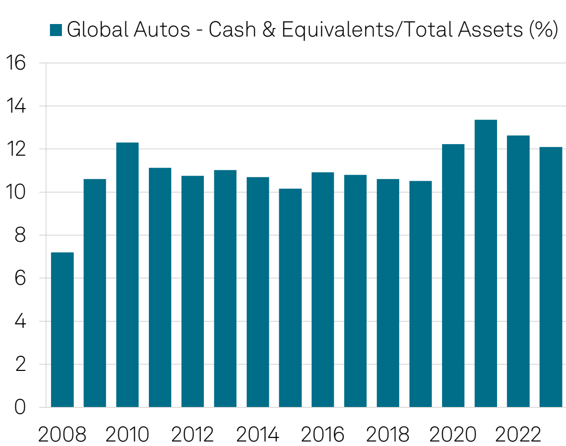
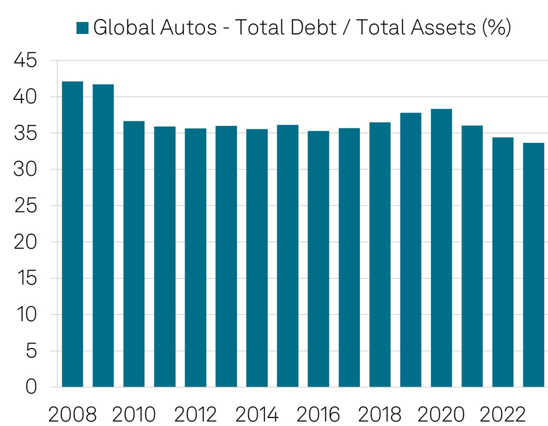


Chart 21

Total debt / Total assets



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

Building Materials

Broadly stable credit quality in a softer business context

January 9, 2024

This report does not constitute a rating action.

What's changed?

The environment is gloomy in the residential building construction sector. Higher interest rates have impaired consumer demand and we do not anticipate volume recovery before 2025.

Industrial construction and civil engineering improved. Both benefit from investments in low-carbon energy, infrastructure renovations, and government spending.

Increased interest rates are a challenge for highly indebted companies. Higher debt service costs start to dent cash flows.

What are the key assumptions for 2024?

Credit quality will remain largely stable. This will be supported by decent rating headroom and balanced capital allocation. Still, there are pockets of weakness in the 'B' category.

Margins will stabilize as companies' ability to increase selling prices reduces. Still, we anticipate pricing discipline will persist, notwithstanding lower cost inflation.

Climate transition risk will continue to drive capital allocation. Despite weakened business confidence, most companies' capital expenditure (capex) remains unchanged or increases.

What are the key risks around the baseline?

More aggressive financial policies could lead to negative rating actions, particularly if shareholder remuneration remains high while volume decline continues.

Renewed geopolitical tensions or worsening local property crisis, such as in China, could undermine volume recovery in 2024. This could constrain companies with limited rating headroom.

Stricter carbon regulation could constrain high-emitting companies. Yet, large and more sophisticated companies could benefit from market consolidation.

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Ratings Trends: Building Materials

Chart 1

Ratings distribution

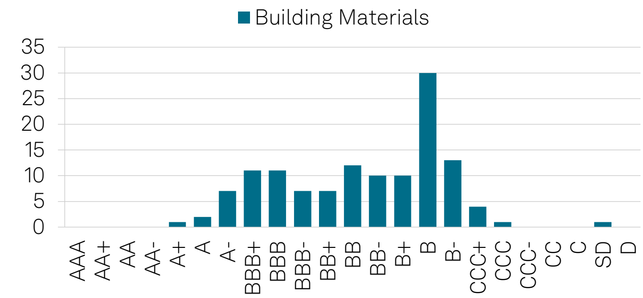


Chart 2

Ratings distribution by region

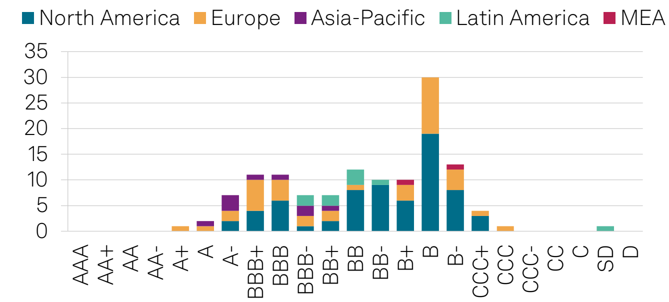


Chart 3

Ratings outlooks

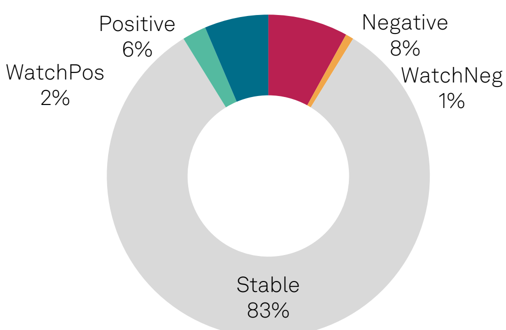


Chart 4

Ratings outlooks by region

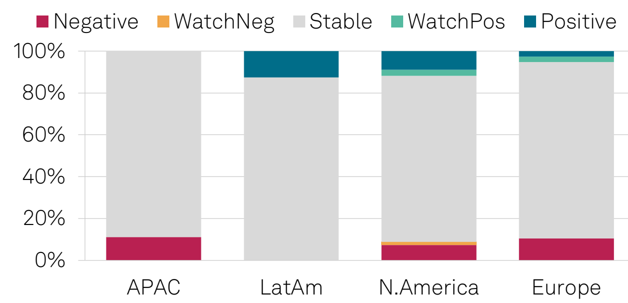


Chart 5

Ratings outlook net bias

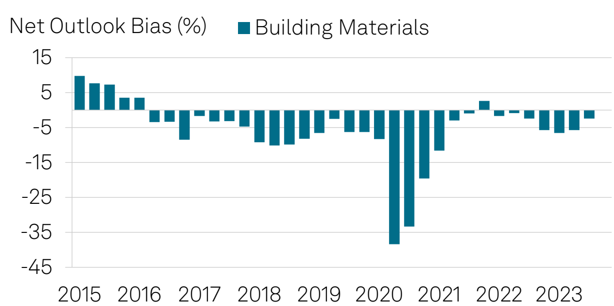
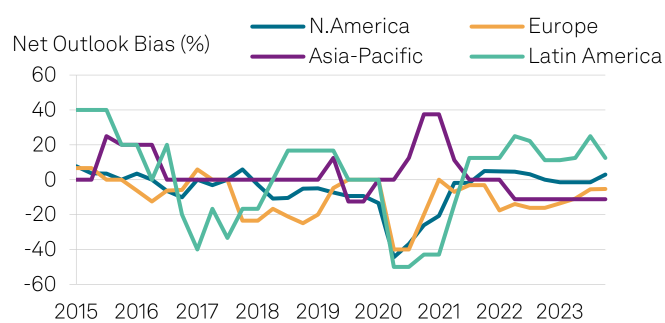


Chart 6

Ratings net outlook bias by region



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

Industry Outlook: North America

Ratings trends and outlook

We expect conditions will remain broadly stable in 2024 as demand for nondiscretionary products, including roofing, persists, while considerable parts of the sector benefit from infrastructure-related spending. Even though the prolonged effects of inflation, weaker housing demand, and high interest rates impair discretionary product volumes, we expect North American building materials companies' credit quality will remain largely stable in 2024. The ratings on more than 85% of issuers have a stable outlook and the rating outlooks on the remaining companies are more or less split equally between negative and positive. We therefore anticipate that most issuers are well prepared to navigate continued macroeconomic normalization. Historically, any deterioration concentrated on low-rated, high-risk issuers.

The housing affordability index is at its lowest since 2006 due to rising borrowing costs and high inflation. Yet, we expect housing affordability to improve modestly, mortgage rates to decline slightly, and home prices to remain mostly flat through 2024.

Building materials companies still experience some margin pressure due to the slightly reduced ability to pass on higher costs to consumers as raw material and labor costs remain stubbornly low, albeit at lower levels, and competition for volumes remains high. On the other hand, companies reduce inventory and operating costs, which increases the likelihood of them meeting profit and leverage expectations in 2024.

Main assumptions about 2024 and beyond

1. Slowing demand for home repairs and construction could bite in 2024.

We expect continued revenue normalization in 2024 after a period of prolonged historically high earnings. The expectation that interest rates will remain high could prolong housing affordability challenges and continue to reduce consumer discretionary spending.

2. Margins will likely stay under pressure; however, strong public infrastructure spending should mitigate pressures for some issuers.

We expect margins will remain under pressure in 2024 because of high commodity, labor, and delivery costs. Aging housing stock and federal investments in infrastructure should increase demand but issuers will likely continue to rely on pricing power to maintain margins.

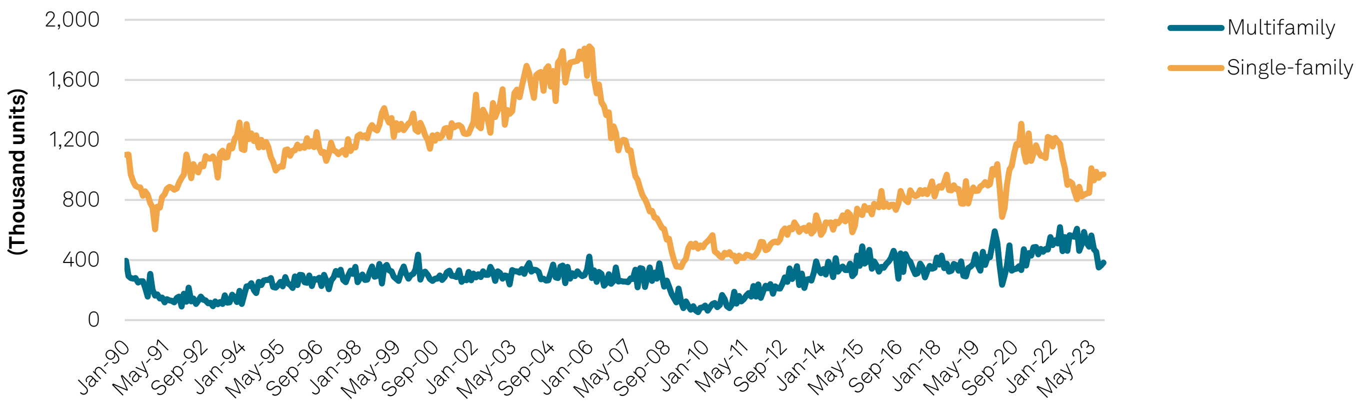
3. Financial policy is key to rating protection if demand were to dwindle.

If investment-grade companies increase shareholder remuneration, rating headroom could quicky disappear, especially considering increased interest rates. Speculative-grade companies with a low product diversity could experience downgrades after one-off dividend distributions or debt-financed acquisitions.

We expect repair- and remodel-exposed companies will be relatively less volatile than those exposed to construction. We expect revenue across the sector, especially in the case of commodity-based companies, will remain flat or decline by low single-digits in 2024. Low discretionary consumer spending levels could impair demand for some building products, such as kitchen cabinetry and bath fixtures. We expect housing starts will remain stable at about 1.4 million in 2024, after a decade-high in 2020 and another increase in 2021 (see chart 7). Since 2022, however, housing starts reduced to pre-pandemic levels because of rising interest rates.

Chart 7

U.S. housing starts

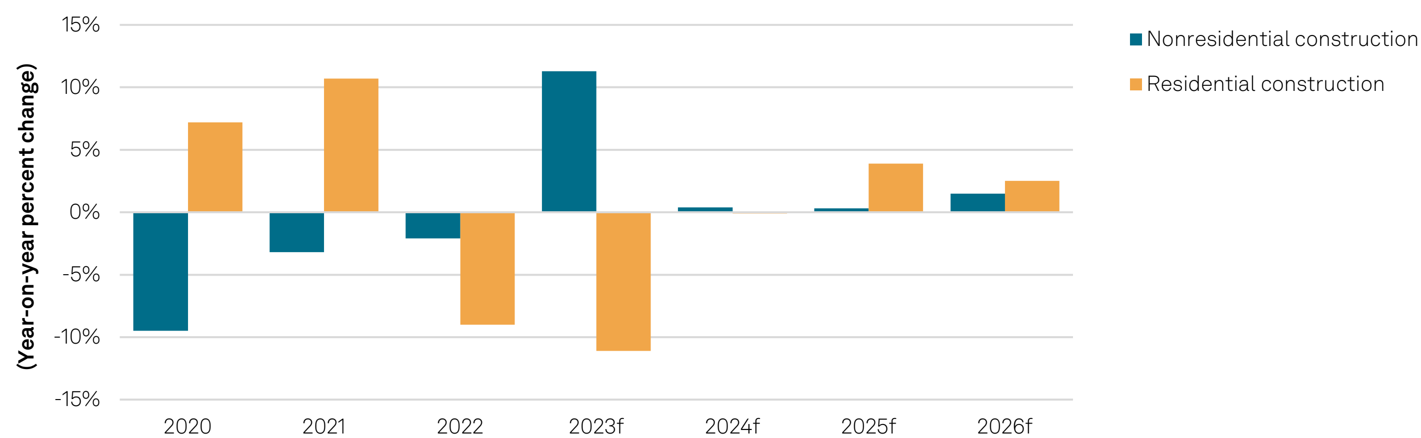


Note: Multifamily starts are housing starts of 5-unit structure. Data as of Oct. 2023. Source: Federal Reserve Economic Data.

Nonresidential construction will increase modestly in 2024, while residential construction will remain flat or decrease (see chart 8). We believe incentives, such as mortgage rate buydowns, help mitigate the negative effect of higher mortgage rates on housing demand and support residential sales. Similarly, the Biden administration's $1.2 trillion infrastructure bill will continue to support nonresidential investments, which will have a modest effect on the market in 2024. However, residential and nonresidential construction forecasts are notably bleaker because the sector still suffers from persistently high inflation and interest rates.

Chart 8

U.S. nonresidential and residential construction forecast



f—Forecast. Source: S&P Global Ratings Economics, Economic Outlook U.S. Q1 2024: Cooling Off But Not Breaking.

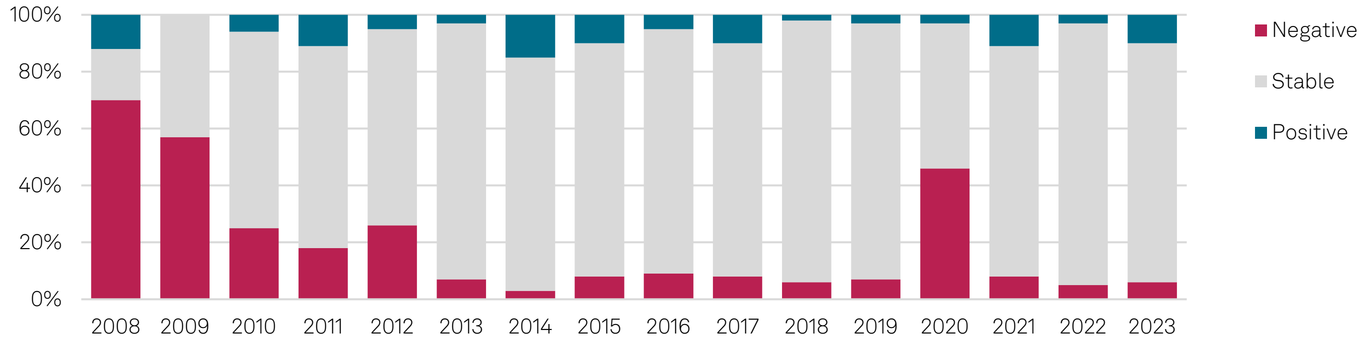
Credit metrics and financial policy

We anticipate an increase in competition will limit pricing power and, together with absorbing fixed costs, could lead to ongoing pressure on margins and earnings. However, tailwinds from nonresidential investments, repair and remodel spending, and new residential building activity will persist in 2024, albeit to a lesser extent than in recent years.

The outlook bias is slightly more positive than in 2022 (see chart 9). It reflects some issuers' ability to keep key credit metrics stable through the cycle and generally stronger credit metrics that resulted from strong financial results in recent years.

Chart 9

U.S. building material companies outlook distribution



Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Interest rates and cost inflation could strain consumer spending and reduce earnings

Slowing demand for home repairs and construction amid persistent cost pressure would likely limit pricing power and put pressure on margins. Unfavorable price-cost mixes, sticky inflation in commodities, and high labor and delivery costs could result in weaker-than-expected earnings and cash flows.

2. High interest rates will increase refinancing risks for speculative-grade issuers

The debt of many speculative-grade issuers is priced at historically low interest rates. As the Fed increases its benchmark rates, we expect issuers will face an increase in their interest expenses and thus a reduction in their interest coverage metrics. On the plus side, most issuers do not have any significant debt maturities before 2025.

3. Slower growth in new construction and a sharper decline in remodel spending could lower revenue and earnings

While we believe home buyers adjust to higher mortgage rates and the demand for new homes is resilient so far, the full effect of higher-for-longer interest rates is still uncertain. A sharper-than-expected decline in the demand for homebuilding or renovation could put pressure on issuers that are more exposed to these segments.

Increased inflation is a risk to our base-case assumption. Most building material companies' margins already suffer from higher raw material prices. If higher interest rates and, with that, higher inflation persist, companies may find it more difficult to pass on costs to consumers. If they did, sales would most likely decrease and margins would drop below our base-case expectations. This could result in negative rating actions, especially for companies with significant exposure to discretionary consumer spending.

Aggressive financial policies remain among the main risks to ratings. Both private equity-owned and listed companies demonstrated aggressive debt-funded activities. While these activities took advantage of cheap debt, many did not deliver the expected credit benefits, resulting in lower credit ratings. Historically, the deterioration concentrated only on low-rated, high-risk issuers. Our downgrade of Stanley Black & Decker Inc. (A-/Negative/A-2) in August this year indicates that investment-grade issuers are also affected now. Expectations of lower growth and prolonged higher interest rates in 2024 increase the likelihood of more issuers turning to similarly aggressive financial policies, which could lead to credit deteriorations.

Industry Outlook: EMEA

Ratings trends and outlook

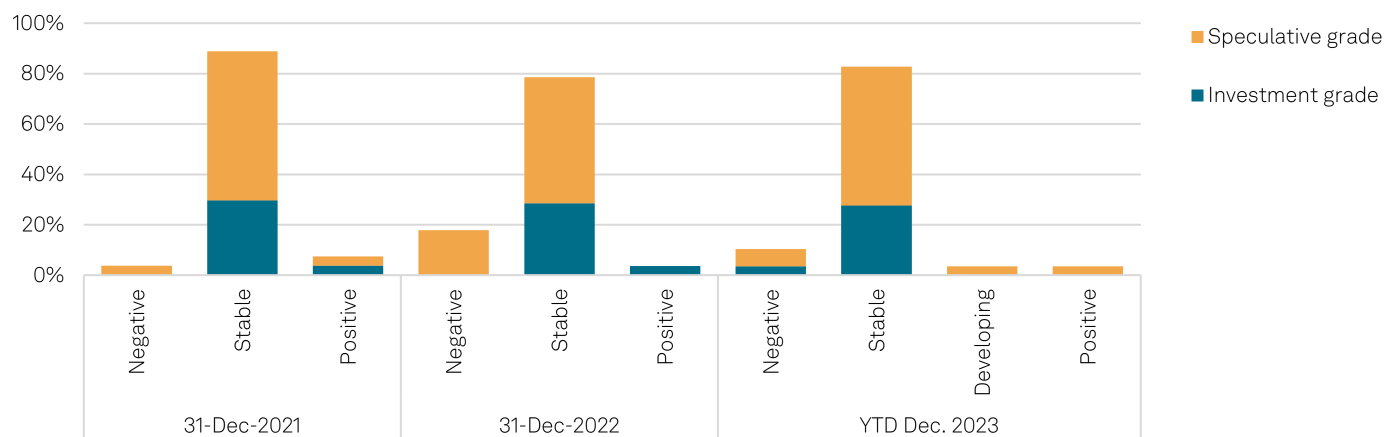
The European building materials sector suffers from a pronounced downturn in residential construction, particularly of new buildings, because increased mortgage rates and still-high construction costs reduced demand. We do not anticipate a rebound before 2025. At the same time, civil engineering remains solid on the back of large infrastructure fundings and projects.

EBITDA margins improved modestly in 2023, thanks to a positive price-cost gap, but companies' ability to increase selling prices will reduce significantly in 2024. The rating headroom that building materials companies built after the pandemic decreases. Still, about four-fifths of rated companies display a stable outlook (see chart 10). Negative outlooks reduced to 10% in December 2023, from 18% in December 2022. Even so, the negative outlook bias persists, indicating that negative rating actions should exceed positive ones in 2024.

We believe speculative-grade companies are more exposed to downgrades, given their weaker business diversity and limited financial flexibility. Rating headroom for investment-grade companies remains sound, with a few exceptions. We believe financial policies will continue to determine companies' creditworthiness and our ratings, both in the investment-grade and the speculative-grade category.

Chart 10

European building materials outlook distribution



YTD—Year to date. Source: S&P Global Ratings.

Main assumptions about 2024 and beyond

1. Volumes will continue to reduce or stagnate in most segments, apart from civil engineering.

According to Euroconstruct, the European construction outlook remains gloomy in 2024, especially in the Nordics, Italy, the U.K., and Germany. Growth should resume only in 2025. Most volume contraction is in new residential construction and residential renovation. Nonresidential building construction should stagnate until 2024. In contrast, volumes in civil engineering increase, thanks to investments in low-carbon energy and infrastructure renovation.

2. EBITDA margins will stabilize in 2024.

This follows a rebound in 2023, after the inflation-reduced drop in 2022. Raw material cost and energy disinflation over the past few quarters reduced companies' ability to increase selling prices, meaning companies may need to reduce their costs to offset lower volumes and protect their margins. Still, we anticipate pricing discipline will persist in the market.

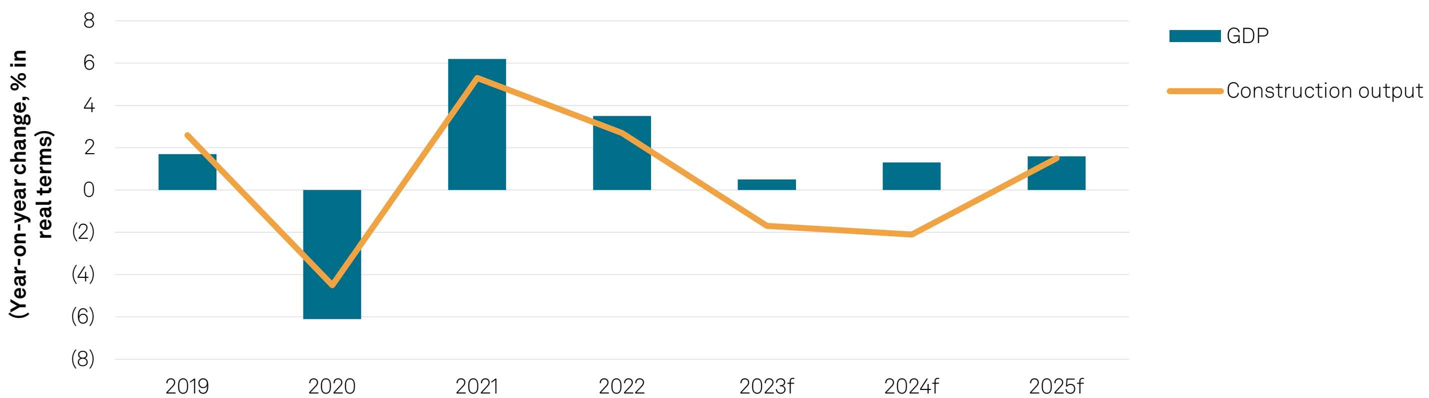
3. Capex plans remain broadly unchanged.

Despite weakened business confidence, most companies' capex remained unchanged or even increased in 2023. We anticipate an increase in capex of about 10% in 2023 and 5% in 2024. Most building materials companies prioritize investments in business segments with higher growth potential and less climate transition risk. Cement companies continue investments to meet their 2030 carbon reduction targets.

The economic and operating environment in the European construction sector remains gloomy in 2024. This largely reflects the sharp rise in interest rates and construction prices, persistently high inflation, households' reduced purchasing power, and falling property prices. Consumer spending continues to stagnate while business confidence remains weak, undermining any chance of a strong GDP rebound. According to Euroconstruct, construction output should contract by 2.1% in 2024, after a decrease of 1.7% in 2023, and rebound moderately in line with GDP growth over 2025-2026 (see chart 11).

Chart 11

GDP and construction output in Europe (EC -19, % change)



f—Forecast. Sources: Euroconstruct, S&P Global Ratings.

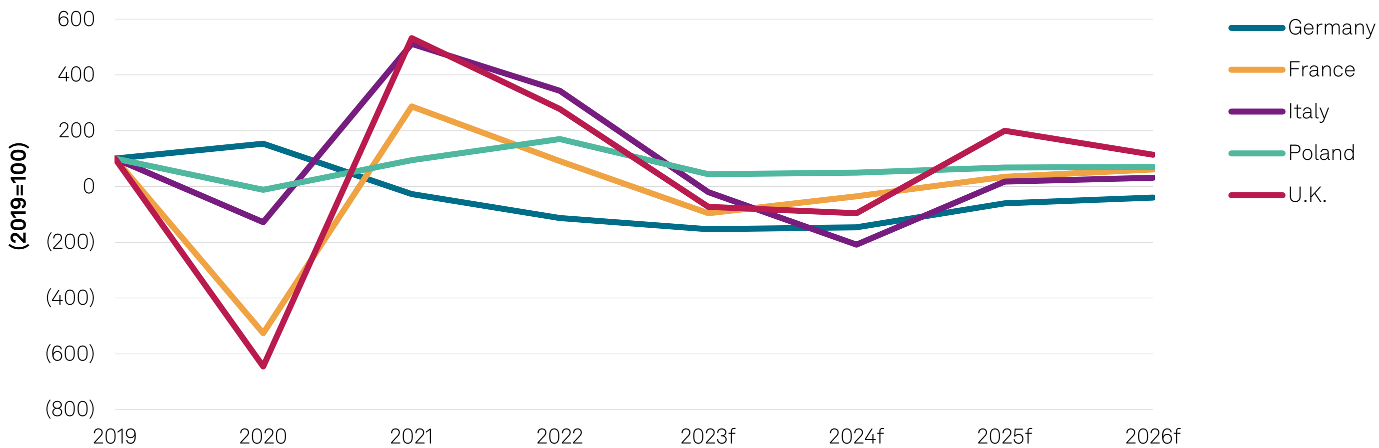
Most of the drop in contraction still relates to the new residential sector, where housing permits remain at a depressed level. The residential building renovation sector, which grew strongly over 2021-2022, will also experience a contraction over 2023-2024. According to Euroconstruct, the market volume of residential construction will reduce by 10% over 2023-2024. Nonresidential building construction should also stagnate until 2024. In particular, the commercial real estate segment suffers from the growing uncertainty about the future of hybrid work practices.

Civil engineering and industrial construction should continue benefiting from investments in low-carbon energy production, energy distribution, and transport networks. This follows the implementation of the NextGenerationEU strategy. Companies offering light products in heating, ventilation, air conditioning, and electricity (including cables and installation materials, lighting, automation, data, and safety products) should experience a lower drop in volumes than companies that offer heavy building materials.

Business conditions are more challenging in the Nordics, Italy, the U.K., and Germany. Volumes in the building materials sector should reduce further in 2024 and rebound modestly in 2025. Construction volumes should drop in most European countries in 2024, driven by the residential sector (see chart 12). We expect some recovery only in 2025. The contraction should be more pronounced in Italy and the Nordics, where the combined drop of the residential sector over 2023-2024 will exceed 20%. The residential sector in Italy performed best over in 2021-2022, with a cumulative growth of about 30%. This was because of generous tax incentives to the residential renovation segment during the pandemic. The current downturn reflects the reduction of these incentives, on top of increased interest rates and high construction costs. However, the residential sector should contract in most countries, including the U.K. (-11%), Germany (-7%), and France (-5%).

Chart 12

Construction output by country (EC -19, index, 2019=100)



f—Forecast. Sources: Euroconstruct, S&P Global Ratings.

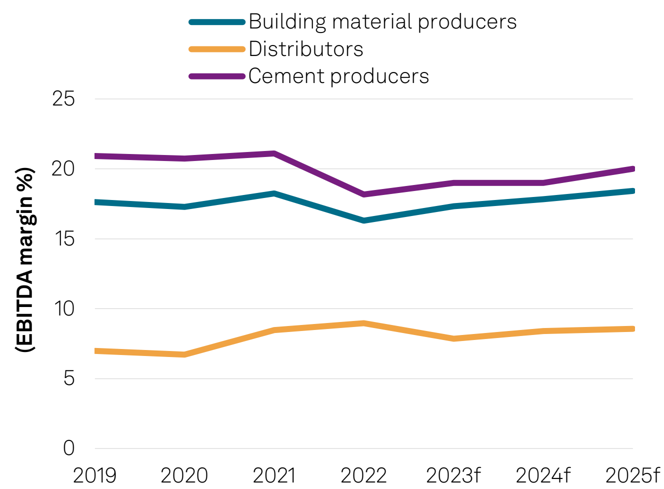
We expect EBITDA margins will be broadly stable in 2024 and improve modestly in 2025 (see chart 13). Margins remain below 2021 levels. Raw material cost and energy disinflation over the past few quarters reduced companies' ability to increase selling prices. As such, companies shift their attention to their cost base to increase efficiency and cost synergies, offset lower volumes, and protect margins.

We anticipate pricing discipline will persist in the market. Building material companies were able to pass on cost inflation to clients over 2022-2023, reflecting both supportive demand and strong pricing discipline. Absolute EBITDA has swiftly recovered from the pandemic and even expanded due to M&As, particularly in the case of private equity-owned distributors (see chart 14). We expect some volume rebound will improve margin modestly in 2025, largely due to better operating leverage.

Raw material cost and energy inflation has eased significantly in 2023 after a peak in 2022, reflecting a globally weakened demand. For example, spot prices on the Title Transfer Facility (TTF) of natural gas, a key energy source in some building materials segments, have dropped significantly since the third quarter of 2022 and averaged below €50 since the second quarter of 2023. Price volatility reduced significantly. Yet, natural gas prices remain about 2x higher than they were before the pandemic, while persisting geopolitical tensions could translate into renewed volatility in the winter season.

Chart 13

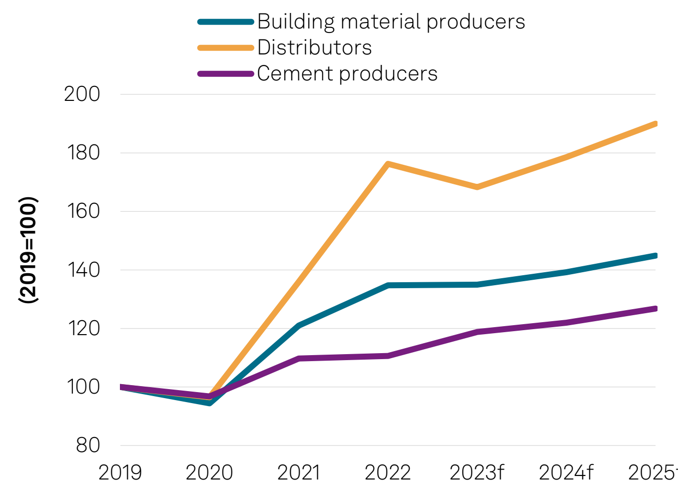
Adjusted EBITDA margin



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

Chart 14

EBITDA trend (index 2019=100)



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

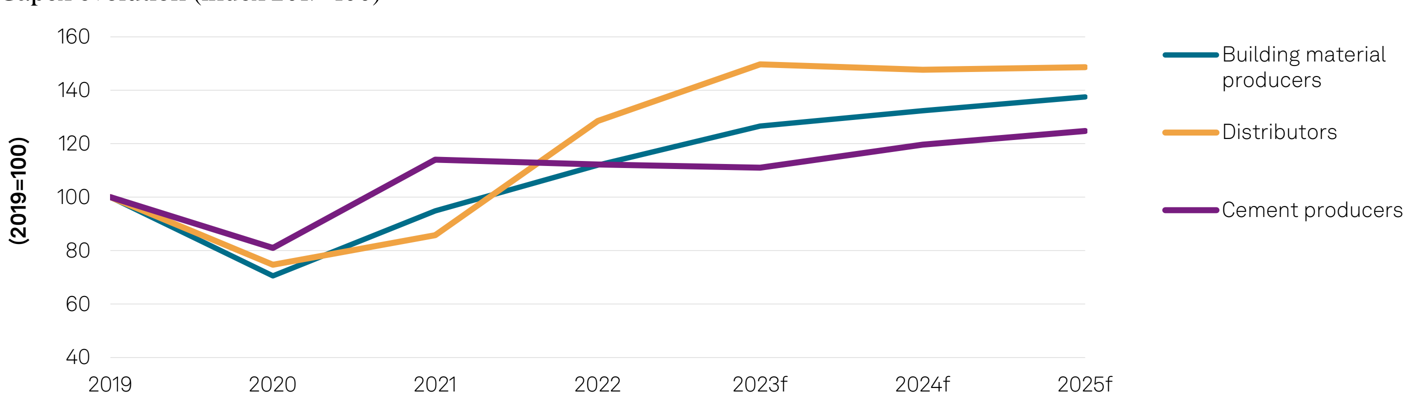
Among other relevant raw materials in the sector, copper, steel, and aluminum wholesale purchase prices have normalized, compared with the peak in 2022. Yet, they remain above pre-pandemic levels because of additional demand resulting from infrastructure renovations, energy efficiency renovations, and digitalization.

We estimate that building materials companies' energy bills, on average, modestly decreased in 2023, compared with 2022, when they increased an average of 50% from 2021 levels. Less hedged companies benefited more from lower spot energy prices in 2023, compared with 2022, and their profitability margins could benefit from a temporarily larger gap between selling prices and costs. However, most Europe-based building materials companies have significant operations outside the continent, where the pressure on energy bills is comparatively lower.

Despite weakened business confidence, most companies' capex remained unchanged or even increased. We anticipate an increase in capex of about 10% in 2023 and 5% in 2024 (see chart 15). Climate transition continues to drive capital allocation. This is the case for cement manufacturers, who invest to reduce their carbon footprint and meet their 2030 carbon reduction targets, and light-side companies that enlarge their product offering to meet the demand for energy efficiency improvements.

Chart 15

Capex evolution (index 2019=100)



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

Climate transition risk is at the core of cement companies' capital allocation. Cement companies assign an increasing share of their maintenance capex to improve plants' thermal efficiency and cut carbon dioxide (CO_2) emissions. Investments relate to increasing the use of alternative fuels or biomass, decreasing clinker content, and accelerating process innovation.

We estimate investments associated with reaching 2030 CO_2 reduction targets account for a large part of European cement companies' yearly maintenance capex. Some companies switch to other building products, which helps reduce their consolidated carbon intensity. The most tangible example is Holcim, whose growth strategy focuses on increasing its share of value-added products and strengthening its environmental credentials by moving away from the core cement business.

Credit metrics and financial policy

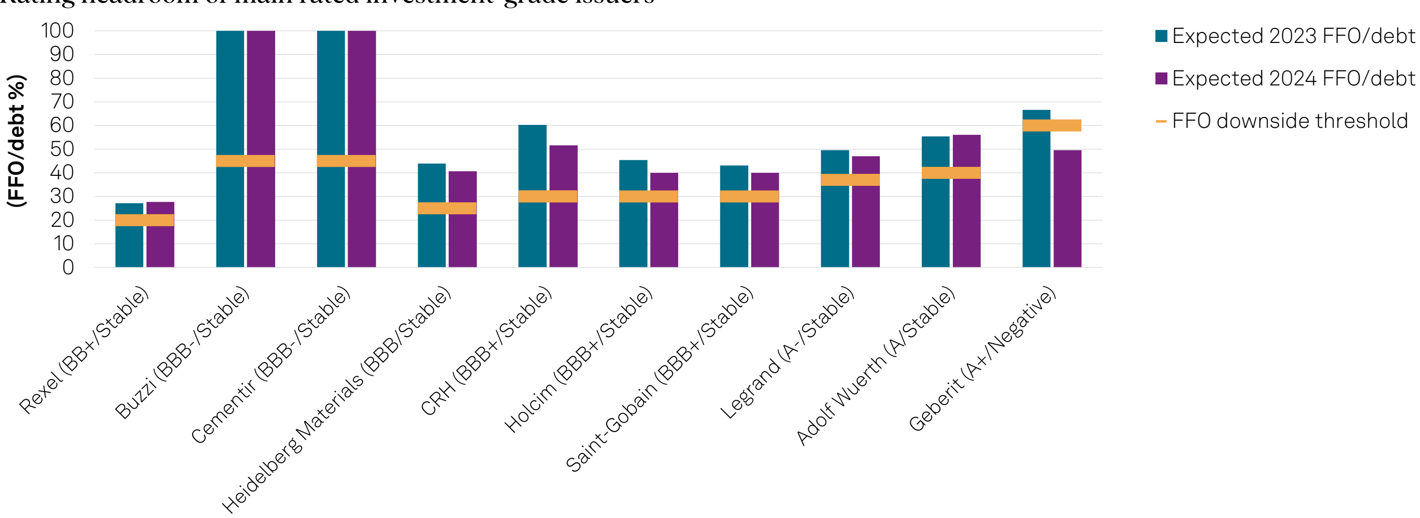
The building materials sector recovered swiftly from the COVID-19 pandemic, benefiting from very strong end-market demand. It started 2023 with, on average, solid rating headroom, with a few exceptions in the speculative-grade category. The drop in volumes in residential real estate construction in 2023 did not translate into a significant weakening of credit metrics for companies that are also active in commercial real estate and civil engineering. This is because these companies could still leverage price increases, while their operating cash flows benefited from reduced cash absorption related to working capital.

Most companies in the investment-grade category benefited from price increases and solid cash flow. In April 2023, for example, we raised our rating on Saint-Gobain to 'BBB+' from 'BBB' to reflect the company's continued solid performance, which enabled it to absorb sustained heavy spending and investments while maintaining strong credit metrics.

Currently, most investment-grade issuers' rating headroom remains unchanged or has reduced modestly (see chart 16). One notable exception is Geberit AG (A+/Negative/A-1), for which we revised the outlook on the long-term rating to negative from stable in November 2023. The outlook revision reflects that the company continues its generous shareholder returns despite a soft environment in the sanitary market. We forecast that median S&P Global Ratings-adjusted leverage of investment-grade issuers will increase modestly to 1.6x in 2024, from 1.4x in 2023.

Chart 16

Rating headroom of main rated investment-grade issuers



Note: FFO-to-debt of Buzzi and Cementir is expected to be above 100%. Source: S&P Global Ratings.

Investment-grade companies' shareholder remuneration remains generous. Share buybacks increased further in 2023, leading to record shareholder remuneration. We expect shareholder remuneration will decrease slightly in 2024, largely due to less share buybacks. We anticipate that investment-grade companies with solid rating headroom will continue pursuing M&As.

Most sponsors in the speculative-grade category have taken a conservative approach since early 2023 to protect companies' credit metrics. We have not seen any announcements of shareholder remuneration or large new acquisitions. That said, speculative-grade issuers' credit metrics deterioration has been more pronounced than investment-grade issuers', largely due to the former's lower business and geographical diversification, particularly in the 'B' category.

We lowered some ratings, largely on the few companies that entered the business downturn with limited rating headroom and that suffered from lower business volume and cash flow generation. Yet, we also upgraded some companies in the 'BB' category to reflect resilient operating performance in some business segments, such as electrical distribution.

We understand most private equity-owned companies will focus on deleveraging in 2024. We therefore believe an increase in financial leverage because of acquisitions or shareholder remuneration will be unlikely over next few quarters, unless business recovery is tangible. We forecast that median adjusted leverage of speculative-grade issuers will remain at about 6x in 2024. We also anticipate that median free operating cash flow (FOCF) will modestly improve in 2024, versus 2023, due to lower working capital cash flow absorption and despite higher interest costs. Yet, FOCF will remain below 2019 levels.

Sector regulation update

Several key regulations to cut carbon emission came into force in the EU in 2023. We anticipate this momentum will continue in the coming years.

In March 2023, the European Union Council adopted key pieces of legislation on 2030 climate targets. The legislation will enable the EU to cut greenhouse gas emissions within the main sectors of the economy, while making sure the most vulnerable citizens, micro-enterprises, and sectors exposed to carbon leakage are well equipped to navigate the climate transition. The laws are part of the "Fit for 55" program, which aligns the EU's policies with its commitment to reduce net greenhouse gas emissions by at least 55% by 2030 compared with 1990 levels, and to achieve climate neutrality by 2050. The new pieces of legislation that are most relevant for the building material sector include:

- EU Emissions Trading System (EU ETS): A carbon market based on a system of cap-and-trade of emission allowances for energy-intensive industries, including cement, power generation, and aviation. The new rules increase the overall ambition of emission reductions by 2030 in the sectors covered by the EU ETS to 62%, compared with 2005 levels.
- Carbon Border Adjustment Mechanism (CBAM) concerns product imports in carbon-intensive industries, such as cement. The objective of CBAM is to ensure--while fully complying with international trade rules--that the EU's greenhouse gas emission reduction efforts are not offset by an increase in emissions outside the EU. This could result from the relocation of production to countries where climate change policies are less ambitious than those in the EU or an increase in imports of carbon-intensive products. The CBAM will apply only as a reporting obligation until the end of 2025. CBAM will be introduced gradually, while free allowances for sectors covered by the CBAM, including cement, aluminum, iron, and steel, will be phased out over 2026-2034. CBAM promotes the import of goods by non-EU businesses, which fulfil the high climate standards applicable in the 27 EU member states, into the EU. This will ensure a balanced treatment of such imports and encourage others to join the EU's climate efforts.

RePowerEU is a key framework to finance energy renovation, including carbon capture, usage, and storage (CCUS) technologies. The adoption of the EU Green Deal, the Climate Law, and the subsequent proposals to increase energy and climate targets for 2030 made carbon capture and storage technologies an important part of the EU decarbonization effort in hard-to-abate sectors, such as cement.

In 2023 there was a recast of the Energy Performance of Building Directive, aiming to accelerate building renovation rates, reduce carbon emissions and energy consumption, and promote the uptake of renewable energy in buildings. It would introduce a new EU definition of a "zero emissions building," applicable to all new buildings from 2027 and to all renovated buildings from 2030. The directive would provide a significant boost to companies whose products target building energy efficiency, such as insulation.

Key risks or opportunities around the baseline

1. Further reduction in demand and inability to keep prices would impair credit metrics.

Revenue and profitability could reduce further if construction cost inflation does not ease and housing materials become too expensive, leading to lower demand, which could spread to commercial end-markets. We understand that building materials producers are not willing to decrease prices and profitability, which would lead to lower volumes sold.

2. The building materials sector is benefiting from long-term megatrends.

The sector faces several megatrends, such as decarbonization, digitalization, a boom in infrastructure investments, and aging housing stocks. We see decarbonization primarily as a risk for ratings in the sector, while the other megatrends could be opportunities. We believe investment-grade companies, which display solid business diversification and higher capex capacity, are more likely to benefit from these trends.

3. More aggressive financial policies could lead to negative rating actions.

Rating pressure may arise if shareholder remuneration remains high, especially in a context of weak demand and declining volumes. Debt-funded acquisitions may also constrain credit metrics. Private equity-owned issuers remain exposed to dividend recapitalization and highly leveraged capital structures with rising interest expenses.

Demand contraction tests issuers' pricing power and cost flexibility. Demand from end-markets started to decline in 2022. Some issuers retained a good level of activity but that was partly due to their existing backlog. However, activity in the residential building end-market in Europe has materially contracted in 2023, on the back of rising interest rates and rising building materials product prices. We do not expect a recovery before 2025.

It will take some time before companies rebuild their order books, new building projects resume, and financial results recover. So far, commercial end-markets have been relatively resilient. However, recession risks could threaten retail and hospitality. Should the market decline be more prolonged and noticeable than we expect, profitability margins, free cash flows, and financial leverage could weaken.

Companies may struggle to implement additional price initiatives and maintain their profitability in 2024. This stands in stark contrast to 2022, when issuers could pass on raw materials inflation. In 2023 some companies started to reduce selling prices, and some also mothballed or permanently closed parts of manufacturing facilities. Therefore, the ability to adapt the cost base to the current downturn will be key for issuers. And we expect companies will continue facing wage inflation.

Several issuers are well positioned to benefit from long-term megatrends. We have identified several megatrends that will likely benefit the building materials sector in the medium to long term:

- Several infrastructure plans will boost activity over the coming years, both in the U.S. and in Europe. In 2021 the U.S. Senate approved the $1.2 trillion infrastructure package, which includes $550 billion in new investments in roads, bridges, power grids, water infrastructure, and broadband, among others. In Europe, NextGenerationEU also contains investments in infrastructure. Many important projects are already ongoing, such as Grand Paris in France and HS2 in the U.K. The onshoring of key industries, such as semiconductors, will also support the demand for building materials. We expect higher revenue growth for issuers exposed to the infrastructure market, such as cement producers and some general building materials manufacturers.
- We also see opportunities from aging housing stocks and renovation needs to meet sustainability targets in the U.S. and Europe. The latter will come with more energy-efficient products, such as insulation panels, heat pumps, and new windows. Regional and European plans, such as the European energy efficiency directive and the French national recovery plan, will support the transition. Companies such as Saint-Gobain, which provide energy efficient products, are well positioned to benefit from the trend.
- Building materials companies must prepare for an increasing use of digital tools and services for customers and in-house processes. Digitalization can help reduce delays, improve know-your-customer initiatives, and increase efficiency and profitability. We believe connected products and the internet of things will be growth areas in the coming years. Companies, such as Legrand, that offer connected products, could show higher growth in this segment. In contrast, smaller companies that cannot invest in digitalization will likely lose some competitive advantages.

On the other hand, we see decarbonization primarily as a risk for ratings. The building materials sector, particularly cement companies, accounts for about 8% of global CO_2 emissions. Building materials producers face cost pressures because the EU's "Fit for 55" program will increase carbon costs significantly.

Annual carbon costs could account for, on average, 75% of EU cement companies' EBITDA, assuming a complete phase-out of allowances. Yet, cement substitution alternatives are limited and demand should remain steady. We monitor cement companies' ability to pass on higher carbon costs and note that issuers that invest less in carbon reduction innovation may suffer more.

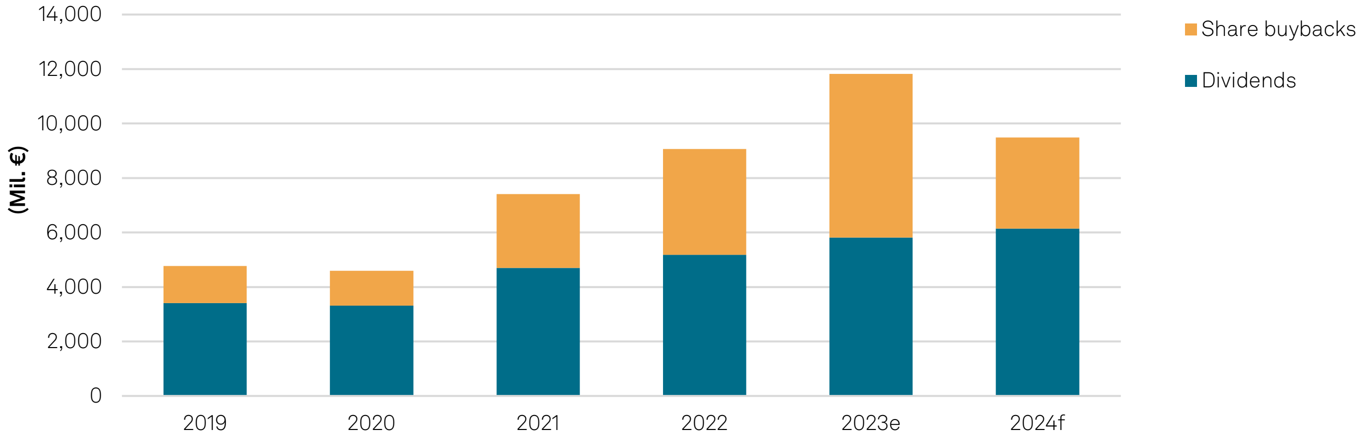
Shareholder-friendly financial policies could consume rating headroom and lead to a greater deterioration of credit metrics than we anticipate. Shareholder remuneration has significantly increased in recent years, on the back of solid results. While dividends of building materials issuers in the investment-grade category have increased by an annual average of about 12% since 2019, share buybacks more than tripled over the same period (see chart 17).

Aggregated share buybacks will reduce in 2024 as revenue and profitability normalize. In addition, some issuers should have completed their share buyback programs by the end of 2023 and in 2024. However, if issuers do not scale down shareholder remunerations, they could face tighter rating headroom. For example, we recently revised the outlook on the rating on Geberit AG to negative from stable as the company continues its generous shareholder remuneration.

Rating pressure could also stem from debt-funded M&As, which usually weaken companies' financial leverage. Private equity-owned issuers remain exposed to dividend recapitalization, while their capital structures are already highly leveraged. This is relevant in the context of rising interest expenses, which dent FOCF. Our base-case scenario does not factor in dividends or transformational M&As for private equity-owned companies because their size and timing are generally uncertain.

Chart 17

Largest European building materials companies' shareholder remuneration



e—Estimate. f—Forecast. Companies include Buzzi Unicem, Compagnie de Saint-Gobain, CRH, Geberit, Heidelberg Materials, Holcim, Legrand, Rexel, and Wuerth. Source: S&P Global Ratings.

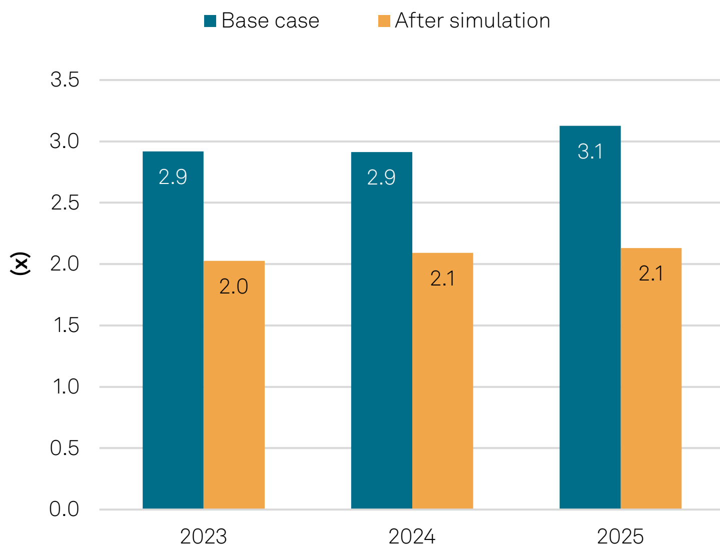
High interest rates impair the FOCF of European private-equity owned issuers, given these companies' weaker business profiles, highly leveraged capital structure, and weaker liquidity profile, compared with investment-grade companies. Since July 2022, the European Central Bank (ECB) increased interest rates 10 times, while the deposit rate increased to 4.0%, from negative 0.5%. As a result, borrowing costs for corporates rose materially. However, many speculative-grade companies have either fixed notes or debt hedges and suffer not yet from the negative effects of rising interest rates on credit metrics.

We applied a stress test to the 18 rated issuers in the 'B' and 'CCC' categories. The stress test assumes an immediate pricing of the existing debt capital structure at an interest rate of 9.5% for issuers in the 'B' category and 10% for issuers in the 'CCC' category. It does not assume any interest rate hedging. We found that the median EBITDA interest coverage would fall to 2.0x over 2023-2024, from 3.0x in our current base-case scenario (see chart 18).

Companies have comfortable headroom under their EBITDA interest coverage ratios in a low-rate environment, but this could change in light of high interest rates. We estimate that about 40% of issuers of the stress test sample could display either negative FOCF or interest coverage below 2.0x, which could put pressure on the ratings (see chart 19). Therefore, we believe the rise in interest rates will structurally damage speculative-grade issuers' free cash flows, which will not return to 2019-2021 levels. We will monitor companies that may report consistently negative free cash flows.

Chart 18

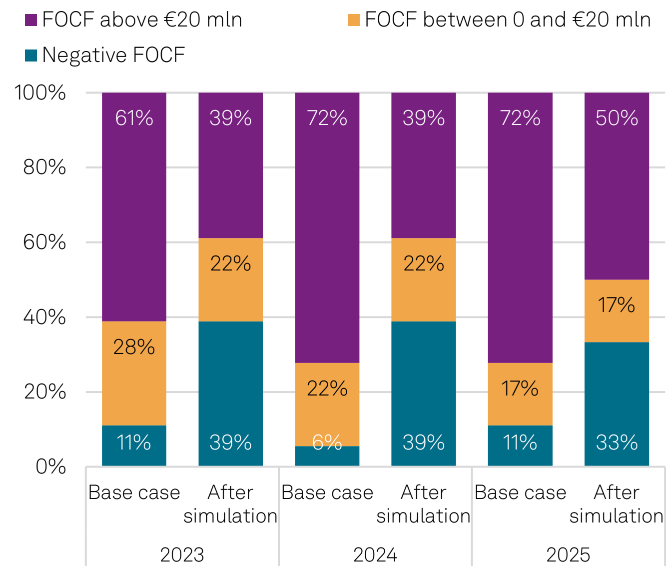
Median EBITDA interest coverage after stress test



Source: S&P Global Ratings.

Chart 19

Share of issuers with negative FOCF



Source: S&P Global Ratings.

About 20% of rated issuers in the 'B' and 'CCC' categories have fixed-rate debt instruments, with no imminent refinancing needs. This leads to stable interest expenses. In addition, most of the issuers with floating-rate debt instruments implemented either partial or full debt hedges, which also limit the increase in interest expenses. European speculative-grade issuers have limited refinancing needs before 2026. However, we expect interest rates (and therefore interest expenses) will be significantly higher when companies will refinance their debt. This will weaken their free cash flows if they do not reduce their debt amounts.

Industry Outlook: Latin America

Ratings trends and outlook

We expect credit quality for Latin America building materials companies will remain broadly stable through 2024 because close to 75% of rated entities have a stable outlook, while the remaining outlooks are positive. 22% of our rated issuers are currently investment grade and 78% are speculative grade, most of them in the 'BB' category.

Revenue growth will decelerate to close to 6% in 2024, compared with an expected 10% in 2023. This is because we now anticipate less pronounced price increases to ensure steady volume growth. We expect some recovery in residential investments and an uptick in nonresidential investments in Brazil and Mexico, the two largest economies in Latin America.

EBITDA margins will stabilize or modestly increase in 2024, driven by easing energy prices, inflation-induced price increase, and operating efficiencies. This, coupled with our expectation of continuously prudent financial policies, will lead to a slight improvement in credit metrics. Yet, several downside risks could affect our expectations for growth and operating margins:

- Economic and political risks remain high in Latin America and could weaken investor sentiments, reduce consumer spendings, squeeze companies' capacity to pass on costs increases, and undermine operating and financial performance beyond our current estimate if they materialize. In our view, policy predictability and investments in critical infrastructure will be key.
- External factors, such as geopolitical risks, are currently contained but could increase energy price volatility and impair operating margins and credit metrics. Nonetheless, we believe most of our rated issuers have some degree of financial flexibility in terms of leverage and liquidity buffers to withstand adverse business conditions and higher investments in capex and M&As without damaging their credit profile.

Proactive decarbonization strategies are an opportunity to prevent longer-term operating and financial risks. So far, CO2 regulations in Latin America are limited.

Most of the rated building materials issuers in Latin America generally maintain extended debt maturity profiles, with no refinancing risk in 2024. However, speculative-grade issuers remain more vulnerable to longer periods of high interest rates, refinancing risks, and sticky inflation.

Main assumptions about 2024 and beyond

1. Softer economic activity and prices will decelerate revenue growth in 2024.

We forecast Latin American building materials companies' revenue will increase by 6% in 2024, from an expected 10% in 2023. The increase will vary by country and benefit from a mix of volumes due to an uptick in public nonresidential investments, a still-high level of remittances for informal construction activities, and softer price increase versus 2023.

2. Easing input costs will stabilize operating margins.

Deflating energy costs, price adjustments in line with inflation, and operating efficiencies should stabilize or, in some cases, slightly improve operating margins, following a partial recovery in 2023, after a shortfall in 2022.

3. Credit metrics will improve modestly, supported by prudent financial policies.

Prudent financial policies and strong operating performance will lead to a modest improvement in Latin American building materials companies' key credit metrics in 2024. Some entities maintain strong liquidity positions and leverage leeway to increase investments and shareholder remunerations without damaging their credit profile.

Our updated forecast for 2024 suggests softer growth prospects for Latin American building materials companies, although business conditions will continue to vary across countries. For 2024, we expect real GDP growth of 1.2% for the region, although this will vary across countries.

- **The Brazilian economy will expand by 1.5% in 2024,** versus 1.2% previously projected, driven by continued--albeit diminishing--fiscal support. We think business conditions for building materials companies will be more supportive in 2024, thanks to higher-than-expected GDP growth and lower interest and inflation rate expectations, which should bolster a recovery in residential investments, as well as public and private nonresidential investments, especially toward the second half of 2024.
- **The Mexican economy will expand by 1.8% in 2024,** after a surprisingly strong 2023, in line with U.S. GDP growth expectations. In our view, Mexico's building materials sector will continue to benefit from robust remittances that support informal housing and home improvements and from the recent sharp uptick in public nonresidential investments. Yet, we lowered our GDP growth estimates for 2024 for other Latin American countries, such as Argentina, Peru, Colombia, and Chile.
- **GDP in Argentina will contract for the second year in a row in 2024.** This suggests difficult business conditions for building materials companies, at least during the first half of 2024 as the outlook is highly uncertain due to the fiscal and exchange rate adjustments that are likely under the next administration.
- **The Peruvian economy will grow just above 2% in 2024,** after relatively flat growth in 2023. We expect demand for cement will grow in line with economic activity, after the normalization in 2023 and all-time highs over 2021-2022.
- **Fixed investments in Colombia continue to contract.** Uncertainty over policies under the current administration will likely subdue investments through most of 2024.
- **We lowered our 2024 growth outlook for Chile by 10 basis points (bps) to 1.9%.** Uncertainties about the new constitution continue to weigh on investor confidence.

Easing input costs will gradually stabilize operating margins, with only some room for further improvements. Following a reduction in EBITDA margins by an average of 210 bps in 2022 induced by input cost inflation, particularly for energy, electricity, and transportation costs, we expect building materials companies will stabilize their operating margins in 2024. This follows a solid partial recovery in 2023, thanks to companies' ability to pass on prices and a resilient demand.

Companies partially regained operating margins in 2023, thanks to significant local currency pricing increments that outpaced easing input costs. We believe building materials companies will pursue more cautious pricing strategies in 2024 to ensure volume growth. Thus, we predict that average EBITDA margins in the sector should stabilize by the end of 2024.

Credit metrics and financial policy

In recent years, Latin American building materials companies prioritized excess cash to reduce their net debt positions over large investments and shareholder remunerations. This enabled them to gradually deleverage their balance sheets, with average adjusted debt to EBITDA of 2.0x-3.0x.

We expect Latin American building materials companies will deliver steady operating performance and sustain their disciplined capital allocation strategies in 2024. Capital allocation strategies will be balanced between growth--through capex and potential acquisitions--with short-term paybacks and debt reductions. The latter will support deleveraging strategies, with adjusted debt to EBITDA inching toward 2x.

Rated companies with leverage leeway and solid cash reserves might increase capex and M&As, particularly in the U.S., to expand and diversify their operations. Even though some entities might slightly increase or resume dividend payments over the next few years, we do not expect a significant shift in financial policies. Finally, Latin American building materials companies' debt maturity profiles bear limited short-term refinancing risks.

Key risks or opportunities around the baseline

1. Economic and political challenges pose downside risks to our growth baseline.

We constantly monitor economic and political risks as they could impair investor sentiment, reduce consumer spending, squeeze companies' capacity to pass on cost increases, and undermine operating and financial performance beyond our current estimate.

2. Geopolitical tensions and adverse weather conditions could undermine our forecast.

Geopolitical events could increase energy price volatility, which, in turn, would undermine operating margin stabilization, cash flows, and credit metrics beyond our current estimate. More-extreme weather conditions could also disrupt construction activities, as seen in Brazil, Mexico, and Peru in 2023.

3. Proactive decarbonization investments can reduce operating and financial risks.

Carbon tax regulation is progressing slowly in Latin America but investments in the reduction of CO_2 emissions remain a priority for many issuers in the region. Several issuers have CO_2 reduction targets for 2030, which will require higher capex in 2024 and beyond.

Economic and political risks prevail in Latin America. These pose downside risks to our growth baseline for 2024. In our view, economic risks in the form of lower GDP growth, higher-than-expected inflation, and a prolonged period of tight financing conditions could impair investor sentiment, consumption trends, and companies' capacity to pass on cost increases. In the absence of sufficient countermeasures, these risks could, ultimately, reduce Latin American building material companies' operating and financial performance beyond our current estimates.

The risk of the U.S. economy facing a deep recession instead of a soft landing, which we currently expect, remains elevated. A recession would have significant negative implications for the global economy, particularly for Latin American countries that share strong economic ties with the U.S. On the other hand, a stronger-than-expected U.S. economy would be positive for Latin America but could increase interest rates, strengthen the U.S. dollar over the short term--which could increase inflation because of foreign exchange pass-through effects--and impair building materials companies' cash flows and credit protection measures. Finally, potential political instability after elections in 2023 and 2024 could undermine investment and impair growth prospects of the overall sector.

Geopolitical tensions and adverse weather conditions could undermine our growth forecast, prevent a stabilization in operating margins, and impair credit protection measures. The Israel-Hamas war increases already-elevated geopolitical risks and could reduce investments in emerging markets, such as Latin America. Moreover, energy prices could increase if the war intensifies and spreads across oil-producing countries in the Middle East.

Geopolitical events are major risks to our growth outlook for Latin American countries. They could hamper a continuous stabilization in operating margins, cash flows, and credit protection measures. In addition, unexpected severe weather conditions, as seen in Brazil, Mexico, and Peru in 2023, for instance, also pose latent downside risks to our forecast.

CO2 regulations remain limited in Latin America, but proactive decarbonization strategies could enable companies to prevent longer-term operating and financial risks. While the EU's "Fit for 55" program paves the way for a significant increase of carbon costs, CO2 regulations in Latin America remain limited at this stage. This may change, although the timing is uncertain for most countries in the region.

Many cement manufacturers in Latin America are proactively reducing their CO2 emissions. Among other things, they've expanded the use of biomass, optimized thermal efficiency at cement kilns, used low-temperature clinkers, increased the use of decarbonated raw materials in clinker, reduced the clinker factor in blended cement, and boosted clean electricity consumption. We consider budgeted investments for 2024 are manageable and will not deteriorate key credit metrics. Instead, these investment initiatives could become a crucial competitive advantage. Smaller players that make relatively slow progress in reducing emissions could suffer, particularly if regulations are enforced and become stricter.

Industry Outlook: Asia-Pacific

Ratings trends and outlook

The outlook on the ratings on all our rated building materials companies in Asia-Pacific (APAC) is stable. Our rated companies' leading competitive position in their respective countries and sufficient financial headroom should help them manage industry headwinds and keep their creditworthiness steady.

All ratings on the building materials companies in APAC remained unchanged in 2023, despite challenging operating conditions. This primarily indicates sufficient financial buffer and prudent financial discipline to offset demand uncertainty and profitability pressure.

Considering the slow recovery of China's property market, Chinese producers will likely endure another tough year. Demand for building materials will remain subdued after a sluggish 2023. Demand for building materials in South Korea will remain under pressure due to the weak domestic construction market. Despite volatile macro dynamics, the building materials industry in Australia continues to demonstrate resilience. We continue to see solid underlying demand for building products and good pipeline visibility.

Main assumptions about 2024 and beyond

1. Continuously high policy rate outside China impairs housing activity.

Given the pressure from higher-for-longer interest rates in the U.S., we expect no meaningful reductions in policy rates over the next six months. Yet, with core inflation continuing to ease, APAC's central banks are unlikely to tighten monetary policy again. Still high interest rates will continue to weigh on housing activity and therefore hamper demand for building materials.

2. Demand for building materials suffers from the slow recovery of the Chinese property sector.

A meaningful increase in demand in China will be unlikely in 2024 as the recovery of the Chinese property sector is slow and sequential. We expect weak demand and excess supply in lower-tier cities will cause an extended L-shaped recovery in property sales. Our base case assumes that sales in 2024 will decline by 5%, after a 10%-15% decline in 2023.

3. Rated companies will maintain prudent financial policies.

Despite their sufficient rating buffer, we expect our rated entities will maintain a disciplined investment appetite due to macro uncertainty. They are usually the industry leaders, with stronger balance sheets and minimal leverage. We believe these companies will adhere to prudent financial policies, balancing growth and keeping their existing credit quality steady at the same time.

In Australia, despite volatile macro dynamics, the building materials industry continues to demonstrate resilience. We continue to see solid underlying demand for building products and good pipeline visibility. Recent data from the Australian Bureau of Statistics shows a relatively stable dwelling approvals trend. Nevertheless, effects from tighter monetary policy through 2023 could lead to softer market conditions in 2024 and weaken the credit quality of companies that are more exposed to new constructions.

Industry cash flows and margins in Australia could be hindered by cost pressures, labor shortages, and rising interest expenses in 2024. We also expect the industry will focus on more aggressive cost-cutting and structural cost-saving initiatives to offset inflationary pressures.

The operating environment in China was challenging in 2023. Weaknesses in the property sector re-emerged in the second quarter and was exacerbated by the default of one of the country's largest private real estate developers. In the first 10 months of 2023, newly started housing constructions experienced a year-on-year decrease of 23.2%.

Chinese building material producers' financial performance may remain sluggish in 2024 because demand could continue to be weak. The sector may not recovery meaningfully in 2024 as it continues to suffer from the fragile recovery of the Chinese property sector. We expect the number of constructions will be low, which could hamper the recovery in demand for building materials.

Profits of cement producers in China continued to decline drastically over the first three quarters of 2023 because of low selling prices, even in light of moderating energy prices. Tightening requirements on production rationalization failed to stabilize prices, with the average price of the national cement market experiencing a year-on-year decline of 15.2% over the first three quarters of 2023.

The recovery of China's property sales will be L-shaped over the next two years. We forecast property sales may decline by another 5% to renminbi (RMB) 11 trillion-RMB11.5 trillion in 2024, after a decline of 10%-15% in 2023. This is mainly due to the sluggish property demand in China's lower-tier cities. The delayed new construction starts could translate into a prolonged low demand for building materials.

Increases in infrastructure investments could support the building materials segment in China. Yet, we expect infrastructure investments will ease in line with economic growth over the next two years, after increasing to high single-digits in 2023. The moderating growth momentum in 2024 also results from more disciplined spending due to an increasing focus on debt risk and investment sustainability.

We expect the demand for building materials in South Korea will remain under pressure due to the weak domestic property market. The domestic construction market will remain subdued in 2024 as construction companies remain selective in their orders and property transaction volumes are low. High interest rates are also likely to weigh down on sentiment in the property market. Potential risks associated with project financing loans and the weaker credit quality of small and midsize construction companies could represent additional downside risks.

Credit metrics and financial policy

We forecast credit metrics of our rated companies will remain resilient in 2024, versus 2023. The satisfactory competitive position and sufficient financial headroom of most rated building materials companies in APAC will help them manage demand and keep their creditworthiness steady. In 2024, we expect our rated universe's credit metrics should sit comfortably within their respective rating range.

The solid balance sheet of our rated issuers in China protects against a potential prolonged weakness in the demand for building materials. Margin recovery for Anhui Conch Cement Co. Ltd. (A/Stable/--) and Beijing New Building Materials Public Ltd. Co. (A-/Stable/--) could be gradual, even in case of moderating coal prices. Sluggish demand could continue to weigh on prices.

Our rated Chinese building materials producers' capex may remain sizable for business expansion, M&As, and investments in environment-related projects. Yet, their strong balance sheets will enable them to absorb spendings while keeping leverage low. We expect the issuers' financial policy will remain prudent because of industry headwinds. A deterioration in these companies' credit metrics is unlikely because they will refrain from aggressive expansions.

Our rated company in South Korea will likely maintain steady operating performance over the next two years. KCC Corp.'s (BB+/Stable/--) credit metrics could improve in line with its profitability. This is due to stabilizing raw material costs and its strong pricing power in the building materials business. KCC holds a leading position in South Korea's domestic building materials market and has the largest domestic market shares in coating and gypsum boards. Even so, KCC’s silicone business reported operating losses in 2023, which could weigh on its overall operating results over the next 12-24 months.

Our rated company in Australia maintains a strong balance sheet. This provides CSR Ltd. (BBB+/Stable--) with a material rating buffer to withstand softening building and construction activities in Australia. We anticipate the company's performance will be resilient in 2024, supported by the good short-term visibility of its sales. We also expect CSR will maintain strong free cash flows, which will support future capex for growth and property investments, as well as shareholder returns.

CSR also benefits from a conservative financial policy. Its adjusted leverage is below 1x since 2016. As of fiscal 2023 (year ended June 30), CSR has no interest-bearing debt on its balance sheet. In our view, this differentiates CSR from other investment-grade peers and provides the company with a sizable rating buffer to withstand industry shocks, without a material decrease in creditworthiness.

Key risks or opportunities around the baseline

1. Worsening property crisis in China slows demand recovery.

The Chinese building materials sector's downside risks largely result from the property sector. A further slump in the property sector will hit the resumption of construction activities. This could exacerbate the already challenging operating conditions in the sector, which struggles with low demand and a limited ability to pass on costs.

2. Moderating input costs could ease profitability pressure.

The pressure on profitability may start to ease as energy prices moderate after reaching peak level. The price of thermal coal, the major energy source and the key cost component for building materials producers, will reduce over 2024-2025.

3. Stricter environmental requirements will benefit industry leaders.

APAC lags Europe in carbon trading but more countries will likely introduce their own emission trading systems. The effect on the sector depends on the design of the schemes and carbon prices. Since our rated entities are generally industry leaders and generate less emissions than the industry average, they should fare relatively better than peers when a carbon tax is rolled out.

The Chinese building materials sector's downside risks largely stem from the property sector, which accounts for over one-third of the nation's cement usage. That said, we believe property sales are bottoming out. In our view, China's annual property sales could reach RMB10 trillion-RMB11 trillion in 2024. A decline in new property sales could prolong the decrease in new constructions and reduce demand for products and services from related downstream industries, including building materials and construction.

The pressure on margins will ease as energy prices decline. We expect thermal coal prices will moderate over 2024-2025 as demand in China, India, and other countries in Southeast Asia countries gradually peaks and demand from the EU and the U.S. declines. Thermal coal is the major energy source and the key cost component for building materials producers. Our price assumptions reflect our expectation that the global transition from coal-fired power generation will be protracted, as demonstrated by the current energy crunch.

Companies will continue to focus on managing costs through operational efficiencies, given inputs costs are still higher than average. The extent of recovery in profitability of Chinese players could lag its other APAC peers because the country's sluggish demand may keep prices low.

China's national carbon trading scheme was launched in July 2021 and currently only covers power producers. The government plans to also include other high-emission industries, such as building materials, steel, and petrochemicals. The effect of the national carbon trading scheme on cement producers is uncertain and depends on the government's allocation of carbon quotas and carbon prices, which are currently at about 10% of those in Europe.

Regardless of whether carbon quotas are allocated free of charge or at a cost, we believe our rated companies are better positioned than their peers. This is because their emissions are below the national average. Therefore, they are more likely to benefit from the introduction of carbon pricing because those that cannot meet national standards will likely shut down or be acquired by stronger players who can meet the standards.

Related Research

- Sanitary Plumbing Products Maker Geberit Outlook Revised To Negative On Weakening Credit Metrics; 'A+' Rating Affirmed, Nov. 27, 2023
- Credit FAQ: Tough Times Ahead for European Private-Equity-Owned Building Materials Distributors, Nov. 9, 2023
- SLIDES: EMEA Sector Update: Building Materials, Oct. 30, 2023
- Stanley Black & Decker Inc. Downgraded To 'A-' On Weaker-Than-Expected Performance; Outlook Negative, Aug. 23, 2023
- Compagnie de Saint-Gobain Upgraded To 'BBB+' On Strong Metrics Resilience; Outlook Stable, April 24, 2023
- Decarbonizing Cement Part One: How EU Cement Makers Are Reducing Emissions While Building Business Resilience, Oct. 27, 2022
- Decarbonizing Cement Part Two: Companies Could See Pressure On Ratings As The EU Firms Up Carbon Rules, Oct. 27, 2022

Industry Forecasts: Building Materials

Chart 20

Revenue growth (local currency)

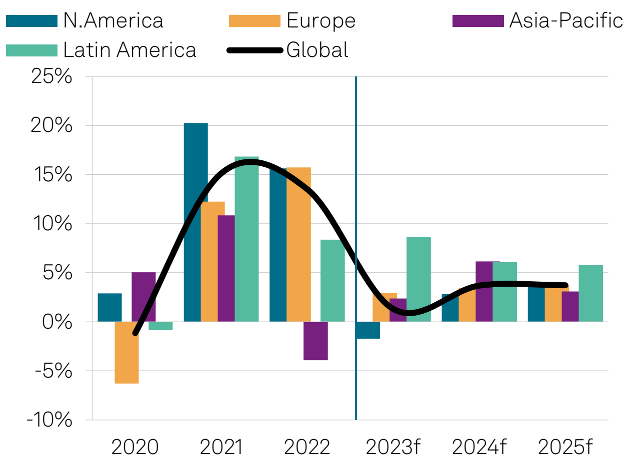


Chart 21

EBITDA margin (adjusted)

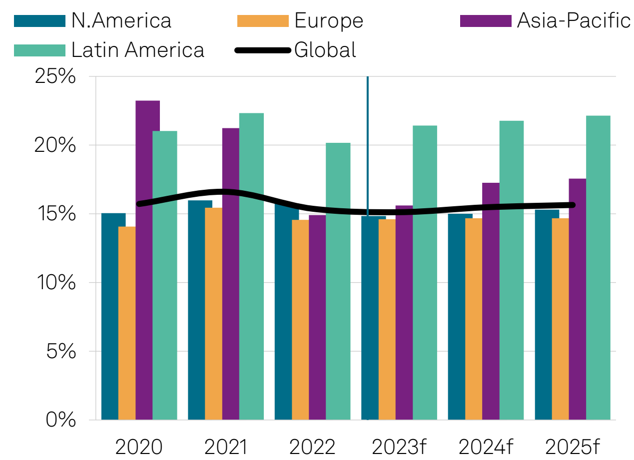


Chart 22

Debt / EBITDA (median, adjusted)

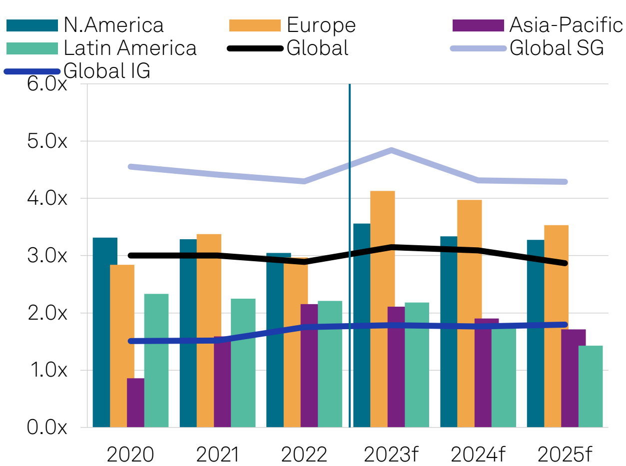
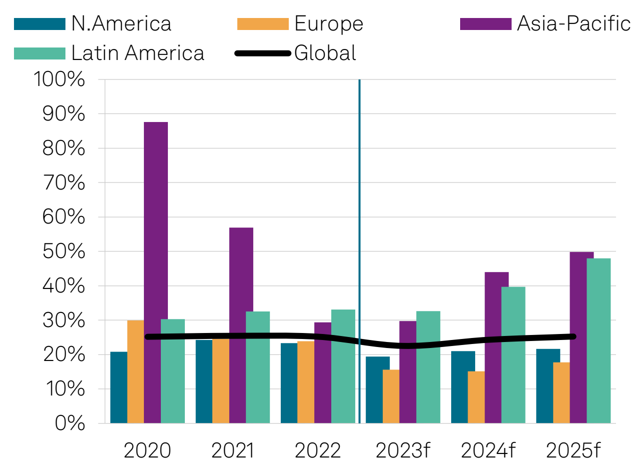


Chart 23

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: Building Materials

Chart 24

Cash flow and primary uses

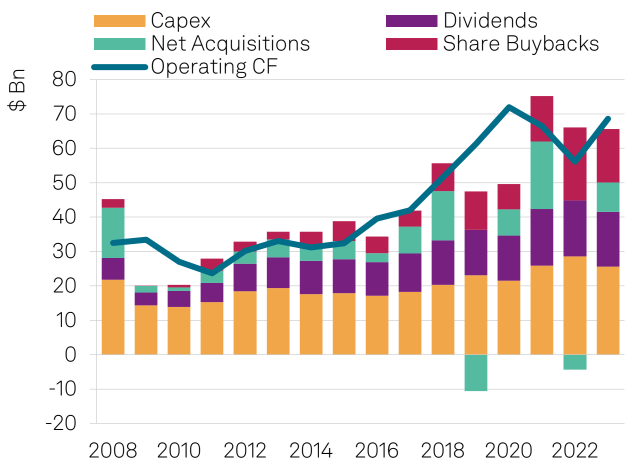


Chart 25

Return on capital employed

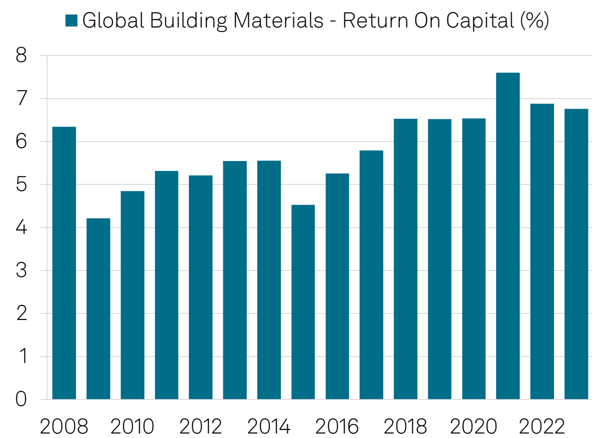


Chart 26

Fixed- versus variable-rate exposure

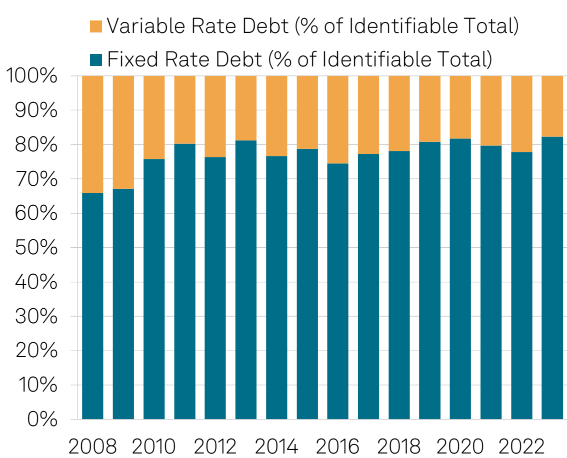


Chart 27

Long-term debt term structure

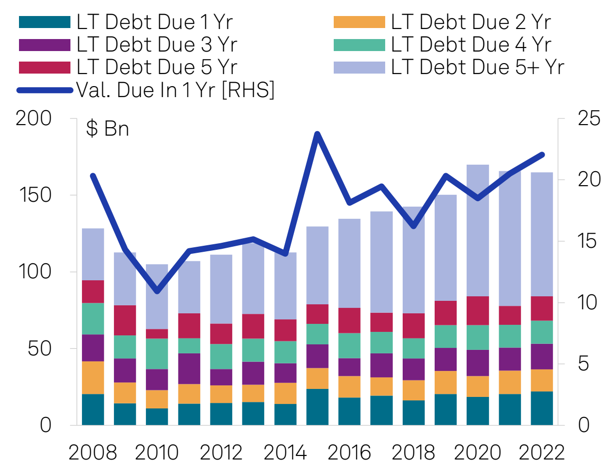


Chart 28

Cash and equivalents / Total assets

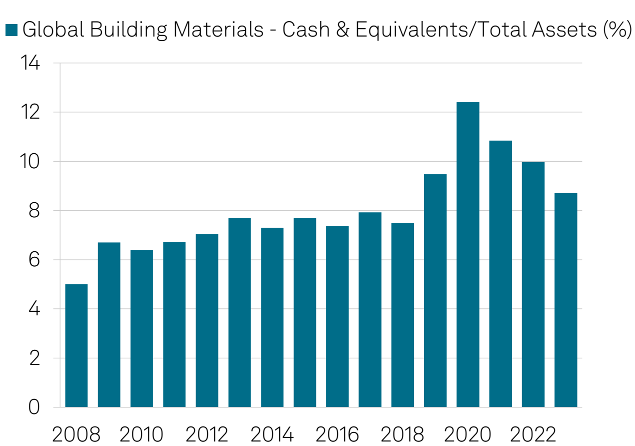
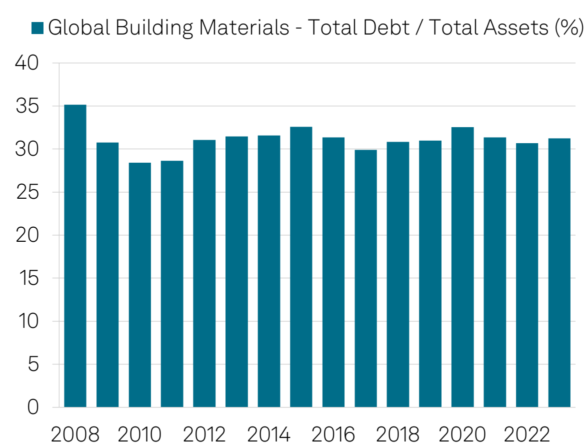


Chart 29

Total debt / Total assets



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

Capital Goods

Megatrends and megaprojects ease a cyclical downturn

January 9, 2024

This report does not constitute a rating action.

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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.

Ratings Trends: Capital Goods

Chart 1

Ratings distribution

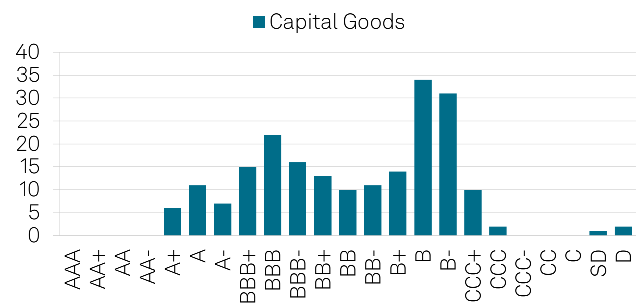


Chart 2

Ratings distribution by region

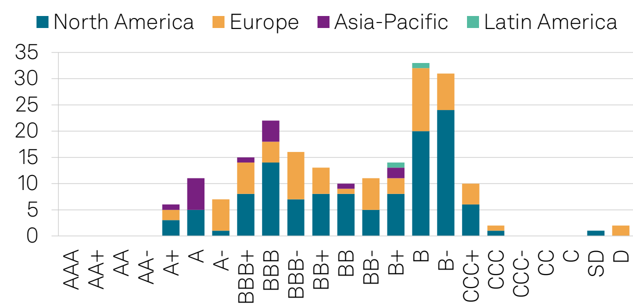


Chart 3

Ratings outlooks

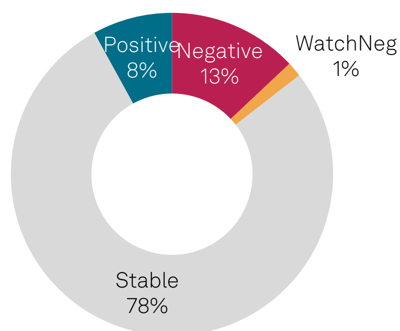


Chart 4

Ratings outlooks by region

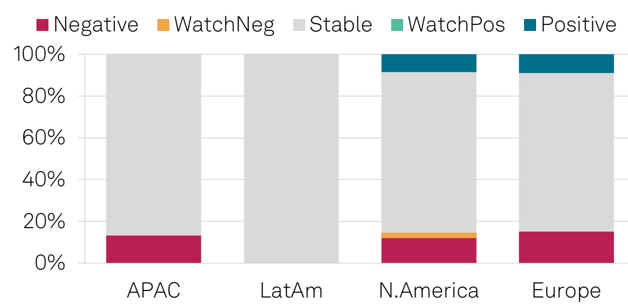


Chart 5

Ratings outlook net bias

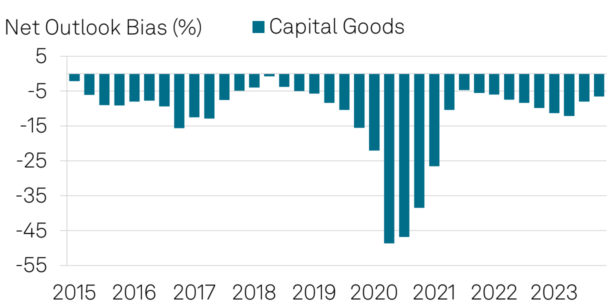
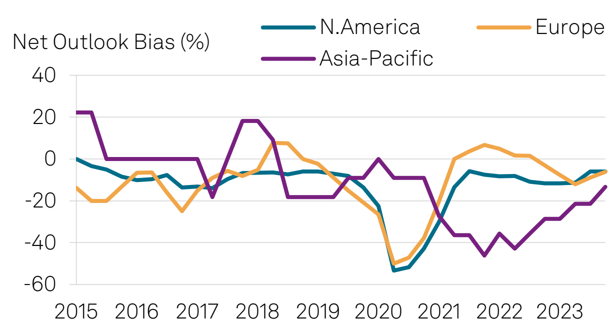


Chart 6

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.

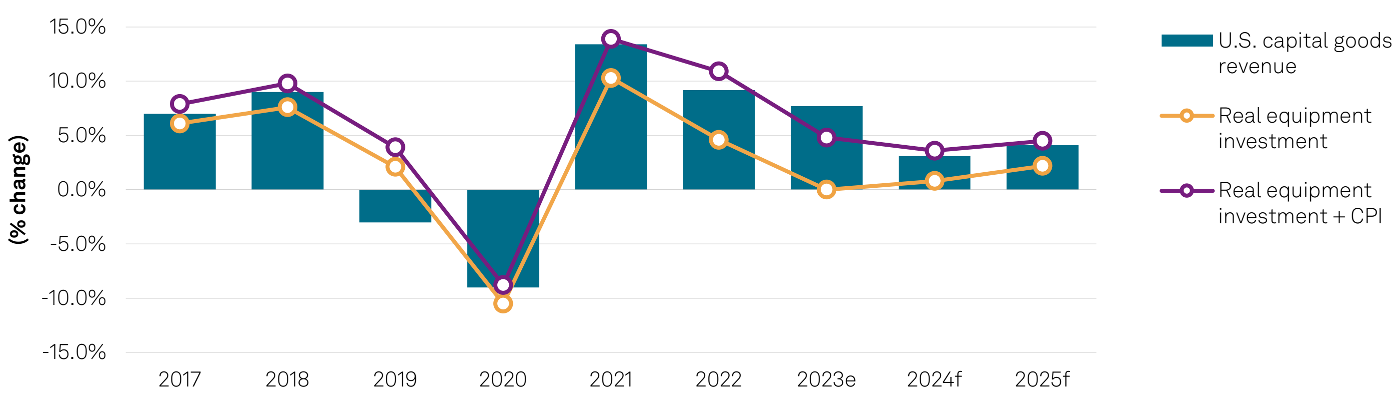
We expect a slowdown in revenue growth for global capital goods in 2024, as higher interest rates affect investment decisions around the world and catch-up demand following the COVID-19 pandemic fades. We assume generally flat volumes and cooling prices, which might yield low- to mid-single-digit percent 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)

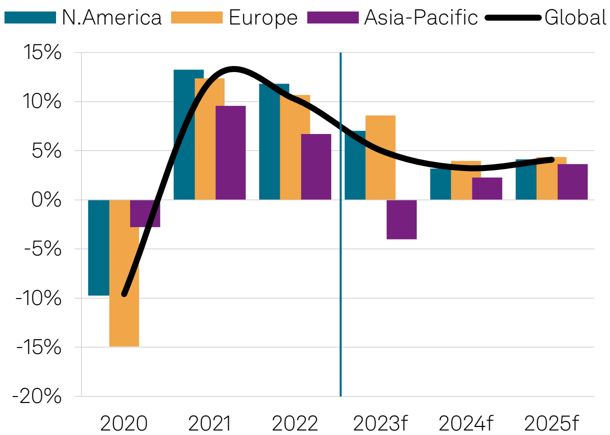


Chart 9

EBITDA margin (adjusted)

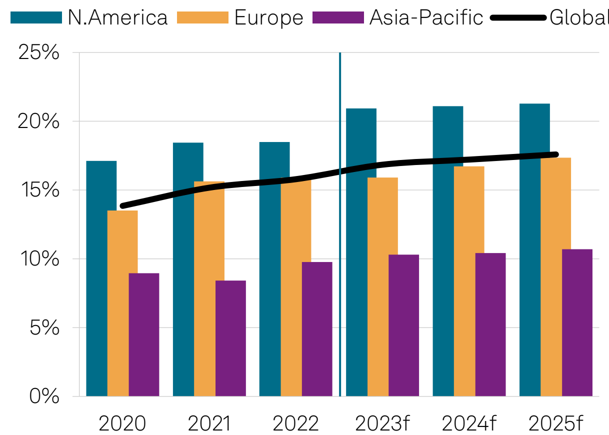


Chart 10

Debt / EBITDA (median, adjusted)

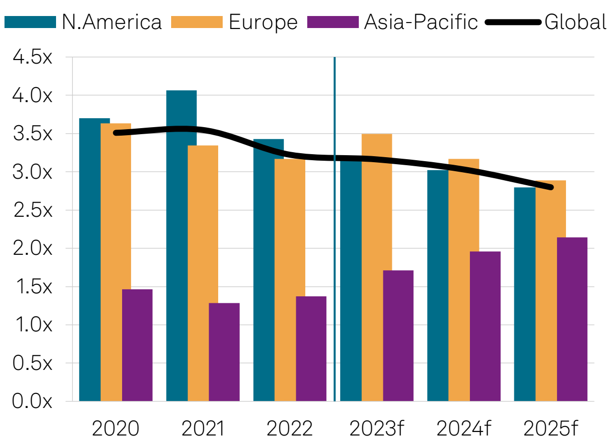
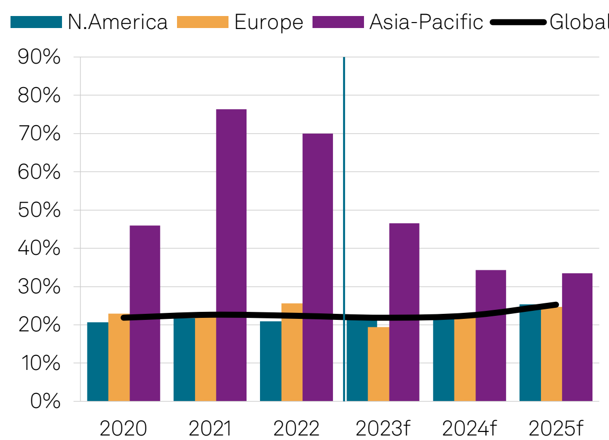


Chart 11

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

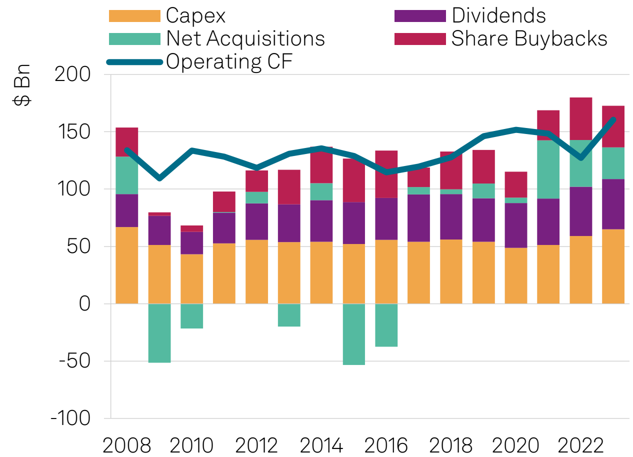


Chart 13

Return on capital employed

Chart 14

Fixed- versus variable-rate exposure

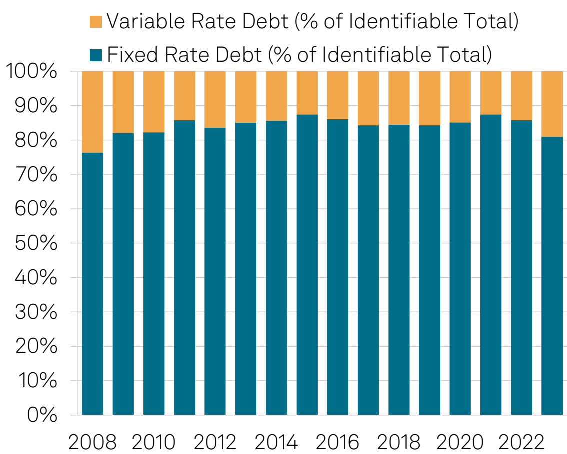


Chart 15

Long-term debt term structure

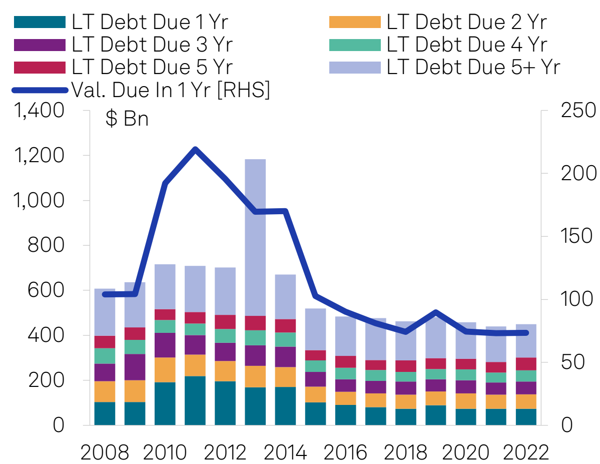


Chart 16

Cash and equivalents / Total assets

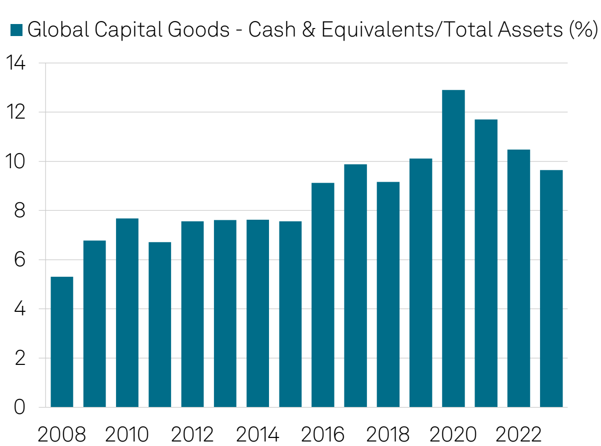
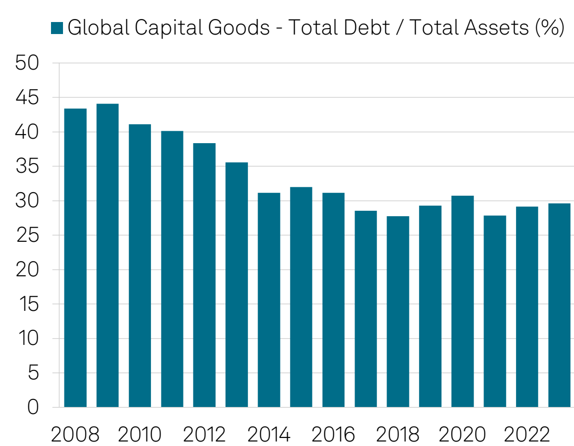


Chart 17

Total debt / Total assets



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

Chemicals

Weak industry conditions improve in the second half of the year

January 9, 2024

This report does not constitute a rating action.

What's changed?

Petrochemicals will remain in a cyclical trough longer than anticipated. While we expected the industry to improve in early 2024, supply and demand will remain challenged through 2024.

Recovery in the sector pushes into mid-2024. Headwinds like macro uncertainty, the China slowdown, weak demand, and pricing pressure, will persist but lessen in 2024.

Destocking bites deeper. Chemical buyers relied on their inventory to supplant purchases longer than we anticipated. As a result, chemical volumes sold last year were below expectations.

What are the key assumptions for 2024?

Global economy growth will slow slightly. We forecast the global GDP will grow 2.8% compared to 3.3% in 2023, driven by slower growth in the U.S. and Asia-Pacific (APAC).

Profitability to drag in 2024; cost competitiveness differs by region. We expect U.S. producers to trail Middle Eastern counterparts but perform better than those in Europe and APAC.

Broadly stable fertilizer prices. With affordability normalized, limited capacity additions, and reduced Chinese exports, fertilizer prices should remain broadly stable in 2024.

What are the key risks around the baseline?

Demand risk. Poor growth could stall or reverse a recovery in credit metrics in 2024, while destocking and recessionary conditions could hurt demand in key markets.

Capital market access. Rising rates could make access to debt markets and affordability difficult for speculative-grade credits, although the maturity profile in 2024 looks relatively light.

A bearish outlook for Europe petrochemicals extends past 2024. This depends on capacity rationalization of older, less efficient plants to rebalance the market and help competitiveness.

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Ratings Trends: Chemicals

Chart 1

Ratings distribution

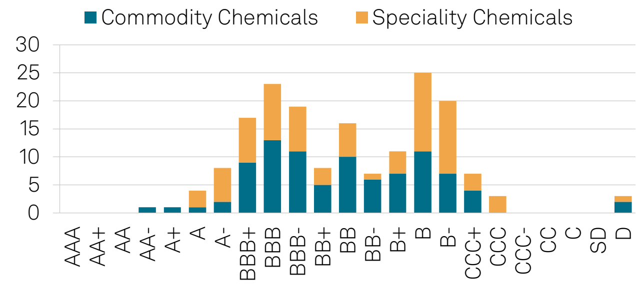


Chart 2

Ratings distribution by region

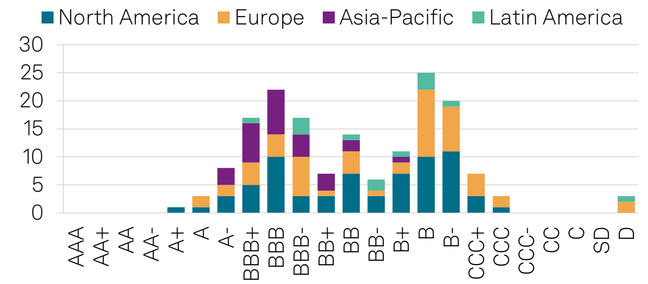


Chart 3

Ratings outlooks

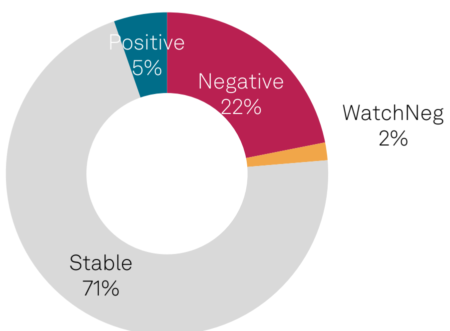


Chart 4

Ratings outlooks by region

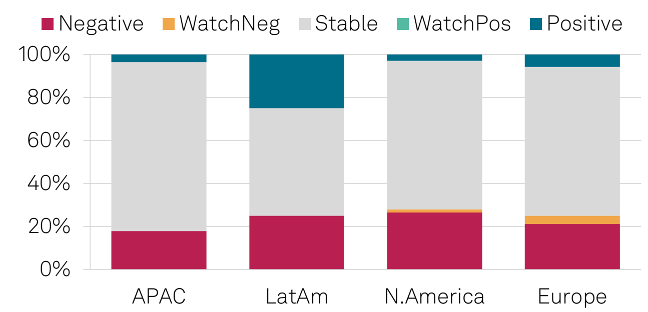


Chart 5

Ratings outlook net bias

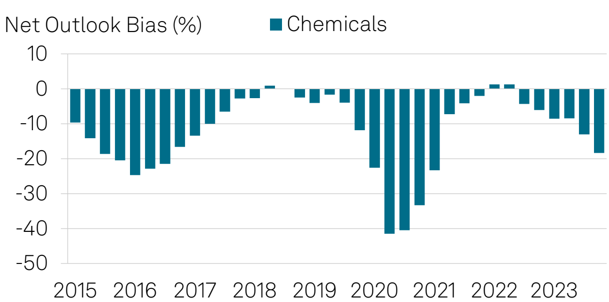
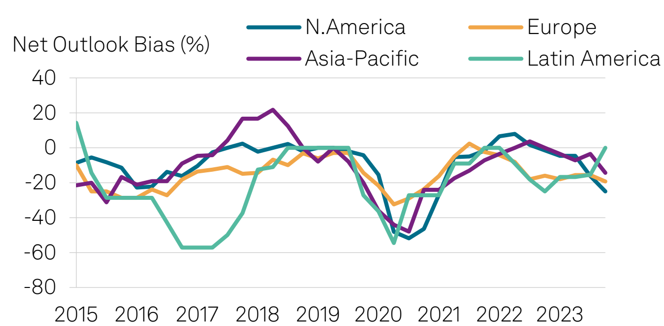


Chart 6

Ratings net outlook bias by region



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

Industry Outlook

Ratings trends and outlook

Nearly a quarter of our ratings outlooks are negative and only 5% are positive. The resulting net negative outlook bias at slightly below 20% is a post-pandemic peak. Median credit ratios, including total debt to EBITDA and funds from operations (FFO) to total debt weakened in 2023 relative to the previous year. We believe median ratios will strengthen slightly next year, driven by our assumption for modest demand growth and improved EBITDA and margins.

This growth assumption applies broadly across the sector, including key subsectors such as petrochemicals, agriculture, and many specialty chemicals, but we assume growth will be uneven across individual companies and regions. Additionally, most growth will likely occur in the second half of 2024, when we expect there will be a less pronounced impact from disruptive factors such as destocking.

Our negative outlooks speak to the risks to credit quality if this base case for growth does not play out or if supply additions in sectors such as petrochemicals are more disruptive than we expect.

Main assumptions about 2024 and beyond

1. Petrochemicals in a cyclical trough through 2024, but slow improvement to start in 2025.

Destocking, some challenged key end markets (such as housing), and slower-than-expected growth in China has hampered demand in the petrochemicals industry. Additionally, the ramp-up of new capacity and limited permanent capacity closures to date have led to oversupplied industry conditions. We expect these challenges, which are exacerbating already weak supply and demand fundamentals, to continue in 2024, delaying a recovery in the sector.

2. Overall global economic growth forecasts are slightly slower than 2023.

Strong labor markets and fiscal tailwinds drive the upside, whereas uncertainties about the lagged transmission of cumulative rate hikes since early 2022 are driving the downside. In the U.S., we forecast a growth rate of 1.5% in 2024, with the eurozone expected to grow slightly at 0.8%. In APAC, while headwinds remain, we forecast a healthy growth rate of 4.4%. Higher interest rates will affect consumer spending and lead to overall slower economic growth. However, we believe many companies' revenue and earnings will improve as destocking in most sectors begin to benefit issuers through strengthened volumes. We expect inflationary pressures will ebb somewhat in 2024, allowing margins to slightly improve.

3. Improved affordability and broadly balanced supply and demand will stabilize fertilizer prices in 2024.

This follows a period of marked correction in fertilizer prices in the second half of 2022 and first half of 2023 after a structural supply shortfall sparked by the Russia-Ukraine war caused unsustainably high fertilizer prices. This eroded farmers' affordability and caused demand destruction.

The petrochemical sector will remain in a cyclical trough. Our base case assumes continuing challenges in supply and demand fundamentals in the olefins and polyolefins chains through 2024. Large capacity additions (primarily in China and the U.S. Gulf Coast) began in 2021 and we expect them to continue to ramp up in 2024. This combined with a general macroeconomic malaise is likely to leave earnings depressed in 2024 (albeit with some gradual improvement from trough 2023 levels).

We expect a more tangible improvement in earnings starting in 2025, given more-favorable supply/demand dynamics. Any sustained improvement in profitability would likely be driven by a rebound in demand from China and permanent capacity closures to help ease oversupply conditions. Our base case assumes natural-gas based U.S. producers will remain toward the lower end of the global cost curve, trailing Middle Eastern producers but still advantaged compared with more naphtha-based petrochemical companies in Europe and Asia.

The U.S. economy is headed for a soft landing. After outperforming expectations so far in 2023, led by spending on consumer services, the U.S. economy appears to be headed for a soft landing in 2024, growing at 1.5% compared with 2.4% in 2023. Sharp monetary policy tightening during the past year and a half will have an effect in the coming year, when higher costs of capital will lower business capital expenditures and hiring. Consumer spending is poised to be more in line with real income growth as excess cumulative savings dwindles. We continue to forecast core inflation (excluding volatile energy and food prices) will fall closer to levels consistent with the Federal Reserve's target of 2.0% by the middle of next year.

A soft eurozone economy remains likely over the near term, with real incomes set to rise because of disinflation and resilient labor markets. The eurozone GDP forecast is broadly unchanged at 0.8% in 2024 versus 0.6% in 2023. Production has suffered from high energy prices and destocking (manufacturing is in recession). Fiscal policy is no longer expansionary (although there are differences from country to country), and the passthrough of policy rate hikes has been relatively swift. It's likely the eurozone economy will bottom out in the first quarter of 2024 or see a shallow recession, but once inflation eases significantly enough to prompt the European Central Bank (ECB) to lower its policy rates, we believe the economy will rebound. The pattern of the economic slowdown, which we expect will continue over the first half of 2024, likely changes as the strong momentum in services abates with the end of the manufacturing recession possibly in sight.

In APAC the overall economic growth rate will slow slightly, to a still-healthy 4.4% from 4.7%. Emerging market economies such as India, Indonesia, Malaysia, and the Philippines are posting the strongest growth. With core inflation continuing to ease, the region's central banks are unlikely to tighten monetary policies again but will exhibit no meaningful declines for at least the next six months. China's property weakness continues to weigh on the economy, but growth momentum has slightly improved because of policy support. We predict the country's GDP growth will slow to 4.6% in 2024 from 5.4% in 2023.

The structural cost disadvantage of Europe-based nitrogen producers versus those based in the U.S. or the Middle East will persist. We also expect crop nutrition deliveries will remain broadly stable despite increased application rates and the fact that affordability for farmers has improved from the low 2022 levels. This is because we expect buyers will continue to display cautious behavior in an environment of declining fertilizer prices and--in certain regions--will build into their purchasing decisions the risk of drought from El Nino. As a result, fertilizer buying may be delayed closer to the application season, taking some purchases from 2023 into 2024.

In potash, given improved fertilizer affordability and as farmers prioritize nitrogen and phosphate applications, we anticipate healthy demand and the ongoing structural supply deficit to somewhat support prices. In phosphate, we believe supportive grain fundamentals, China export limitations, low inventories in India, and higher acreage in Brazil will support demand and prices.

Credit metrics and financial policy

Overall, issuers across the sector have lowered earnings expectations at the midpoint of 2023, citing weak end market demand (or in some cases channel destocking overshadowing a relatively strong end market) and competitive pressures affecting pricing. Generally, we expect earnings to remain pressured going into the first half of 2024, with companies exposed to less-discretionary end markets and with pricing power to fare better than the industry average.

We expect credit metrics to improve in the second half of 2024, largely a result of inventory destocking throughout many of the chemical sectors. Destocking has taken longer than we expected as GDP growth in China and Europe is slower and the U.S. consumer base has allocated spending power more toward services than manufacturing. Benefitting from a strong 2022, many companies' balance sheets, especially those in the investment-grade space, are in sufficient shape to weather trough industry conditions, particularly in the petrochemical space.

The portfolios outlook is largely stable at 72%. However, this has trended lower due to some negative rating actions in the deep speculative-grade space and in Europe, where high energy costs, destocking, and overall weak economic conditions have led to underperformance and low plant utilization rates for some issuers.

Key risks or opportunities around the baseline

1. Lower demand as customers dip into their inventories and hold off/reduce purchases.

We believe customers will run down inventory levels and increase their purchases of chemicals in 2024. Although demand will increase, we do not expect demand to strengthen as much as it did after the pandemic. The risk to our base case is that customers could delay increasing purchases for longer than we expect or a more fundamental demand weakness could set in.

2. Capital market access concerns remain for deep speculative-grade issuers.

Most chemical issuers proactively refinanced debt maturing in 2024, albeit at higher interest costs. However, for smaller deep speculative-grade issuers, access to capital may prove daunting.

3. Headwinds for European producers extend well beyond 2024.

This is due to higher cost positions and competitive pressures, prompting decisions to rationalize production footprints.

Demand recovery is key. After a choppy year for demand, we expect a less-stormy back half of 2024, with modest demand growth overall. Overall, we assume demand will be more predictable absent the vagaries of destocking or an unexpected China slowdown that characterized 2023. This relatively steady growth is an important credit support, especially at lower rated companies, not only for earnings improvement but also for reducing working capital and improving operating cash flow generation.

Speculative-grade issuers' ability to refinance maturities is an important factor. Most chemical companies were proactive in managing their debt maturities and took advantage of lower rates and extended their overall debt maturities. Even speculative-grade issuers, which are more exposed to increases in interest rates and scrutinizing capital markets during industry troughs, have relatively light debt maturity profiles in 2024.

However, given the current unfavorable operating climate, there are growing refinancing risks. For speculative-grade issuers, debt maturities meaningfully ramp up during 2025 and beyond. If interest rates stay high and industry conditions in some chemical sectors remain weak, speculative-grade issuers may struggle to access capital. Indeed, nearly half of the debt maturing during 2024-2026 is held by issuers rated 'B-' or below. Even if an issuer can refinance, the transaction could weaken its cash flow metrics.

Headwinds for petrochemical producers in Europe are extending well beyond 2024. Like global peers, petrochemical producers in Europe face industry overcapacity and weak end-market demand. In Europe, the situation is exacerbated by elevated energy prices; limited access to low-price gas feedstock in contrast to U.S. or Middle East producers; competitive pressures; and rising carbon dioxide costs. These result in higher production costs in the region and highlighted competitive disadvantage of European producers. We expect the gap in margins to industry peers with production footprints more focused on the U.S. or Middle East will remain given continued higher energy costs.

Capacity utilization in the EU27 chemical industry declined once more in the third quarter of 2023, according to the European Chemical Industry Council, and was at 74.1% versus the normal range of 82%-85%, notwithstanding numerous production footprint rationalizations and ongoing efficiency measures. In addition, temporary and permanent shutdown of older, inefficient, and uncompetitive sites in Europe continue amid sustained high energy, raw material, and labor costs, and competitive pressures. According to Chemical Week, more steps to remove surplus capacity in Europe are expected as firms look to shut older, less efficient plants. The success of these efforts to improve competitiveness will be key to the credit quality in 2024 and beyond.

Related Research

- Financial And Refinancing Risks Run High For Low Speculative-Grade U.S. Chemical Producers, Oct. 31, 2023
- Credit FAQ: Europe's Chemical Sector Feels The Chill In A Cooling Economy, Sep. 13, 2023
- Sector Review: Recovery Won't Be Quick For Asia Chemicals, Jul. 20, 2023
- Industry Top Trends Update Europe: Chemicals, Jul. 18. 2023
- Industry Top Trends Update Asia-Pacific: Chemicals, Jul. 18. 2023
- Industry Top Trends Update North America: Chemicals, Jul. 18. 2023

Industry Forecasts: Chemicals

Chart 7

Revenue growth (local currency)

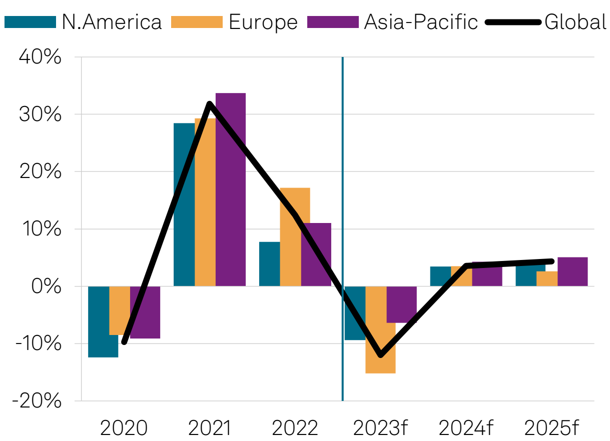


Chart 8

EBITDA margin (adjusted)

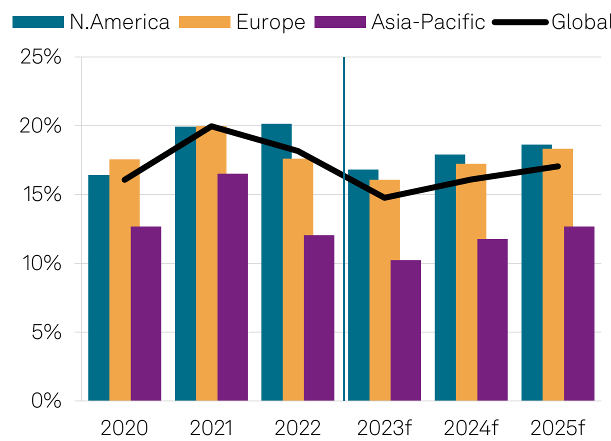


Chart 9

Debt / EBITDA (median, adjusted)

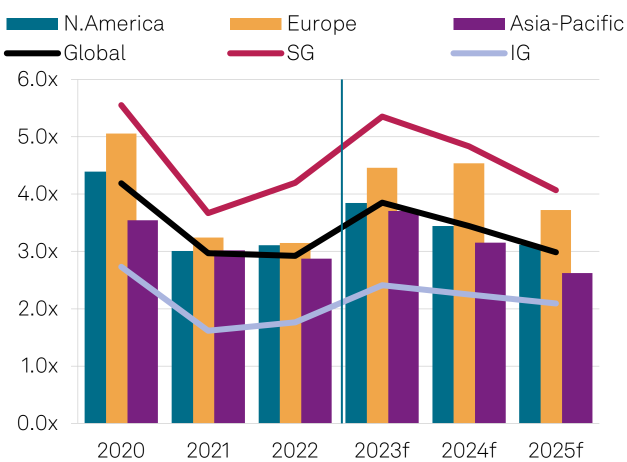
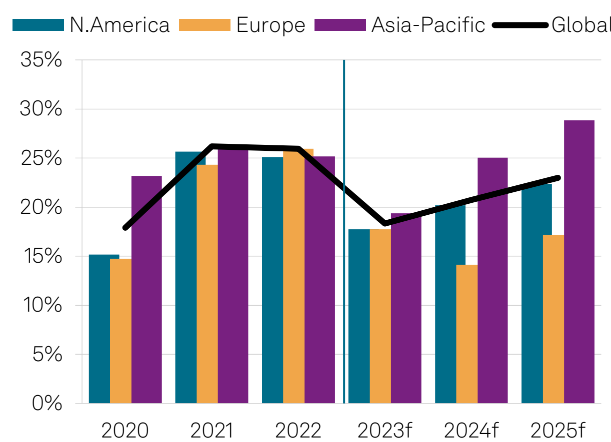


Chart 10

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: Chemicals

Chart 11

Cash flow and primary uses

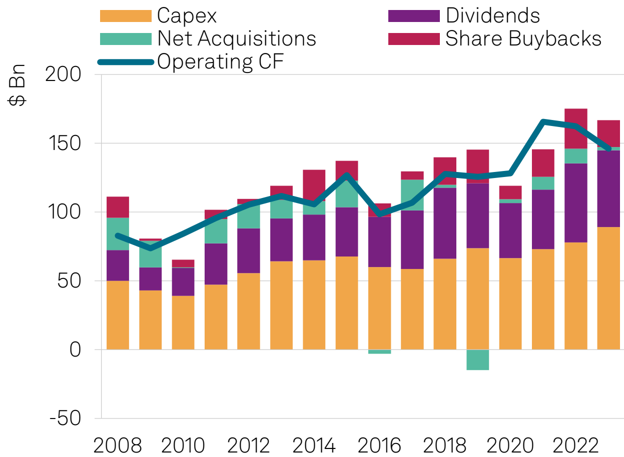


Chart 12

Return on capital employed

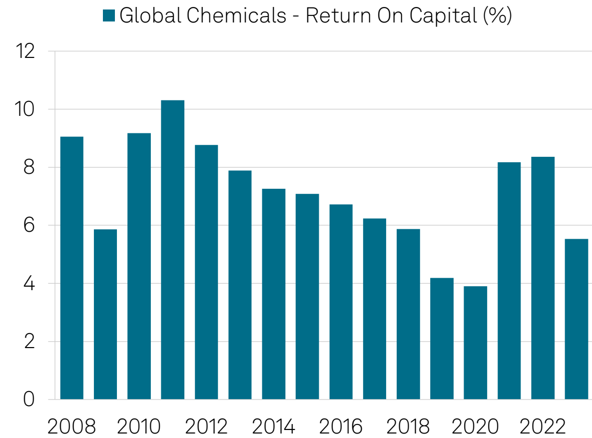


Chart 13

Fixed- versus variable-rate exposure

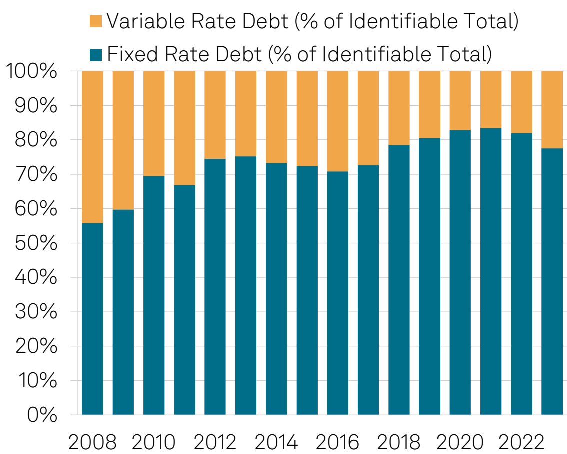


Chart 14

Long-term debt term structure

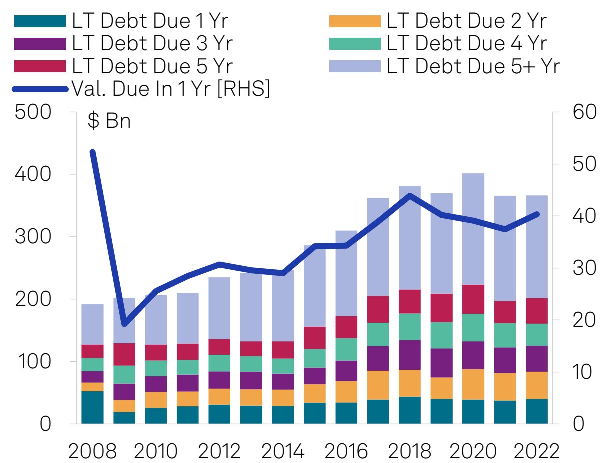


Chart 15

Cash and equivalents / Total assets

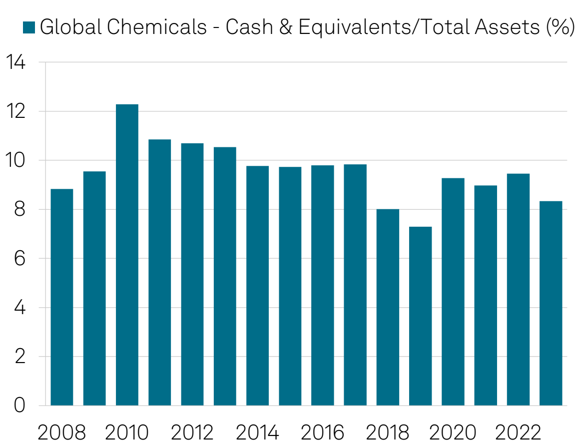
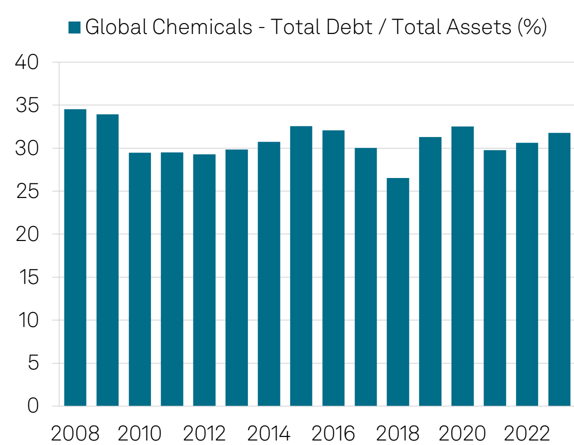


Chart 16

Total debt / Total assets



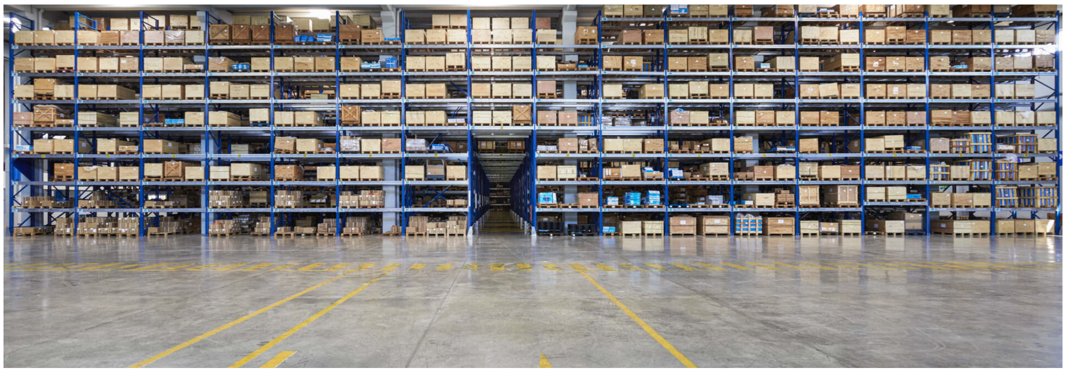
Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2023) figures use the last 12 months' data.

Consumer Products

Carryover pricing boosts margins, as volumes stay subdued

January 9, 2024

This report does not constitute a rating action.



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What's changed?

Price increases will wane. Branded consumer product companies will slow their pricing growth to the mid-single digits on average.

Mature markets will face volume compression. As consumers seek value and look for cheaper private-label alternatives, we expect a moderate decline in volumes by low- to mid-single digits.

Working capital management will be critical. Given weaker sales volumes, the ability to optimize inventory will be a key driver of free cash generation.

What are the key assumptions for 2024?

Cost pressures will continue to abate. As input costs decrease, capacity in supply chains is building up, given lower sales volumes and cautious ordering from retailers.

Advertising and promotional spending will increase. As competition intensifies, gross margin gains from lower input costs and carryover pricing gains will be deployed to strengthen brand equity.

Financial policy surprises will be limited. Most of the rated companies will adhere to their financial policies, with minimal revisions to shareholder returns and merger and acquisition (M&A) strategy.

What are the key risks around the baseline?

Sales volumes will decline sharply across both major consumer markets. There will be a sharp pullback by Chinese consumers coupled with a demand contraction in the U.S.

Refinancing conditions will remain tough. Companies with highly leveraged capital structures will struggle to refinance amid weak operating performance and tight capital markets.

Geopolitical tensions will worsen. Spillovers have been lower than we expected, but further escalations could induce commodity price volatility, hurting global trade and consumer sentiment.

Ratings Trends: Consumer Products

Chart 1

Ratings distribution by region

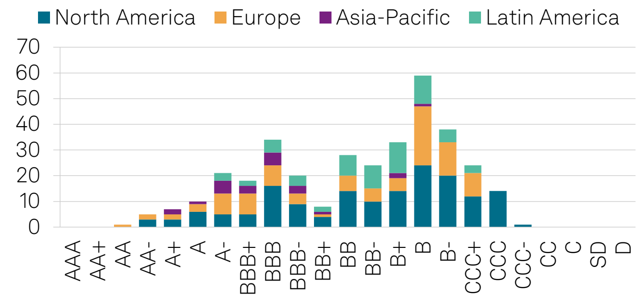


Chart 2

Ratings distribution by subsector

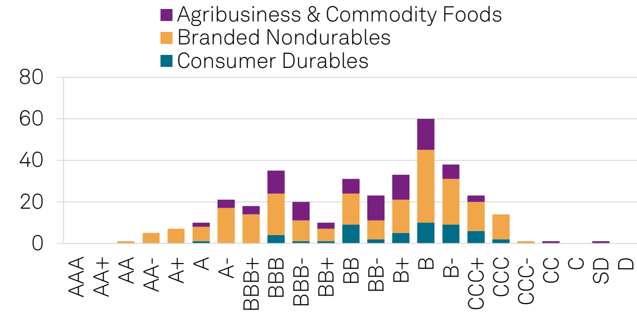


Chart 3

Ratings outlooks by region

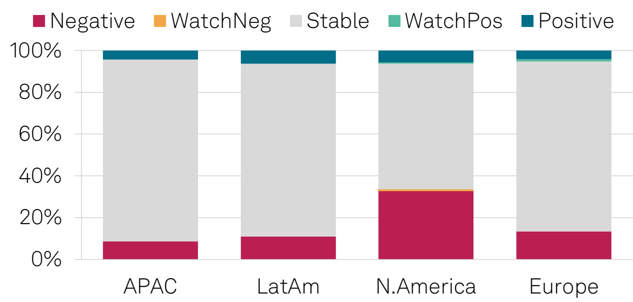


Chart 4

Ratings outlooks by subsector

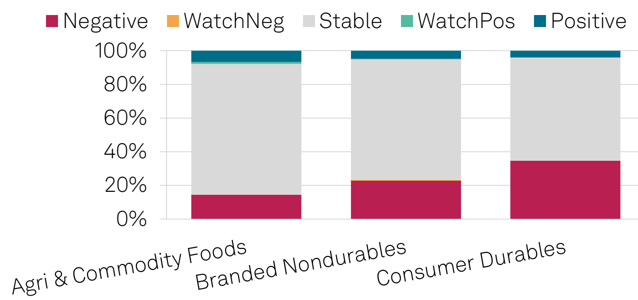


Chart 5

Ratings outlook net bias by region

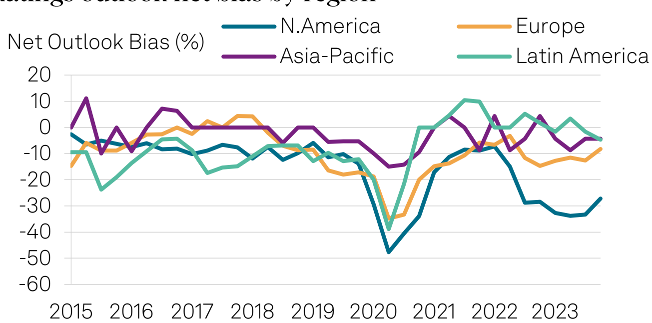


Chart 6

Ratings net outlook bias by subsector

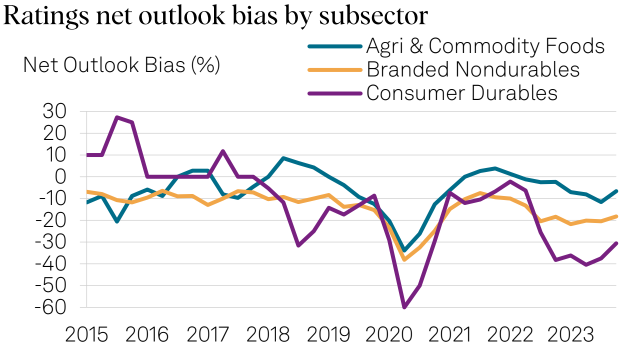


Chart 7

Ratings outlooks

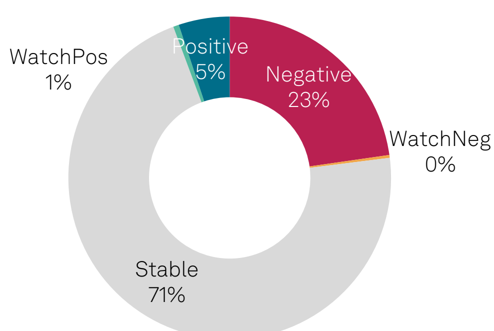
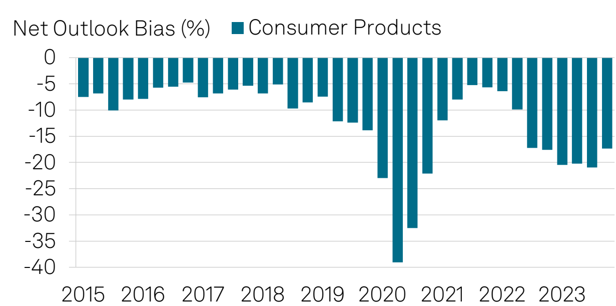


Chart 8

Ratings net outlook bias



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

Industry Outlook

Ratings trends and outlook

In 2023, there were 61 downgrades across the global consumer products sector and these outnumbered the 36 upgrades. The bulk of the rating actions were concentrated on speculative-grade issuers. The negative rating actions were primarily due to these companies' higher exposure to inflationary headwinds and weakness in toplines and margins in addition to high leverage and refinancing risks. Many companies navigated higher costs by raising prices and cutting costs, but risks intensified because of higher interest rates and the uncertain macroeconomic backdrop.

Persistent inflation and some weakening of consumer demand also led to the negative outlook bias remaining high. Globally, we have negative outlooks on 23% of the issuers we rate in the sector--almost the same level as a year ago. More negative outlooks in North America reflect the greater proportion of discretionary products manufacturers rather than greater pressure in the region.

Large consumer goods multinationals with strong brands, significant geographical presence, and wide product ranges will strengthen their competitive advantage. These companies have sufficient price and mix flexibility, as well as product range across discount, mass market, and premium segments, to curtail the overall impact of tepid volumes. Accordingly, credit prospects are broadly stable for investment-grade companies, given their strong market positions within their categories, generally good product diversification, sound cash flow characteristics, and potential flexibility to tighten discretionary spending in times of stress.

Still, the 'B' rating category accounts for the highest number of issuers in the sector, at more than one-third. This group includes many smaller and highly leveraged companies with weak business risk profiles. They remain vulnerable to significant volatility in operating performance, and may find it challenging to restore profitability and cash flows. Higher interest rates will also gradually intensify the pressure on many of them, which have already been hit by rising costs. Meanwhile, weaker macroeconomic conditions and a pullback in consumer spending could be a tipping point for many of these issuers with limited financial flexibility.

Main assumptions about 2024 and beyond

1. Inflation will trend downwards, but the easing of operating costs will be gradual.

Both headline and core inflation continue to decline following their peaks in late 2022; however, core inflation remains stubbornly high. Labor markets remain tight across many economies and many consumer-facing business have to bear the brunt of higher wages on their margins. Many businesses have reduced opening hours to save labor costs but retain staff to avoid repeating the difficulties finding workers post-pandemic. Many retailers will remain cautious about ordering, which will free up capacity in supply chains but result in lower bargaining power at the suppliers' end.

2. Moderate improvement in margins on back of carry over pricing and cost savings.

Consumer goods companies will be hard pressed to continue to markedly raise prices. Also, the high price pass-throughs by global consumer goods companies have widened the opening for price competition from private label products. Branded consumer product companies will slow their average pricing growth, and deflationary pressure will be limited to certain niche segments where commodity prices have declined sharply and lower-priced alternatives are available to consumers.

3. Consumers will be cautious, as many households will continue to face cost-of-living pressures.

Consumers in the U.S. will continue to see real income growth slowing, which will keep the savings rate lower than pre-pandemic levels. In Europe, while disinflation is easing household income constraints, employment continues to rise but output is flat, raising questions about productivity and profits. In Latin America, the easing of inflation will help lower interest rates, but the pace will depend on the U.S. Federal Reserve. In China, consumer confidence will remain subdued, while in the wider Asia-Pacific region we expect weaker sales volumes as lower- and middle-income households cut back on discretionary spending, trade down, and become more price conscious.

Inflation will trend downwards, but the easing of operating costs will be gradual. Both headline and core inflation continue to decline following their peaks in late 2022. Headline inflation rose to higher rates than core and is now generally lower, reflecting the recent declines in food and fuel prices. However, core inflation remains stubbornly high--near 5% in several major advanced economies. Labor markets remain tight across many economies and many consumer-facing business have to bear the brunt of higher wages on their margins. Many businesses have reduced opening hours to save labor costs but continue to retain staff to avoid repeating the difficulties finding workers in the post-pandemic period. As inventory levels remain high, many retailers will remain cautious about ordering from the consumer product companies in response to weaker sales volumes. This will free up capacity in supply chains but result in lower bargaining power at the suppliers' end.

Moderate improvement in margins on back of carry over pricing and cost savings. Given the current normalization in commodity and input prices and a weak consumer outlook in addition to the carryover effect of the previous price increases, consumer goods companies will be hard pressed to continue to markedly raise prices at the same pace. Also, the high price pass-throughs by global consumer goods companies have yielded greater ground for price competition from private label products. We expect branded consumer product companies will slow their average pricing growth to the mid-single digits. Along with higher carryover pricing from the previous quarters, this should still result in margin uplift for consumer product companies with strong brands and those well positioned in their categories.

While we expect increased promotional intensity to manage stock levels, we do not expect branded consumer product companies to reduce selling prices directly. Deflationary pressure will be limited to certain niche segments where basic commodity prices have declined sharply and lower-priced alternatives are available to consumers. As we enter a period of normalization and tough competition, we expect most consumer goods companies to launch ambitious cost-savings programs to improve operating efficiency, especially in their supply chains and distribution functions. At the same time, much of the gross margins gains from lower input costs and carryover pricing gains and efficiency savings will be ploughed back into higher investment in brand revitalization and marketing expenses.

Consumers will be cautious, as many households will continue to face cost-of-living pressures. Interest rates will need to stay higher for longer and higher consumer credit costs on mortgages, autos, and credit cards will curtail household disposable income. Consumers in the U.S. will continue to see real income growth slowing, which will keep the savings rate lower than pre-pandemic levels. In addition, the lifting of the student loan moratorium will contribute to ongoing challenging affordability.

In Europe, while disinflation is easing household income constraints, employment continues to rise for a variety of reasons, but with output flat, this is raising questions about productivity and profits.

In Latin America, the easing of inflation will help lower interest rates, but the pace of reduction will depend on the U.S. Federal Reserve and will guide increasing consumption locally.

Meanwhile, in China, consumer confidence remains subdued, while the wider Asia-Pacific region excluding China and emerging markets has shown resilience led by robust domestic demand growth. We expect weaker sales volumes over the next few quarters as consumers--particularly lower- and middle-income households--continue to cut back on discretionary spending, trade down, and become more price conscious to deal with falling real incomes. Home consumption will still be resilient, with strong performance from private-label products as consumers look to tighten spending by eating out less.

Subsector overview for 2024

The five-point scale in chart 9 below presents our assessment of the significance of the forward-looking risk factors for 2024, with the risk level increasing from left to right. For ease of presentation, we combined certain adjacent subsectors like Food & Beverage and Apparel & Luxury goods. Detailed subsector comments follow below.

Chart 9

The key risk factors that we incorporate into our base-case forecasts by subsector

Note: The five-point scale presents our materiality assessment of forward-looking risk factors, with the risk level increasing from left to right. Source: S&P Global Ratings.

Agribusiness. We have a slightly negative rating outlook for the Agribusiness sector reflecting the still weak protein processing cycle in the U.S. We believe a recovery is underway for U.S. poultry processors, which will likely accelerate in 2024 as pricing stabilizes with lower industrywide inventories and declining feed costs. However, the outlook for beef processing in the U.S. will remain very weak for 2024 and into 2025 as cattle costs remain high, with significant herd rebuilding only starting to take hold this year. Pork margins should also rebound in 2024 with better cutout values as farms cut production but remain below historical levels given still excess industry production capacity. We will closely monitor industry conditions in 2024 to assess if credit measures sequentially improve as companies lap last year's depressed margins. A slower-than-anticipated rebound could lead to additional downgrades over the next year.

In South America, the outlook for the beef sector is the opposite of that of the U.S. A positive cycle is boosting beef processors margins, with sound cattle availability lowering cattle prices.

For pork and poultry, on one hand, the consumers' preference for beef can hurt demand, but margins will improve with the record high corn harvest lowering input costs along with some capacity reduction.

Outside of the protein processing segment, we have a stable outlook for the agribusiness sector, underpinned by strong global oilseed demand for biofuel feedstocks and an easier comparison to 2023 for ingredient providers, many of which faced significant volume pressure last year from customer destocking. The sector has benefited from high commodity food market prices (e.g., sugar) and sustained strong demand for large crops (e.g., wheat and soybean), enabling strong operating performance and credit metrics for rated issuers. Given food security concerns and rising population in emerging markets, we continue to see positive demand-led growth prospects for the sector overall. Although El Nino may lead to southern hemisphere drought or flood conditions in certain regions, notably Australia, which would hurt wheat production, we don't expect major crop disruptions to next year's harvests, particularly with Argentina's output likely to rebound after suffering a severe drought in 2023.

Still, South American drought conditions could hurt global soybean and sugar production, especially in Brazil, where the preponderance of agribusiness companies we rate are located. Brazilian sugar refiners in particular could face margin compression. However, downgrade risks are mitigated by the issuers' current very low leverage levels, given the still strong global sugar pricing landscape, despite weaker ethanol profits, with prices about 15% lower than last year.

M&A deals have picked up, with record profits in commodity trading. Notably, the merger of Bunge Global SA and Viterra Ltd. created one of the largest merchandiser and processor of soft commodities (i.e., wheat and soybean mostly) globally. We expect more sector consolidation over the coming years, although this remains subject to commodity cycles.

Alcoholic beverages. We have a stable rating outlook for the alcoholic beverage sector, underpinned by strong cash flow generation and the ability to manage discretionary expenses in what is likely to be a period where demand modestly softens across several regions, both mature and developing.

Sales growth is likely to slow in 2024 to low-single digits from high-single digits, reflecting a variety of factors, including lower volumes after significant pricing actions to offset inflation in 2023, a difficult comparison to a 2023 rebound in on-premise demand in several regions, and the possibility of a temporary and modest negative mix shift away from premium products with a weakening consumer in key economies like the U.S. The emerging market outlook is also mixed, with economies like China (where premiumization is a key performance driver) facing growth headwinds.

Global alcoholic beverages group Diageo has lowered its performance outlook in Latin America and the Caribbean on weaker volumes and also mix due to higher downtrading. In addition, certain issuers have to lap recent dispositions of lower performing brands, including those exposed to geopolitically sensitive countries like Russia, which, coupled with negative foreign exchange rates, may further pressure topline performance in 2024.

Still, this industry performs well through economic cycles given its structurally high margins, ability to cut discretionary expenses in marketing and promotions when demand softens, and strong free cash flow conversion of EBITDA. Therefore, we expect companies to sustain leverage near their stated targets and/or continue to steadily reduce leverage toward their long-term targets for the minority of issuers that are above their targets because of recent M&A.

Apparel. An uncertain macroeconomic landscape and cautious consumer will lead to flat to low growth for apparel companies in 2024. We expect moderate margin expansion as companies continue to cut costs and sell down their excess inventory. Successful remediation of inventory challenges from the past two years without recourse to excessive discounting is key to operating performance and cash flow generation in 2024. As companies work to normalize inventory levels, supply will likely be more aligned with weaker demand trends. We expect share repurchases to be muted as cash flow is managed prudently due to uncertain operating conditions. M&A could pick up as some issuers have announced asset sales to reduce leverage as profitability declined in 2022 and 2023.

Beauty and cosmetics. We expect the beauty segment to continue to benefit as consumers seek affordable indulgences during weaker macroeconomic periods. However, the 2024 forecast for our rated peers differ due to specific business challenges for the small U.S.-based rated peer set. Overall, we expect growth from both price and volume, and margin expansion through lapping higher costs and cost-savings initiatives.

Skincare, making up more than 40% of the cosmetic market by value, has been particularly resilient and remains one of the key growth drivers. Dermo-cosmetics (with health care professional endorsement) retains its long-term momentum and supportive margin. Competition has increased, mainly because of e-commerce penetration, new brands, and a rise in promotional activities for product launches. Additional competitive pressure comes from small, new, and digitally focused regional players.

Global players are experiencing a significant reset in the travel retail business in Asia, mainly due to an uneven recovery in China and the Chinese government's effort to crack down on "daigou" (Chinese shoppers who buy goods abroad and sell them in the domestic markets). Our estimate of mid-single-digit growth in 2024 is in line with historical trends.

Durables. We anticipate 2024 will continue to present challenges for durable goods manufacturers, driven by our expectations for slow economic growth in most parts of the world resulting in ongoing weak demand. We assume flat to modestly lower net sales--the main drivers being lower volumes and increased promotional activity, partially offset by the carryover impact of previous price increases. Consumers are stretched and are delaying discretionary purchases of small and large appliances while prioritizing essentials like food and beverage, household, personal care, and health care products.

Retailer ordering behavior will likely trend toward normalization and the disparity between sell-in and sell-out should narrow. We forecast adjusted EBITDA margins will nevertheless continue to recover in 2024 because of lower commodity costs, better supply chain conditions, higher and more consistent production cadence, and benefits from productivity improvements, partly offset by lower sales volume.

While easing commodity costs provided modest margin tailwinds in 2023, we assume the potential for further disinflation is limited. We expect less volatility around working capital investment following the unwind of excess inventories in 2023. Durables issuers are more likely to be more conscious of inventory levels matching demand trends in 2024 as supply chains are in better shape. We expect companies will increasingly focus on innovations and promotions, which will allow them to compete better as consumer spending tightens.

M&A strategies are unlikely to change from 2023 and will be limited to tuck-ins and potentially include the purchase of distressed businesses. We expect financial policies will largely prioritize credit metric improvement as opposed to large shareholder payments, especially for speculative-grade issuers.

Household products and personal care. Household products and personal care companies are recovering margins as inflationary pressures on input costs have decreased, and supply chains have improved. We expect mid- to lower-income consumers to trade down to private label or mid-tier priced items as prices remain high. We believe the personal care segment will remain more resilient than household products as consumers tend to remain loyal to brands when it comes to personal hygiene products. Accordingly, in 2024, we forecast low- to mid-single-digit revenue growth as pricing normalizes to the low-single-digit area. We also expect modest volume declines to turn slightly positive, depending on the company's mix. We anticipate revenues will be affected by foreign currency effects, especially given the global footprint of many of these companies. We expect large multinational companies' financial policies to remain consistent, with some bolt-on acquisitions, typical dividend payments, and share buybacks.

Luxury. As expected, growth in the luxury industry is normalizing due to the strong comparison base and weak macroeconomic environment, although we expect positive industry fundamentals to remain broadly unchanged in the long term. The personal luxury industry has a long track record of positive performance, with very few negative trends (e.g., the 2008-2009 economic crisis and the start of the COVID-19 pandemic in 2020).

Sales to Chinese customers remain broadly resilient despite economic headwinds, and we expect increasing spending outside Mainland China due to the rebound of international travel.

Still, the personal luxury goods industry is based on discretionary spending, with a focus on high price points. We expect growth to slow, due to lower consumer confidence and a strong comparison base.

Downside risks are mainly based on a drop in U.S. consumers' discretionary spending on personal luxury goods in a weaker macroeconomic environment.

Nonalcoholic beverages. We have a neutral rating outlook for the nonalcoholic beverage sector as dominant manufacturers with little store-brand competition continue developing innovative products by introducing new taste profiles and packaging. We assume no near-term material negative impact from GLP-1 drugs repurposed for weight loss because widespread use faces numerous hurdles in 2024 including cost, availability, and side effects. We expect organic net sales growth in 2024 to moderate to the mid-single-digit percentage area from the high-single percentage area expected in 2023, due to very high pricing that was intended to offset inflation and foreign currency depreciation. We anticipate a more balanced pricing and volume mix in 2024. We anticipate slight adjusted EBITDA margin improvement as supply chain cost volatility lessens and consumers continue to purchase affordable beverage products even if economies weaken as we expect.

Nonalcoholic beverage issuers should capture volumes if they are able to effectively distribute products locally and regionally that meet potential consumer economic behaviors. This could include large quantity volume purchases to maximize spending power contrasted with smaller packaging and serving sizes for more stretched consumers. We anticipate product partnerships with alcoholic beverage manufactures to continue to have a minimal positive impact on nonalcoholic beverage manufacturers' topline given the scale of their core offerings.

Reported sales will be held back by low-single-digit foreign currency translation headwinds, particularly in highly inflationary economies, including certain developing and emerging countries in Latin America, Africa, and parts of Eurasia.

Packaged foods. Volumes largely remain negative through 2023 for most of the industry players as consumers pull back purchases amid extraordinary price increases. We estimate sector revenues, on average, will increase somewhat in 2024 thanks to low-single-digit price increases, partially offset by slightly negative to modestly positive volumes, and increased promotions. We expect ongoing elasticity and cautious consumer behavior to continue, including value-seeking and less pantry loading. We forecast EBITDA margins will continue to recover in 2024 as companies lap price increases, easing inflation, and the return to productivity measures. We believe companies will increase their investments in promotions, innovations, and brand-building to restore volume growth.

While private-label products have gained some share, it is still largely in commoditized categories or where they already have a higher degree of penetration. We expect companies to continue reshaping their portfolios through divestures of noncore assets and acquisitions--most of which will likely be into faster-expanding categories or new regions. Furthermore, we expect continued dividends and share buybacks will be in line with companies' stated long-term targets.

Tobacco. We have a neutral rating outlook for the tobacco sector as elevated cigarette volume declines mainly in the U.S. have been partly offset by strong pricing power. Moreover, issuers are likely to refrain from leveraging their balance sheets given recent demand trends and regulatory risks.

We continue to expect combustible cigarette volume deterioration in 2024, although with a potential for it to ease slightly compared to the 2023 high-single-percentage decline as the rate of inflation wanes.

Discount brands--including those of major manufacturers--are likely to sustain historically strong share in the high-20% area. Our volume expectation assumes limited fuel price volatility, which is a geopolitical risk factor, as well as a minimal impact from the anticipated FDA ban on menthol cigarettes, given industry participants are likely to contest it--which could delay enforcement. We anticipate nicotine users will continue to move between categories, including combustible cigarettes, e-vapor, and oral nicotine, which will incentivize large tobacco companies to continue funding next-generation product initiatives.

Competition in the noncombustible segment in the key U.S. market is set to increase as Philip Morris International Inc. is gearing up to launch the IQOS rollout, following its acquisition of Swedish Match.

Modest declines to tobacco issuers' very high EBITDA margins are possible, though we anticipate still ample cash flow to pay dividends and repurchase modest amounts of stock while maintaining some balance sheet flexibility.

Credit metrics and financial policy

We forecast a moderate improvement in the credit metrics for the global consumer goods sector in 2024. This would follow a very difficult 2023 when companies' high cost headwinds eroded EBITDA margins and drove a peak in the sector's median leverage. Although our forecasts for 2024 indicate broadly flat revenues due to lower volumes and a slowdown in price growth, EBITDA margins across the sector as a whole should expand slightly due to the combined benefit of previous strong price increases, fewer disruptions, and our expectation of waning inflationary pressures in the second half of the year.

The bulk of the global consumer goods companies we rate are mostly speculative grade, with a large majority in the 'B' category (see chart 2). Many of these companies have weak business risks profiles, alongside highly leveraged capital structures. Higher interest rates and tight financing conditions will further constrain these companies' already limited financial flexibility.

At the other end of the spectrum, many large highly rated global multinationals continue to allocate a significant part of their free cash flow to shareholder returns. Based on our estimates, more than one third of the top-rated investment-grade European consumer goods companies typically return surplus capital to shareholders via share buyback programs, in addition to regular dividends. These include companies such as AB InBev, Unilever PLC, Imperial Brands, Henkel AG & Co. KGaA, Nestle S.A., LVMH Group, Pernod Ricard S.A., and Diageo PLC**.** In the event of any significant operating headwinds, these companies can choose to limit shareholder returns to preserve cash and increase headroom under the credit ratings.

In Europe, we do not expect significant financial policy surprises in 2024. Most of the rated companies will likely maintain their stated financial policy, with limited revisions to shareholder remunerations. Considering that several challenges continue to restrict management bandwidth, higher funding costs and fairly limited financial headroom, we do not anticipate large M&A transactions. We think consumer goods companies will approach sizable M&A with caution, but we continue to factor in portfolio transformation through investment, bolt-on acquisitions, and disposals. This trend also reflects strategies focused more on their core businesses in times of challenging macroeconomics. Companies will continue to invest in developing and strengthening digital capabilities, so we expect that capital expenditures will remain elevated.

In the U.S., we expect financial policies to remain rational, in part due to higher interest rates. Several issuers lowered leverage targets over the past one to two years due to the difficult operating environment and to offset the impact of higher rates on cash flow. In 2024, we believe hurdles stemming from the uncertain macroeconomic environment and higher cost of financing will also limit large M&A. We believe most issuers will focus on portfolio refinements rather than transformational acquisitions.

In 2023, there were two large M&A transactions in packaged food that had an impact on our view of credit quality. When Campbell Soup Co. announced its intention to purchase Sovos Brands Inc., we downgraded Campbell because of elevated leverage and our expectation that metrics would not be restored until 2026. J.M. Smuckers Co.'s planned acquisition of Hostess Brands Inc. led us to revise the outlook to negative due to risk in its ability to lower leverage.

In Latin America, we expect to see lower dividends, M&As, and share buybacks, as leverage is picking up from weaker domestic consumption across countries, lower export profits amid stronger foreign exchange rates, and fierce competition, while producers adjust volumes after a weak year of consumption. The high interest rates also reduced companies' cross-border debt issuances, while heavy interest burden pressured cash flows.

In Canada, operating performance was characterized by lackluster EBITDA and margins as well as inventory destocking by key retailers and tightening consumer spending, not fully offset by the easing of raw material and supply chain costs. As most speculative-grade Canadian companies have U.S. exposure, we expect profitability dynamics to be similar to that of the U.S. issuers.

In Asia-Pacific, pressure on profitability will ease thanks to ongoing markup efforts by consumer goods companies and lower input cost inflation. This, along with prudent financial policies, will likely support the credit profiles of consumer-product companies in 2024. We expect that global multinationals in Japan and China such as Japan Tobacco Inc., Suntory Holdings Ltd., Ajinomoto Co. Inc., and Midea Group Co. Ltd., will maintain their ongoing financial policies with spending targeting their focus areas such as shareholder remunerations, brand investments, and growth initiatives including acquisitions. We believe these companies will likely continue generating stable cash flows aided by their solid brand equity and diversified portfolios, enabling them to sustain their financial policies.

One risk factor is weak consumer confidence in China. Falling real estate prices and the weaker macroenvironment could sap consumers' spending appetite. Asia-Pacific discretionary goods companies operating in China, especially those with weaker brand equity, could face severe pricing pressure and hence lower profitability than others.

Most rated Chinese consumer product firms have sound finances for our ratings on them. However, smaller issuers or those with a higher financial leverage could see credit headroom compression given shrinking household wealth and tepid consumer sentiment amid property sector woes. We assume China's property crisis will not greatly affect the credit quality of rated Japanese consumer companies because of limited exposure to the Chinese market.

Key risks or opportunities around the baseline

1. Robust labor market continues to underpin consumers' confidence to spend

We expect household purchasing power will increase as a result of disinflation and wage growth. In the eurozone, inflation will likely ease to an average 2.9%, wages will rise by 4%. In the U.S., households have not yet run down their excess savings balances from COVID-relief policies, but real wage growth is slowing.

2. Leveraged issuers may struggle with tight financing conditions and the high cost of debt service.

We expect further credit deterioration in 2024, continuing the diverging trends of resilience at the investment-grade level and downgrades largely at the lower end of the ratings scale. Many lower-rated borrowers will be forced to refinance at much higher rates. Across all the corporate ratings, the consumer products sector has the highest negative bias, with negative outlooks or ratings on CreditWatch with negative implications on 23% of issuers.

3. Increased digitization can generate greater operating efficiencies and cost savings, but cyberattacks are becoming more widespread.

Branded consumer goods companies are investing in a wide assortment of technology to improve efficiency and accelerate growth. However, given the scale and scope of business disruption arising from recent cyber events, the financial impact of cyberattacks is growing, along with its potential to erode credit quality, accentuate credit risks, and strain ratings over time.

Robust labor market continues to underpin consumers' confidence to spend. The labor market is critical to consumer spending. While there are uncertainties about the lagged transmission of cumulative rate hikes, if workers keep their jobs--or expect to keep their jobs--then spending is likely to be maintained. Labor markets remain tight across many economies and wage growth prospects may continue to spur consumers to spend. We also expect household purchasing power will increase as a result of disinflation and wage growth.

In our soft-landing scenario for the eurozone, inflation will likely ease to an average 2.9%, wages will rise by 4%, and employment will stagnate. In the U.S., households have not yet run down their excess savings balances from COVID-relief policies, but real wage growth is slowing. We expect unemployment to peak in 2025 at 4.6%, only slightly above the long-run steady state unemployment.

Leveraged issuers may struggle with tight financing conditions and the high cost of debt service. On the back of a slowing economy and the high cost of debt, we expect further credit deterioration in 2024, continuing the diverging trends of resilience at the investment-grade level and downgrades largely at the lower end of the ratings scale. Many lower-rated borrowers will be forced to refinance at much higher rates than they enjoyed over the past years, and this would further strain cash flows, given many of the rated companies in the consumer product sector are highly sensitive to a drop in growth.

Across all the corporate ratings, the consumer products sector has the highest negative bias, with negative outlooks or ratings on CreditWatch with negative implications on 23% of issuers.

Increased digitization can generate greater operating efficiencies and cost savings, but cyberattacks are becoming more widespread. Branded consumer goods companies are investing in wide-ranging technology solutions to improve their efficiency across the supply chain and accelerate growth in e-commerce and direct-to-consumer operations. Digitization and advanced technologies can help consumer goods companies gain competitive advantage through innovation, process and cost efficiencies across production, supply chain, marketing, and distribution.

However, amid increasing technological dependency and global interconnectedness, cyberattacks pose a potential systemic threat and significant single-entity event risk. Given the scale and extent of business disruption arising from some recent cyber events in the consumer products sector, the financial impact is becoming more substantial and they increasingly have the potential to erode credit quality, accentuate other credit risks, and strain credit ratings over time. U.S.-based Clorox Co., for example, significantly lowered fiscal 2024 (June 30) guidance primarily due to temporary out-of-stock and some lost distribution on account of cyberattack-driven operational disruptions. We revised our outlook to negative from stable, reflecting the potential for a lower rating if Clorox does not demonstrate material sequential recovery in 2024 from the recent cyberattack.

Related Research

- European Retailers' Margins Are Unlikely To Regain Their Pre-Pandemic Strength, Nov. 7, 2023
- Corporates Up Their Cyber Preparedness As Cyber Attacks Become More Widespread, Oct. 25, 2023
- Industry Credit Outlook: A Second Half Rebound May Be Tall Order For U.S. Consumer Products Companies, Aug. 21, 2023
- Peer Comparison: A Cocktail Of Growth And Financial Discipline Will Keep Most Alcoholic Beverage Sector Ratings Steady, June 21,2023
- Slides: EMEA Consumer Goods Overview, Credit Trends, And Outlook, May 16, 2023
- 2023 CAGNY Presentations Highlight The Long Road To Recovery For Consumer Products Companies, March 15, 2023
- Personal Luxury Goods' Allure Endures As New Challenges Beckon, March 2, 2023
- Why One In Four U.S. Consumer Products ‘BBB’ Category Issuers Have Lowered Leverage Targets Significantly, Feb. 16, 2023

Industry Forecasts: Consumer Products

Chart 10
Revenue growth (local currency)

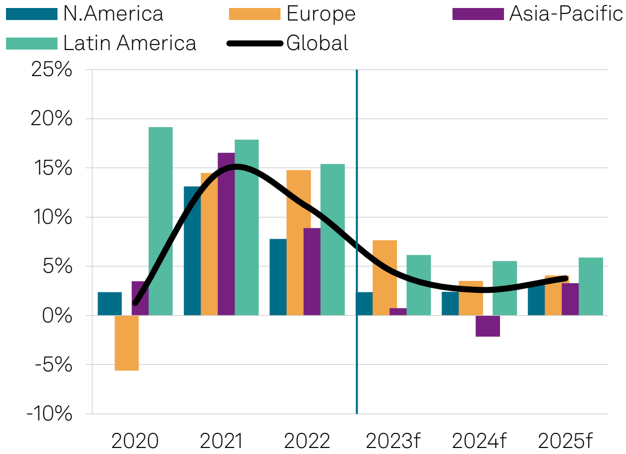


Chart 11
EBITDA margin (adjusted)

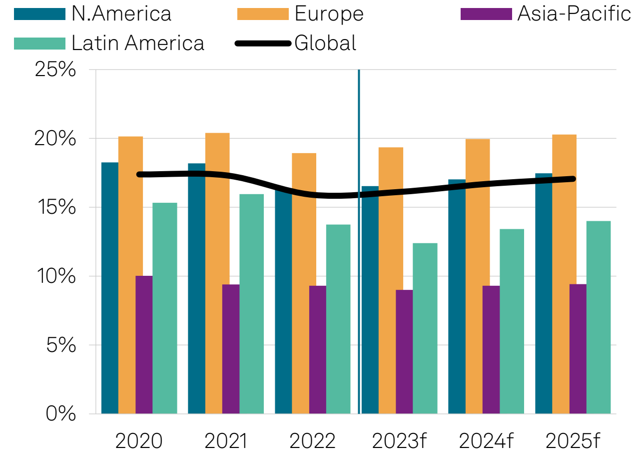


Chart 12
Debt / EBITDA (median, adjusted)

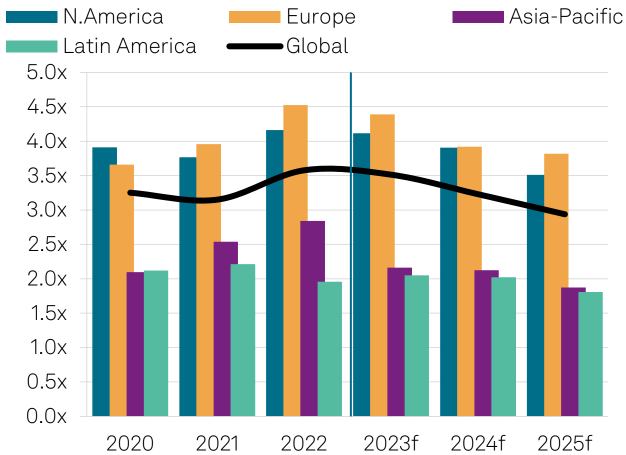
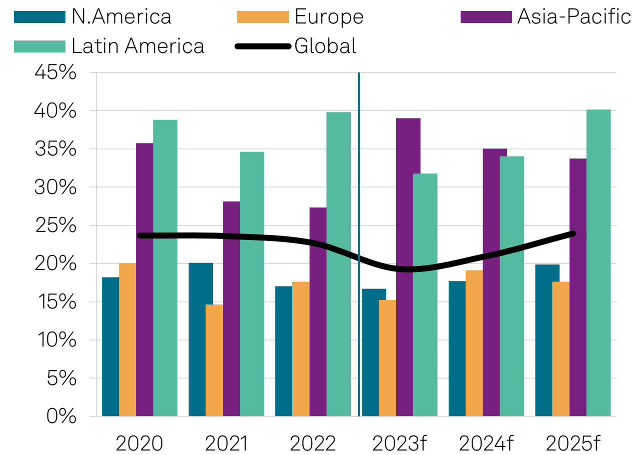


Chart 13
FFO / Debt (median, adjusted)



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: Consumer Products

Chart 14

Cash flow and primary uses

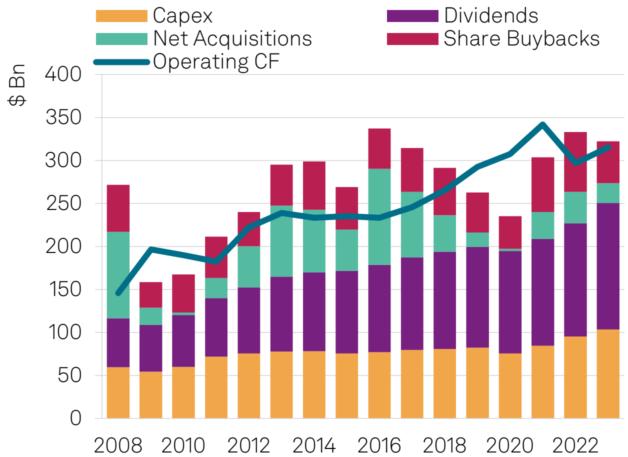


Chart 15

Return on capital employed

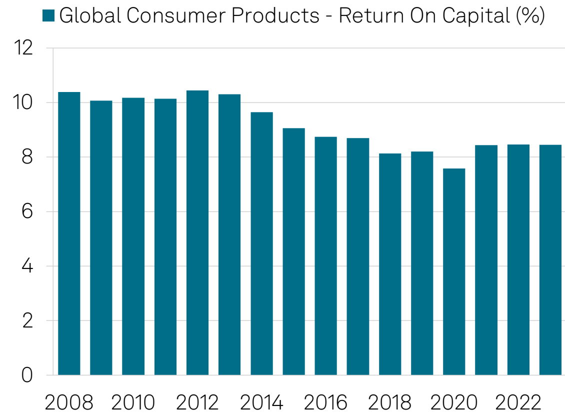


Chart 16

Fixed- versus variable-rate exposure

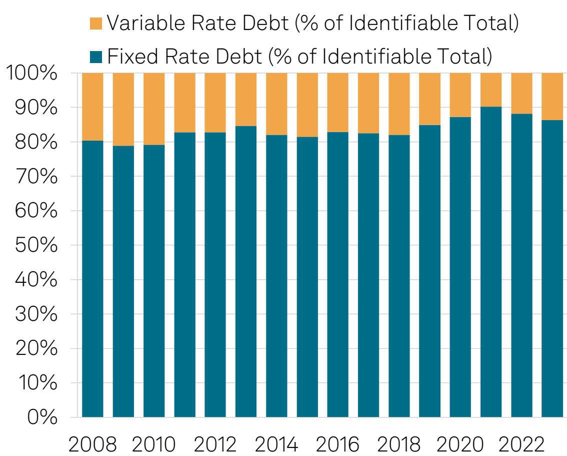


Chart 17

Long-term debt term structure

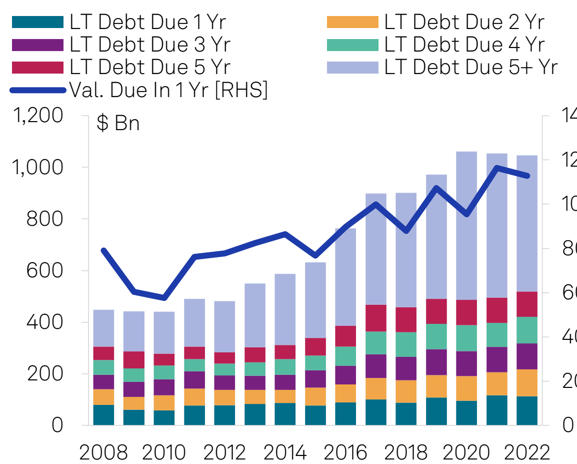


Chart 18

Cash and equivalents / Total assets

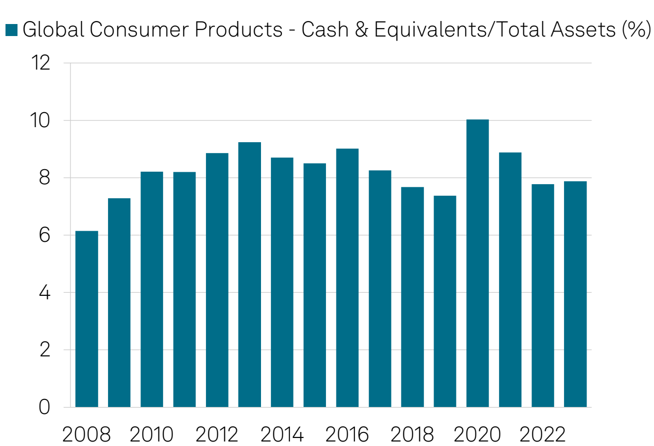
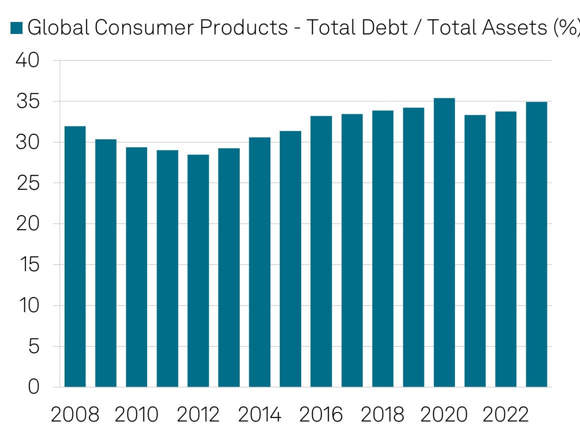


Chart 19

Total debt / Total assets



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

Health Care

Ratings pressure in the first half could ease in the second

January 9, 2024

This report does not constitute a rating action.

What's changed?

Deterioration at the low end continues. The low speculative-grade rated end of universe will see further deterioration into at least the first half of 2024.

Demand normalized, labor improving. Almost all companies saw demand normalize in 1H23. Inflationary and labor costs also moderated, though labor remains a longer-term challenge.

Services remain vulnerable. The labor-intensive, lower-margin, heavily sponsor-owned health care providers at the lower end of the ratings spectrum remain vulnerable to downgrades.

What are the key assumptions for 2024?

Demand a limited concern. Patient and procedure volumes should remain steady, with revenue growth in most sectors projected at mid- to upper-single digits.

EBITDA margins steadily improve. With costs stabilizing and demand normalizing, we project EBITDA margins will continue to slightly improve in 2024.

More M&A. Mergers and acquisitions (M&A) have already returned to pharma, and we're expecting M&A volumes in services to resume.

What are the key risks around the baseline?

Inflationary/labor pressures persist. Improved in 2023, but the worst may not be over.

Reimbursement pressures. The reimbursement environment has been relatively benign. However, with health care costs increasing, payors may get tougher on reimbursement.

No Surprise Act remains a surprise. Problematic implementation of No Surprise Act has had a negative impact on free cash flow generation, which could have negative ratings consequences.

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Ratings Trends: Health Care

Chart 1

Ratings distribution by region

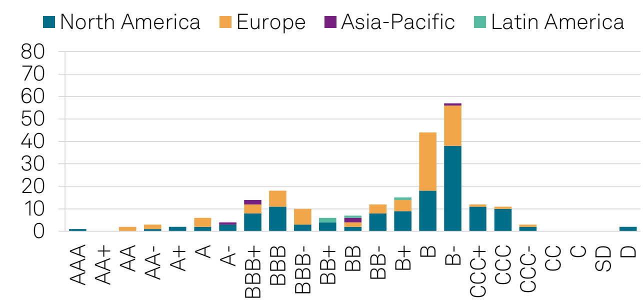


Chart 2

Ratings distribution by subsector

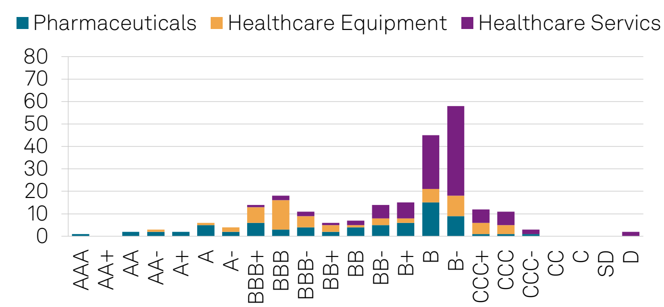


Chart 3

Ratings outlooks

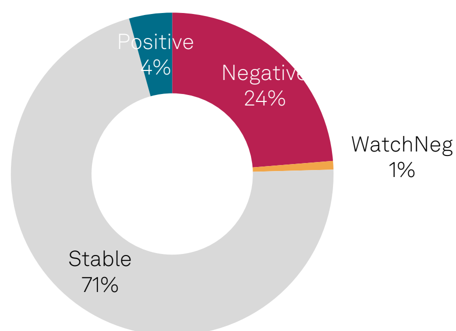


Chart 4

Ratings outlooks by subsector

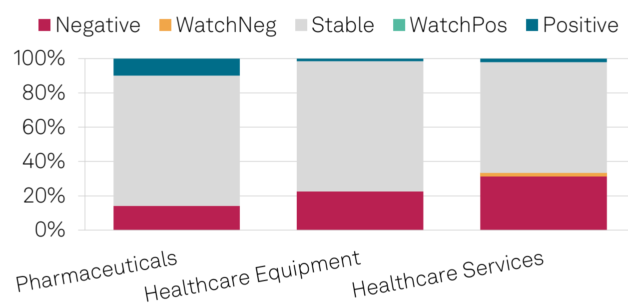


Chart 5

Ratings outlook net bias

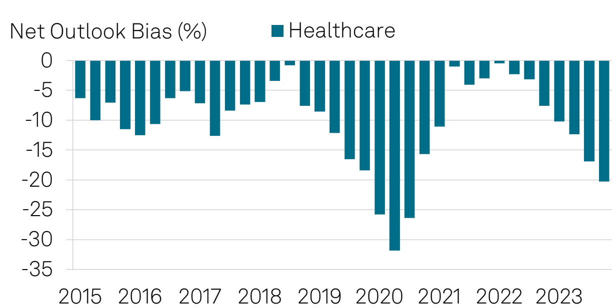
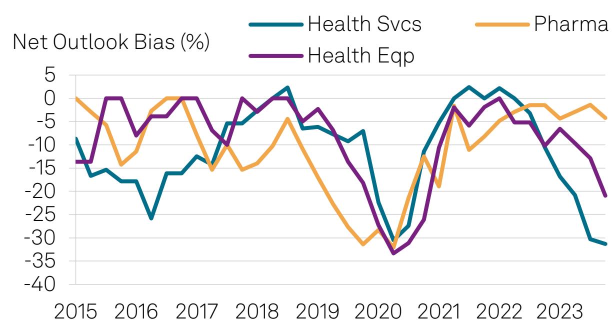


Chart 6

Ratings net outlook bias by subsector



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

Industry Outlook

Ratings trends and outlook

Our overall ratings outlook remains stable for the pharmaceutical and medical device and life science products subsectors of the health care industry. However, the outlook for the much larger health care services subsector remains negative and will likely remain so into the first half of 2024.

Health care services ratings continue to deteriorate, despite improving conditions. The health care ratings universe has seen more ratings deterioration in 2023 and we believe the deterioration will persist into at least the first half of 2024. The deterioration is largely contained in the very low-end of the speculative-grade ratings universe, which is populated mainly by sponsor-owned health care services companies. These highly leveraged companies are struggling to generate adequate sustained free cash flows given the inflationary environment, particularly on labor, as well as the high interest rate environment. The ongoing disruptions caused by the No Surprise Act and Medicaid redetermination process have also been detrimental to free cash flows.

While health care demand remains solid and the labor situation has improved, with EBITDA margins for most companies being flat to up versus the prior year, they remain below pre-pandemic levels and are unlikely to return to those levels through 2024, as labor costs will remain a challenge and cash flows will remain weighed down by elevated interest expense. Thus, we maintain a negative outlook for the health care services subsector.

Defaults to remain elevated in 2024. Health care is a traditionally defensive industry, in that demand is relatively constant; people get sick in good and bad times, leading to a relative high visibility in terms of demand and sales. However, in 2023 we have seen a record number of defaults in our rated universe, the second straight year of the industry setting such a record. This was partly because of the impact on EBITDA margins of inflationary pressures, particularly on labor, combined with the impact on cash flows from higher interest rates and the disruptions caused by No Surprise Act and Medicaid redeterminations. It was also partly due to the high level of private equity participation in health care, highlighted by the fact that over half of our rated universe is private equity owned and have above-average leverage.

Though health care labor costs have improved, they remain relatively high and a long-term concern given persistent the shortages of health care personnel. Interest rates will also remain elevated over the next year, despite the potential for cuts in the second half of 2024. And efforts to streamline the arbitration process under the No Surprise Act, and hopefully speed up cash collections, as well as the Medicaid redetermination process, will run through the first half of 2024.

Many of our rated companies also face 2025 debt maturities and must refinance in a difficult refinancing environment while still unable to sustain positive free cash flows. Thus, while we do not believe the rate of default in health care will set a record for a third straight year, given the overall improvement in labor and EBITDA margins and No Surprise Billing, it will likely remain elevated.

Medical devices and products companies outlook is the most stable. The medical device and products subsector remains the most stable of the health care subsectors. Procedure volumes have fully normalized in the second half of 2023 as procedure backlogs built up during the pandemic was worked through in the first half of 2023. Labor and supply chain issues have largely stabilized for medical device and product makers, as have freight costs. We project solid mid-single-digit growth of 5%-7% across several medical device categories.

Meanwhile, life science companies have seen some slowdown in demand, due to a combination of a decline in sales COVID-19 related products and tests as well as a slowdown in China. A slowdown in R&D activity amongst the biotech startups has also led to sales pressure. However, we do not have significant concerns regarding the rated life science and research tools companies as they generally maintain conservative balance sheets. We view the sales slowdown as temporary and believe the longer term growth prospects remain intact.

Pharma sees solid growth prospects as it returns to M&A. The windfall of COVID-19-related vaccine and treatment sales has dissipated and the best-selling drug in the industry, Humira, has seen biosimilar competition emerge in the U.S., creating a drag on industry sales growth. However, industry growth has held up well and the prospects for the industry looks promising, at least until 2026, when Medicare drug price changes under the Inflation Reduction Act are scheduled to be implemented. We believe the pipelines of many of the rated players are healthy, and expect the GLP-1 diabetes and weight loss drugs, new classes of cancer drugs, and new Alzheimer's treatments to drive sales growth.

M&A has returned after a relatively quiet period, and we continue to view M&A as strategically important for the highly rated Big Pharma and biotech companies. We believe sustained adjusted leverage for this group of companies has permanently shifted higher, to the 1.5-2.5x range, over the past several years, after having been traditionally sub-1.5x on an adjusted basis. Thus, even when many companies, such as Pfizer, saw their leverage decline below our upside triggers, given the relative pause on M&A activity and strong COVID-19 related sales, we did not take positive rating action, given the expectation of future major debt-financed acquisitions. And acquisitions have significantly returned in 2023--including Pfizer's $43 billion acquisition of Seagen Inc., Merck's $10.8 billion acquisition of Prometheus Biosciences, Amgen's $26 billion acquisition of Horizon Therapeutics, Abbvie's acquisition of Cerevel Therapeutics for $8.7 billion and ImmunoGen for $10.1 billion--and Bristol-Myers' $21 billion of acquisitions consisting of Karuna Therapeutics (for $12.7 billion), RayzeBio ($3.6 billion), and Mirati ($3.7 billion). The significant use of financial capacity led to downgrades on Bristol-Myers (downgrades to 'A' from 'A+') and Pfizer (to 'A' from 'A+') and outlook revision to negative from stable on Amgen (BBB+/Negative/A-2).

The implementation of the Medicare drug price change in 2026 clouds the longer term prospects, especially as the regulation gets phased in, though it is too early to speculate on the earnings and ratings impact, given the still evolving price negotiation process, the level of discounts, and ability to retain market shares. We have not reflected the impact in our company projections at this time.

Main assumptions about 2024 and beyond

1. Demand for health care remains stable.

There are pockets of softness, depending on specialty and geography, mainly relating to labor availability. However, we believe health care demand has normalized and we project it will continue growing in the mid-single digit area.

2. Labor and inflationary costs moderate but remain a challenge.

The labor situation had improved in 2023, but longer term, the specialized needs of the industry make increasing the labor supply challenging.

3. Adjusted EBITDA margins and free cash flow generation to improve.

We are projecting flat to moderate improvement in EBITDA margins for 2024 for many companies. However, particularly for the health care service providers, there remains work to be done.

Margin pressures and cash flows could worsen. For health care service providers, EBITDA margins improved in 2023 and we project margins and free cash flow generation will improve in 2024, especially toward the second half of the year. Labor pressures have peaked, supply chain pressures have eased, and cost-cutting and efficiency initiatives have taken further hold. The reimbursement environment has been relatively benign, as providers were for the most part able to pass on their inflationary costs through pricing and reimbursement increases.

However, we believe the reimbursement environment may become more difficult in 2024, given rising medical cost ratios at health insurers and increasing health care costs at plan sponsors. Labor remains a long-term concern as well. Should companies' continued efficiency efforts fall short and cost inflation reemerge, EBITDA margins could decline, increasing pressure on cash flows and pushing adjusted leverage to higher, potentially unsustainable, levels.

Labor remains a top challenge for the health care industry, especially for health care services subsector, which makes up the majority of our rated corporate universe. The labor situation had improved in 2023 and health care hiring remains strong, leading all industries. However, longer term, the highly trained, specialized needs of the industry makes increasing the labor supply challenging. By some estimates, the nursing shortage may not improve until after 2025 and per the American Medical Association (AMA), the U.S. could be 130,000 doctors short by 2030. Thus, while labor expenses for many service providers grew mid-single digits in 2023 versus roughly 9% in 2022, the worst may not be over.

Despite the full normalization of health care patient and procedure volumes in the first half of 2023 and the expectation of solid mid- to high-single-digit topline growth for the industry, a stabilization of supply chains, and moderating inflationary and labor pressures, the elevated interest rate environment along with legislative developments such as No Surprise Act and Medicaid redetermination have combined to weaken free cash flow generation at many of our rated health care service providers.

The No Surprises Act led to immense payment backlog. The implementation of the No Surprises Act in 2022 has wreaked havoc on many health care service providers. The Act sought to protect patients from surprise medical bills that arise when they inadvertently use out-of-network providers by making providers and health insurers negotiate a final amount, which has taken a toll on the cash flows of providers, many of which are highly leveraged sponsored-owned companies that are exposed to labor and interest expense inflation. Per the latest figures available, 489,000 claims were submitted to the arbitration system between April 2022 to July 2023, fourteen times more than originally projected by the U.S. Department of Health and Human

Services (HHS). This led to long delays in payments and contributed to the elevated number of negative rating actions and defaults amongst the lower rated speculative-grade end of the health care ratings universe, such as TeamHealth, Radiology Partners, Envision, and Air Methods. Given the volume of claims and delay in processing, the Centers for Medicare and Medicaid Services (CMS) is working on amending the process, though we believe the impact on companies will likely be felt well into 2024.

Credit metrics and financial policy

We expect credit metrics for the health care industry to deteriorate in 2024, despite steady demand, easing inflationary and labor pressures, and cost saving and efficiency measures leading to improved adjusted EBITDA margins. We see labor costs as a long-term risk, along with a tougher reimbursement environment, especially as employers seek to lower their health care bill.

The health care industry has been among the most active when it comes to M&A, especially within the pharmaceutical subsector as a pipeline for future products. With the rebound of M&A, we see a deterioration of credit metrics as companies utilize their capacity within the current ratings. We expect this elevated level of M&A to persist in 2024.

Meanwhile, M&A activity amongst the health care services subsector remains muted, given many companies' current struggles with free cash flow generation and already high leverage levels from past acquisition sprees. However, we believe M&A will return in the near term, given the strategic need for continued consolidation, to gain economies of scale, and to extract higher reimbursement rates from payors, despite the elevated interest rate environment.

The U.S. Federal Trade Commission (FTC) is likely to remain focused on health care M&A, concerned that consolidation in the industry has contributed to the rise in health care costs. The FTC is not only scrutinizing acquisitions by larger players, such as Amgen (on its acquisition of Horizon, ultimately approved) and HCA Healthcare (acquisition of five Utah hospitals in 2022, ultimately canceled), but also by sponsor-owned companies that employ "roll-up" strategies, some of which--like the health care services sector, which remains relatively fragmented, could see consolidation as a path to increase market power in a specialty or geographic region, and a means to extract higher prices/reimbursement from the already consolidated healthcare insurance players that dominate U.S. health care. Greater scrutiny by the FTC could hamper sponsor-owned company's abilities to pursue roll-up strategies as well as their ability to increase prices to justify past acquisitions done at high multiples and de-lever quickly, clear negatives from a credit perspective. We do not believe the increased FTC scrutiny will necessarily lower M&A volumes in the industry, given the strategic need for M&A within the pharmaceuticals and health care provider industries. However, acquisitions may take longer to complete.

Key risks or opportunities around the baseline

1. Margin pressure could worsen.

EBITDA margins improved in 2023 but cost and reimbursement pressure could reverse those trends in 2024, and labor costs remain a long-term challenge.

2. Free cash generation fails to improve.

Many health care services companies are still struggling to generate sustained positive free cash flows. While we expect some of the headwinds to start to moderate in mid-2024, if they persist it would lead to further deterioration of credit metrics, liquidity, and credit ratings.

3. FTC is a near term wildcard with longer term implications.

M&A transaction volumes will rise across the health care sector. However, the FTC is on high alert in both the pharmaceutical and health care services subsectors.

4. Legislative risk remains.

While health care policy has not come up as a major talking point in the upcoming presidential election yet, there's bipartisan support for lowering health care costs and increasing transparency, which could lead to further legislation that would be disruptive to providers, contributing to negative rating actions.

Margin pressure could worsen. Companies have largely seen adjusted EBITDA margins improve in 2023. However, companies could see EBITDA margins pressured should labor costs or reimbursement pressures rise. Many health plan sponsors are seeing costs to provide health care coverage to employees growing at an unsustainable double-digit rate, and health insurance companies are facing rising medical cost ratios as health care utilization has increased. This could lead to more difficult discussions on pricing and reimbursement.

While labor costs growth has moderated, health care labor remains a challenge given steadily growing health care demand, health care employee burnout, and the persistent shortage of doctors and nurses, especially in select areas of growing need. The latest jobs data also shows that despite a slowing market, health care continues to drive jobs growth. This will pose a long-term challenge for the sector.

Free cash generation fails to improve. Despite cost cutting and efficiency efforts, improving topline demand, and moderating inflationary/labor costs, many health care services companies are still struggling to generate sustained positive free cash flows. The elevated interest rate environment is part of the reason, but legislative developments, such as No Surprise Billing and the Medicaid redetermination process, have also weighed on cash flows. We expect the negative impact from such developments to start to moderate in mid-2024, leading to expected improvement in the second half of 2024. However, if the headwinds continue it could lead to further deterioration of credit metrics, liquidity, and credit ratings.

Consolidation resumes, and the FTC is watching. M&A has returned to the industry, especially in the pharmaceutical sector, and we believe transaction volumes in health care services will rise as well. However, the FTC is increasingly scrutinizing M&A in in both subsectors to ensure that newly enlarged firms do not wield disproportionate power in setting prices. A number of mergers were delayed--such as Amgen's acquisition of Horizon--and even canceled--such as HCA Healthcare Inc.'s aborted acquisition of five Utah hospitals from Steward Health Care System. The FTC could put the brakes on strategically necessary M&A.

Legislative risks could increase. We are entering a U.S. Presidential election year. While health care policy has not come up as a major talking point yet, there remains a high level of bipartisan support for health care legislation that seeks to lower costs and increase transparency. Legislation like the well-meaning No Surprise Act, to protect patients from surprise billings, have had a disruptive effect on providers, contributing to negative rating actions.

Related Research

- Research Update: Bristol-Myers Squibb Co. Downgraded To 'A' On Plans For $21 Billion Of Debt-Financed Acquisitions; Outlook Stable, Dec. 27, 2023
- Merck & Co. Inc., Dec. 22, 2023
- Research Update: McKesson Corp.'s Leverage Has Declined; 'BBB+' Rating And Stable Outlook Affirmed, Dec. 18, 2023
- Hologic Inc., Dec. 15, 2023
- Research Update: LifePoint Health Inc. Outlook Revised To Stable From Negative On Steadily Improving Performance, Ratings Affirmed, Dec. 14, 2023
- Research Update: Pfizer Inc. Downgraded To 'A' From 'A+' On Proposed Seagen Inc. Acquisition, Dec. 13, 2023
- Research Update: ADMI Corp. Outlook Revised To Stable From Negative On Maturity Extension And Solid Liquidity; 'B-' Rating Affirmed, Dec. 12, 2023
- Johnson & Johnson, Dec. 11, 2023
- Medtronic PLC, Dec. 6, 2023
- Thermo Fisher Scientific Inc., Dec. 5, 2023
- Tear Sheet: Eli Lilly & Co., Dec. 4, 2023

Industry Forecasts: Health Care

Chart 7
Revenue growth (local currency)

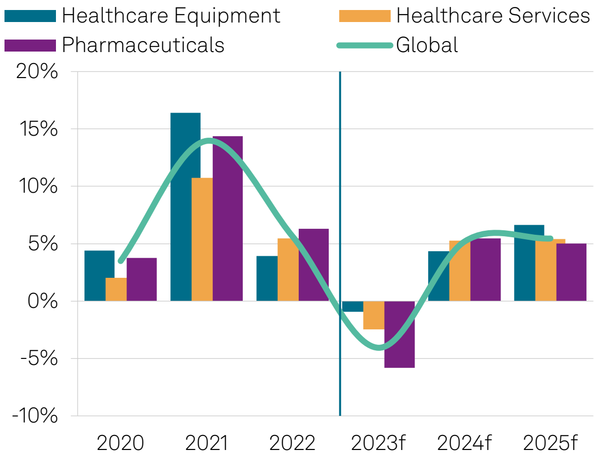


Chart 8
EBITDA margin (adjusted)

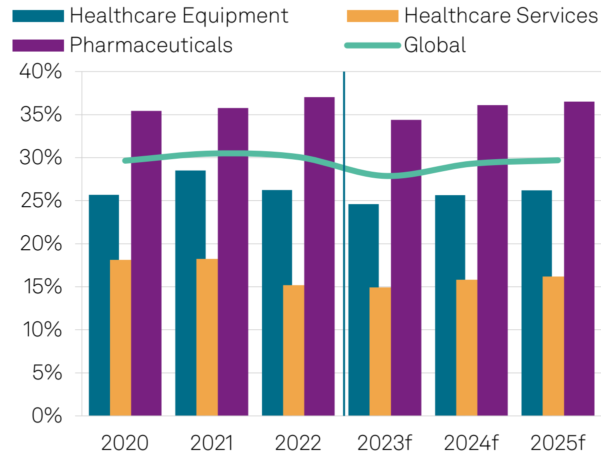


Chart 9
Debt / EBITDA (median, adjusted)

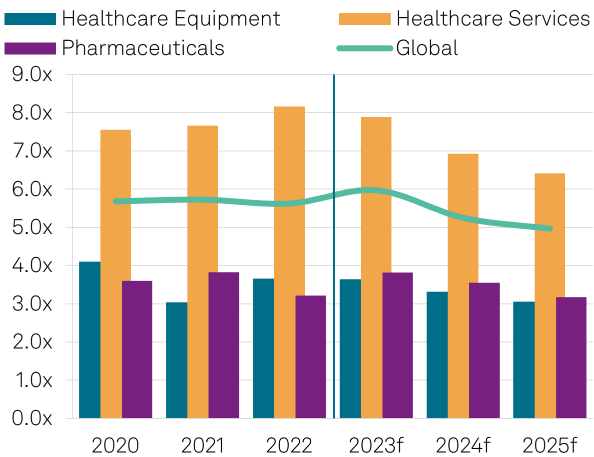
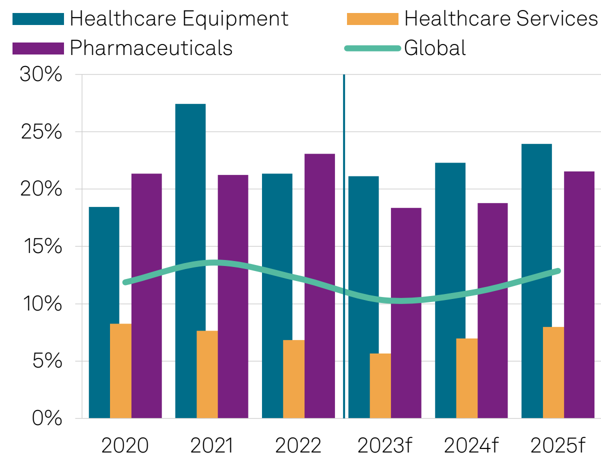


Chart 10
FFO / Debt (median, adjusted)



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: Sector

Chart 11

Cash flow and primary uses

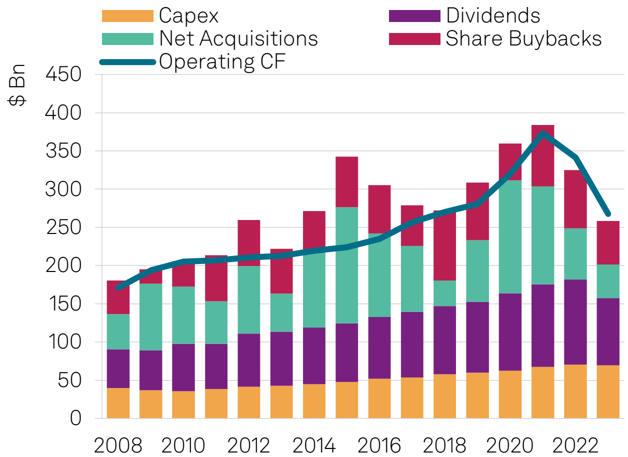


Chart 12

Return on capital employed

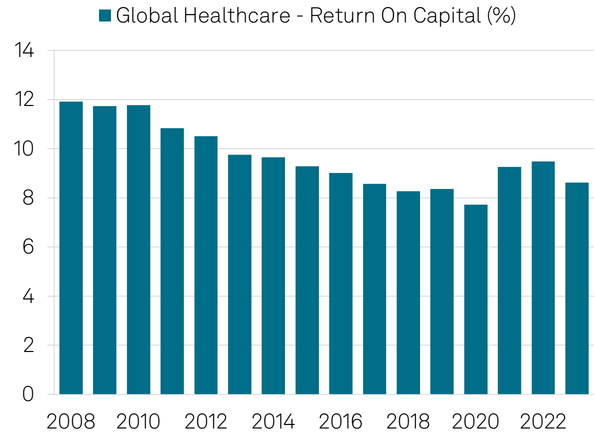


Chart 13

Fixed- versus variable-rate exposure

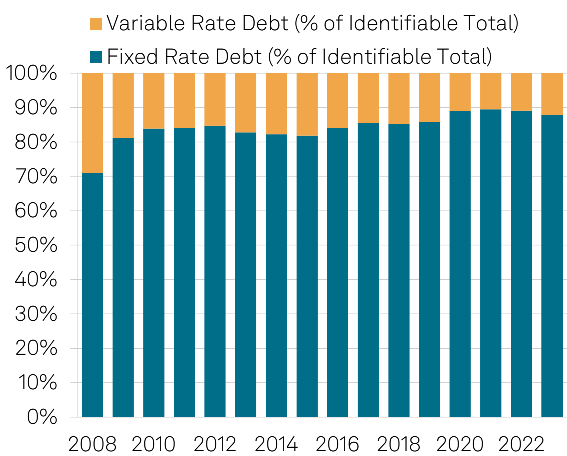


Chart 14

Long-term debt term structure

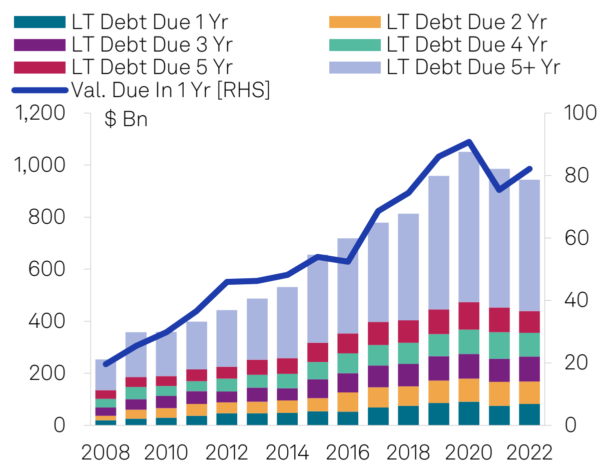


Chart 15

Cash and equivalents / Total assets

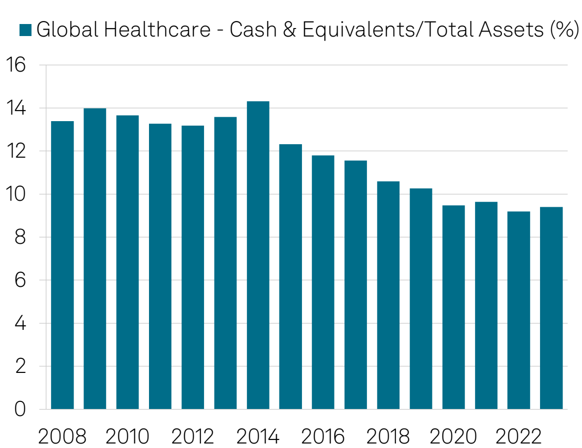
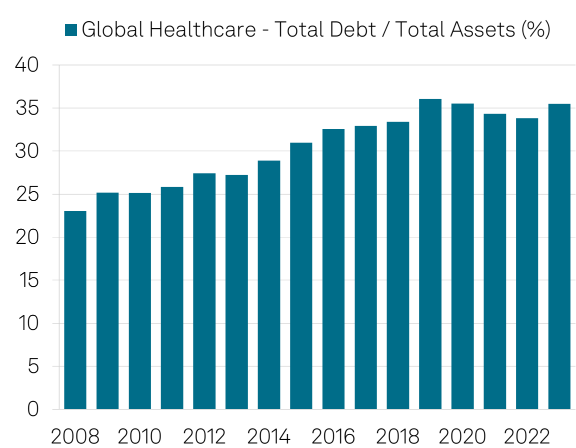


Chart 16

Total debt / Total assets



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

Homebuilders and Developers

Resilient demand to spur recovery

January 9, 2024

This report does not constitute a rating action.

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What's changed?

Housing demand remains resilient in the U.S. Mortgage rates increased close to 8%, further hurting affordability. However, low existing home inventories supported homebuilders.

Access to financing could remain difficult in Europe. Banks are tightening lending conditions, especially for commercial real estate developers, which could face elevated refinancing risks.

Brazil announced several changes to its housing program. We expect a higher number of launches due to changes to the Minha Casa, Minha Vida housing program.

What are the key assumptions for 2024?

U.S. cycle times are shorter. Cycle-time reductions enable homebuilders to prioritize returns through higher asset turns and increased delivery volume.

China's property sales value drops 5%. Provincial capital cities and lower-tier cities will see sales value decline 3% and 9%, respectively, alongside lower prices and volume drop of up to 5%.

Latin America and Europe improve profitability. Margins will likely recover more evenly in 2024, given stable inflation and higher-priced projects. In Europe, demand stymies the rate of recovery.

What are the key risks around the baseline?

U.S. existing home inventories increase from low levels. Lower mortgage rates could attract existing homeowners to sell, possibly siphoning sales from prospective new-home buyers.

Europe sees further monetary tightening. More-restrictive conditions could cause banks to issue fewer mortgages, dragging down housing purchases and developers' sales further.

China rolls out policies to support sales in higher-tier cities. Relaxing home purchase restrictions, mortgage rates, and downpayment requirements could aid sales in certain cities.

Ratings Trends: Homebuilders and Developers

Chart 1

Ratings distribution

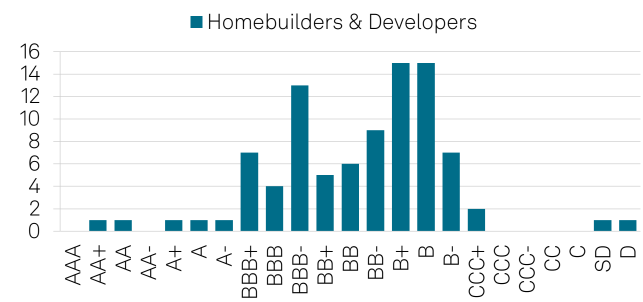


Chart 2

Ratings distribution by region

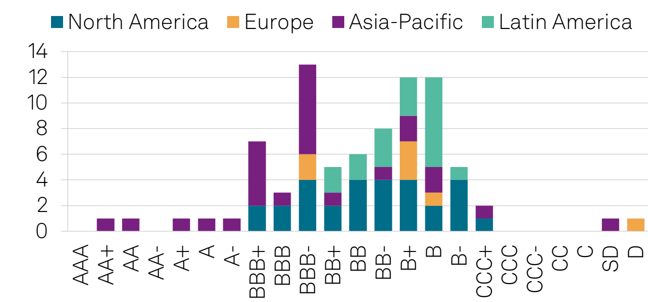


Chart 3

Ratings outlooks

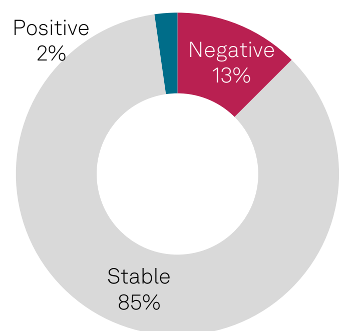


Chart 4

Ratings outlooks by region

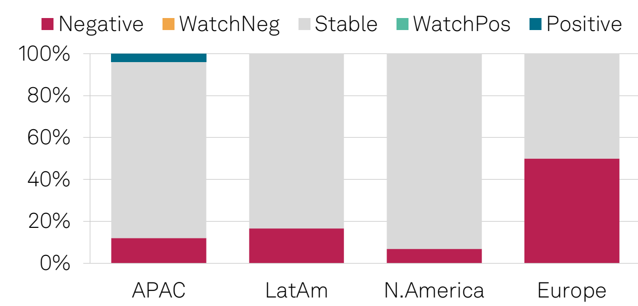


Chart 5

Ratings outlook net bias

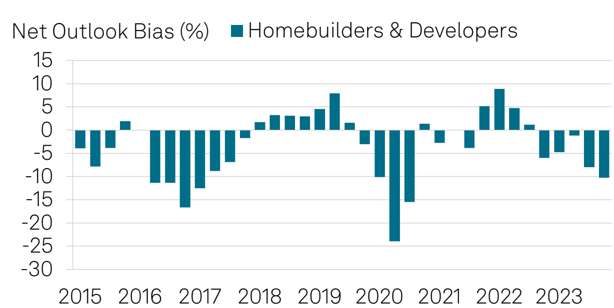
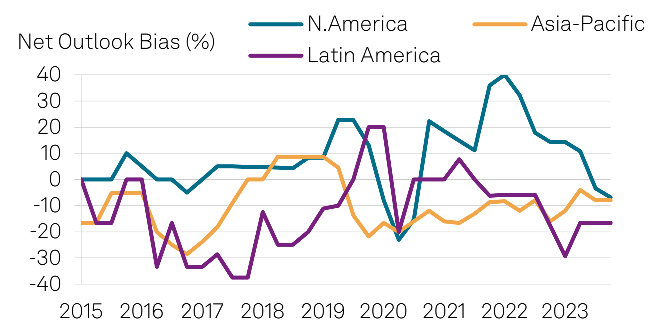


Chart 6

Ratings net outlook bias by region



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

Industry Outlook: U.S.

Ratings trends and outlook

Our overall outlook for the U.S. homebuilding sector is stable. Of the homebuilders we rate, 93% have stable outlooks and 7% (two credits) have negative, indicating the possibility of two downgrades over the next 12 months. We began 2023 with about 30% of our credits on positive outlook and upgraded 13 credits during the year. Of note, we upgraded two credits to investment grade, bringing the total number of investment-grade U.S. homebuilders to seven out of 28. We also rated one new public homebuilder. After the upgrades of 2023 and with no credits currently on positive outlook, we expect minimal upgrades in 2024.

Despite a stable outlook and our expectation for declining revenue and EBITDA growth in 2023, the sector benefits from good long-term demand, tight supply, low existing home inventory, a healthy labor market, good cost management, and judicious capital allocation. Many homebuilders used the windfall from peak operating performance in 2022 to reduce debt and bolster land to improve their balance sheets.

As of Jan. 1, 2024, we publicly rate 28 issuers in the U.S. homebuilding and real estate developer sector. Issuers' revenues range from $640 million to slightly over $33 billion. Currently, 25% of our ratings on U.S. homebuilders are investment grade (‘BBB-’ or higher) while 39% are rated ‘B’ or lower. Of our rating outlooks, all except two credits are stable, both of which are negative.

Main assumptions about 2024 and beyond

1. Shorter cycle times

Cycle time reductions are enabling homebuilders to prioritize returns through higher asset turns and increased delivery volume.

2. Reversal of revenues and EBITDA declines from prior year

We expect better operating performance in the second half of 2023 to continue into 2024 with year-over-year growth in both revenues and EBITDA.

Construction cycle times decreased in the second half of the year, reflecting improvements in the supply chain. We expect this will increase cash flow and inventory churn. This improvement should play out in overall operating performance as we assume financial results improve significantly from 2023 based on our previous forecasts. In 2023 we expect our rated universe of homebuilders' revenues and EBITDA to decline about 7.5% and 21%, respectively, which is better than the respective declines of 17% and 35% that we projected in July. In 2024 we anticipate revenues grow about 5%, with EBITDA increasing about 6.5% for our rated homebuilder universe. As we anticipate cycle times will improve, we concurrently expect those numbers to expand with them.

Credit metrics and financial policy

Financial discipline for homebuilders before and during the pandemic yielded stronger ratios and a growing credit buffer, indicating their credit quality improved. We expect most homebuilders to sustain solid credit protection measures with robust profitability and lower debt levels, given the cushion under their existing credit metrics and the continued improvement in construction cycle times.

Before taking any negative rating actions, we would anticipate an increase in debt levels through incremental financing and a decline in cash balances that reduce the credit buffer. This could occur through a significant increase in land and land development spending, including small bolt-on acquisitions. Alternatively, a decline in EBITDA could reduce the buffer, but we instead anticipate EBITDA growing about 6.5% in 2024 for our rated universe.

We believe larger public homebuilders have an inherent competitive advantage over smaller builders due to the high cost of capital. Smaller, private, new homebuilders tend to borrow from local and regional banks. Their borrowing costs are generally higher than the larger public builders, and we think the local and regional banks will likely reduce the amount of credit they are willing to extend to the smaller, private builders. This bodes well for mergers and acquisitions (M&A), but we expect to see more land purchases and small bolt-on acquisitions than any large, public M&A activity.

Key risks or opportunities around the baseline

1. Higher-than-expected input costs

Cost inflation continues to challenge the market. However, lower lumber costs have offset some higher input costs. If input costs trend higher than we expect while lumber prices increase, margins could deteriorate.

2. Existing home inventories increase from low levels

If mortgage rates decline enough for existing homeowners to feel confident to sell, the increase in existing home inventories could siphon sales from prospective new-home buyers.

3. Higher-than-expected incentives due to higher-for-longer mortgage rates

The level of incentives that builders offer helps them maintain sales pace but also pressures profitability. If the level remains higher than normal, we expect pressure on gross margins.

Cost inflation could impair profitability as input costs continue to rise, specifically for lot prices. However, low lumber prices are offsetting most of these costs after declining about 65% since February 2022. While we assume revenues will increase in 2024, if input costs trend higher than expected and lumber prices increase, we expect some deterioration in margins.

A reduction in resale competition is likely increasing the prospective buyer pool for new homes, and we believe this will persist while rates remain elevated. Currently one-third of housing inventory is new construction compared to historical norms of a little more than 10%, according to the National Association of Homebuilders. Combined with the slowdown in new home construction starts over the past several quarters, this has only increased the housing deficit.

The lock-in effect--in which existing homeowners do not list their homes due to their below-market mortgage rates--is further compounding the limited resale market. It provides strong support for the new home market and has resulted in market share gains for publicly traded homebuilders. If mortgage rates decline enough to allow existing homeowners to feel confident to sell, the increase in existing home inventories could siphon off sales from prospective homebuyers who see existing homes as a more affordable option than newly built.

The rise in mortgage rates over the past year has led to higher monthly mortgage payments. Consequently, homebuilders that provide a rate buy-down incentive strategy have been a key component in mitigating those higher mortgage rates in addition to reducing the size of homes to be sold, providing better affordability for customers while maintaining a targeted sales pace for homebuilders.

However, these incentives have been offered at higher levels than before the pandemic, resulting in a decline in profitability. If mortgage rates begin to decline, which we began to see in December with rates closer to 7%, and remain at these lower levels, we expect a decline in the utilization of these incentives, aligning to pre pandemic levels. All else the same, this could help stabilize margins. However, at the current level of higher-than-normal incentives, we continue to expect pressure on gross margins.

Industry Outlook: EMEA

Ratings trends and outlook

We continue to anticipate significant credit rating pressure for developers in 2024, mainly from subdued demand and elevated cost of construction. However, we expect this to gradually ease during the year. Additionally, we see Spanish developers faring better than average, as demand is less vulnerable to rate increases.

In Europe, four of six (67%) ratings have a negative outlook, highlighting pressure from declining demand for newly built properties amid rising interest rates and significantly higher building costs since the beginning of 2022. Numerous bankruptcies of non-rated companies have occurred this year, as well as the downgrade of Signa Development Selection AG (D/--), the commercial property development subsidiary of Signa Holding GmbH (Signa). Signa was one of the largest private real estate investment companies in Austria, where it filed for insolvency because it was facing a substantial liquidity crunch.

Main assumptions about 2024 and beyond

1. Demand for newly built residential properties to remain low but could gradually recover

The stabilization of central rates, increase in real income, and growing preference for energy efficient assets should progressively revive demand for newly built assets. We expect price declines to slow as developers consider new launches and revive demand. We anticipate a strong labor market and housing scarcity to support prices.

2. Access to financing to remain difficult, particularly for commercial real estate

European banks are tightening their lending conditions, especially for developers of commercial real estate, which we believe could face more elevated refinancing risks. We also anticipate high lending rates to still bear on demand, notably from first-time buyers.

3. Construction cost pressures to ease

The cost of most building materials has stabilized in 2023 and subcontractors have adjusted their prices amid weaker demand. Developers should therefore see margins benefit in 2024 and 2025.

Higher rates and inflation have dented real estate purchasing power and depressed demand for real estate. In Europe, mortgage loans pay most sales, except in Spain, where the proportion is smaller. We believe the European Central Bank (ECB) will maintain its deposit facility rate at 4% in the first half of 2024, after a 450 basis point (bp) increase within the last 18 months. We expect the ECB to decrease it by 75 bps in the second half of 2024 and by 125 basis points in the first three quarters of 2025, to about 2%. At the same time, real incomes could rise in 2024 because of disinflation and resilient labor markets. We believe both factors will revive demand and limit price declines this year (see chart 7). Moreover, we anticipate Spanish developers will experience less stress, as their sales have support from cash transactions, mortgages with low loan to values, and more international demand.

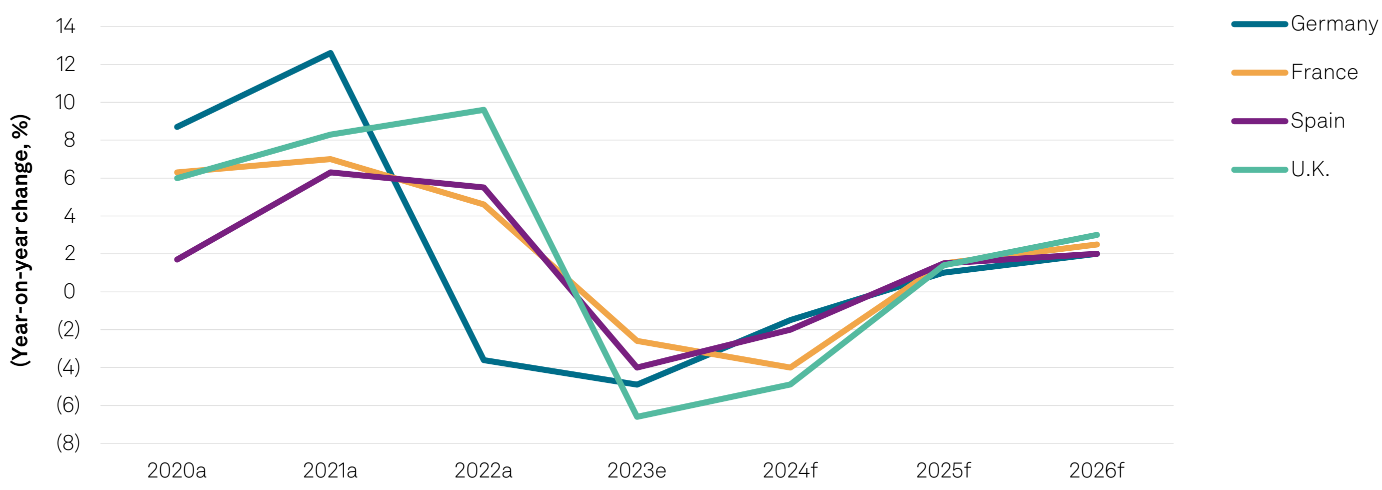
We view commercial real estate developers as vulnerable to refinancing risks. This is because obtaining bank financing on new property developments, especially speculative ones that are not pre-let and riskier by nature, could become harder (see "Credit FAQ: Spotlight On Refinancing Risks In European Commercial Real Estate", April 24, 2023).

Margins continue to experience heavy pressure, reflecting weaker prices as demand suffers and persistently high construction costs as developers lower selling prices to sustain sales volumes. However, the cost of raw materials, such as steel, aluminum, timber, energy. and water, has significantly moderated compared to its peak in the end of 2022. Moreover, some subcontractors have readjusted prices further to accommodate a weakening demand. Therefore, developers' margins could improve in 2024 given the lag from contract renegotiations, though remain lower than in 2021.

Chart 7

S&P Global Ratings economists' nominal house price forecasts

Year-on-year change in Q4 (%), as of July 20, 2023



a—Actual. e—Estimate. f—Forecast. Source: S&P Global Ratings. Economic Research: European Housing Markets: Sustained Correction Ahead, July 20, 2023.

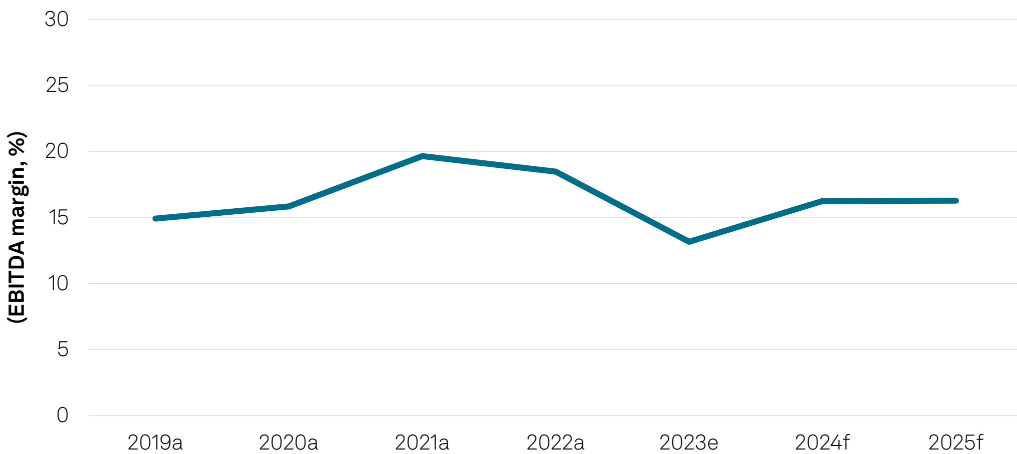
Credit metrics and financial policy

Revenue could recover modestly in 2024, after a strong decline in 2023. We expect EBITDA margins to improve due to easing construction cost inflation and potentially stronger sales (see chart 8).

Chart 8

Pressures on EBITDA margin could ease in 2024

Average S&P adjusted EBITDA margin for S&P Global-rated homebuilders & developers (EMEA), as of Dec 7, 2023



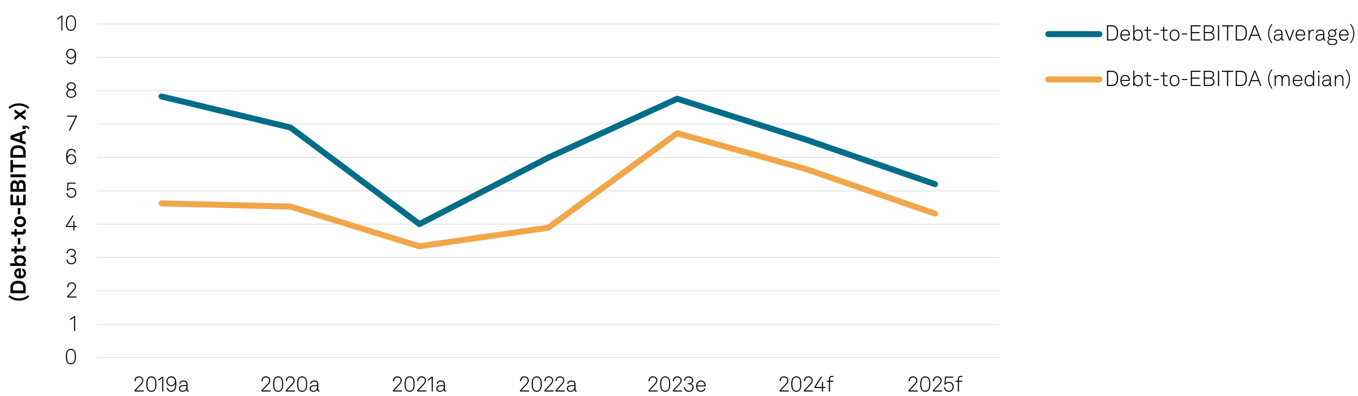
a—Actual. e—Estimate. f—Forecast. Source: S&P Global Ratings.

We do not expect leverage to recover before the end of 2025, as demand gradually increases and new debt supports new project launches (see chart 9).

Chart 9

Debt-to-EBITDA Should Recover Progressively

Average and median S&P adjusted debt-to-EBITDA ratio for S&P Global-rated REITs, as of Sept. 21, 2023



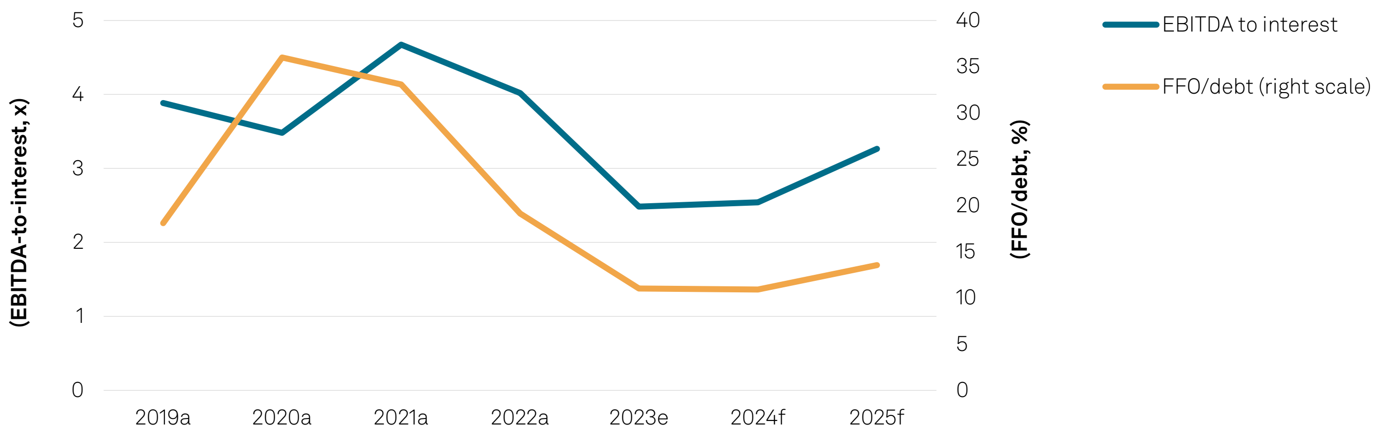
a—Actual. e—Estimate. f—Forecast. Source: S&P Global Ratings.

Interest coverage and funds from operations (FFO) to debt could bottom out by the end of 2024 because of fragile demand recovery and funding costs stabilization, although they will likely remain lower than 2020-2021 levels for a prolonged period (see chart 10).

Chart 10

ICR and FFO-to-debt should bottom out in 2024, as revenue slowly recovers

Average S&P adjusted EBITDA-to-interest ratio and FFO-to-debt ratio for S&P Global-rated REITs (EMEA), as of Sept. 21, 2023



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

Key risks or opportunities around the baseline

1. Further monetary tightening

More-restrictive bank conditions could cause banks to issue fewer mortgages, dragging down housing purchases and developers' sales further.

2. Intensifying regulatory and environmental requirements

While these are fueling demand for new builds, they also represent additional costs, administrative hurdles, and technical challenges for developers.

3. Support from government

Any governmental attempt to revive housing demand, either through household incentives or large orders, will benefit property developers.

Developers' sales and price flexibility could be weakened if banks tighten lending conditions, either in pursuit of increased margins or because of higher-than-expected rate increases by central banks. This is especially likely in countries where rates are variable or where servicing household debt represents a high burden, such as the Netherlands, Sweden, and the United Kingdom (U.K.).

Environmental requirements could be either an opportunity or a risk for developers. As regulations become more restrictive toward low-energy-efficient housing, such as through minimum energy performance certificate (EPC) standards, they encourage the purchase of new builds that are typically more energy efficient and safer than aging or second-hand residentials. However, these requirements may also delay the execution of projects and pile on costs to developers. Restrictions on building permits to limit land artificialization may also constrain the launch of new developments in coming years, especially in Western Europe.

In 2023, governments showed only little support to the sector--mostly through incentives to renovate and small-scale bulk acquisitions. In contrast, some strong historical incentive programs, such as the U.K.'s Help to Buy scheme or France's PINEL system, have been halted or won't continue in 2024. We think more support from governments could significantly incentivize the purchase of newly built assets and boost the performance of property developers.

Industry Outlook: Other EMEA

Gulf Cooperation Council

In the United Arab Emirates (UAE), residential real estate developers are benefitting from robust demand. Dubai is particularly strong, defying global trends and remaining relatively immune to high interest rates, inflation, and uncertainty around the fallout from geopolitical conflicts. After three years of double-digit percent growth in real estate transaction numbers, prices, and rentals, the average price has approached peak levels of 2014, increasing cyclical correction risks.

We think prices for Dubai's property market could start to stabilize and even decline slowly over the next 12-18 months if lingering global economic pressures undermine sentiment and demand, while a high level of new supply leads to market saturation. High interest rates had a limited effect on demand in Dubai, where the bulk of real estate transactions are paid in cash and the share of mortgage transactions dropped to only 16% of all transactions in the first nine months of 2023. We expect a mild slowdown and believe developer ratings will remain resilient with support from reduced leverage, accumulated cash balances, and hefty liquidity buffers.

In Saudi Arabia, strong demand for residential real estate in the capital Riyadh and Jeddah led to price increases. Megaprojects related to the Vision 2030 plan have significantly activated the market and expats and local Saudis are relocating in Riyadh, which actively attracts businesses in its quest to become a large regional business hub. However, higher prices and higher mortgage rates are hindering demand as transaction numbers contract. However, the demand for residential real estate in Saudi Arabia is more sensitive to high interest rates, demonstrated by new mortgages declining year to date in 2023.

The country is almost at its target of increasing homeownership by Saudi nationals to 70% by 2030 (67% as of September 2023). This target, as well as expat population growth, will sustain demand for real estate in 2024. There is still no freehold title to real estate for foreigners in Saudi Arabia, so the real estate market is generally less volatile than in neighboring Dubai, which has a higher share of expats who can purchase freehold properties. Saudi nationals account for about 60% of the population in Saudi Arabia, compared to less than 10% nationals in the UAE.

Qatari real estate is undergoing a cyclical correction after the boost related to the World Cup in November-December 2022. Oversupplied real estate properties have seen price and rental declines, as more new units were delivered in 2023. We expect pressures to persist over the next two to three years.

Israel

The housing market was pressured by a stiff decline in the number of transactions together with higher interest rates. Accordingly, we expect the credit quality of homebuilders and developers to deteriorate, especially small or the more leveraged ones that are more sensitive to the decline in cash flow generation. The rapid and unusual increase of housing prices by about 20% in 2022 and much higher interest rates led to affordability deteriorating further. This results in a whopping 40% drop in the number of transactions year over year as of the end of September 2023. The level of unsold new units as of September 2023 is a historical high and 38% higher than at the beginning of 2022.

Nevertheless, the slowdown in demand translates only to a mild decrease in housing prices of 2.4% in the first three quarters of 2023. The low demand together with much higher funding cost and tighter financing conditions results in a significant decline in land acquisitions by developers and an about 30% drop in building starts. The latest war has enhanced these trends and led to a slowdown in construction, with a shortage of labor and the volatility of raw material costs following the disruptions in supply.

If lower demand persists, we expect companies to suffer from lower revenue and profitability, given higher interest rates, higher construction costs, and lower sale prices. We expect these trends to translate into lower credit quality, especially for leveraged companies that purchased land at peak prices in recent years (especially in 2021-2022), which are more exposed to changes in prices and financing costs. If the war expands to other regions or lasts longer than we expect, or if the Israeli economy recovers slower than we expect, we expect homebuilders and developers to experience more pressure.

In the medium to long term, we expect transaction volumes and prices to bounce back with the expected recovery in the economy and a low unemployment rate. Our estimation is based on higher construction costs and rents, Israeli demographics that support rigid demand growth, and the potential shortage in supply following the current slowdown in building starts and land acquisitions.

Industry Outlook: Asia-Pacific

Ratings trends and outlook

We believe China's property sales will track an extended L-shaped recovery in 2024. The market will become more polarized, with the state-owned developers increasingly eclipsing the market share of private property firms, and leverage at all entities will stay elevated. In Hong Kong, we expect the credit profiles of rated developers will remain stable amid falling home prices, given their growing non-property development income and prudent land acquisitions. In Indonesia, the credit quality between higher- and lower-rated developers will further diverge in 2024.

Main assumptions about 2024 and beyond

1. China's property sales value to drop 5%

Rounds of policy support aimed at upper-tier cities will stabilize these markets first while lower-tier cities contend with excess supply and weak demand. We expect sales value in the four biggest first-tier cities will rise 3%. Second-tier cities (mostly provincial capital cities) and lower-tier cities will see sales values decline 3% and 9% respectively.

2. Hong Kong's home prices to fall 5%-10%

Softening economic growth, rising interest rates, and near-term oversupply are weighing on Hong Kong's home prices. As sales volumes declined and new supply held steady, inventory started to build. We think prospective homebuyers are reluctant to buy at this juncture. Pent-up demand could release when economic growth stabilizes and interest rates ease.

3. Indonesia residential marketing sales to grow 5%-10%

Supportive regulatory policies and end user demand of landed houses underpins our expectation of sales growth in 2024.

China's property sales could approach a bottom. Based on China's past property cycles, we estimate the country's annual property sales will find a support level at RMB10 trillion-RMB11 trillion. This is close to our sales estimate of RMB11 trillion-RMB11.5 trillion in 2024. In our view, state interventions will stop sales from following a descending staircase--that is, sequential declines over the next three to five years. While first-tier cities will see an increase in sales value despite flat prices, second- and lower-tier cities will decline in sales value as prices fall and volumes drop up to 5%.

In Hong Kong, we expect primary residential transaction volume to moderately rebound. This is on the back of a recent cut in the city's property stamp duties. However, amid high interest rates, we expect annual sales volume will likely not recover to 15,000-21,000 units seen during 2017-2021. We estimate primary transactions will range from 11,000-13,000 units in 2024, from our estimated 11,000 units in 2023.

In Indonesia, the new round of value-added tax (VAT) exemption will help reduce developers' inventory. The newly released supportive policy outlines a phased reduction on VAT from November 2023 to December 2024. Homebuyers will save up to 11% on VAT for residential units priced below IDR2 billion, provided they are handed over to the buyer before the end of 2024. The new policy will support the end-user demand of landed houses, which constitutes the majority of residential marketing sales in Indonesia.

Credit metrics and financial policy

In China, developers will likely continue to discount units to boost sales and cash flow. Slowing sales and margin pressure will take its toll. We estimate that the average leverage (debt to EBITDA) of rated developers will rise to close to 5.0x between 2023 and 2025, from around 3.0x in 2019. State-owned developers have relatively smooth access to funding, while many private developers have difficulty borrowing, especially those already in distress. This will allow state-owned developers to continue to buy land and roll out more saleable resources than their private peers.

In Hong Kong we expect rated developers, which are market leaders in the sector, will likely sacrifice margins to gain market share and meet their contracted sales target. Their margins will, therefore, likely shrink 2023-2025, which could push up leverage. As most rated developers have sufficient landbank in Hong Kong, we expect they will remain prudent in their land acquisitions to control their debt level and leverage.

Indonesian developers have divergent credit metrics between higher- and lower-rated issuers. Developers in the 'BB' rating category could see modest deleveraging in 2024, owing to their good sales growth in the past two years or increasing recurring income. For developers with weaker credit quality, after temporary deleveraging in 2023 from tender offers below par, we expect their 2024 average leverage to revert to 2022's level. This is due to declining EBITDA after lower marketing sales in the past two years.

Key risks or opportunities around the baseline

1. Chinese government still has policy tools to support sales in higher-tier cities

Further policy easing in higher-tier cities, such as relaxing home purchase restrictions, lowering mortgage rates and easing downpayment requirements, could effectively support sales because those cities have better underlying fundamentals, like stronger economies, lower overbuild, and population growth from inward migration. However, this could further siphon off purchasing power from lower- to higher-tier cities. Lower-tier cities, with their deeper inventory overhang, will likely continue to lag for the next year or two.

2. Hong Kong's solid demand for private homes could put a floor to the downturn

The divergence in residential rents and prices suggests real demand for private homes in Hong Kong. While home prices are softening, residential rents have still been rising. In our view, the current turbulence would have to last longer and be substantially worse than our baseline scenario to fundamentally erode residential property demand in Hong Kong.

3. Refinancing pressure on Indonesia developers remains elevated

Refinancing activity will increase through 2024 to address the looming maturity wall in 2025. This may heighten the sector's refinancing risk again, especially for those rated in the 'B' category and below, should their access to offshore funding remain constrained.

Policies in higher-tier cities in China have not eased as much as they can. For instance, there are still some purchase restrictions on eligible homebuyers and maximum home purchases in tier-one and tier-two cities. In our view, this leaves room for future easing.

In the past, policy easing worked possibly too well for the China property sector. The shantytown redevelopment policy boosted China's property sales in 2016, especially stimulating sales in lower-tier cities. National primary sales by value soared 34.8% in 2016, with a 22.5% jump by gross floor area. This time, we think China's urban village renewal programs will be smaller in scope in comparison. Details on such programs are yet to be specified.

Indonesian developers have turned to domestic banks to meet refinancing needs over the past 12-18 months. This trend will likely continue due to the constrained offshore funding environment and heightened borrowing costs. However, domestic banks are unlikely to fully satisfy the sector's refinancing needs, especially to address the offshore maturity of around US$700 million in 2025.

Industry Outlook: Latin America

Ratings trends and outlook

Our outlook for Latin America (LatAm) homebuilders and developers remains mostly stable. More than 70% of our rated portfolio has a stable outlook and less than 15% a negative outlook, representing a slight improvement from last year. In our view, most of the downside risks we noticed for the industry earlier this year have gradually dissipated amid a fairly better macroeconomic environment, with controlled inflation and declining interest rates. Although overall results have not quite fully recovered compared to past years, we believe the worst has passed for the majority of our rated portfolio, which in turn triggered some positive rating actions.

After one more year of pressured margins in Brazil, we expect homebuilders to post a more consistent recovery starting in 2024, benefiting from a higher mix of post-2021 projects that had comparatively minimal supply-chain disruptions. Also, we expect the recent revision of the National Index of Construction Costs (INCC) methodology will mitigate potential mismatches like we've seen before, better protecting developers' margins. Additionally, we anticipate homebuilders exposed to low-income buyers will benefit from recent changes to the federal housing program. Still, Brazilian homebuilders’ margin recovery and cash generation trajectory amid a high interest rate environment will permeate potential future rating actions, both positive and negative.

In Mexico, the stable outlook benefits from homebuilders' flexible business models, geographic and segment diversification, and healthy balance sheets, including low leverage and solid liquidity positions. Despite hikes in Mexico's reference rate and their effect on the long-term yield curve, mortgages rates remain attractive and relatively stable. We anticipate housing starts to stay low but stabilize, while home prices continue to increase, benefiting from a demand that still surpasses the tight supply of units. However, we believe this price increase will moderate as inflation eases. This will help rated homebuilders protect profit margins by passing inflation costs to homebuyers.

However, we highlight the cyclicality of the homebuilding industry, especially due to economic and political volatility in the region. As such, we remain cautious about the long-term outlook for the sector.

Main assumptions about 2024 and beyond

1. Brazilian homebuilders' launches and sales to benefit from higher investments in the housing program

We expect recent changes in the federal housing program to stimulate homebuilders to strengthen their portfolios in the low-income segment as entities with higher exposure to the segment already show benefits in their third-quarter 2023 results. We expect this to further help operations in 2024, with solid growth in launches and steady sales pace, also boosted by resilient demand amid a still-high housing deficit.

2. Improvements to profitability persist, although cash generation remains challenging

Our base-case scenario indicates margins recovering more steadily in 2024, given stable inflation and projects with higher prices. Still, high level of launches will continue to require higher working capital needs, especially for entities more exposed to mid- to high-income segments. This and a still-high interest burden will continue to pressure cash flows in 2024.

3. Mexico's housing starts stabilize while sales and cash flow growth remains healthy

We expect Mexico's housing production to remain low but stabilize following several years of contraction, amid limited government subsidies and low economic growth. However, we expect Mexican rated homebuilders to deliver solid sales and EBITDA growth in 2024 amid a housing deficit and to use a flexible business model while maintaining credit protection measures commensurate with their credit profiles.

We expect launches from Brazilian homebuilders to increase from a better macroenvironment and higher investments in the housing program. In July 2023, Brazilian federal government announced several changes to the housing program Minha Casa, Minha Vida (MCMV), such as raising the home price ceiling, increasing subsidies to homebuyers, and lowering mortgage rates depending on the family income. Such changes directly affect the operations of homebuilders operating within the segment by increasing the pool of potential homebuyers in the program amid a still-high housing deficit in the country and allowing companies to increase units' prices, potentially reflecting better operating margins. Currently, 10 out of the 11 Brazilian homebuilders we rate have some exposure to the MCMV, and we expect such exposure to increase in 2024 as even entities historically focused on other income segments announce their intention to grow in the MCMV program, given the favorable headwinds for the segment.

Moreover, the macroenvironment has been improving over the year, with our expectation of 1.52% GDP growth in 2024 from projected 2.9% in 2023, coupled with stable inflation and declining but still-elevated interest rates. We expect this to gradually help lift consumers' disposable income and confidence over the next quarters. In such a scenario, we anticipate Brazilian homebuilders to increase the number of launches in 2024 more steadily than in previous years, assuring good sales pace and profitability levels.

Profitability improves overall, but cash generation remains a concern for mid- to high-income homebuilders. Most Brazilian homebuilders are still reporting pressured margins arising from the still-high mix of projects from before 2021, which were hurt more by high inflation. Still, we expect most of those projects to be delivered across 2023 and first quarter of 2024, unlocking the opportunity for profitability improvements through 2024 with the better backlog margin from projects launched or sold from 2022 on. On the other side, we anticipate some companies to struggle with high cash consumption for longer than expected if launches increase, especially for those focused on mid- to high-income segments, given higher working capital needs during the projects' construction phase.

Mexican rated homebuilders' sales and EBITDA margins to remain healthy, with 5%-8% revenue growth in 2024 on the back of low-single-digit percent unit growth and average price increases. We anticipate operating margins will remain resilient as inflation eases, despite higher labor costs. We assume rated homebuilders will continue to pass on most inflation costs to homebuyers through average price increases, particularly in medium and residential segments that tend to be more inelastic to price changes, and because of its proven ability to adapt its product offering according to market needs. Rated homebuilders will remain prudent in terms of developments, net cash flows, and debt, which should keep their leverage broadly stable in 2024. We expect refinancing risk will be limited in 2024, due to homebuilders' ample liquidity positions and proactive liability management over the past 12 months.

Rated homebuilders enjoy a solid competitive position in a highly fragmented market that has seen a supply contraction for several years. Housing starts in Mexico reached a historical low, with a decline of 8.7% or 128,368 units in the 12 months ended October 2023. In our view, this is due to tough business conditions over the last few years, the dwindling number of federal subsidies, and relatively high inflation, which weighs on homebuyers' investment decisions. We expect Mexico's economic activity to slow down in 2024. Alongside a limited federal housing subsidy budget of about MXN4.7 billion, we expect this to keep housing starts low and to stabilize around 130,000-135,000 units per year, below the 2019 level of about 160,000 units per year when the housing subsidy was well above MXN6.0 billion per year.

Still, we expect rated homebuilders to benefit from the housing deficit in the country, supportive demographics in Mexico's young population, and slowly growing formal employment. Although the central bank significantly raised the reference rate since 2022, mortgage rates have remained broadly stable. Moreover, government-owned entity Instituto del Fondo Nacional de la Vivienda para los Trabajadores (Infovanit) committed to freezing rates through September 2024. We also anticipate Infonavit and el Fondo de la Vivienda del Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado (Fovissste) will continue expanding their housing programs and customer base, which will incentivize potential homebuyers. We also expect house price increases to moderate, in line with easing inflation.

In our view, these factors support the expected 2024 growth trajectory of the following Mexican rated homebuilders: Consorcio Ara S.A.B. de C.V. (national scale: mxAA-/Stable/--); Inmobiliaria Ruba S.A. de C.V. (national scale: mxAA-/Stable/mxA-1+); and Vinte Viviendas Integrales S.A.B. de C.V. (global scale: BB-/Stable/--; national scale: mxA-/Stable/--). We expect rated Mexican homebuilders to continue leveraging their competitive positions and business flexibility from strong inventories; landbank reserves; and geographic, product, and financing diversification to raise top-line growth and increase their market share in this highly fragmented market.

Credit metrics and financial policy

We expect metrics will gradually improve for Brazilian homebuilders in 2024. Following the 2015-2017 Brazilian economic crisis, the overall housing sector adopted more conservative approaches to leverage and financial policy. Most rated issuers increased cash balances and maintained extended debt maturity profiles, while increasing access to the local debt market. This has led to minimal negative rating actions in 2022-2023, as metrics remained broadly in line with our expectations.

Nonetheless, persistently high interest rates and our expectation of an average basic interest rate of 9.9% in 2024 still weigh on companies' interest burden and coverage ratios, especially regarding already pressured FFO generation given weaker profitability. We have seen some of our rated issuers focus on liability management by refinancing upcoming maturities with better cost lines or by reducing gross debt position for those with a more consistent cash generation cycle.

Additionally, we expect Brazilian homebuilders to continue to rely heavily on construction financing debt or even structured product issuances, as these credit lines usually have better cost and terms. As such, we forecast credit metrics to broadly improve in 2024 for Brazilian homebuilders, with FFO-linked ratios forecast to increase during the next few quarters.

We expect financial policies for Mexican rated homebuilders to remain supportive to key credit metrics, as in the past few years. We assume rated homebuilders continue demonstrating prudent financial policies over the next 12 months, including prioritizing strong balance sheets that support low leverage, maintaining sound liquidity, and making investment decisions subject to its financial position. Moreover, rated homebuilders have proven access to local debt capital markets and credit facilities, which enhances flexibility toward refinancing needs, which we view as low for 2024. Following two years of high investments in land and housing construction, we expect working capital needs to moderate in 2024, which will contribute to expanding free operating cash flow and credit metrics consistent with the ratings.

Key risks or opportunities around the baseline

1. Macroeconomic risks pose downside risks to our forecast on LatAm homebuilders

Economic and political conditions in the region have proven relatively volatile in past years. Such a track record makes us more cautious regarding long-term prospects for the industry in the region, although we expect the macroenvironment to remain relatively stable in the short term.

2. Housing deficit, demographic trends, and access to mortgage loans provide solid medium to long term growth prospects

The region maintains a significant housing deficit, and benefits from a growing middle-class and a mortgage lending sector with well capitalized banks, that provides solid medium- to long-term growth opportunities for the sector.

The LatAm region historically presented more volatility in terms of economic and political conditions, posing mid- to long-term risks for homebuilders. Our base case assumes that both the Brazilian and Mexican economies slow down in 2024. We expect Brazil's GDP to grow 1.5% and Mexico's 1.8%, reflecting lower fiscal stimulus measures in Brazil and subdued demand in Mexico from its main partner, the U.S., despite still-tight financial conditions in both countries.

In our view, weaker-than-expected economic activity coupled with a prolonged period of high interest rates in Mexico could further reduce disposable income and ultimately reduce housing demand, especially in the mid- to high-income segments, which could squeeze homebuilders' capacity to pass through potential cost increases and undermine operating and financial performance if not addressed. In Brazil, we expect a decrease in interest rates to translate into some decrease on mortgage rates, consequently improving homebuyers' affordability. In addition, recent changes on the Brazilian construction cost index and in the MCMV program will further protect home builders' ability to pass through inflation costs to buyers through higher prices.

In Brazil, the housing program is a priority on the current federal government's agenda. Still, we are uncertain about the details of the Lula administration's policies, especially on the fiscal front, which we believe could push back investments until homebuilders gain more visibility regarding such policies.

In Mexico, general presidential elections will take place in 2024 and, although we do not expect a major shift in the country's housing policy in the next 12 months, we recognize it can delay homebuyers' investment decisions until they have more visibility on the country's policy direction.

The housing deficit, demographic trends, and access to mortgage loans provide solid medium- to long-term growth prospects. In many LatAm countries, we observe a significant housing deficit (close to 6.0 million in Brazil and 8.0 million in Mexico) and a growing middle class as economies are slowly increasing, although it will likely remain below historical levels in 2024 and on. Moreover, in Brazil and Mexico, the housing sector benefits from well-capitalized banks and supportive mortgage-lending activities. In Mexico, mortgage rates remain broadly stable, despite volatile reference rates from the central bank. In our view, these provide solid medium- to long-term growth opportunities for the sector.

Moreover, in Brazil the federal government housing program announced new income thresholds for its brackets, aiming to accommodate more families within the program, among other changes. This increases the addressable market for homebuilders that operates with the program. Additionally, the new government already announced its intention to increase the level of investments in the program, which can present further upside for Brazilian homebuilders operating in the low-income segment.

Related Research

- Credit FAQ: What Does Property Company Signa's Failure Mean For Ratings?, Dec. 12, 2023
- Credit FAQ: Spotlight On Refinancing Risks In European Commercial Real Estate, April 24, 2023

Industry Forecasts: Homebuilders and Developers

Chart 11

Revenue growth (local currency)

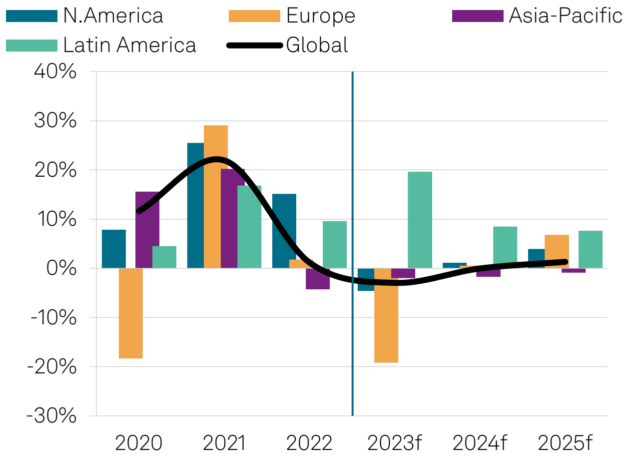


Chart 12

EBITDA margin (adjusted)

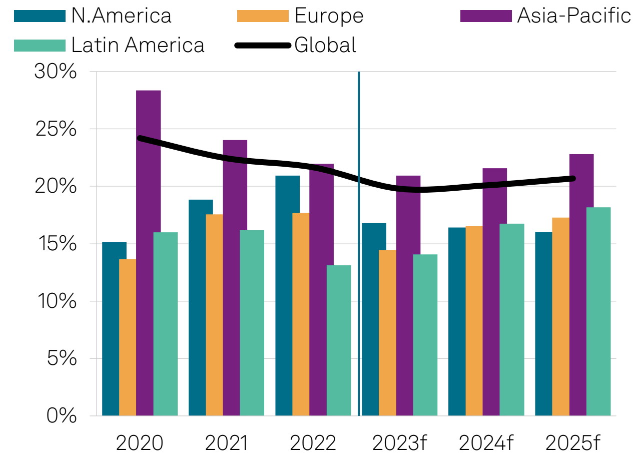


Chart 13

Debt / EBITDA (median, adjusted)

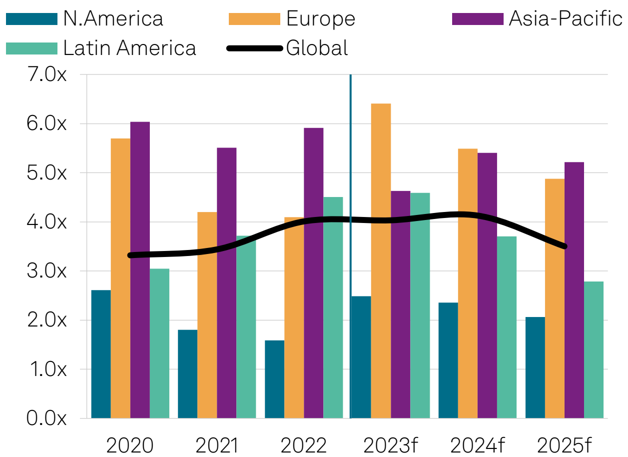
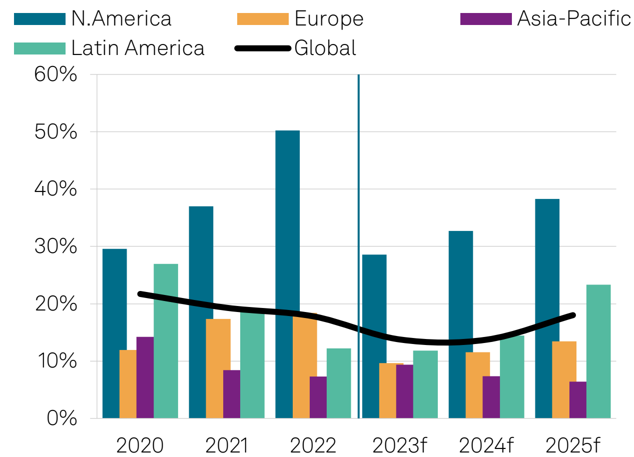


Chart 14

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: Homebuilders and Developers

Chart 15

Cash flow and primary uses

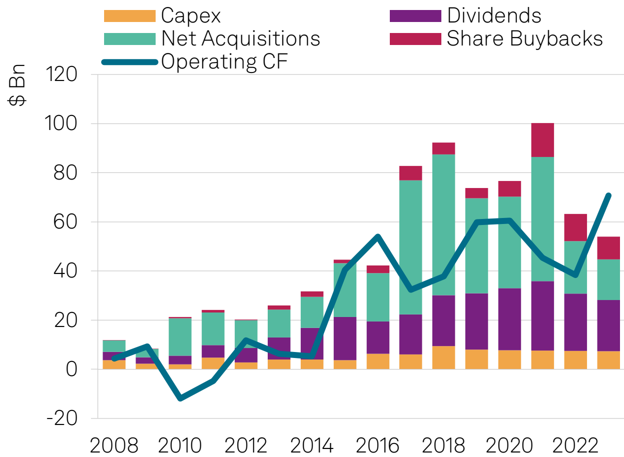


Chart 16

Return on capital employed

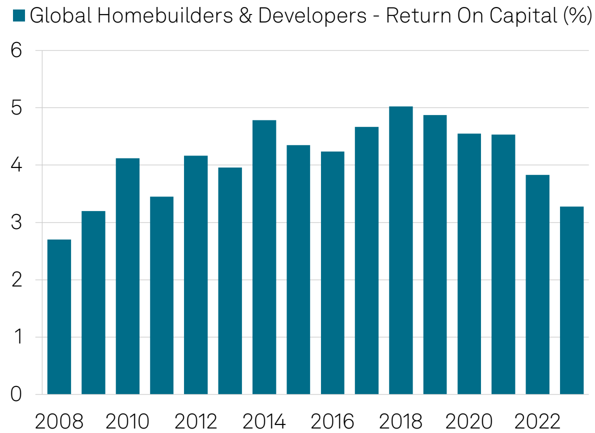


Chart 17

Fixed- versus variable-rate exposure

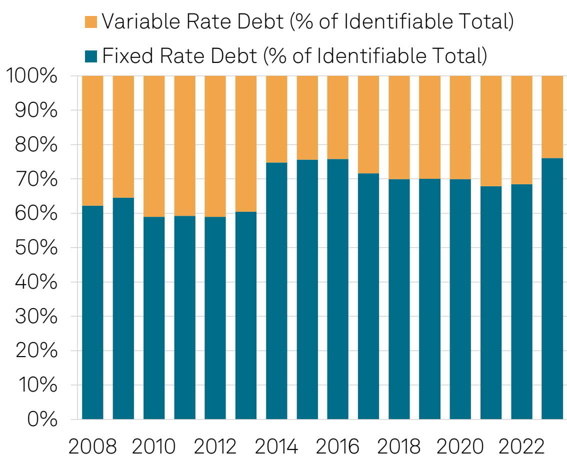


Chart 18

Long-term debt term structure

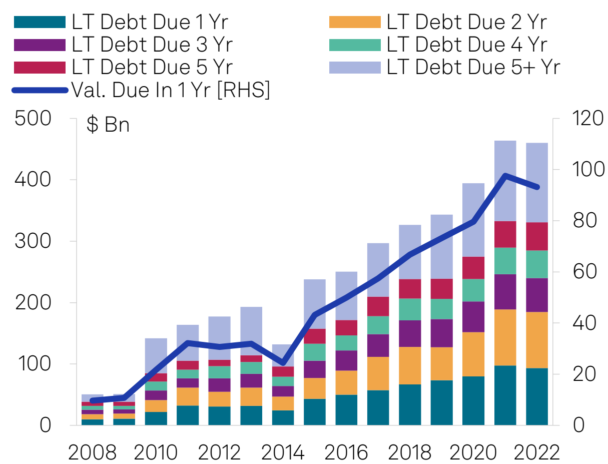


Chart 19

Cash and equivalents / Total assets

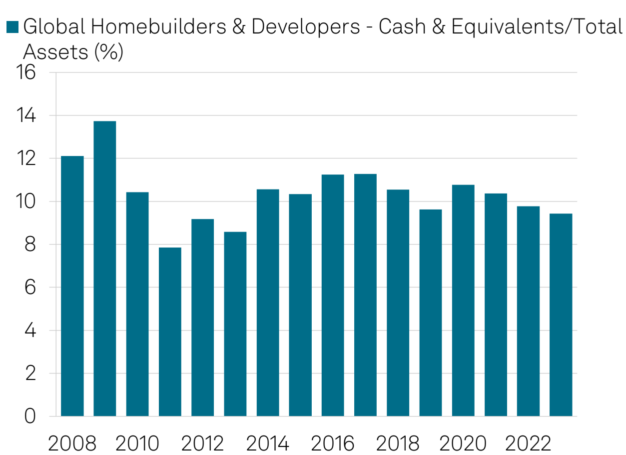
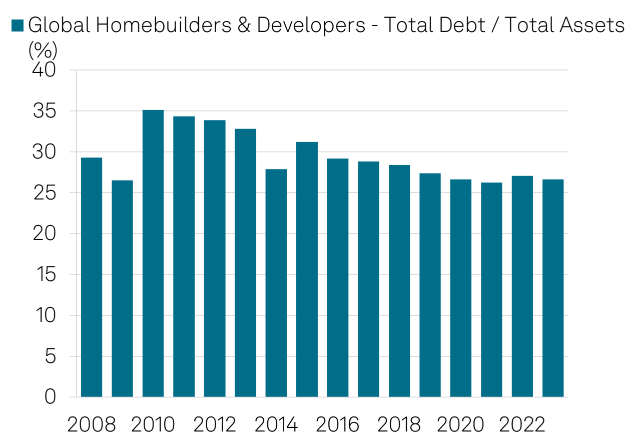


Chart 20

Total debt / Total assets



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

Hotels, Gaming, and Leisure

Spending on leisure slows under high prices and rates

January 9, 2024

This report does not constitute a rating action.

What's changed?

Resilient leisure spending will be tested. With prices and rates high, consumers may look for bargains, causing travel and leisure spending growth to moderate.

Cruise and Macao gaming are rapidly catching up with overall leisure sector. Full fleets are sailing, and China's reopening will remain an enormous boost to the Macao gaming market.

M&A may restart. Buyers may look past elevated rates or become flexible on how much debt to use to finance transactions. Still, if leveraging mergers and acquisitions (M&A) occurs in a slowing economy, leverage cushions could wilt.

What are the key assumptions for 2024?

Gaming. Macao gaming market will remain strong, but a slowing U.S. economy could weaken Vegas and regional gaming revenue. Inflation continues to take a toll on costs in EMEA gaming.

Lodging. U.S. hotel sector revenue per available room (RevPAR) growth slows to low-single digits, European lodging rates plateau, and timeshare operators spend to pursue new owners.

Cruise. Forward bookings for 2024 are pacing ahead of historical levels and at higher prices, suggesting the industry can absorb higher capacity next year.

What are the key risks around the baseline?

Leveraging transactions could exceed leverage cushions. While a significant number of companies have fully recovered since the pandemic, leveraging M&A or other transactions preceding a slowing economy could put downward pressure on ratings.

High prices and high rates weaken demand more than we assume. This is particularly true for big ticket discretionary items like timeshare and recreational vehicles.

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Ratings Trends: Hotels, Gaming, and Leisure

Chart 1

Ratings distribution by region

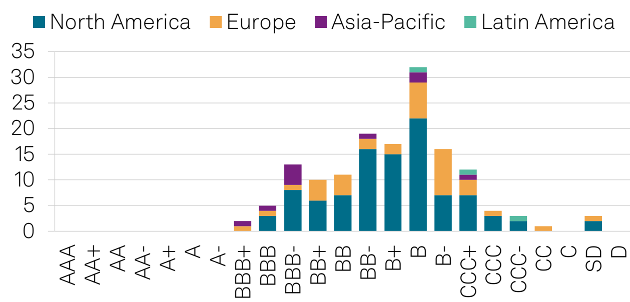


Chart 2

Ratings distribution by subsector

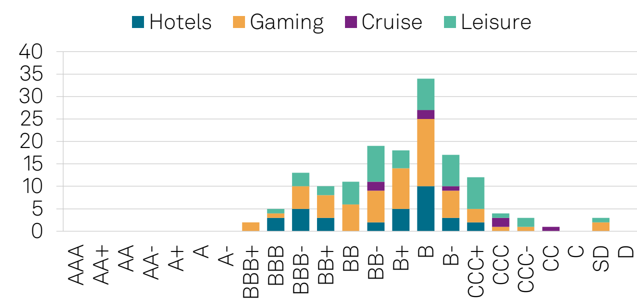


Chart 3

Ratings outlooks

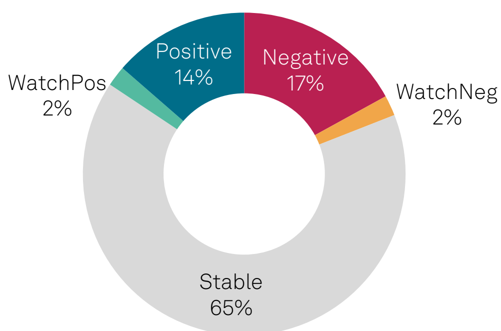


Chart 4

Ratings outlooks by subsector

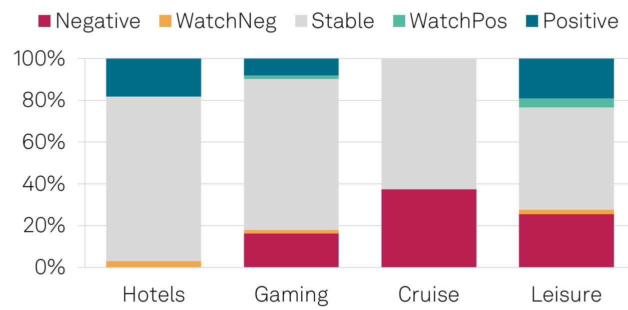


Chart 5

Ratings outlook net bias

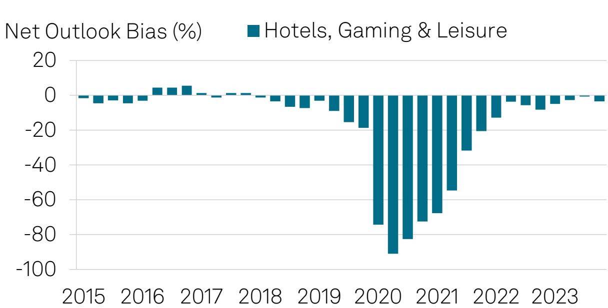
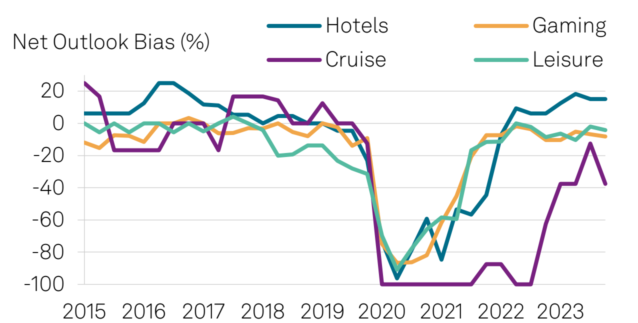


Chart 6

Ratings net outlook bias by subsector



Source: S&P Global Ratings

Industry Outlook: Gaming

Ratings trends and outlook

Rating trends on gaming operators have been mixed. Ratings on U.S. gaming operators were largely stable in 2023 since many were already back to or above pre-pandemic levels. But there was a positive bias for gaming operators exposed to Macao given China's reopening in January and the subsequent and ongoing recovery in Macao gross gaming revenue (GGR). In Europe, while some operators have presented improving credit metrics despite increased regulation and restrictions in markets such as the U.K., legal disputes and regulatory fines have also contributed to negative rating actions. Other operators with market leading positions in key markets have seen improving credit measures and consequently positive rating actions.

Main assumptions about 2024 and beyond

1. Strong momentum in Macao mass gaming market will continue.

Macao mass GGR is recovering faster than we expected. We now estimate mass GGR for 2024 will be 5%-15% higher than in 2019.

2. A slowing economy could weaken regional gaming revenue and spending in Las Vegas.

Pressure on consumer spending from high inflation and increasing unemployment could slow discretionary spending on gaming, leading to modestly lower regional gaming revenue in some markets and a slowdown in spending in Las Vegas. However, a favorable event calendar in Las Vegas in 2024 may be an offset.

3. Inflationary pressures in EMEA gaming may continue to weaken cost base and margin, offset by synergies.

Inflationary pressures in Continental Europe and the U.K. may lead to stubbornly high costs; however, synergies from recently acquired businesses could offset these pressures for some issuers.

Strong recovery in Macao's mass gaming market will support faster deleveraging for rated issuers. Our latest base-case assumptions project Macao mass GGR for 2024 at 5%-15% above 2019 levels, implying 20%-30% growth year on year. The strong momentum in the mass market is mainly due to growth in the premium segment. However, we project base mass will grow during 2024 as more people visit Macao, in line with a recovery in air passenger capacity to Macao and Hong Kong.

The region will also face an easy year-over-year comparison in the first quarter of 2024 because, while coronavirus-related restrictions were relaxed in January 2023, it took some time for the market's recovery to accelerate. Junket (also known as VIP) volume will likely stay near current levels. Operators are unlikely to significantly expand junket VIP operations amid tightened regulations, in our view.

We expect the improvement in EBITDA for rated issuers will accelerate over the next several quarters due to increased Macao visitation and greater availability of hotel rooms in the market. Therefore, we estimate rated issuers' EBITDA will be about 95% of their 2019 levels in 2024, on average. This is except for MGM China, which is outperforming the market largely due to incremental tables awarded to them under a new concession.

A favorable event calendar may somewhat offset the impact of a slowing economy in Las Vegas. Macroeconomic factors that could impede consumers' discretionary spending are rising, which pose risks to U.S. gaming revenue. However, the ongoing recovery in convention and group visitation and a strong event calendar in Las Vegas may be sufficient to offset these headwinds. The performance of destination markets, such as Las Vegas, tends to be more volatile during a downturn than regional gaming markets. However, the continued recovery in group and convention visitation, the return of international travel, and investment in new attractions, including Allegiant Stadium and the MSG Sphere (2023), will likely continue to support a recovery in visitation.

In addition, supply growth in the market has been modest and much lower than in 2008-2010. Hotel room capacity will expand by about 2.4% in 2024 following the December 2023 opening of the Fontainebleau Las Vegas. The market will also benefit from a favorable event calendar over the next year. For example, Formula 1's Las Vegas Grand Prix race, scheduled to occur annually in November through at least 2025, will attract significant visitation and spending during what is normally a slower period for the market.

In addition, Las Vegas will host the Super Bowl at Allegiant Stadium in February 2024. While Super Bowl weekend is typically a good weekend for Las Vegas, and will coincide with Lunar New Year in 2024, we believe hosting the event will draw additional customers and events ahead of the game. These events may help offset the loss of CONEXPO-CON/AGG, a construction trade show held every three years that attracted record attendance of 139,000 in 2023.

Inflationary pressures may continue to weaken cost base and margin, offset by synergies. Demand for gaming operators in EMEA has remained resilient thanks to low unemployment and the countercyclical nature of the industry. However, EBITDA margins have come under pressure in 2023. Despite the recent moderation in inflation, we expect inflationary pressure on the cost base to remain high during 2024. However, we expect large companies to focus on the integration of acquisitions completed over the last 12-18 months and the resulting cost synergies. We believe this will partly offset inflationary cost pressures and expect modestly improving EBITDA margins in 2024.

Key risks or opportunities around the baseline

1. Development projects could delay deleveraging or add incremental leverage.

Global and U.S. operators such as Las Vegas Sands Corp., Wynn Resorts Ltd., MGM Resorts International, Caesars Entertainment Inc., and Genting Bhd. will likely bid for three full-scale casino licenses available in New York. The scale of these projects could add leverage compared to our base-case forecasts.

2. U.S. casino operators may see cash flow benefits from digital gaming, but risks remain.

U.S. casino operators may begin to see positive cash flow contributions from their digital gaming businesses, but additional investments required for new markets or cannibalization remain longer-term risks.

3. Potential for tighter regulation in key geographies for European players.

While we do not expect any major changes in key European geographies other than the implementation of the U.K. White Paper, increasing regulations in other markets, such as Australia, could lead to a drop in revenues.

Large-scale development projects could delay deleveraging or add incremental leverage. We expect global and U.S. operators such as Las Vegas Sands Corp., Wynn Resorts Ltd., MGM Resorts International, Caesars Entertainment Inc., and Genting Bhd. to bid for the three full-scale casino licenses available in New York. The scale of these projects could add leverage compared to our base-case forecasts and slow improvement in the operator's credit measures or eat into substantial leverage cushion for others.

The project sizes range from $2 billion on the low end for expansions or redevelopments of existing properties to more than $5 billion for new developments. However, the leveraging impacts could be 12-18 months away. We believe New York is unlikely to award licenses before the second half of 2024 and don't anticipate winning bidders would initiate any material capital spending before 2025. These developments could take several years to complete given the complexities of building in New York and the likely large scale of the projects.

Many of these operators also have development projects underway in other regions in the U.S. and around the world in Singapore, the United Arab Emirates, and Japan. In Macao, high investment commitments under new concessions are manageable with the ongoing GGR recovery.

U.S. casino operators may see cash flow benefits from digital gaming, but risks remain. U.S. casino operators may begin to see positive cash flow contributions from their digital gaming businesses in 2024. As online sports betting has ramped up, operators' losses have been narrowing and many operators, except for those investing in and rolling out new brands, expect modestly positive contributions next year. Digital gaming--both online and mobile sports betting and iCasino--present opportunities to grow the customer and cash flow base over time.

However, the segment also presents risks as it expands. Newly legalized states are often highly competitive and typically require a lot of investments and marketing spend to build the customer base in that state and scale up. In addition, the expansion of online gaming in the U.S. poses a longer-term cannibalization risk to brick-and-mortar casino cash flow. The extent of the risk depends on the legislation each state enacts to legalize digital gaming.

In states with existing casino operations, if the legislation limits or ties licenses to existing brick-and-mortar casino operators, then cannibalization may pose less of an overall cash flow risk to existing operators because digital gaming would complement their existing land-based offerings. In those markets, if customers substituted a trip to the casino for digital gaming, the existing operator would still capture that revenue. In contrast, if states open up licenses more broadly, existing brick-and-mortar casino operators could see greater substitution and cannibalization of their cash flow.

There is the potential for tighter regulation in key geographies for European players. The implementation of the U.K. White Paper during 2024 is the largest single piece of regulation that could have a material impact on revenue. While large operators have incorporated internal measures to comply with the law, failure to comply after the consultation period could negatively impact the revenue of gaming operators in the U.K. Other geographies are also imposing increasing regulatory measures, such as Australia, where a point of consumption tax increase will likely go into effect in July 2024 in the state of Victoria; there is also a potential for advertising restrictions.

In addition, in the U.S., an increasing number of states present a regulated market for sports betting and iGaming. This is opening new avenues for European players to offset part of the revenue softening on the old continent. We have seen an expansion in the implementation of new regulation in states such as Massachusetts, which presents a real opportunity for European players with a presence in the U.S., such as Entain through BetMGM and Flutter.

Industry Outlook: Hotels And Timeshare

Ratings trends and outlook

With strong leisure, group, and improving business travel trends, most lodging issuers have restored credit ratings to pre-pandemic levels, and a large majority of outlooks are stable. Leveraging M&A has the potential to absorb leverage cushions and negatively impact ratings.

Main assumptions about 2024 and beyond

1. U.S. hotel sector RevPAR growth slows to low-single digits.

U.S. RevPAR growth will likely slow in 2024 from around 5% expected in 2023, as a move toward normalization causes hotel demand to be dependent on GDP and real consumer spending growth, combined with modest hotel rate growth in 2024.

2. EMEA average daily rates will plateau despite expected business travel rebound.

The positive pricing momentum witnessed in 2023 has started to slow down in the last quarter of 2023. European lodging companies may have exhausted their capacity to raise prices as high inflation and higher interest rates are squeezing consumers' disposable income. However, we project a modest uptick in business travel in the last quarter of 2023. A gradual return to a steady pace of business trips could support the growth of occupancy rates at least back to pre-pandemic levels.

3. Latin America's lodging companies could face tougher business conditions.

Continued recovery in economic activity helped reactivate group travel and business events, and savings of travelers from advanced economies resulted in a solid demand for leisure activities in 2023. Our base case for 2024 anticipates a slowdown in economic activity in Latin America (LatAm), largely due to subdued demand from advanced economies.

4. Timeshare companies pursue new owners.

Timeshare sales growth will likely be muted in 2024 as the industry prioritizes new owner growth following years of sales and upgrades sold to existing owners. Slower growth would reflect sales to new owners that are made at a lower price point, with the intention of upgrading those members in subsequent years.

U.S. hotel sector RevPAR growth will likely slow in 2024 from around 5% expected in 2023, as a move toward normalization causes hotel demand to be dependent on GDP and real consumer spending growth. We also expect demand will be confronted by modest average daily rate (ADR) growth in 2024. Owners and operators catering to group and business travelers continue to outpace the broader U.S. market as the segment recovers, and we expect this divergence will continue over the next 12 months as early indications of negotiated rates for events over the next couple of quarters are strong.

Meanwhile, we believe downside risks remain concentrated in leisure travel. While leisure travel has remained more resilient than previous expectations, tightened personal travel budgets could lead consumers to search for deals or pull back on travel spending as they prioritize nondiscretionary purchases, pressuring average daily rates and occupancy in some markets in 2024. S&P Global economists expect consumer spending will become more aligned with real income growth (which has been muted over the past year), as excess savings accumulated in the pandemic dwindle.

Additionally, while we no longer forecast a recession, we expect a modest increase in unemployment over the next two years as businesses face higher cost of capital, which could put additional pressure on consumers. Lastly, higher labor and other operating costs will likely pressure margins for hotel owners in a slow RevPAR growth environment.

Nonetheless, most U.S. lodging issuers have restored credit ratings to pre-pandemic levels, and a large majority of outlooks are stable. The timing of upgrades, if any, will depend heavily on financial policy decisions.

EMEA average daily rates will plateau in 2024 despite an expected rebound in business travel. European lodging operators have benefitted from consumers' willingness to resume leisure travel and were able to raise rates above average inflation in most countries. As a result, in 2023 RevPAR increased 10% for midscale and upper scale operators and about 30% in the budget and economy segment. We saw consumers on tight budgets trade down from midscale and upscale operators to economy and budget operators, causing a shift that could persist in 2024.

Rate increases have already started to decelerate in the last quarter of 2023, and we believe ADRs will plateau in 2024 because consumers' discretionary budgets will continue to be squeezed by high inflation and consumers' disposable income will shrink. However, we expect some respite due to enhanced business travel in 2024.

We believe LatAm's lodging companies will face tougher business conditions in 2024. Continued recovery in economic activity helped reactivate group travel and business events, and savings of travelers from advanced economies resulted in a solid demand for leisure activities in 2023. Our base case for 2024 anticipates a slowdown in economic activity in the region, largely the result of subdued demand from advanced economies. We believe high interest rates will continue to pressure households' disposable income in 2024.

We estimate ADR growth will moderate in the next 12 months, after low-teens percent growth in 2023. Occupancy rates at LatAm's main destinations have mostly recovered from the pandemic, and we expect these levels to remain broadly stable. We assume occupancy remains relatively flat as operators favor holding ADR levels over gains in occupancy. Profitability may be vulnerable because of persistent wage pressures and weaker capacity to pass through costs in 2024.

On the upside, we expect LatAm economies to continue taking advantage of global trends such as supply-chain relocation and energy transition, which would sustain some demand for business travel. We expect 0%-3% growth in RevPAR in Mexico to well above pre-pandemic levels. For all-inclusive resorts across Mexico, the Caribbean, and Central and South America, we expect a strong high season based on operators' publicly disclosed forward booking data. However, net package RevPAR may contract in the second half with a decline in occupancy rates offsetting currently high ADRs.

Timeshare companies pursue new owners. Timeshare sales growth will likely be muted in 2024 as the industry prioritizes new owner growth following years of sales and upgrades sold to existing owners. Slower growth would reflect sales to new owners that are made at a lower price point, with the intention of upgrading those members in subsequent years. This likely leads to lower volume per guest (VPG), which offsets anticipated incremental tour flow in 2024.

We expect industry contract sales will be flat to up in the low-single-digit percentage area in 2024. In addition to driving lower VPG, attracting new buyers will require higher marketing and advertising expense and compress margins in 2024. We expect contract sales for operators with exposure to Maui, primarily Marriott Vacations Worldwide and Hilton Grand Vacations, could be subdued through the first half of 2024 by lower-than-normal occupancy levels at the island's resorts and staffing shortages caused by loss of available housing.

Lastly, while M&A activity is hard to predict, we believe it will be muted following multiple years of acquisition activity (such as Hilton Grand Vacations' acquisitions of Diamond and Bluegreen and Marriott Vacations' Acquisition of Welk).

Key risks or opportunities around the baseline

1. Hotel M&A restarts and leverage increases.

Although there is still a substantial gap in bid-ask spreads for hotel real estate, and the buyer pool reportedly remains smaller than normal, some deals are getting done despite higher rates.

2. Inflationary wage pressure could continue to affect lodging companies' margins in 2024, especially in the U.K.

While we believe eurozone inflation has passed its peak, we expect prices will continue to rise above the European Central Bank's (ECB's) target of 2%, including labor costs, and consumer confidence will remain below pre-pandemic levels in 2024.

3. Lower-than-expected economic activity in the region may result in weaker operating and financial performance for Latin America's lodging companies.

A slowdown in the U.S. or Europe could also depress economic activity in LatAm. In our view, this may lead to a decline in occupancy rates and pressure companies' ability to continue to pass on cost increases through higher ADRs. Additionally, lodging companies that operate under dollarized rates, particularly at beach destinations, may take a hit to profitability if local currencies appreciate against the dollar.

4. Timeshare sales will depend upon health of the consumer.

Sales growth in 2024 will depend on how well consumers hold up under a potentially tougher macroeconomic backdrop as higher interest rates and inflation have diminished savings accumulated over the course of the pandemic.

Hotel M&A restarts and leverage increases. Although there is still a substantial gap in bid-ask spreads for hotel real estate, and the buyer pool reportedly remains smaller than normal, some deals are getting done despite higher rates. Also, the hotel sector remains fragmented, cyclical, and highly competitive, which leads to potential consolidation opportunities. Companies that currently have cushion in leverage measures for ratings may use it up doing deals.

M&A potential is also present in the branded hotel space. Choice Hotel's bid for Wyndham is one example of a potentially highly leveraging transaction, and led us to place ratings on CreditWatch with negative implications.

Inflationary wage pressure could continue to affect lodging companies' margins in 2024, especially in the U.K. The rise in interest rates that the ECB implemented over the course of 2023 helped to ease the generalized price increases, but the same measures by the Bank of England have been less effective. This is linked to the persistent high wage growth that the country experienced during the year. On top of a general tight labor market in the U.K., which is causing a general rise in wages, the hospitality sector suffers from a structural shortage of staff. Margins of lodging companies operating in the U.K. could be more impacted than their European or U.S. peers in 2024.

Lower-than-expected economic activity in the region may result in weaker operating and financial performance for Latin America's lodging companies. Our base case assumes economies in LatAm will slow to below trend in 2024. A higher-than-expected slowdown in the U.S. or Europe could also depress economic activity in the region by reducing trade volumes or foreign direct investment, amid still high interest rates, which will continue to weigh on investment decisions and household income.

In our view, weaker-than-expected economic activity may lead to a decline in occupancy rates and pressure companies' ability to continue to pass on cost increases through higher ADRs. Additionally, lodging companies that operate under dollarized economies, particularly at beach destinations, may take a larger hit to profitability if local currencies appreciate against the dollar. This has been the case of the Mexican market in the last part of 2023.

Conversely, economies in the region could see larger foreign investment and trade related to supply-chain relocation and energy transition, provided countries create a stable political and social environment that fosters economic growth. This could result in higher-than-expected demand on business travel. It could also result in strong demand for leisure activities.

Timeshare sales will depend upon health of the consumer. Sales growth in 2024 will depend on how well consumers hold up under a potentially tougher macroeconomic backdrop as higher interest rates and inflation diminish savings accumulated over the course of the pandemic. S&P Global economists expect unemployment to tick upward over the next two years and consumer spending to converge with real income growth, which has been negative for the past four months. If the economy worsens and consumer sentiment remains at historically low levels for a long time, we believe building new buyer pipelines will become more difficult.

Industry Outlook: Cruise, Recreation, Fitness, Theme Parks, And Play

Ratings trends and outlook

The majority of ratings in this cohort have stable outlooks with significant differences among various segments. Cruise ratings remain multiple notches below pre-pandemic levels, although the rating bias skewed positive in 2023 with several multi-notch upgrades and outlook revisions to positive or stable from negative. Recreational vehicle (RV) retailers have negative outlooks reflecting a harsh decline in retail sales. Fitness operators' outlook bias depends upon the company's membership recovery.

Main assumptions about 2024 and beyond

1. Cruise recovery continues with moderate yield growth and historical levels of occupancy.

We believe forward bookings for 2024 that are pacing ahead of historical levels and at higher prices will support the industry's absorption of incremental capacity. However, we expect yield growth to moderate next year following a strong recovery in 2023.

2. RV retailers feel the strain, while OEMs still have cushion in credit metrics.

Outlooks for rated dealerships are negative because the decline in sales coupled with significant discounting to clear aged inventory has led to a dramatic decline in EBITDA. Original equipment manufacturers (OEMs) have more cushion.

3. Economic pressures could slow the fitness sector's recovery.

We expect fitness center issuers will continue to see a recovery in memberships in 2024 but may be at risk in an economic slowdown.

4. Theme park attendance and per capita spending could falter.

A pullback in broader leisure spending may lead to attendance declines and lower per capita spending at regional theme parks.

5. Toy companies face a stretched consumer.

Weakened consumer demand may lead to toy companies struggling to achieve growth in 2024.

Cruise recovery continues with moderate yield growth and historical levels of occupancy. The large cruise operators have been reporting forward bookings for 2024 that are ahead of historical levels and at higher prices. This suggests the industry is absorbing incremental capacity added in recent periods and planned for 2024. In addition, we expect occupancy for most cruise operators to be around historical levels for a full year in 2024. In 2023, occupancy in the early part of 2023 was still below historical levels.

In our view, the risk of discounting to fill the ships is lower than in previous economic slowdowns because the price gap between a cruise vacation and comparable land-based vacation is wider than usual. However, we expect yield growth will moderate in 2024 following a strong industry recovery in 2023.

Nevertheless, we expect cruise operators will continue to see cash flow and leverage improvement over the next year, albeit at a more moderate pace than 2023, when the industry began recovering. Despite continued cash flow and leverage improvement, the industry's leverage will remain higher than pre-pandemic levels in 2024 given extraordinary borrowings that occurred while the industry was shut down during the pandemic.

RV retailers feel the strain, while OEMs still have cushion. Retail demand for RVs dropped precipitously throughout 2023 with sales of new RVs down approximately 20%-25%. Meanwhile, we expect wholesale shipments from OEMs will decline around 40% for full-year 2023 as they and retailers right-size inventory levels.

Outlooks for rated dealerships are negative as the decline in sales coupled with significant discounting to clear aged inventory has led to a dramatic decline in EBITDA. As a result, leverage could remain above our downgrade thresholds through the first half of 2024.

However, if favorable inventory positioning and various cost mitigation efforts coincide with a stabilization of retail sales, we believe margins could improve and lead to lower S&P Global Ratings-adjusted leverage for our rated dealerships in 2024, potentially in line with current ratings. Our current expectation is for high-single-digit to low-double-digit percent increases in retail unit sales in 2024.

OEMs face the same retail-based challenges as retailers and have suffered a larger decline in shipments than retail unit sales. However, they have been able to moderate increases in leverage because of working capital benefits (primarily from inventory declines).

In contrast, working capital for retailers is not as much of a benefit because new inventory is purchased using floorplan financing, which then must be paid down following the sale of the product such that the increase in operating cash flow from an unwind of inventory is offset by a repayment of the company's floorplan facility. Therefore, OEMs have more cushion in their credit metrics than retailers.

Economic pressures could slow fitness sector recovery. Fitness center issuers have benefited from the recovery in memberships and favorable trends across the industry because there has been an ongoing shift toward consumer spending on experiences and in-person fitness options. A majority of our rated fitness center issuers achieved a full recovery in dues revenue in 2023 because of higher monthly membership fees enacted during the year; however, memberships still remain below pre-pandemic levels in the mid-tier and luxury segments.

A full recovery in memberships could happen by the end of 2024 as fitness center issuers continue to benefit from this shift in consumer preferences. We expect memberships will be flat to up low-single digits as a trend across the sector. However, some issuers may never fully reach pre-pandemic levels because some consumers have changed their daily routines with the prevalence of remote and hybrid working models, which may result in some never returning to a daily in-person gym routine.

In addition, an economic slowdown could be a headwind for membership growth in 2024, particularly in the mid-tier segment where members could trade down to value options to save money. Additionally, luxury gym operators took aggressive price increases in 2023 to offset lower membership bases compared with pre-pandemic levels. However, at some point even more wealthy consumers may begin to feel inflationary fatigue and membership growth trends could begin to slow.

Theme park attendance and per capita spending could falter in 2024. Despite attendance declines at regional theme parks in 2023--largely due to weather-related disruptions--per capita spending remains resilient for now. While we forecast modest revenue growth, macroeconomic risks persist and could slow the pace of growth. Although the Federal Reserve's fight against inflation hasn't materially weakened the regional theme park sector's performance, we believe park attendance and per capita spending could falter next year.

S&P Global economists forecast increasing risk for a macroeconomic downside scenario caused by a slowdown in business activity, increased unemployment, and a decline in consumer spending. Under our downside scenario, we forecast lower growth in 2024, which may lead consumers pulling back on leisure spending, causing industrywide revenue and profitability to decline. In addition, rising labor and other cost inflation hurts theme park profitability.

Despite these risks, we believe theme park performance will be less volatile in a downturn than destination travel because theme parks are easier to access and are a relatively low-cost form of entertainment. We believe greater geographic diversity and scale can help mitigate any potential EBITDA volatility caused by regional economic downturns or weather-related event risk.

Toy companies face a stretched consumer in 2024. Toy companies were met with a challenging holiday season in 2023 and a potentially declining overall North American toy market for the full year. Weakening consumer discretionary spending, persistent inflation, and the post-pandemic shift back to experiences all presented significant headwinds. In addition, a more price-sensitive consumer likely led retailers and toy companies to increase promotions and discounts, pressuring margins.

Coming off another challenging holiday season and facing an economic slowdown, toy companies may face pressure achieving top-line growth in 2024 due to softening consumer spending as a result of declining savings, reinstated student loan obligations, and higher costs due to inflation over the past three years. In 2024, we expect flat to a modest decline in toy company revenue in the low-single-digit percentage area.

Despite our base-case forecast for an economic slowdown, we continue to believe consumers will reliably purchase toys for their children during the important holiday shopping season and special occasions, even though they may do so in moderately lower volumes, as the toy industry is somewhat resilient to economic slowdowns.

Key risks or opportunities around the baseline

1. A more moderate ship delivery schedule will likely support deleveraging.

Many cruise operators have not placed new ship orders since the pandemic. As a result, operators may have no ship deliveries in some years, potentially accelerating deleveraging.

2. Big-ticket RV purchases face higher rates for longer.

We believe downside risk depends on the extent of a slowing macroeconomic environment and the consumer's financial health. While inflation cooled in the second half of 2023, consumer sentiment remains low and higher interest rates could make financing RV sales less palatable, especially for new buyers.

3. Higher build costs could lead to a pullback in growth capital expenditures for fitness operators.

Higher interest rates and build costs could lead to lower growth capital expenditures and fewer new club developments.

4. Demand for park visitation competes with the broader leisure sector.

Theme park operators are undergoing various organic and inorganic growth initiatives to increase visitation and season pass sales.

5. The shift back to experiences may lead to a declining toy industry.

The toy industry saw record volumes during the height of the pandemic in 2020 and 2021 but may face a declining market over the next few years.

A more moderate ship delivery schedule over the next few years will likely allow operators to continue reducing leverage despite incremental ship debt. In addition, many cruise operators have not placed new ship orders since the pandemic. Cruise operators must generally commit to ship orders at least three to five years in advance given the limited number of shipyards globally that are equipped to build cruise ships for the contemporary and luxury segments.

Carnival, for example, has no scheduled ship deliveries beginning in 2026, and Royal has no scheduled deliveries starting in 2027, which could support accelerated deleveraging in those years. NCL has at least one ship scheduled for delivery every year from 2025 to 2028 but has no deliveries in 2024.

We believe cruise operators have prioritized cash flow recovery and leverage improvement as they've emerged from the pandemic ahead of ship orders. However, improving balance sheets, the need to reinvigorate the fleet with new ships and new amenities to stay competitive, and the requirement to periodically replace aging ships may cause operators to resume placing orders for new ships.

How operators balance leverage reduction and ship orders will provide insight into financial policy going forward. We believe the largest operators will likely target one to two ship deliveries a year once they resume ordering ships. This level of spending is probably manageable inside of their cash flow bases, especially for Carnival and Royal.

Big ticket RV purchases face higher rates for longer. We believe downside risk depends on the extent of a slowing macroeconomic environment and consumer demand health. While inflation cooled in the second half of 2023, consumer sentiment remains low and higher interest rates could make financing RV sales less palatable, especially for new buyers. Additionally, S&P Global economists forecast a modest increase in unemployment through 2025, which increases the risk that big-ticker discretionary purchases, such as RVs, will be put on hold.

RV industry shipments have been a leading economic indicator in the past, and shipments have tended to decline ahead of recessionary periods (due to interest rate hikes near the top of a cycle that reduce the availability of consumer financing and retail demand). The current interest rate environment is a burden on retail volumes. We believe dealers have responded to inflation by partly pivoting their inventory strategies to acquire used RV units, and OEMs have been proactive at providing more affordable entry-level products.

Higher build costs could lead to a pullback in growth capital expenditures for fitness operators. Significantly higher build cost and higher interest rates in 2024 could result in fitness center issuers pulling back on growth capital expenditures and new developments, potentially resulting in lower top-line growth. However, there may still be significant opportunities for fitness issuers to take an asset-light approach. Vacant office spaces, malls, and competitor facilities that closed in response to the pandemic present numerous opportunities for new developments and growth with minimal capital expenditures required compared to completely new builds.

Fitness center issuers who adopt an asset-light approach could improve credit metrics and generate more free operating cash flow (FOCF), thereby alleviating the burden of higher financing costs in the current high interest rate environment. For example, Life Time Inc. recently shifted its financial strategy to include more growth from asset-light opportunities, which we expect will help improve its cash flow profile in 2024.

Demand for park visitation competes with the broader leisure sector. The regional theme park sector benefits from high barriers to entry due to significant capital requirements and limited land availability to build new greenfield parks. However, demand for regional theme parks competes with other forms of entertainment for consumer wallet share, including live events, gaming, and leisure travel. Therefore, operators must continuously reinvest in their parks to improve the guest experience and increase visitation.

Since parks have reopened following the pandemic, theme park operators have undergone various price optimization strategies and have added new attractions to their parks. We also expect there to be additional capital outlays for added amenities such as hotels at existing parks. In efforts to preserve margin, they also implemented cost reduction measures, including optimization of staffing levels and scheduling at attractions, and mobile ordering and menu optimization at food and beverage outlets.

Theme park operators have also demonstrated an appetite for M&A opportunities for further growth. For instance, in November 2023, Six Flags Entertainment Corp. and Cedar Fair L.P. announced a merger that will roughly double the combined company's EBITDA base, improve geographic diversity, and provide expanded park access for season pass holders.

The shift back to experiences may lead to a declining toy industry over the next few years. During the pandemic, toy companies saw record top-line growth, with U.S. toy industry retail sales growth of 16% in 2020 and 13% in 2021, according to Circana (an American market research company formerly known as NPD). Fueled by the pandemic, lockdowns, and school closures, consumers purchased more toys.

However, beginning in 2022, across the leisure sector we have seen a shift in consumers preferences for experiences over goods. In 2022, retailers ordered atypically high volumes of toys in the first half of the year out of fear of persistent supply chain disruptions and following empty shelves during the 2021 holiday season (brought on by the high level of pandemic-related toy purchases). However, growing macroeconomic pressures led to less demand than anticipated and toy companies saw a less than stellar holiday season in 2022; they faced another challenging environment in 2023 as retailers reverted to a typical order flow.

Toy companies may face a declining toy market over the next few years as the industry potentially modestly contracts from inflated pandemic levels. In 2024, our macroeconomic forecast has consumer spending slowing to about 1.8% because excess savings has dwindled. Consumers may continue to prefer experiences over goods--including travel, leisure, and dining out over the next year or two--and ultimately buy fewer toys.

Related Research

- Research Update: Carnival Corp. Upgraded To 'BB-' From 'B' On Favorable Bookings And Pricing, Expected Deleveraging; Outlook Stable, Dec. 22, 2023
- Research Update: Hasbro Inc. Outlook Revised To Negative Due To Weakened Credit Metrics, Dec. 13, 2023
- Peer Comparison: European Budget Hotel Chains Travelodge And B&B Hotels: Identical Ratings, Divergent Business Models, Dec. 12, 2023
- Bulletin: Choice Hotels International Inc. Ratings Remain On CreditWatch Negative On Announced Exchange Offer, Dec. 12, 2023
- Research Update: CWGS Enterprises LLC Outlook Revised To Negative Due To Leverage Spike And Reliance On Late-2024 Retail Recovery, Dec. 7, 2023
- Research Update: RV Retailer Intermediate Holdings Outlook Revised To Negative Due To Leverage Spike And Reliance On Late 2024 Recovery, Dec. 7, 2023
- Research Update: Caesars Entertainment Inc. Outlook Revised To Positive On Strong Operating Performance; 'B+' Rating Affirmed, Nov. 21, 2023
- Research Update: Melco Resorts And Studio City Outlooks Revised To Positive On Strong Macao Mass Gaming Market Recovery; Ratings Affirmed, Nov. 16, 2023
- Research Update: Wynn Resorts Ltd. And Wynn Macau Ltd. Upgraded To 'BB-' On Macao Recovery And Strong Las Vegas Results, Outlook Stable, Nov. 15, 2023
- Credit FAQ: What We've Learned About Cybersecurity Risk Following Recent Attacks In The U.S. Gaming Sector, Nov. 8, 2023
- Research Update: Hilton Grand Vacations Inc. Ratings Placed On CreditWatch Negative On Plan To Acquire Bluegreen, Nov. 6, 2023
- Research Update: Cedar Fair L.P. Ratings Placed On CreditWatch Positive On Proposed Merger With Six Flags Entertainment Corp., Nov. 3, 2023
- Research Update: Six Flags Entertainment Corp. Ratings Placed On CreditWatch Positive On Proposed Merger With Cedar Fair L.P., Nov. 3, 2023

Industry Forecasts: Hotels, Gaming, and Leisure

Chart 7

Revenue growth (local currency)

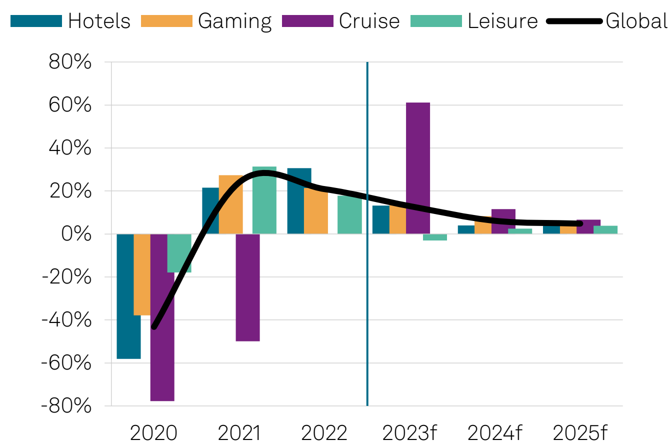


Chart 8

EBITDA margin (adjusted)

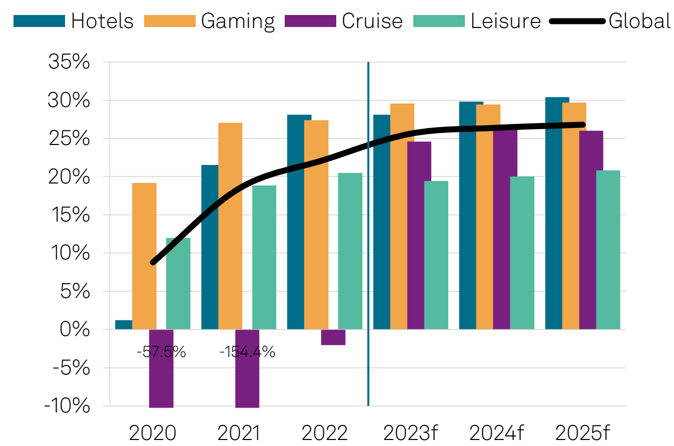


Chart 9

Debt / EBITDA (median, adjusted)

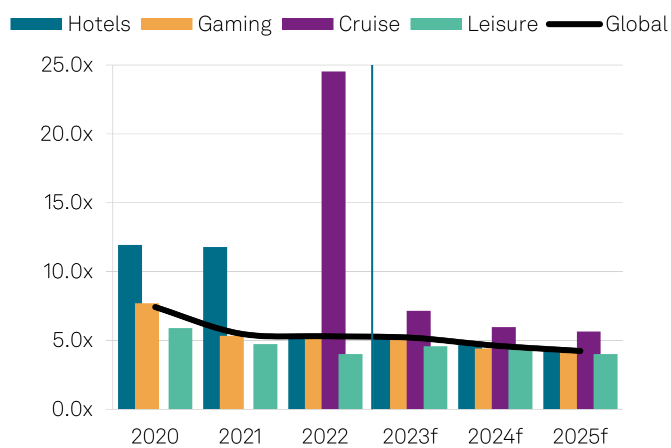
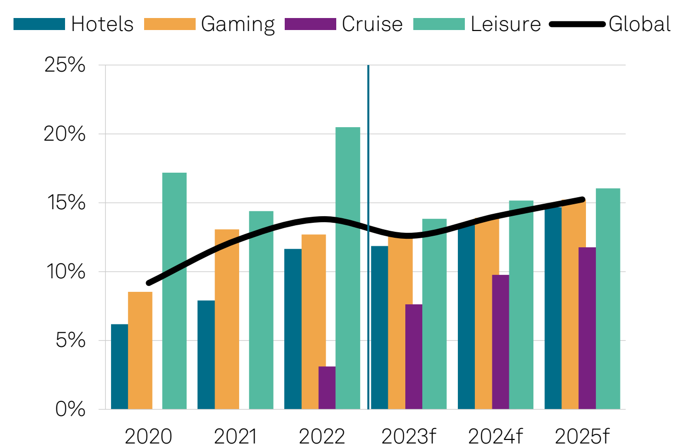


Chart 10

FFO / Debt (median, adjusted)



Source: S&P Global Ratings.
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: Sector

Chart 11

Cash flow and primary uses

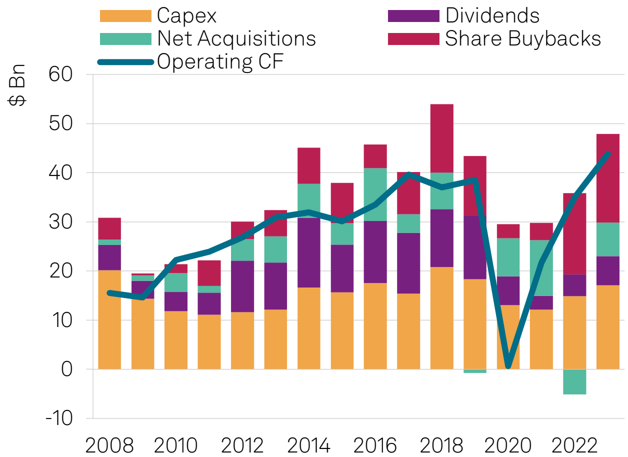


Chart 12

Return on capital employed

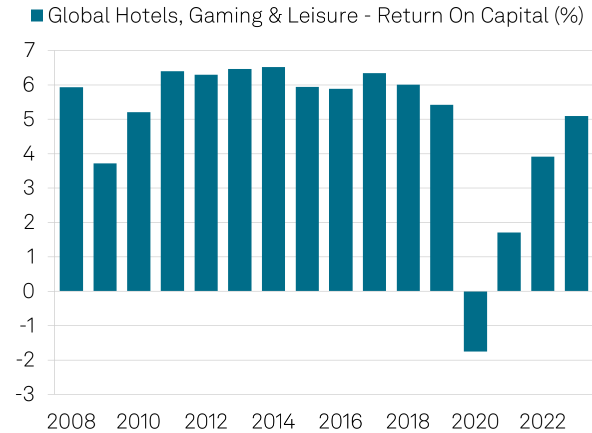


Chart 13

Fixed- versus variable-rate exposure

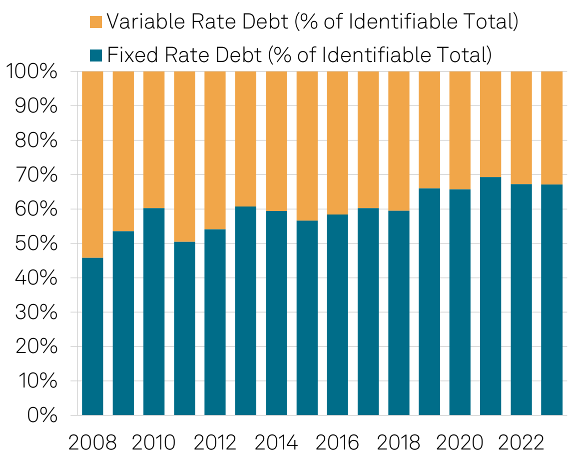


Chart 14

Long-term debt term structure

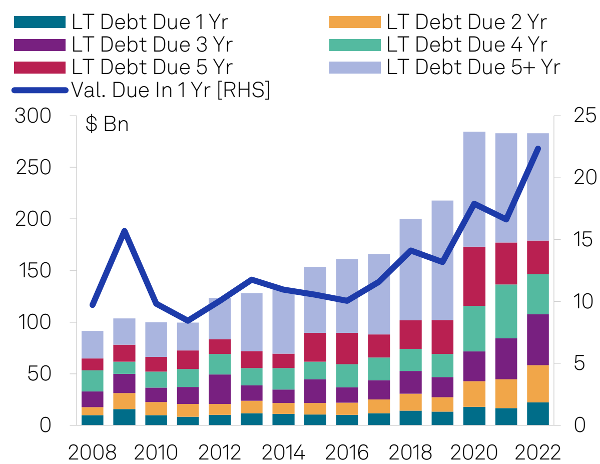


Chart 15

Cash and equivalents / Total assets

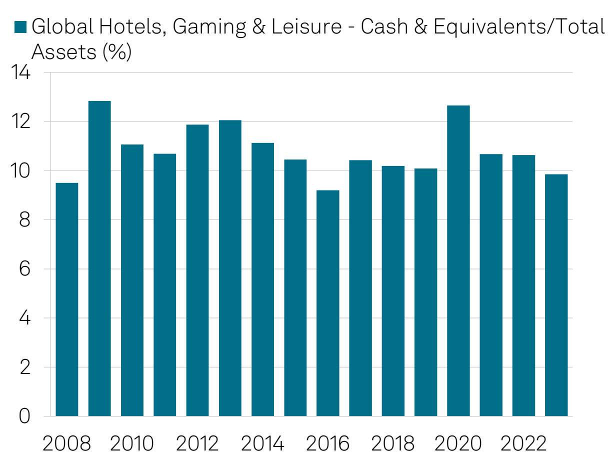
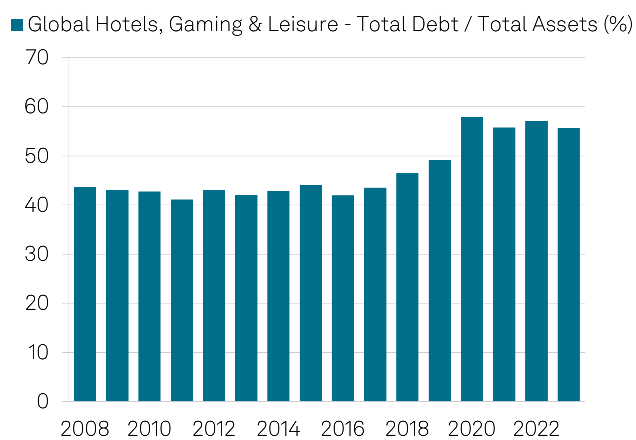


Chart 16

Total debt / Total assets



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

Media and Entertainment

Looking for bright spots amid the industry's sea of gloom

January 9, 2024

This report does not constitute a rating action.

What's changed?

Content bubble pops. The recently settled writers and actors strikes allow the industry to reevaluate content spending. Streamers lift profitability, but demand drops for content creators.

Secular advertising trends. We believe secular pressures, more than macroeconomic cyclical trends, are driving continued soft advertising spending on legacy media, including linear TV.

Higher for longer. Persistently high interest rates put refinancing pressure on lower-rated companies with near-term maturities. Many can't survive with higher interest burdens.

What are the key assumptions for 2024?

Consumer balance sheets weaken. Consumer spending on discretionary media may weaken as COVID-19 pandemic-aided savings are depleted. Streaming subscriber growth may suffer.

Muted advertising improvement in the second half. For legacy media sectors dependent on advertising, we expect improving trends. U.S. political advertising will reach records.

Normalizing content spending. Content spending returns following the end of the Hollywood strikes, but with fewer dollars and projects. It will still take six months to ramp up to normal.

What are the key risks around the baseline?

Accelerating secular trends in the media ecosystem. Worsening declines in linear TV and continued soft advertising could weaken media companies' credit metrics.

Streaming reaching profitability. Some streamers may become profitable in 2024. Is there a place for those media companies with weaker streaming prospects?

Macroeconomic weakness/geopolitical shocks. While not in our base case, a macroeconomic recession or geopolitical shocks could hurt consumer discretionary spending.

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Ratings Trends: Media and Entertainment

Chart 1

Ratings distribution by region

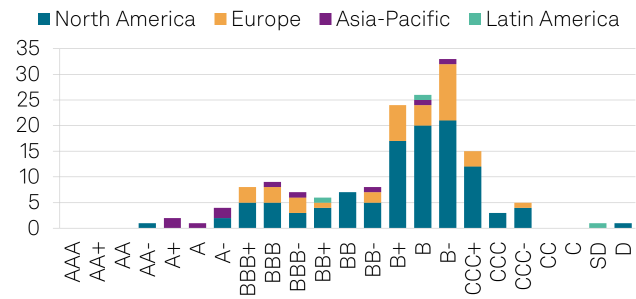


Chart 2

Ratings distribution by subsector

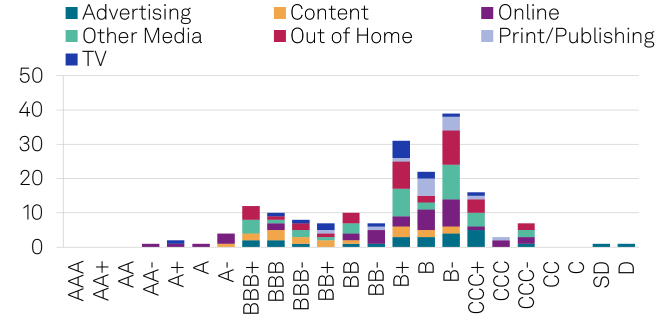


Chart 3

Ratings outlooks by region

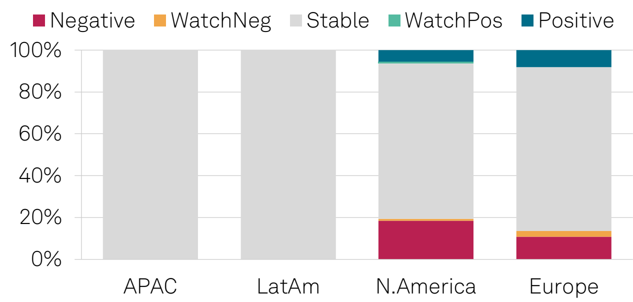


Chart 4

Ratings outlooks by subsector

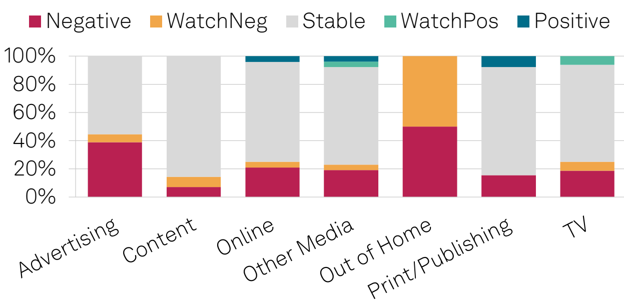


Chart 5

Ratings outlook net bias by region

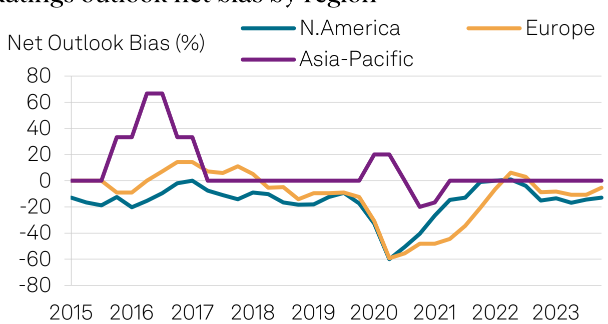


Chart 6

Ratings net outlook bias by subsector

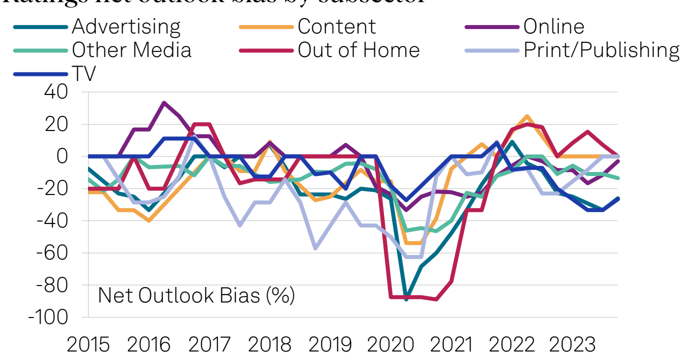


Chart 7

Ratings outlooks

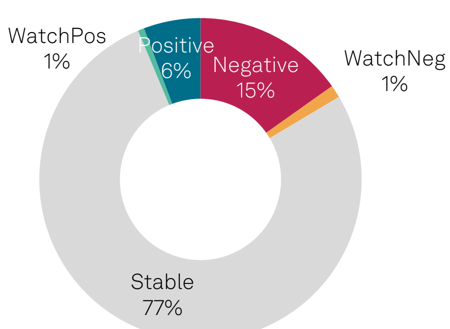
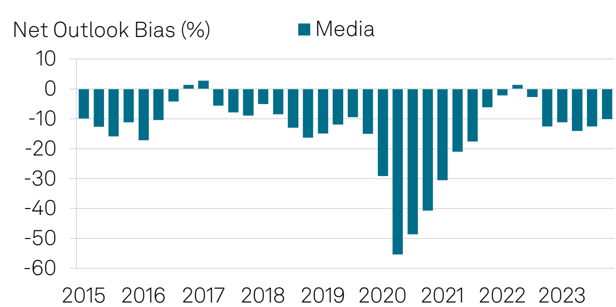


Chart 8

Ratings net outlook bias



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

Industry Outlook: Media and Entertainment

Ratings trends and outlook

Our two-year forecast for the global media and entertainment sector remains negatively biased. Since the start of the COVID-19 pandemic in 2020, the global media and entertainment industry has faced intensifying secular pressures. The pandemic affected consumer behavior, accelerating secular trends that were percolating prior to the global shutdown. These trends all pointed to greater dependence on digital platforms and digital distribution as audiences in key media markets around the world defected from linear TV to streaming, global box office suffered because audiences expected films would be released to streaming, and advertisers moved more of their ad budgets away from legacy media to digital platforms that offer superior audience targeting opportunities. Since the world emerged from the pandemic in 2021, the industry has struggled to remake itself and meet changing consumer behavior.

Many companies launched their own streaming services, constrained in-house captive studios to exclusively support them, and struggled to stem the decline of their linear TV networks. The decline of the still highly profitable linear TV ecosystem has been most painful because of oversize profits, which parent media companies used to finance film and TV studio productions, global expansion and investments, and share repurchases. Thus, media companies' revenue growth has been tepid, EBITDA declined, and free cash flow and credit metrics weakened.

We believe 2024 could be the year when the media sector begins to turn the corner and improves EBITDA and cash flow. Streaming losses should lessen, improving on a trend that began in 2023, and two streaming services--Warner Bros. Discovery Inc. (WBD)'s Max and The Walt Disney Co.'s Disney+--could turn sustainably profitable. As content production returns to normal following settlement of the 2023 Hollywood writers and actors strikes, film studios can do what they're supposed to do: make movies and TV shows.

After a year of weak global advertising due to geopolitical events and fears over a macroeconomic recession, we believe advertisers resumed spending in the second half of 2023. This recovery, however, has been limited to digitally focused media platforms, including search, streaming, social media, digital commerce, retail media networks, and connected TVs. Spending on legacy media (TV, radio, and print) remains weak. We expect these trends to continue into 2024, with only modest improvement in advertising on legacy media platforms starting in the second half. Linear TV, in particular, will benefit from the Paris Summer Olympics, the Union of European Football Associations' Euro Football Championship, and, in the U.S., advertising for a presidential election year.

Reassessing media's ratings and thresholds. As the industry navigates secular struggles, we are concerned that it isn't as strong as it has historically been. In particular, the streaming business may require more content investments and therefore be less profitable than the linear TV it is replacing. The studio business no longer has its previous earnings potential because content is no longer monetized across multiple third-party platforms globally. And legacy companies are losing advertising revenues to digital platforms. Diversified media companies can recapture a portion of this as they build scale with their streaming businesses, but pure-play digital media companies will benefit more. These issues could have negative ratings implications for legacy media companies. We plan to reevaluate our view versus other corporate sectors in 2024 and could adjust leverage thresholds and ratings for the industry or specific companies that we believe are more vulnerable or worse-positioned to adapt.

Although historically among key credit metrics we have primarily relied on leverage (i.e., debt to EBITDA), others are becoming increasingly important in our analysis. In particular, the secular changes affecting media will likely permanently weaken cash flow. Thus, we could more often rely on free operating cash flow to debt in our ratings and outlooks.

Credit metrics and financial policy

We expect credit metrics will modestly improve in 2024 for global diversified media companies. Over the last two years, these companies have heavily invested in new original content as they launch streaming services, which has weakened credit metrics. As they now shift their focus to reaching profitability and improving cash flow, we expect modest EBITDA improvement as streaming EBITDA losses should improve faster than declines in linear TV. We expect companies to apply excess free cash flow to debt reduction. Still, many still have credit metrics above our ratings thresholds. How we address our ratings on these companies, by maintaining or lowering ratings, will depend on both their ability and pace to return to credit metrics appropriate for the ratings. A key driver to credit measure improvement is whether they increase streaming profitability faster than linear TV cash flow degrades.

We are watching the long-term impact of higher interest rates on the credit quality of lower-rated companies. We believe rates, for at least the next several years, will likely remain higher than the historic lows of the last decade. Thus, our ratings outlook for media issuers rated in the 'B' category and lower remains challenged. Refinancing and elevated financing costs will remain risks. Many media companies have addressed capital structure issues and extended maturities in 2023, but a high volume of maturities in 2025-2026 remain. This is particularly concerning in the U.S., where two-thirds of issuers have ratings in the 'B' and 'CCC' categories.

Key risks or opportunities around the baseline

1. Can streaming profitability approach that of linear TV?

Linear TV was very profitable, and we are uncertain if streaming can replace linear TV's earnings. While we expect streaming losses to improve significantly in 2024, it may be too early in streaming's development to speculate on long-term profitability. Besides Netflix Inc., no other media company has yet sustained streaming profitability.

2. Does media consolidation finally happen?

It has stalled over the past year as companies revise their streaming ambitions and deleverage their balance sheets. While there are many positive reasons for further consolidation, we believe regulatory concerns, access to capital, sizable differences in perceived valuation, and cultural issues will limit significant mergers and acquisitions (M&A) in 2024.

3. Artificial intelligence (AI) presents both opportunities and risks to media companies.

AI will likely unlock material workflow efficiencies, in particular reducing time and cost to create content. The new contracts that settled the strikes attempted to place AI guidelines in film and TV production. We expect ad agencies to adopt AI to better deliver creative campaigns. However, for companies that operate a largely cost-plus model, this could lead to lower per-campaign creative revenue. AI regulation will also evolve, potentially limiting its immediate effects on ad-dependent media companies.

4. Continued privacy and regulation changes could limit targeted advertising opportunities.

Further tightening of privacy regulation and privacy-preserving measures could limit the ability to target users and measure results of ad campaigns, affecting digital advertising revenue. This could weaken the credit strength of advertising companies that fail to adapt longer term.

Significant M&A are challenging even though consolidation is needed for the media industry to remain independent. The digitalization of content delivery, driven in part by the launch of captive media businesses by global tech companies, has turned a regionally centric media industry to global and has exposed those legacy media companies that don't have scale to global competition. Consolidation would appear to be a solution to the problem of scale. However, it has been minimal over the past 18 months as companies have focused on deleveraging their balance sheets after several years of heavy investments in streaming.

We believe significant M&A will be challenging to pull off in 2024 for several reasons. First, regulators have taken a negative view on the scale of the global technology companies and have sought to block most transactions involving media and technology companies. Second, as one would expect among a people-driven industry, cultural compatibility remains a key consideration for the media sector. Third, we believe a significant valuation gap remains between what potential acquirers are willing to pay and what potential targets think they're worth, especially for legacy linear TV assets. Finally, balance sheets remain stretched among both potential acquirers and targets, limiting debt-financed deals and making targets expensive versus public market multiples.

Prospects for industry consolidation in Europe, the Middle East, and Africa (EMEA), especially in linear TV broadcasting, remain uncertain. We believe obtaining approvals from regulatory and competition authorities could be challenging, given that so far regulators have ruled against regional consolidation in France. Unlike in the U.S., we believe synergies in content acquisition and cross-country operating costs would likely be limited, reducing the attractiveness of cross border transactions.

Adoption of AI by legacy media companies will be gradual rather than abrupt as the technology evolves and is subject to regulatory and legal risks. Despite AI dominating news headlines for most of 2023, it has yet to materially shift media companies' business strategies or financial and credit metrics. Over the near term, we expect media companies to use AI to improve workflow efficiencies by reducing time and costs to create content. Film and TV studios are likely to use AI to start development of scripts. Global ad agencies have quickly adopted AI to better deliver creative campaigns. Over the long term, we believe technological disruption, including the adoption of generative AI, will likely enhance ad agencies’ service offerings and market positions. They already own some technology and experience in this area and will continue to invest. This positions them well to advise and educate clients on AI's application and related regulatory, legal, and compliance considerations.

Elevated regulatory risks could hamper digital advertising growth and put pressure on our ratings on ad companies. Privacy regulation and consumer preferences continue to change toward higher privacy and less trackable data available for targeting digital advertising. Changes in privacy measures require companies to constantly adapt their business models and how they collect customer data. This makes access to first-party data especially important and requires investment in data assets and technologies. Inability to remain competitive could lead to downgrades in our ratings and negative revisions in outlooks, especially on smaller and less diversified media companies.

Outlook For Content

Ratings trends and outlooks

Our rating outlook trend for media companies focused on creating and owning film and TV content is neutral. Original long-form video content (film and TV) remains the lifeblood of the entertainment industry. The old adage about media, "content is king", remains as true today as when media magnate Sumner Redstone said it years ago. The Hollywood writers and actors strikes constrained short-term growth prospects for the content ecosystem as many projects were delayed or abandoned. The strikes lasted several months, but their effects will linger well into 2024 and beyond. Disrupted, delayed, or cancelled products have left holes in global film release slates and streamers' programming schedules. While content production should return to normal by the second half of 2024, film and TV release schedules won't be repaired until 2025.

Content also includes non-film and non-TV creators, such as music publishers, video game developers, and sports leagues and teams. Our rating outlooks for these sectors is positive. Music continues to have strong industry tailwinds that support our forecast for the sector. Monetization of music is improving as music streaming services such as Spotify, Amazon.com, and Apple Inc. raise prices and music publishers strike deals with social media platforms that open new monetization avenues. Premium video-game publishers continue to have solid engagement and demand, supported by strong intellectual property (IP). While challenges persist in mobile gaming, which historically had been the fastest expanding video game segment, games with stronger IP and a track record of success are more immune to these trends. Sports operators such as NASCAR and TKO Group Holdings Inc., which owns both Ultimate Fighting Championship and World Wrestling Entertainment, continue to garner steep increases in TV broadcast rights. Sports remains the only genre without precipitous viewership declines on linear TV.

Main assumptions about 2024 and beyond

1. The content bubble hasn't burst, but it is deflating.

The runaway train of increasing content spending to fuel streaming growth has slowed as media companies pivot from subscriber growth at all costs to achieving profitability by rationalizing content spending. This is further cemented by the strikes that halted or delayed content production and gave film and TV production studios the opportunity to further rethink projects and reduce content production plans.

2. Film and TV production returns to normal by mid-2024.

In the meantime, as everyone tries to ramp up production, it could be chaos as projects fight over sound stage time, crews and equipment, and talent.

Media companies reassess their content strategies. Over the past few years, they dove headfirst into building their streaming platforms, and an explosion of spending on new content was a key part of their growth strategy. Entering 2023, the companies reassessed this strategy and began scaling back content spending. We expect that to continue to moderate into 2024 as studios pivot their focus toward improving profitability and cash flow, and are more discerning in both how much they spend and what type of content they produce. Several studios have reduced spending guidance, including Disney's $25 billion on content in 2024 as opposed to its previous guidance of $29 billion. Additionally, studios are reassessing exclusivity for content as many, during the streaming subscriber craze, had stopped licensing content to third-party companies.

These studios are now more willing to license library content to competitors. This change has two benefits to the studios: It improves profitability and cash flow, and it can widen the appeal of the licensed content. Warner Bros. Discovery did recently with nonexclusive licensing deals for HBO and DC Comics content for Netflix. We expect the studios to continue to tinker with their content and licensing strategies as they optimize their streaming platforms and drive profitability.

Media companies have begun repairing their studio model. This business used to generate solid cash flow from the licensing of library content to third parties. With the launch of in-house streaming services, this stream mostly disappeared from the large captive studios. However, many have moved back to a hybrid model that includes both content made exclusively for in-house streaming and third-party licensing. This should restore some profitability and cash flow.

Key risks or opportunities around the baseline

1. As streamers cut content budgets, independent studios' bottom lines could be pressured.

Independent film and TV studios have benefitted the last few years as media companies spent persistently to build out their nascent streaming platforms. With the pivot toward profitability, that spending pipeline has slowed. In addition, captive global studios have reembraced a model that again includes a third-party licensing component. This has increased supply, pressuring the value of content. We believe this will turn up pressure on smaller, independent studios' bottom lines, which already faced the scarcity of talent, crews, and studio space.

2. The cost of sports TV broadcast rights increases and increases.

Sports leagues and networks are the prime beneficiaries of linear TV's dependence on sports programming. They also are willing to sign main broadcast deals with linear TV, as opposed to streaming services that could offer significantly more money, because of linear TV's broad reach. We expect TV networks to continue to win major broadcast rights with secondary packages being awarded to pure-play digital companies. Upcoming sports broadcast rights renewals that could significantly increase fees include the National Basketball Association domestic market and NCAA college football playoffs.

3. Opportunities are there to consolidate film and TV studios, especially outside the U.S.

M&A could help smaller studios get much-needed scale and increase efficiency, but we do not expect many deals as balance sheets are already stretched. The regulatory environment in the U.S. is less favorable for larger players, particularly tech companies, to make acquisitions. We believe there are more acquisition opportunities within the European studio ecosystem as even larger European studios are far smaller than those buried within global diversified media companies. However, we are skeptical that many transactions will be completed due to tough financing conditions and difficulty agreeing on valuations.

Outlook For Content Distribution

Ratings trends and outlook

Our rating outlooks for those media companies engaged in distributing content, which includes linear TV, movie exhibitors, and direct-to-consumer video streaming services, is negatively biased, especially for those media companies that own linear TV. This media segment continues to face significant secular pressures as digitalization (i.e., the internet) changes the way content is distributed. Our outlooks for U.S. national TV and streaming, which face the brunt of these changes, is solidly negative while we are neutral on local TV broadcasters because they have yet to experience the same pressures on operating and financial metrics. These secular changes will eventually affect linear TV across the world, and our country-specific views reflect that varied pace. For example, it may be gradual for some markets (such as France and Germany, where there are strong local language programming options). Conversely, many English language markets, including the U.K. and Australia, are not far behind the U.S. in terms of competitive pressures from streaming services. We believe the Hollywood strikes were opportunities for the media sector, and in particular their streaming businesses, to rethink programming spending plans and accelerate their path to profitability.

Main assumptions about 2024 and beyond

1. Streaming losses will meaningfully improve.

After years of elevated investments in building their streaming services, we believe 2023 marked the peak of losses for the major global streaming services. We expect several will turn profitable in 2024. The path to profitability will be fueled by both average revenue per user (ARPU) growth, through price increases and advertising, and reduced content and marketing spending. We would not be surprised if smaller players that lack content and library scale and the ability to absorb losses to continue investing in streaming abandon their ambitions. European linear broadcasters will likely continue investing in streaming in the near term as they face less fierce competition than their U.S. peers and still have capacity.

2. Pressure to the linear TV model continues unabated.

While the greatest stresses are in the U.S., pressure on the global linear television ecosystem is intensifying as audiences leave to digital platforms and advertising remains weak. We expect U.S. pay-TV subscriber declines to remain steady at about 8% in 2024, with subscribers to legacy multichannel video programming distributor services declining at over 13%, somewhat tempered by virtual pay-TV subscribers expanding 4.5%. Overall pay-TV penetration in the U.S. will decline to about 50%. This will not affect all media companies uniformly. Ironically, those with greater exposure to sports may be better positioned to retain revenues, but the high fixed costs for sports rights fees means that margins and cash flow may decline faster.

3. The global box office was on the path to recovery before the Hollywood strikes.

They hurt the 2023 nascent global box office recovery and disrupted the theatrical release schedule. We don't expect the box office to resume increasing until 2025 as many films originally scheduled for release in 2024 have been delayed to 2025, leaving holes in the 2024 film slate. As a result, cinema operators' metrics remain under pressure as these companies still bear very high debt and cash interest burdens.

Finally, streaming has a path to profitability. Every major streaming platform turned the corner in 2023, and we expect meaningful improvements in 2024, with several achieving modest profitability by the end of the year. This will come as ARPU significantly expands due to price increases enacted throughout 2023 and higher advertising revenue through ad-supported tiers. We think streaming services have additional room to continue raising prices. Consumers are accustomed to modest annual price increases like Netflix has done at regular intervals for many years. Additionally, even as streamers raise prices, they provide lower-priced, ad-supported tiers that can retain subscribers who are less willing to pay more without meaningfully increasing churn, which should reduce subscriber acquisition costs. We also expect cost discipline to further aid in reducing streaming losses. Media companies have pared back content and marketing spending and are much further along in launching in global markets, which have significant upfront investment costs that affect profitability.

It remains an open question as to what the long-term margin profile will be for streaming and whether its cash flow can replace that of linear TV. Netflix has achieved 20% margins though global scale and efficient content spending and monetization. Could legacy media companies achieve, or even exceed, these margins? Netflix has avoided high-priced sports rights while media companies can monetize content costs across both streaming and linear TV platforms.

Companies that lack scale and sufficient resources to invest in streaming will continue to scale back growth ambitions, especially in the U.S., where competition is fierce and linear viewing is rapidly declining due to cord cutting. AMC Networks and Lionsgate/Starz already took such actions, and we expect others to follow over the next few years. Our outlooks on such players are increasingly negative because we think they will struggle to retain audiences and remain competitive over the medium term. Growth over time in their streaming revenue is unlikely to offset declines in the linear TV business.

Media companies in Europe continue building out local streaming platforms. Netflix, Amazon, and Disney dominate most of these subscription video-on-demand markets. Local broadcasters still have relatively few subscribers compared with global platforms, but are expanding their streaming presence and building strategies around local content offering. European broadcasters lack scale and financial resources compared with global powerhouses and need to carefully balance programming investment against reducing profits and cash flow. At the same time, many benefit from owning integrated production studios that help them produce and acquire original content and build broader libraries that underpin their streaming offerings. Similar to global platforms, they tend to have multiple pricing tiers ranging from free ad-supported to premium paid. In the near term, in our view digital advertising revenue from streaming will surpass subscription revenue, but it should help broadcasters offset the decline from linear TV advertising.

In the U.K., ITV PLC continues to invest in platform development and original content in ITVX, which in the second quarter of 2023 reached 12.5 million monthly active users and 1.4 million subscribers. We think this investment will weigh on ITV's margins in 2024. In Germany, Bertelsmann SE & Co. KGaA is investing in RTL+, a broad bundled service that provides access to on-demand video, music, magazines, and audiobooks and to Videoland, which surpassed 6 million subscribers in 2023. We don't expect it will become profitable within the next 12-24 months. CME Media Enterprises Ltd.'s streaming service Voyo competes very successfully against global platforms in the Czech Republic because of its focus on local content. Some smaller local streaming-oriented players that lack this advantage scaled back their expansions and restructured operations in the face of declining advertising markets and high competition. Global players such as WBD have also curbed their investment in local content and streaming expansion, exiting several European markets.

Linear TV is still bleeding viewers. The ecosystem, especially in the U.S., continues to face secular challenges. We anticipate that profitability and cash flow will further degrade. We forecast that U.S. pay-TV subscriber declines will remain in the 8% area in 2024, resulting in a low-single-digit percentage annual decline in affiliate revenues, and that viewership will decline at the current teens percentage rate, resulting in a low- to mid-single-digit decline in advertising revenues. TV has been supported by sports programming historically available exclusively on linear TV, but more media companies are also putting it on their streaming platforms, which could exacerbate linear TV's decline. Recently Disney—owner of ESPN, the leading sports-focused network in the U.S.—said it expects to launch an ESPN streaming service in 2025 that would have the same content as its linear TV network, which could further accelerate the decline of linear TV.

Can sports save U.S. national TV? Sports has been a major support to the linear ecosystem and is one of the few bright spots for viewership and advertising. If more sports and viewership shift to digital over time, we would expect advertising to follow. This finally seems to be the case for general entertainment advertising, which has declined double-digit percentages in 2023. However, premium sports programming can be found on alternative distribution media (e.g., both NBC and Paramount make their NFL broadcasts available on their streaming platforms and TV networks, Amazon has the rights to the NFL's Thursday night game, and Alphabet's YouTube has the NFL's Sunday Ticket package). Linear TV networks use sports to better protect their top lines so they can garner bigger affiliate fee increases and capture a greater share of advertising spending. However, networks incur higher programming costs that are likely to increase even as revenues come under greater pressure. Conversely, advertising and affiliate fee revenues are increasingly weaker for linear TV networks without sports, but they have a greater ability to control programming costs. Thus, we expect greater margins and cash flow degradation for those with significant exposure to sports, and weaker revenues and cash flow for those lacking sports.

U.S. local TV is performing well, but secular clouds are forming. The near-term forecast on local TV broadcasters in the U.S. is less negative than nationally focused TV network and cable network companies due to relatively low content spending needs and fewer near-term pressures on key revenue streams, in particular retransmission revenue. Local TV broadcasters are not immune to the rising pay-TV subscriber declines affecting nationally focused media companies. Over the last few years, local broadcasters have more than countered these declines by increasing retransmission fees by double-digit percentages, exceeding pay-TV subscriber declines. But we believe this will be more difficult as broadcast networks prioritize content for their streaming platforms, weakening the programming on their broadcast networks and the ability to command sufficient price increases to offset increasing subscriber churn.

Still, we expect retransmission revenue will remain stable for the next few years as live news and sports remain must-have content. Recognizing that network content is becoming less exclusive, the local TV broadcasters are also trying to shore up additional content. Many have acquired sports rights over the last year, particularly local teams looking for greater reach amid the collapse of regional sports networks.

The secular changes in linear TV affect broadcasters across the world. In some EMEA markets, for example France and Germany, regulation and strong local language programming support linear viewership and broadcasters' competitive standing against global media platforms. Conversely, many English language markets, including the U.K. and Australia, are not far behind the U.S. in audience declines and competitive pressures from streaming services. EMEA broadcasters continue building out their streaming services, which will weigh on margins in the next two to three years, but in our view, they still have capacity to invest.

Strikes set back the global box office recovery; what does 2024's revised film slate look like? For cinema exhibitors, the Hollywood strikes couldn't have come at a worse time. They wrecked the film theatrical release slate for the second half of 2023 and into 2024, setting back the domestic box office recovery that had accelerated with the summer releases of WBD's "Barbie" and Comcast Corp.'s "Oppenheimer". As a result, the box office will remain well below pre-pandemic levels in 2023, with admissions about 30% below 2019 figures. Higher ticket prices and strong spending per patron on concessions, which remain well above 2019, will partly offset this.

The theatrical releases of some completed big budget films (such as WBD's "Dune: Part Two") were delayed into 2024 because actors were prevented from publicizing their films. Partially completed films (such as Walt Disney's "Deadpool 3") didn't hit their original release dates. Also, new projects couldn't get started, so their release dates were pushed out into 2025 and beyond. We therefore expect limited improvement in the global box office in 2024, hampered by fewer film releases. That said, we anticipate continued ticket price inflation, mostly through increasing adoption of dynamic pricing strategies, and resilient concession spending. We also believe cinemas will remain the main channel for blockbuster film releases and don’t expect near-term changes to theatrical windows.

For cinema operators, we believe credit metric improvement will be limited. Revenue growth will mainly come from higher ticket prices and concession spending. Still, persistently higher costs (especially related to staff and energy), which originally rose in 2022, and high interest costs will depress profitability and cash flow. AMC Entertainment Holdings Inc., Cineworld Group PLC, and Vue Entertainment International Ltd. all made progress in fixing their balance sheets, but the lackluster second-half box office results in 2023 pressured those repaired balance sheets, leaving the companies susceptible to a weak 2024 box office. If admissions don’t pick up or there is further disruption to release schedules, lower-rated operators risk free cash flow deficits continuing into 2024 and eroding their liquidity.

Brazil's Globo continues to advance its successful online platform Globo. In Latin America, diversified media company Globo Comunicacao e Participacoes S.A. continued to advance its digital transformation, seeking to adapt to audiences that are increasingly inclined to streaming platforms and online channels. The main strategy in that direction is the expansion of the online platform Globoplay, through which it has sought to connect the media and content segments via new business and technology partnerships. New partners include Xandr Inc., a technology company focused on advertising, curation, and data management, to improve marketing in digital platforms and TelevisaUnivision for the distribution of international content in Globo’s platforms, reaching a broader market for proprietary content. Even though the company does not publicly disclose much information about the platform’s performance, the subscriber base has been increasing steadily over the last few years, 10%-12% each of the last few quarters.

Key risks or opportunities around the baseline

1. Streaming profitability may be structurally lower than that of legacy TV.

U.S. linear TV was very profitable, generating margins in excess of 40% for unscripted networks. It is unclear if streaming will ever replace the linear TV's earnings. Still, streaming is early in its development. Besides Netflix, no other major streaming service has yet achieved profitability.

2. The Disney/Charter deal may provide a blueprint that makes TV bundles more attractive.

The September distribution agreement is a first step in blending the linear TV and streaming ecosystems and could be a positive for the ecosystem. It brings more value to the consumer through high-quality streaming content and rationalizes costs by eliminating long-tailed TV networks. We believe this could become a template for others and help alleviate pay-TV churn.

3. Streamers could finally benefit from sports rights ownership.

For several years, streaming platforms have acquired broadcast rights for sports leagues (e.g., Alphabet's YouTube TV won the NFL's Sunday Ticket package, Amazon won the NFL's Thursday night game, and DAZN outbid Sky for Italy's Serie A's domestic broadcast package). But in most cases, these wins remain opportunistic. It's unclear whether they can sustainably monetize these rights. However, as they snap up more sports rights in competition with linear TV networks and broadcasters, these wins could accelerate the decline in linear TV and help growth in streaming subscribers.

Scale is key for streaming profitability. Netflix has reached more than 20% margins largely due to its global reach (close to 250 million subscribers) and cost discipline, which allows it to keep cost growth below revenue growth. While the remaining streamers since the end of 2022 are controlling costs far better, they have yet to achieve the same global scale, a key component of improving margin. Disney is the furthest along with 112 million Disney+ core subscribers (150 million including Hotstar), while Max is at 95 million) and Paramount+ at 63 million. These companies’ ability to continue increasing ARPU while still building out their global scales and subscriber bases will be instrumental in sustainably building profitable businesses that can offset the secular challenges in linear TV.

The Disney/Charter agreement deal could give linear TV model a boost. We believe this landmark agreement has broad ramifications for the media sector. Pay-TV is still the largest cash flow stream for media companies, and they have sought to preserve it even as they build out their streaming services. By bundling direct-to-consumer services into the pay-TV bundle, this agreement may add life to the bundle for two reasons: Consumers may now feel there's value in continuing to subscribe, and the deal may also smooth the transition from pay-TV to streaming because of greater subscriber scale. This will help media companies better migrate advertisers from linear TV to ad-light streaming and accelerate profitability.

We also believe it could slow the migration of traditional pay-TV subscribers to virtual pay-TV alternatives or over-the-air viewing. We believe the subscriber economics for local broadcasters are better from traditional pay-TV providers than from virtual providers. At the same time, we believe the amount and stability of cash flow from retransmission revenue are materially better than the advertising revenue generated from over-the-air viewing. While we believe there still could be blackouts from time to time between pay-TV distributors and local TV broadcasters, both this agreement and the Nexstar Media Inc./DirecTV distribution deal support our view that broadcast television, which includes news and sports, continues to be must-have programming.

Outlook For Advertising

Ratings trends and outlook

We expect our ratings on most advertising-dependent companies to remain stable in 2024 despite our anticipation that real global economic growth will remain weak for the next two years. Our ratings outlook primarily reflects these key points:

- Slow economic growth in key advertising geographies, including the U.S. and Western Europe in 2024 and 2025.
- Better-than-GDP growth in global advertising spending. This includes modestly improved advertising in legacy media, such as linear TV and radio, but not until the second half of 2024.
- Increasing divergence in advertising trends for digital media platforms, such as connected TV, social media, e-commerce, and retail media networks, which will accelerate in 2024, versus legacy media platforms such as linear TV, radio, and print, where advertising will continue to decline due to worsening structural trends. We don’t expect a recovery in either linear TV or print to pre-pandemic advertising.
- Global diversified media companies' exposure to the pressures on linear TV advertising. But they also benefit from growth in digital advertising on their proprietary streaming platforms.

We took several rating actions over the last 18 months as advertising revenues for legacy media weakened and thus far failed to recover. We both lowered ratings and revised outlooks on most advertising-dependent media companies. In particular, we lowered our ratings on U.S. radio companies whose advertising revenues continue to decline and on digital programmatic advertisers with significant exposure to economically challenged verticals, including mortgage refinancing, insurance, and retail.

We expect credit metrics of ad-based companies will gradually strengthen in 2024, especially if, as we expect, advertising on legacy media improves in the second half. In the U.S., companies that earn political advertising revenue will benefit from the presidential election. We assume most companies will remain focused on controlling costs, and so we expect slower growth in wages (which accounts for about 65% of operating costs) as inflation gradually eases. Improving cost efficiency due to technological advancements and completion of restructuring and cost-saving programs should also allow them to invest in tech and data capabilities without materially weighing on profits.

Global ad agency holding groups could increase their top lines above GDP, but remain exposed to macroeconomic risks. We believe this business model remains relevant in the rapidly evolving media universe. Over the past several years, agencies have refocused and rationalized their business portfolio mix, increasing data and tech capabilities and expanding into faster-expanding market segments such as e-commerce, sponsorships, experiences, and public relations. Additionally, the digital advertising ecosystem has become much more complicated, with numerous advertising options requiring more tailored approaches or creative and more frequent targeted campaigns, and increased demand for measurable outcomes. This complexity has benefitted ad agencies because most advertisers lack the staff, expertise, data, and analytical capabilities to navigate this new advertising ecosystem.

Large investment-grade ad holding groups generally have good rating headroom for organic investments, potential M&A, or shareholder returns. Companies have been doing sizable share buybacks in 2023, but could scale this back in 2024 if macroeconomic conditions soften to avoid a material weakening in credit metrics. We expect companies will remain very selective with large M&A and don’t assume acquisitions will materially pick up at least until the second half because macroeconomic conditions might remain volatile and cost of capital remain high.

Main assumptions about 2024 and beyond

1. Legacy advertising trends will remain weak into 2024.

We expect U.S. GDP to increase 1.5% in 2024, U.K. GDP to increase 0.4%, and eurozone GDP to increase 0.8% as tightened monetary conditions dampen consumer and business demand. Advertising trends are highly correlated with consumer spending, which is broadly the largest component of GDP (two-thirds in the U.S.).

2. Legacy advertising trends will remain weak into 2024.

S&P Global economists expect prolonged, slow economic growth in key advertising markets (U.S., U.K., and Germany). We expect consumer spending to weaken and, as a result, do not see an improvement in legacy ad spending until at least the second half. However, the impact on the various advertising media will vary greatly, as advertising on digital will continue to expand at high-single-digit percentages and outdoor platforms at mid-single-digit percentages. We expect core legacy linear TV advertising, which excludes the 2024 Summer Olympics in Paris and U.S. election spending, will continue to modestly decline, while radio advertising will be relatively flat after steep declines in 2023.

3. Digital advertising remains the growth engine for the advertising ecosystem.

We forecast global digital advertising revenue will increase at a high-single-digit percentage rate in 2024, reflecting stabilizing global macroeconomic growth, albeit modestly slower than in 2023. Digital was the first ad sector to slow in 2022 and the first to recover starting early in 2023. Digital video and retail media networks will be the fastest expanding subsegments as both benefit from the continued shift to online shopping, digital video consumption, and connected TV and better demographic targeting provided by video on demand viewing.

4. Performance-based advertising will continue to outperform brand advertising.

Companies have pulled back more on brand advertising over the last year and increasingly shifted their ad spending toward performance-based advertising as they look to use advertising budgets more efficiently. These campaigns are more data-driven and likely to result in a customer response. Similarly, national advertising has been more challenged over the last year while local advertising has performed better due its greater focus on direct response.

The impact on advertising from weak economic conditions will vary widely by medium. Advertising formats already facing secular pressures, such as network television, cable television, radio, and print, will likely incrementally decline over the long term as advertisers reassess the efficacy of these formats given the continued audience declines. Meanwhile, we expect digital advertising will increase significantly faster than GDP in 2024 and continue to drive total nominal advertising growth. We expect performance-based digital advertising, retail media, social media, connected TV, and video advertising will outperform slow growth in programmatic advertising (which is more commoditized and more cyclical).

Media and entertainment companies in China face another challenging year in 2024, following an uneven recovery in 2023. Chinese consumers are likely to remain cautious as consumer confidence is muted, particularly as concerns that the property sector downturn could continue to weigh on the economy. Therefore, China's online advertising spending is likely to increase in the mid-single-digit percentages in 2024 as advertisers are reticent to spend amid tepid demand for discretionary consumer goods. Some online platforms such as Tencent Holdings Ltd.'s short-form video platform, WeChat Channels, will benefit from increasing advertising load to monetize an expanding user base and activity. This may result in advertising share losses for some online social media platforms, particularly those with a greater proportion of image- or text-based content and more heavily reliant on brand advertising.

The secular shift of advertising away from traditional media will continue. We think much of the current weak advertising trends for legacy media, including linear TV, is not due to macroeconomics but to secular changes. Advertisers are finally abandoning linear TV. While audiences have been leaving linear TV in key markets such as the U.S. for quite some time, advertisers have been slower to follow because the available impressions and unique viewers on all ad-based streaming services remain too small to make buying on streaming platforms efficient. In addition, ad-based streaming services still must solve several major structural issues, especially a lack of industry standards (audience measurement, buying, etc.) between the streaming services, before advertisers more fully embrace advertising on streaming.

However, as new free ad-supported channels and ad-supported tiers of global online streaming platforms create more ad inventory, they could further dilute linear TV advertising pricing and shift ad dollars away from linear TV. In 2023, the declines in TV advertising in Europe were less pronounced compared with U.S. networks, but markets with weaker economic growth, in particular Germany, were hit hard. In 2024, we expect TV advertising revenue will recover, but similar to the U.S. remain below 2021-2022 levels. We believe broadcasters will continue diversifying operations into content production, distribution, and streaming.

We believe print advertising will continue to decline, reflecting a weaker economy and continued structural shift to digital media consumption. Outdoor advertising growth will remain sluggish from weak economic growth but continue to benefit from continued expansion of digital outdoor formats that now account for more than 30% of their revenue and the ongoing recovery of mobility. Global out-of-home operators such as JCDecaux Group will especially benefit from a recovery in international travel, including an expected rebound in mobility in, to, and from China compared with depressed 2023.

Online classified platforms' exposure to advertising remains modest, with digital (mostly programmatic) advertising below 30% of total revenue. In 2024, we expect faster growth in digital advertising will benefit these businesses, complementing their subscription revenue from listing packages with professional clients and offsetting some macroeconomic pressure.

We expect advertising spending by the technology sector to start recovering in 2024 after a temporary decline in 2023 that followed weaker operating results and a cost-cutting focus. This could particularly benefit those ad agencies, such as WPP PLC and The Interpublic Group of Companies Inc., that have higher exposure to tech clients. Ad agencies having the strongest offering in data analytics and targeting, such as Publicis Groupe S.A., should continue to achieve above-average growth rates even in the low-growth macroeconomic environment. Agencies will also capture the rapid growth in retail media. Omnicom Group Inc. recently made its largest ever acquisition, a digital commerce business to scale up its presence in retail media.

Key risks or opportunities around the baseline

1. Lower economic growth could stall any improvement in legacy advertising.

Advertising spending is highly dependent on key periodic macroeconomic indicators (GDP, consumer spending, employment, etc.). Persistently high inflation and higher interest rates for longer could more quickly deplete consumer savings, weaken consumer discretionary spending, and delay an improvement in legacy advertising spending.

2. We expect little visibility into forward advertising trends.

Digital (now making up over 70% of global advertising) and radio advertising are characterized by short lead times. This has been exacerbated by advertisers' caution in committing to spending because they are concerned about macroeconomic weakness. The uncertainty has extended to the U.S. TV sector, which faced both uncertainty with the macroeconomic forecast and Hollywood strikes. As a result, advertisers were reluctant to make early commitments in the 2023/2024 U.S. TV season upfront (for non-sports ad inventory), instead looking to delay commitments in the scatter market.

3. Privacy and regulation changes continue.

Further tightening of privacy regulation and privacy-preserving measures implemented by the largest tech platforms could limit the ability of ad companies to target users and measure results of ad campaigns, thus affecting digital advertising revenue. This could weaken the credit strength of advertising companies that fail to adapt over the longer term.

Elevated regulatory risks could hamper digital advertising growth and put pressure on our ratings on ad companies. Privacy regulation and consumer preferences are changing toward more privacy and less trackable data for targeting digital advertising. Changes in privacy measures require ad companies to constantly adapt their business models and change ways in which they collect customer information. This makes access to first-party data especially important and requires investment in data assets and technologies. Inability to remain competitive could lead to downgrades or negative outlook revisions, especially on smaller and less diversified companies. For example, Alphabet said that it will turn off third-party cookies on Google in the second half of 2024.

Related Research

- SLIDES: U.S. Media And Entertainment Industry: Key 2024 Themes And Concerns, Jan. 3, 2024
- U.S. Advertising Forecast Powered By Digital, Jan. 2, 2024
- The Ratings View, Nov. 29, 2023
- Bertelsmann SE & Co. KGaA, Nov. 28, 2023
- That's All, Folks: Key Takeaways From Media And Entertainment Q3 Earnings, Nov. 22, 2023
- Credit FAQ: Increasing Static Around U.S. Broadcast Radio's Recovery Prospects, Nov. 14, 2023
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- Netflix Inc. Upgraded To 'BBB+' On Improving Margins And Strong Cash Flow; Outlook Stable, Aug. 2, 2023
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- Gauging The Business Risks Of Local U.S. TV Broadcasters (2023 Update), June 21, 2023
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- Credit FAQ: Calculating Leverage For Large U.S. Media Companies (2023 Update), March 13, 2023
- Credit FAQ: The Ripple Effects Of Diamond Sports Group's Potential Default, Feb. 15, 2023
- Assessing The Impact Of Higher Interest Rates On U.S. Media And Entertainment Companies Rated 'B-', Jan. 9, 2023
- Media Industry Implications From Our Rating Action On AMC Networks Inc., Dec. 22, 2022

Industry Forecasts: Media and Entertainment

Chart 9

Revenue growth (local currency)

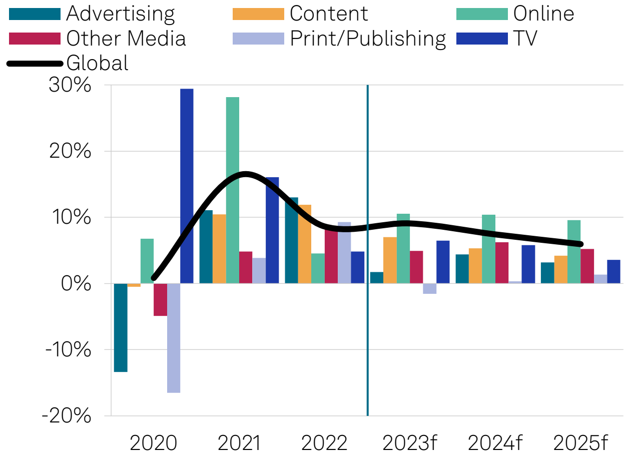


Chart 10

EBITDA margin (adjusted)

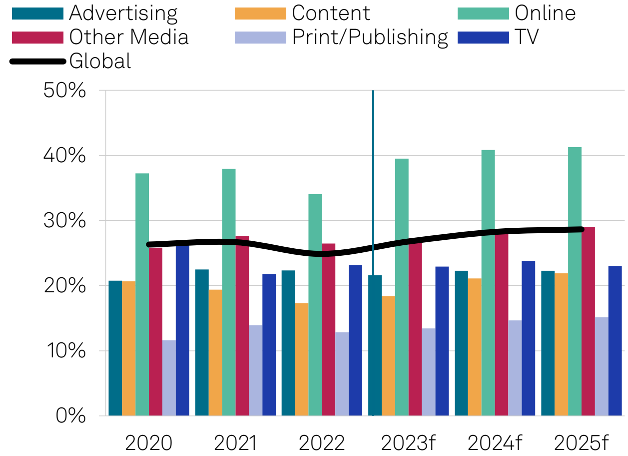


Chart 11

Debt / EBITDA (median, adjusted)

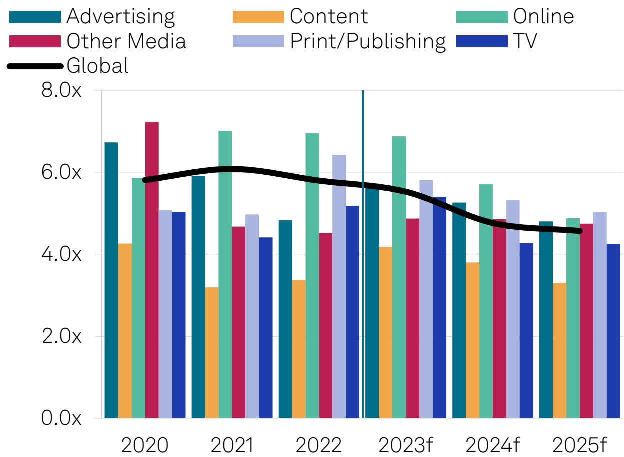
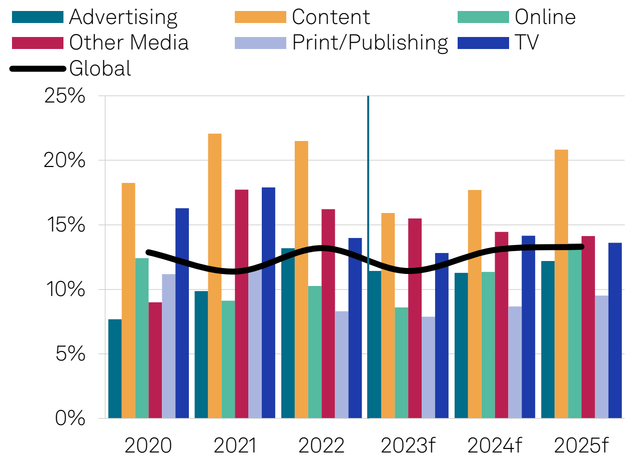


Chart 12

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: Media and Entertainment

Chart 13

Cash flow and primary uses

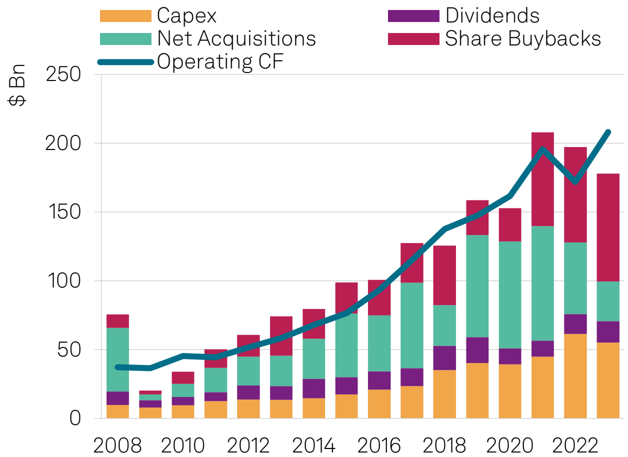


Chart 14

Return on capital employed

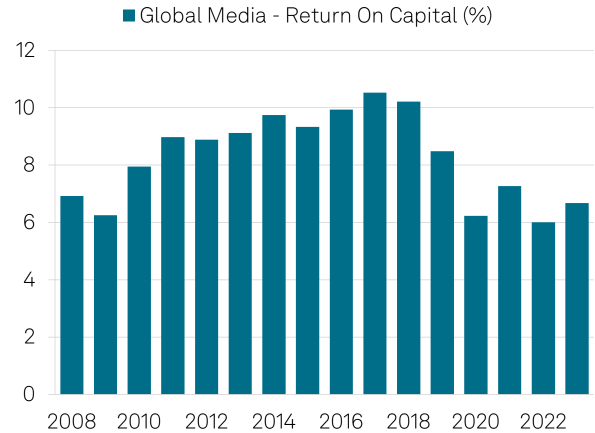


Chart 15

Fixed- versus variable-rate exposure

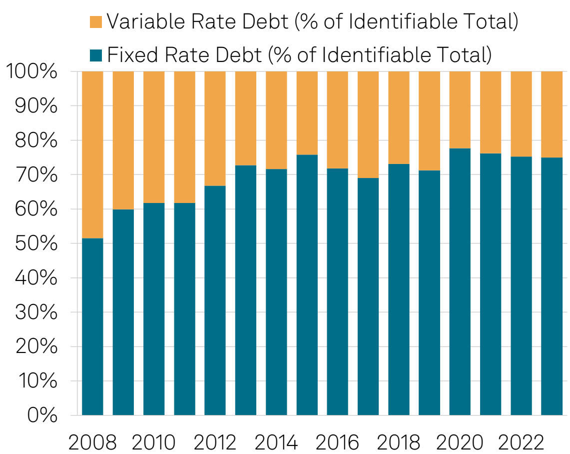


Chart 16

Long-term debt term structure

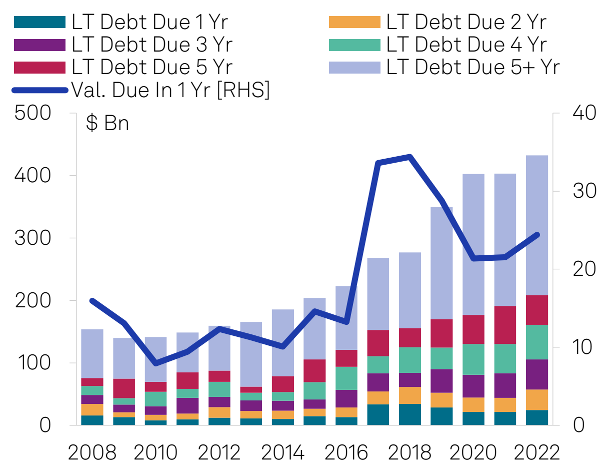


Chart 17

Cash and equivalents / Total assets

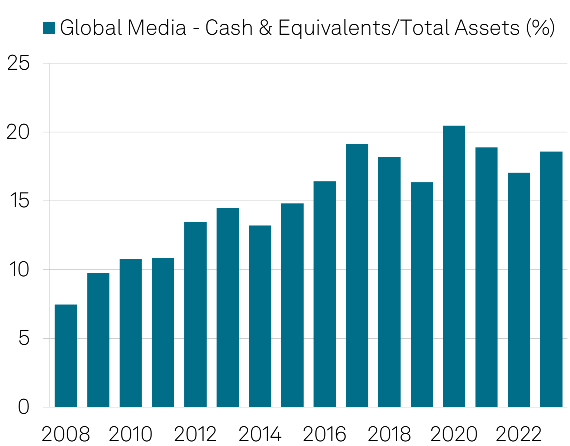
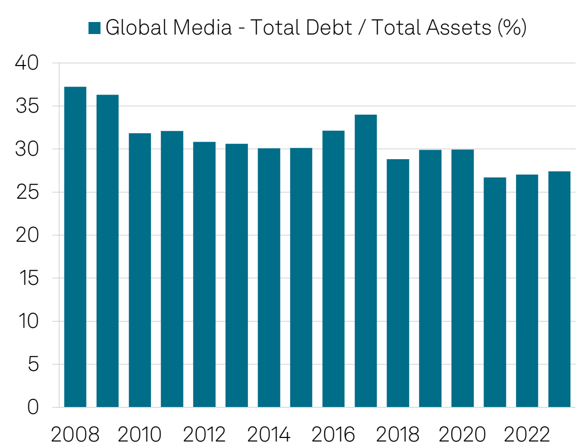


Chart 18

Total debt / Total assets



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

Metals and Mining

Unique assets and product scarcity support credit quality

January 9, 2024

This report does not constitute a rating action.

What's changed?

Prices and profits are down from record highs, but both are holding up. Markets remain balanced for most metals, owing to supply constraints and steady demand.

Disruptions add volatility. Mine output has been disrupted by environmental issues, weather, and public scrutiny. Steel and aluminum output steadied after energy disruptions in 2022.

Free cash flow drops as spending persists. Capital budgets are likely to remain elevated in 2024 despite lower earnings, which will eat into some issuers' cash reserves.

What are the key assumptions for 2024?

Price assumptions supported by tight markets and global production costs. Price downside appears limited, owing to generally low inventories and structurally higher input costs.

Profit measures return toward long-term averages. Return on capital of about 7% in 2023 is lower for the third consecutive year, but still higher than most years in the past 15.

Capex holds around decade highs. Investment should ease in 2026, but we expect a few more years of high capital expenditures (capex) to sustain output and grow future-facing metals.

What are the key risks around the baseline?

Weaker prices consume cash flow while capex stays high. We don't expect capex will drop in 2024 or 2025 because most investments are multiyear and occur regardless of price cycles.

Unpredictable disruptions. Weather events, social unrest, regulatory changes, and geology can all disrupt operations and financial performance for companies or regions.

Looser financial policies. Companies in this volatile industry could use more debt to fund acquisitions or capital plans.

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Ratings Trends: Metals and Mining

Chart 1
Ratings distribution

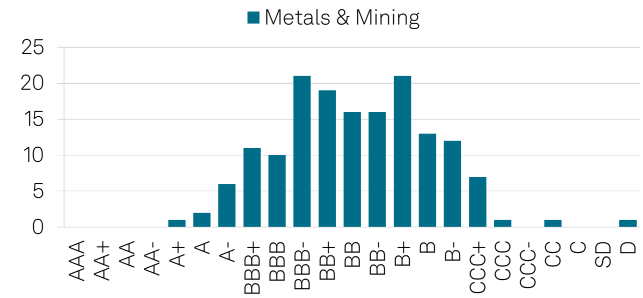


Chart 2
Ratings distribution by region

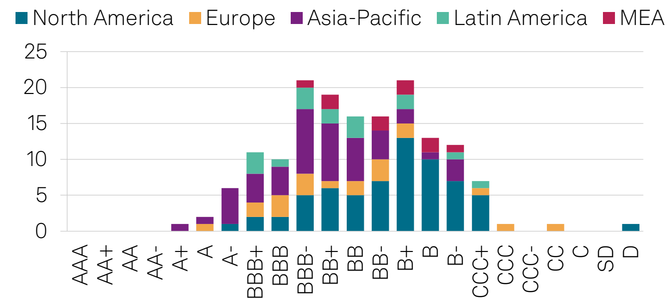


Chart 3
Ratings outlooks

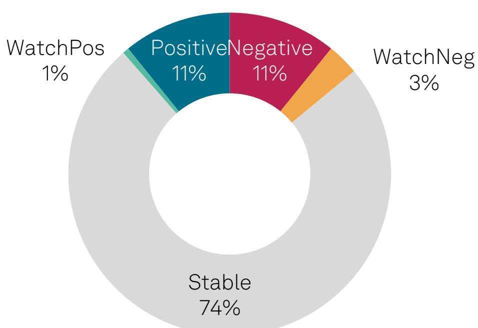


Chart 4
Ratings outlooks by region

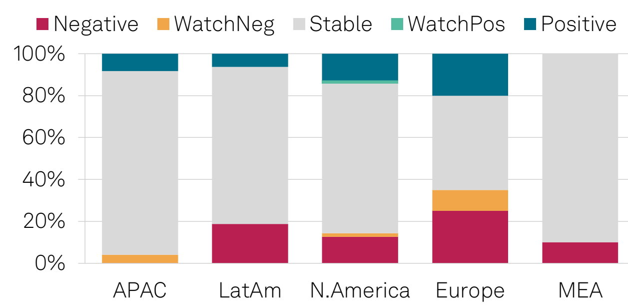


Chart 5
Ratings outlook net bias

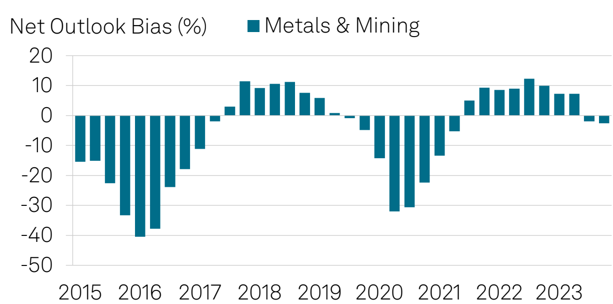
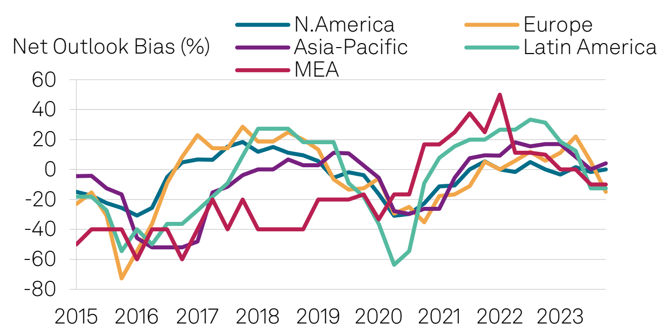


Chart 6
Ratings net outlook bias by region



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

Industry Outlook

Ratings trends and outlook

The credit outlook in global metals and mining stabilized at a higher level in 2023. Our rating outlook bias is balanced, with as many positive outlooks as negative ones, and we've been upgrading as many companies as downgrading in the past two to three quarters. In most cases, these rating actions related to company-specific matters rather than a large trend affecting a particular subsector. A spike in earnings and cash flow in 2021 and 2022 accelerated a long, fundamental improvement in credit quality after some difficult years in 2013-2014 and 2019-2020. Total debt in the sector is down over the past three years. After almost a decade of capital restraint, companies deployed windfall cash flows in 2021 and 2022 for new exploration, pent-up capital investments, and shareholder returns. Many issuers now use variable distribution mechanisms that distribute excess cash flow to shareholders during market peaks and cut back as cash flows shrink in a downturn. This appears to have reduced the capacity to deploy cash for large corporate development. In addition, such policies, coupled with the sector's more robust balance sheets, should support credit metrics through weaker price cycles.

The credit outlook in steel and aluminum remains slightly positive, ex-China. We have positive outlooks on a few large names globally (ArcelorMittal S.A., Gerdau S.A., Reliance Steel & Aluminum Co., Tata Steel Limited). Supply constraints and trade moats have supported profitable prices in most regions, even through soft demand from manufacturing and construction in Asia and uneven conditions in the U.S. automotive industry. The recently announced acquisition of U.S. Steel Corp. (BB-/WatchPos/--) by Nippon Steel Corp. (BBB+/WatchNeg/--), and the prior acquisition proposal by Cleveland-Cliffs Inc. (BB-/Positive/--), highlight the strategic importance of those U.S.-domiciled assets, including some of the industry's oldest coal-consuming blast furnaces. U.S. trade barriers have held longer than any the past few decades, and customers have generally passed through higher steel costs amid a cyclical profit upswing for manufacturers.

On the other hand, the outlook for the Chinese steel sector, the world's largest, is more bearish because of ongoing weakness in the property sector. While output has been strong due to demand from infrastructure and the manufacturing sector--noting the rapid growth in electric vehicles (EVs)--margins have been weak and many companies are taking losses. The steel mills continue to produce to keep unit costs low but restoring profitability is likely to depend on stabilization of property sector demand.

Market conditions in Brazilian steel have also been weak. The weak economy has reduced apparent consumption in the country by almost 5%, while competition remained fierce with imported steel, especially from China, squeezing margins and leading to negative EBITDA in some cases. In 2024, we expect lower interest rates and lower inflation to boost consumption, while imported products soften after achieving more than 20% of steel sales in the country.

Steel and aluminum producers will continue spending significantly to complete next-generation assets within the next few years. For example, some steel producers are investing in electric-arc furnace (EAF) steel minimills, and some are investing to replace coal-fired furnaces with hydrogen. Meanwhile, two large aluminum rolling mills are being constructed in the U.S. Even though many of these projects are discretionary, steel and aluminum producers face strategic pressure to reduce carbon emissions from their production processes. Steel is one of the largest emitters of greenhouse gases among industries, and accounts for an estimated 7%-9% of global carbon emissions, according to the World Steel Association. Furthermore, changing blast furnaces to EAFs involves operational and workforce changes, which can be complex, as shown by Tata's Port Talbot proposals in the U.K.

Miners face rising costs to sustain and grow production. Also, friction around mining operations is fairly common, and public scrutiny or financial demands could be rising with consideration of environmental and social effects. Mineral deposits in many cases are national assets, with extraction and profit rights negotiated with mining companies. And irrespective of negotiated arrangements, numerous local issues can arise for these unique, critical assets. Mines typically become less efficient with higher unit costs as they deplete reserves over the several decades of mine life. The world's easiest and most attractive deposits are already being mined, so new mines tend to be more remote, more expensive, and more difficult to operate. As such, miners face a continual grind on capital and operating costs to advance mines and to support incremental processing with generally declining ore grades.

Main assumptions about 2024 and beyond

1. Price assumptions hold at higher levels than previous downturns.

Production constraints for many metals have contributed to tighter supply-demand balances. Steel and aluminum face persistently high energy inputs, including carbon costs. Several mined metals, notably copper and nickel, require considerable spending to sustain production, let alone grow production as demand rises for electrification.

2. Flexible returns should buffer credit in a downturn.

With more companies using a formulaic and flexible approach to distribute excess cash flows, lower shareholder returns in a downturn should support cash flows in this volatile sector. Large cash distributions to equity followed quickly behind the 2021 spike in prices, so that cash hasn’t built up for use in corporate development like large capex or mergers and acquisitions (M&A).

3. Energy transition will require even more capital.

Steel and aluminum capex is higher around the world with the focus shifting toward future-facing commodities and critical minerals, as companies invest to transition to a lower-carbon footprint or to supply growing market segments. Adding capacity in mining is expensive, with world-scale mines typically requiring several billion dollars of capital and more than a decade to develop.

Prices for most metals are down 20%-30% from record highs in 2021 and 2022, but still about 20% higher than before 2020. Fundamentally tight markets for most metals and higher production costs around the world support higher prices.

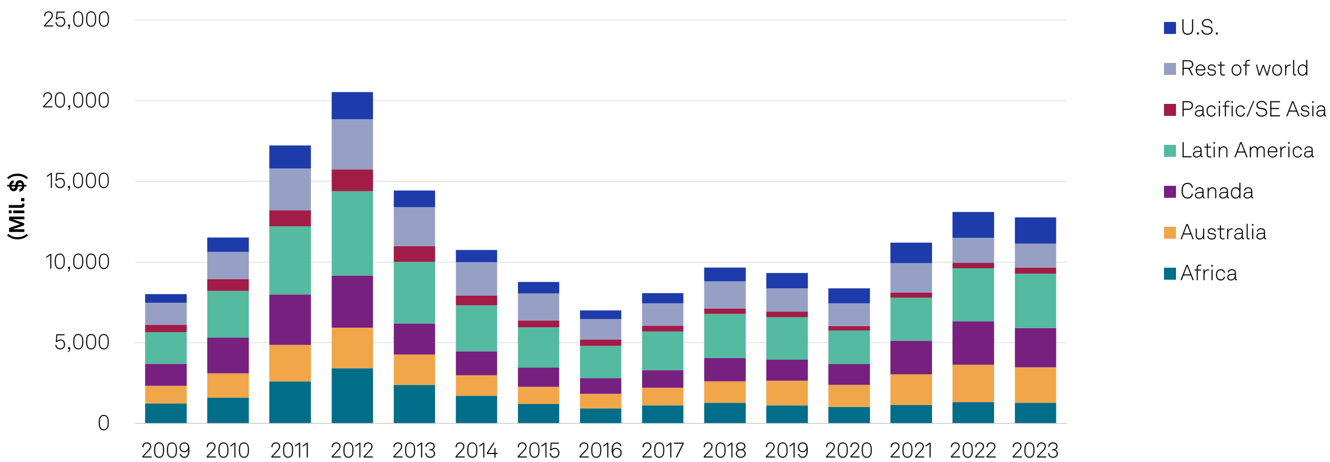
China's influence on metals markets is changing: Exports of low-cost steel appear less attractive, considering economic tradeoffs for high energy-consuming commodities. China's steel output appeared to level off in 2022 and 2023, but aluminum output keeps climbing, and higher inventories are putting pressure on prices for that metal. Also, global demand and sentiment appear less sensitive to some weaker post-COVID economic data from China. Nevertheless, China's demand for bulk commodities like iron ore and metallurgical coal is still a dominant theme in those markets.

Costs are higher for most metal producers, including consumables, labor, and capital items. Furthermore, the typically inverse relationship between the U.S. dollar and metal prices has broken down for a few years, so that local currency costs have been rising in many countries, as a weaker U.S. dollar and lower metal prices coincided. In Europe, energy costs have eased--though are still relatively high--and the availability of electricity has normalized.

Lower prices and higher costs are biting into cash flow, as capex rises back to multiyear highs. We expect capex to remain elevated in 2024 and 2025, even if spending flattens on a year-over-year basis. Large cash returns to equity for windfall earnings in 2022 have consumed large amounts of excess cash, but we expect those distributions to drop significantly as cash flows weaken. Also, mining companies have increased exploration budgets most years since 2016 but scaled back slightly in 2023 along with weaker market conditions (see chart 7). Exploration spending remains below the peak of more than a decade ago. Gold accounts for most exploration spending (55%), copper is the next largest (21%), and silver is third (6%).

Chart 7

Exploration budgets by location



Source: S&P Global Market Intelligence.

We don't expect capex to drop much unless cash flows weakened sharply. Even then, growth capital projects in this industry tend to be large and run over several years, regardless of market conditions. And new investments in metals output are targeting growing markets and critical minerals like copper, nickel, recycled aluminum, lithium, and cobalt. Also, steel and aluminum producers are spending to reduce greenhouse gas (GHG) emissions from their operations. Commercial grade aluminum in the U.S. was recently added to the Advanced Manufacturing Tax Credit in the Inflation Reduction Act (IRA), which will likely benefit the costs of U.S.-domiciled primary aluminum production. The strategic rationale appears strong for investments in metals production, so we expect elevated capex as companies continue expanding capacity into lower carbon megatrends like lightweighting, recycling, and lower carbon emissions.

Lower debt levels and demands on capital could increase debt usage in 2024 and 2025. Debt levels for most companies are lower than only a few years ago, which opens up capacity for debt usage for corporate development. Credit ratio buffers have declined for many companies in the past year, as lower EBITDA translates into higher debt leverage and weaker cash flow. Even so, it would still likely take an average-cost company a year or two of 15%-20% lower prices to offset the recent strengthening of earnings and credit ratings. We forecast net debt and adjusted debt to EBITDA for our rated metals and mining companies will likely steady in 2024 after jumping with lower prices in 2023. The metals and mining industry's debt leverage is lower than it's been in almost 15 years, thanks to spending restraint since 2015 and a renewed focus on returns over growth.

Credit metrics and financial policy

Most mining companies are signaling continued capital restraint, particularly as it relates to M&A. Steelmakers, on the other hand, have shown more willingness to stretch to acquire assets. Nippon Steel's all-cash acquisition of U.S. Steel is valued at $14 billion, including assumed debt. Furthermore, steelmakers have been acquiring to integrate throughout the value chain, sometimes in downstream manufacturing and sometimes upstream in scrap gathering. More consolidation is likely in China as the government encourages industry consolidation among the larger players. This reflects the government's desire to stabilize sector profitability through scale benefits, thereby improving creditworthiness and minimizing disruptions during the industry downturn.

Debt-funded acquisition premiums have been virtually nonexistent in mining because operating synergies and incremental returns are difficult to achieve. Mines are discreet cash flow units that rarely benefit from the integration synergies that would exist by consolidating regional market share in a sector like steel. We still doubt the large wave of debt-funded M&As in 2006-2010 will recur, but debt capacity could get consumed with strategic moves over the next few years. By comparison, Newmont Corp. funded its nearly $20 billion acquisition of Newcrest Mining Ltd. mostly with a share exchange, and only a $1 billion cash distribution to the target company's shareholders. BHP Group PLC's $6.4 billion all-cash acquisition of OZ Minerals underscores the trend of discretionary cash available across the sector, as the company looks to increase its exposure to future-facing minerals like copper and nickel. In contrast, Brazilian miner Vale S.A. sold a 13% stake in its base metals division for $3.4 billion to help support growth.

We also expect ongoing consolidation of the coal sector in developed markets to manage emissions risks. For example, BHP continues to reduce its exposure to coal following the sale of two of its metallurgical coal mines to coal company Whitehaven Coal. In addition, Teck Resources Ltd. is selling its steelmaking business to Glencore PLC. After the transaction, Glencore is expected to combine the Teck business with its own coal business and within 24 months demerge the combined entity as part of its net zero by 2050 target. We expect the new entity to be a stand-alone coal business that is sufficiently cash generative to be self-funding to bypass capital markets.

The metals and mining industry benefits from major barriers to entry owing to resource scarcity and the capital intensity of the assets, which will likely support credits with hard asset value. On the other hand, cash flows are among the most volatile of any industry we rate, which was a key factor for issuers reducing net debt levels in recent years. Mining companies, in particular, face periods of extraordinary cash windfalls that do not correspond with large capital spending. Many of these companies have adopted scalable shareholder returns that provide a more transparent look at financial policy and cash flows.

Key risks or opportunities around the baseline

1. Supply-demand balance breaks down.

Demand remains good, but key economic indicators for 2024 show a slowdown in key industries like construction and manufacturing. Meanwhile, output for most metals appears intractably constrained because of natural resource limits, energy availability, or trade barriers.

2. Capital investment breaks down.

Capital cost blowouts and project execution problems can drag on financial performance and credit quality.

3. Financial discipline breaks down.

With less debt and fairly strong equity currencies, companies have plenty of financial firepower to deploy for corporate development.

Real constraints on output as well as producer discipline are keeping inventories low for most metals, while demand held up in 2023. Weak demand could pull prices and earnings down closer to previous troughs, especially if higher interest rates around the world hit heavy metal-consuming industries like autos, construction, or manufacturing. More likely, perhaps, is the risk of unexpected disruption. In mining, a range of phenomena can affect output or earnings. For example, copper mines in Peru and Panama stopped output because of social unrest. Alcoa Australia is reworking its bauxite mining plan in Western Australia to address a recent change in its permitting approvals. Disruptions can also be financial if governments adjust taxes or royalties over the life of an asset.

Metals and mining capex have increased steadily since 2016, which includes large copper mine extensions like Teck's Quebrada Blanca Phase 2 and Freeport-McMoRan Inc.'s transition to underground at the Grasberg mine and its smelter construction. Capital cost overruns in mining are frequent for these unusual assets, which often require substantial infrastructure, equipment and operations in difficult physical conditions, and life-of-mine investments for waste containment and closure. Depending on timing of price swings, overruns or delays can materially affect the long-term returns of a single mine.

The biggest risk to credit quality will probably be debt usage and financial policies. These companies with heavy assets have the lowest debt levels in years, so we expect more debt to fund important investments. At the same time, debt-funded equity premiums with low integration potential relies on sustained higher earnings to maintain return on capital, a key indicator of long-term profitability in this capital-intensive industry.

Related Research

- Cleveland-Cliffs Inc. 'BB-' Issuer Credit Rating Affirmed And Off CreditWatch Developing; Outlook Positive, Dec. 22, 2023
- Nippon Steel 'BBB+' Ratings Placed On CreditWatch Negative After Announcement Of U.S. Steel Acquisition, Dec. 20, 2023
- United States Steel Corp. Rating Placed On CreditWatch Positive On Proposed Acquisition By Nippon Steel Corp., Dec. 20, 2023
- S&P Global Ratings Metal Price Assumptions: Holding Higher For Longer, Oct. 16, 2023

Industry Forecasts: Metals and Mining

Chart 8

Revenue growth (local currency)

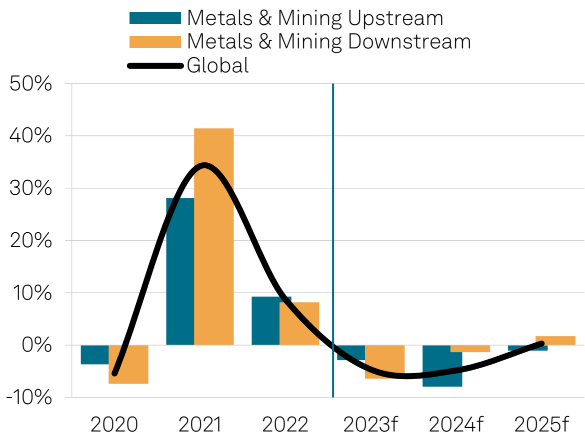


Chart 9

Capex Growth

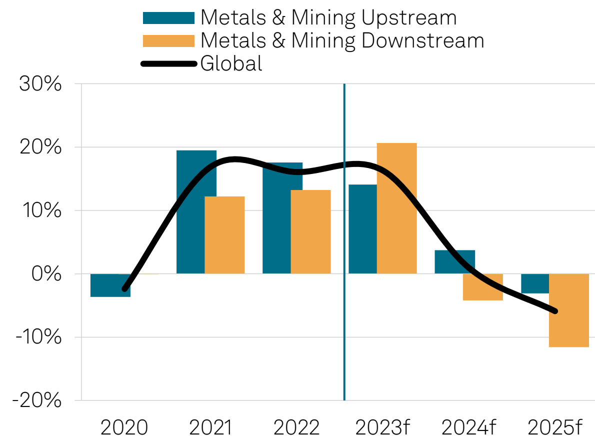


Chart 10

Debt / EBITDA (median, adjusted)

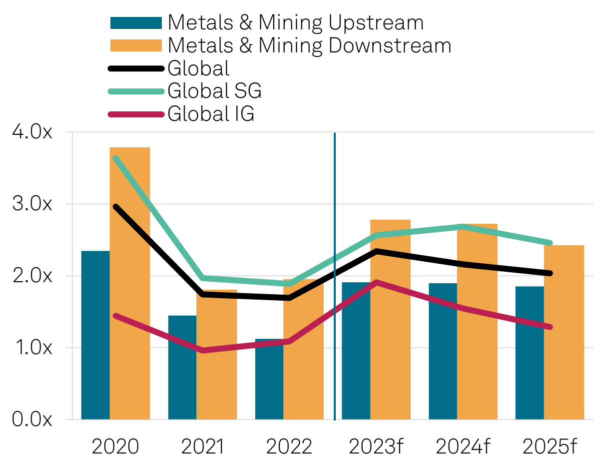
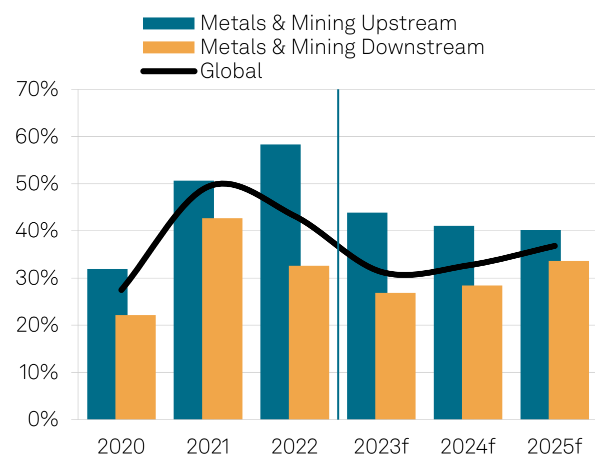


Chart 11

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: Metals and Mining

Chart 12

Cash flow and primary uses

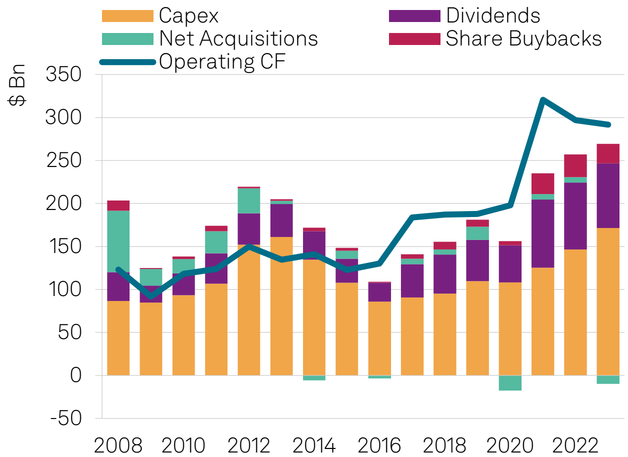


Chart 13

Return on capital employed

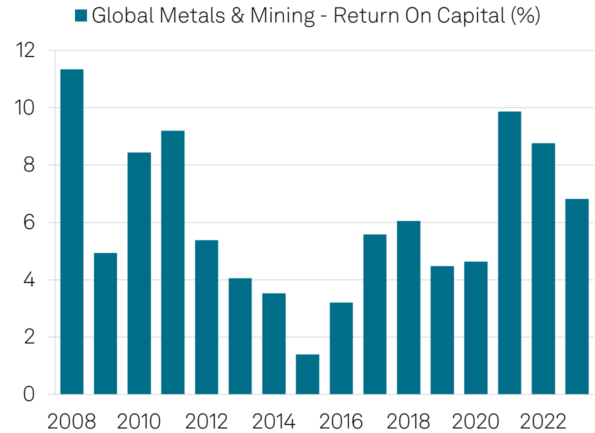


Chart 14

Fixed- versus variable-rate exposure

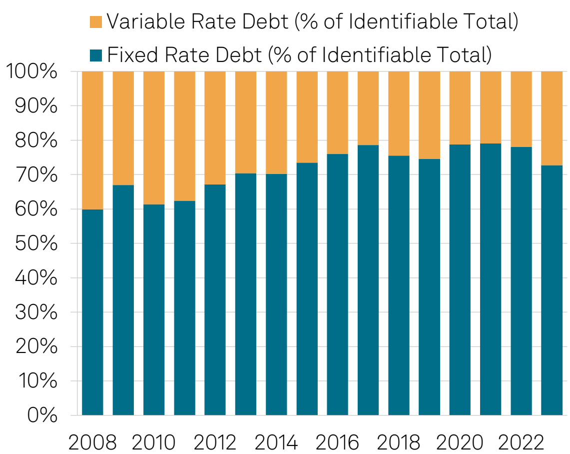


Chart 15

Long-term debt term structure

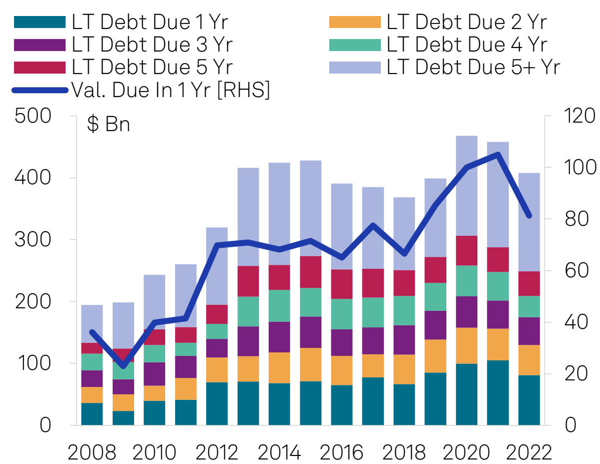


Chart 16

Cash and equivalents / Total assets

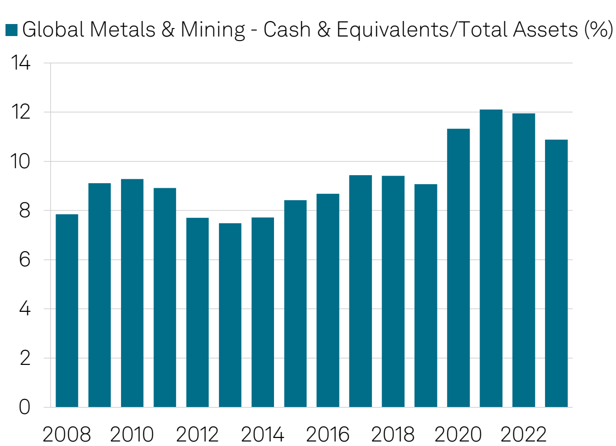
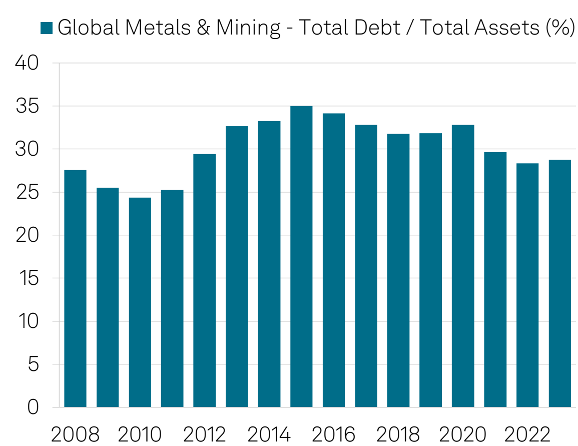


Chart 17

Total debt / Total assets



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

Oil and Gas

The industry's overall credit profile remains resilient

January 9, 2024

This report does not constitute a rating action.

What's changed?

Oil faces downside risks. Demand growth is slowing to about 1 million barrels per day (bpd) in 2024 from more than 2 million bpd over 2021-2023.

Balance sheets are stronger. Producers and refiners have used two years of strong prices and margins to deleverage.

Mergers and acquisitions (M&A) increased. Various deals, mostly in North America, signal a desire for quality reserves and critical mass during the uncertainties of energy transition.

What are the key assumptions for 2024?

Oil prices support credit quality. OPEC+ will continue to support prices through production cuts.

Global gas prices remain stable. High inventory levels will keep U.S. gas prices suppressed and we expect the Title Transfer Facility (TTF) to be elevated but range-bound.

Refining margins remain strong but below the peak levels of 2022. Credit quality has improved, which will help companies withstand any headwinds in 2024.

What are the key risks around the baseline?

OPEC+ supportive policies could change. If oil prices decline, OPEC could reverse supportive policies to garner market share and attempt to permanently drive out marginal cost producers.

Government intervention is stepping up. Producers' strong profits, energy affordability and security, and decarbonization mean risks from regulation, taxation, and policies.

Financial discipline may worsen. Producers might increase investments or shareholder returns, only for prices and cash flow to fall further, eroding balance sheet strength built up since 2021.

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Ratings Trends: Oil and Gas

Chart 1
Ratings distribution

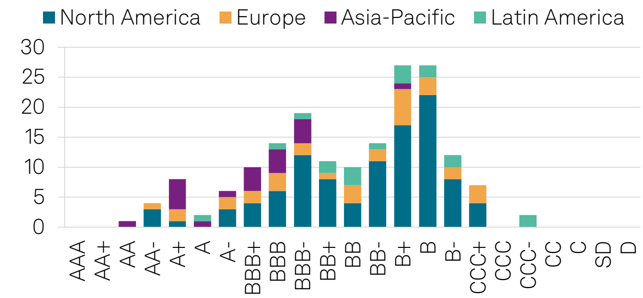


Chart 2
Ratings distribution by region

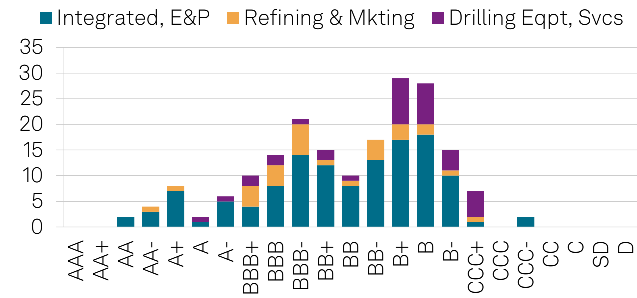


Chart 3
Ratings outlooks

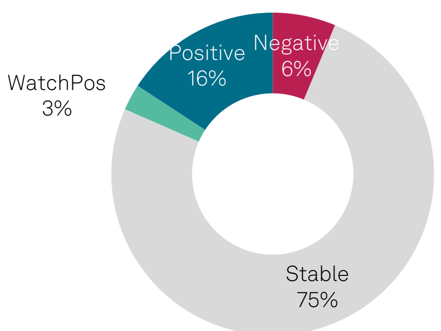


Chart 4
Ratings outlooks by subsector

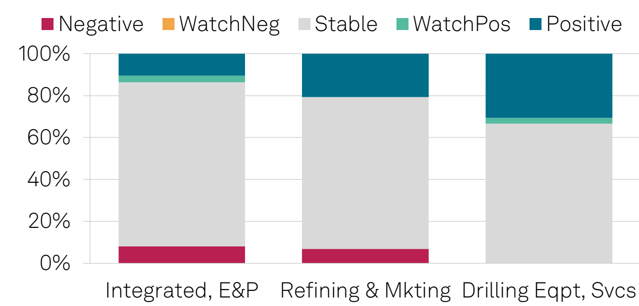


Chart 5
Ratings outlook net bias

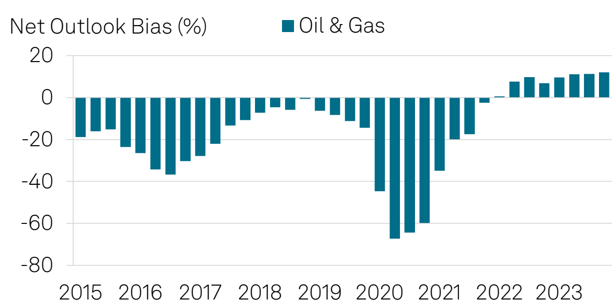
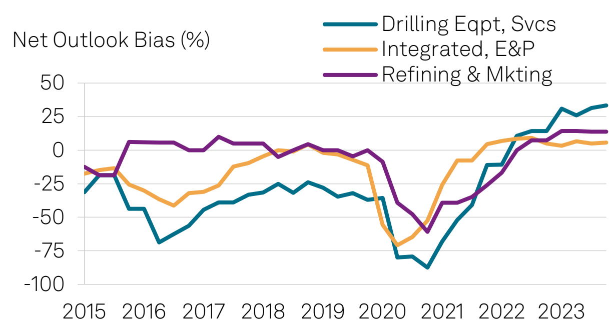


Chart 6
Ratings net outlook bias by subsector



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

Industry Outlook

Ratings trends and outlook

The overall positive ratings trends we have seen in previous years continued in 2023. Healthy oil and TTF natural gas prices, robust refining margins, and financial discipline that limited production growth allowed companies to garner strong netbacks and cash flow. Producers remain focused on a financial discipline that targets limiting outspend and capital expenditure (capex) levels. The high levels of M&A activity in 2023, particularly in North America, have largely been credit positive as most acquirors have used equity as a currency. We expect positive momentum to slow in 2024 as issuers allocate more cash flow to equity-friendly initiatives.

Oil field services (OFS) has been slower to join the positive ratings trends due to upstream capital discipline, but recent upgrades and positive outlook revisions reflect improved margins and a focus on the balance sheet. We believe some segments of the OFS space will exhibit less cyclicality during industry troughs owing to improved market dynamics. Over the last several downturns, retired equipment has not returned, and many companies have either filed for bankruptcy or merged, resulting in fewer suppliers and greater discipline with respect to pricing and new builds.

The refining industry had another good year due to above-average refining margins, strong balance sheets, and ample liquidity. In North America, refiners remain well positioned, with lower input costs than most of their global peers and supportive demand. We expect demand for distillates like diesel and jet fuel will support above-average margins for 2024 as gasoline margins begin to normalize. Credit ratios remain strong, and companies will likely continue to focus on returning cash to shareholders after repaying debt borrowed during the pandemic.

Refining capacity is growing globally, with significant capacity additions in Africa, China, and the Middle East coming online in 2024. Net capacity could increase by about 1 million barrels per day, which would keep pace with global demand growth if all this capacity successfully comes online. European refiners will also experience solid margins compared with their Asian peers, which have higher costs and compete with Russian product exports diverted from Western markets. We expect global biofuels and alternative fuel consumption to continue to grow, but this is unlikely to become a meaningful credit driver until the second half of the decade. Lower demand and higher climate-related costs will weigh on European and U.S. West Coast refiners before the broader asset class.

Main assumptions about 2024 and beyond

1. Despite recent softness, oil prices should remain supportive of credit quality.

As of the date of this publication, oil prices have retreated somewhat, reflecting weaker demand from China as the COVID-19 demand rebound loses steam and concerns remain over growing production from non-OPEC countries. However, we assume oil prices will remain supportive for credit because we believe OPEC+ will continue to produce less oil and Saudi Arabia and Russia will remain steadfast with their unilateral production cuts. It's unlikely OPEC will want oil prices sustained below $70/barrel because this would be insufficient for several OPEC members to balance their budgets.

2. North American gas prices lie in wait for the liquefied natural gas (LNG) tsunami, while European gas prices remain elevated but stable.

Gas prices in North America will remain suppressed throughout 2024. It's hard to find any near-term catalysts that support higher prices as supply looks to outstrip demand and inventory levels remain elevated. If unseasonable weather patterns occur in the winter, the U.S and European markets could be well oversupplied heading into the winter injection season that begins in April.

3. Refining margins will remain robust as demand likely outpaces supply additions over the next year.

Refining margins in North America will likely be above the long-term average in 2024 despite weakness in the gasoline crack since late summer. Growing global demand for diesel and jet fuel will outpace capacity additions in Asia and the Middle East, which will support margins over the next 12 months, albeit down from peak levels in 2022-2023.

Oil prices will remain supported by OPEC+. Oil prices are under pressure, primarily from non-OPEC production growth, which we expect will outstrip OPEC+ production cuts and increase inventory levels. Indeed, crude oil inventories have been creeping toward the five-year average. We anticipate much of the non-OPEC growth will come from the U.S. and Canada as well as Brazil and Guyana. Global supply growth is likely to outstrip demand growth in 2024 as the COVID-19 impact on demand growth wanes further, particularly from China.

Recently, OPEC+ announced new voluntary cuts of about 2.2 million bpd, with Saudi Arabia and Russia continuing their voluntary production cuts of 1.3 million bpd through the first quarter of 2024. However, the key question remains how much of the production cuts OPEC members will honor.

Natural gas prices will remain stable as inventories stay elevated. Since the beginning of the year, the Henry Hub, despite a record power burn this summer, has been rather lifeless, and we aren't confident about near-term prospects for gas prices. A mild winter, the Freeport LNG outage, and robust production weighed on prices. Although declining prices lowered the gas-directed rig count about 26% since the end of 2022, production continued to rise. This was largely due to improved well productivity, a lag on production from gas drilling last year, and a decline in drilled but uncompleted well count in the Permian.

Natural gas inventories in the U.S. are approximately 3.8 trillion cubic feet as of Dec. 7, 2023, and according to the Energy Information Administration, the Lower 48 will enter the winter heating season, which runs from November 1–March 30, with the most natural gas in storage since 2020. This means the U.S. is well supplied as it heads into the early months of the winter heating season. The panacea for natural gas prices in the U.S. will likely come from the 13 billion cubic feet of LNG growth expected by 2028. We expect natural gas prices will begin responding to LNG buildout sometime in the back half of 2025 and continue an upward trajectory as the U.S. adds capacity through 2028.

European natural gas prices, particularly the TTF, remain elevated and broadly in line with our assumptions. EU efforts to reduce natural gas consumption, a weak EU economy, and alternative LNG sources to Russian natural gas have proven successful in boosting inventories and kept the TTF from increasing further. Indeed, the EU has reached its 95% target inventory levels as it begins its winter heating season and, barring an excessively cold winter, has alleviated supply concerns for this winter.

Refining margins will moderate from peak levels but remain healthy globally. Refiners continue to benefit from above-average refining margins. We believe this trend will continue in 2024 but moderate as more global capacity comes online. Several factors support resilient margins for the next 12 months, including tight inventory levels, growing demand that outpaces globally capacity additions, and market/product disruptions related to Russian sanctions. We anticipate North American refiners will realize some of the highest margins globally due to lower feedstock costs and lower natural gas prices compared with their European and Asia competitors.

North American refiners also have a complexity advantage, which allows them to pivot to higher-value products such as distillates (diesel and jet fuel). We expect these products to have stronger demand than gasoline. In addition, the regulatory framework is supportive for renewable fuel production, which will likely continue to encourage some switching to alternative fuels from traditional and lower companies' overall carbon footprint.

We believe European refineries' margins will benefit from growing global demand for refined products in the coming year and the absence of Russian refined products due to sanctions, which will likely find markets in Asia and India, to the detriment of refining assets in those regions. Longer term, we expect capacity additions from mega-refineries such as Nigeria's 650,000 bpd Dangote refinery in late 2024 and another two million bpd of capacity scheduled to come online by 2025 could pressure margins globally and ultimately lead to some capacity rationalization.

Credit metrics and financial policy

Our hydrocarbon price deck remains supportive of credit quality. We have flat West Texas Intermediate and Brent oil prices for the next three years of $80 and $85 per barrel, respectively. Although we expect companies to allocate more cash flow toward shareholder rewards rather than credit-friendly initiatives, we do forecast credit ratios to improve as they retain some cash flow for debt retirement. We anticipate global capex growth of low-single-digit percent. We believe companies will continue to conduct most M&A in a credit-friendly manner.

Key risks or opportunities around the baseline

1. Insufficient supply restraint from OPEC+ or expectations of weaker demand growth.

Oil market balances hinge on OPEC+ continuing to hold back supply. Demand growth is likely to moderate in our 2024 base case but could soften further with China and India as key drivers.

2. Government interventions.

2022-2023 saw a remarkable step up in government involvement in the energy sector. We believe there are ongoing and increasing risks of impacts on industry players from regulation, taxation, and policy implementation.

3. A reversal of companies' trend to strengthen financial discipline and resilience.

Debt reduction and limiting capital spending and shareholder distributions to internally generated cash flows have been key drivers of recent rating upgrades. Companies could start unwinding these credit benefits if organic or inorganic investments step up materially. This would be exacerbated if operating cash flows fell at the same time.

4. Intensifying environmental risks could potentially affect our ratings.

Oil and gas activities are typically the most exposed to uncertainties of the energy transition.

Insufficient supply restraint and tepid demand. The strong recovery in demand for oil products after the COVID-19 lockdowns and collapse in 2020 is coming to an end. S&P Global Commodity Insights forecasts demand closer to 1 million bpd from 2024 from about 2.4 million bpd in 2023 and an average of 1.9 million bpd in the decade before 2019. With flattish demand in developed markets, China and India are likely to be significant contributors. If higher interest rates or other challenges start to weaken global economic activity further, oil demand might soften more. The anticipated summer recovery from the seasonal quarter-on-quarter dip in early 2024 could then be muted.

This underlines the importance of the continued supply restraint by OPEC+ countries, especially the ongoing 1 million bpd cuts by Saudi Arabia and the 0.5 million bpd announced by Russia. These cuts look necessary to balance the market in 2024, even assuming baseline demand growth of 1 million bpd. Even with Brazil joining the exporter group, production growth from the Americas--with the U.S. producing more than ever before--will more than cover estimated demand growth in 2024.

We note that natural gas markets in the U.S. decreased in first half 2023, as moderate demand after milder winter weather wasn't offset by lower supply. This pattern might recur, which would limit any rating upside for gas-focused producers. With European gas storage at the top of historical levels, the risk of supply disruptions is unlikely to result in price volatility rather than interventions to limit usage further.

Government interventions. Confronted by gas supply shortages in Europe with the Russia-Ukraine war and decarbonization policies elsewhere, global energy markets have seen a step up in government involvement. The supernormal profits of many primary energy producers as a result of actual and potential supply concerns have drawn both politicians' and consumers' criticism and additional taxation, especially on domestic European activities.

We believe there's risk that higher taxation will not reduce when commodity prices fall. Even with lower debt and cost discipline, this could mean lower funds from operations and credit metrics and potentially tighter liquidity for lower-rated names, particularly if reserve-based facility availabilities decline.

Loss of financial discipline. Most companies have used the bonus of sustained high prices to deleverage and term out/pay down debt maturities. Capital investment has also been controlled and contained well within operating cash flows, especially for publicly listed companies.

Nonetheless, not all companies have set out financial frameworks to guide their capital allocation and distributions to shareholders. Even for those that have, it remains to be seen how much they will cut back distributions as and when markets fall back. Producers might also step up investments significantly or commit to higher shareholder returns, which could pose risks, potentially for ratings, if prices trend or settle at lower levels for some years.

Environmental risk factors. We believe our ratings on producers will depend on their oil and gas activities amid a changing environment for years to come. These businesses will continue to generate most of the operating and free cash flow for at least the next five years in our base cases, underpinning ratings. Oil and gas activities are also typically the most exposed to uncertainties of the energy transition.

Companies are implementing different strategies to underpin credit strength and sustainability for future decades. Carbon capture is likely to play a part, but given the global magnitude, we don't see it as a solution for Scope 3 emissions, which is when fuels are burnt (see "Carbon Capture, Removal, And Credits Pose Challenges For Companies", published June 8, 2023).

Activities in parallel energy markets or other sectors will generally have to grow materially before they can supplement or replace lower oil and gas cash flows to a meaningful extent. We view many low-carbon activities as cash flow negative after capital investment. Nonetheless, we generally believe these investments are affordable, not least in the prevailing price environment.

In our methodology, a different division ordinarily needs to have an ongoing 20% contribution to the group for it to have a significant weight in our ratings. Diversifying into power generation would not necessarily transform our view of a company's overall industry risk exposure because we see the intrinsic risk of unregulated power and gas as broadly comparable to oil and gas production, refining, and oilfield services.

This said, financial resilience is one commonality across issuers, as is a focus on production with low costs as well as low methane and other emissions for most.

Related Research

- S&P Global Report Examines External Funding Outlook For North American and European Oil And Gas Producers, Nov. 16, 2023
- S&P Global Ratings Has Raised Its Henry Hub Natural Gas Price Assumptions For 2024 And 2025, Nov. 7, 2023
- Global Offshore Energy Sector Is On The Road To Recovery, Nov. 7, 2023
- What's Driving The New Wave Of U.S. E&P Consolidation?, Oct. 19, 2023
- Clear LNG Outlook Could Turn Murky Near End Of Decade, June 27, 2023
- Carbon Capture, Removal, And Credits Pose Challenges For Companies, June 8, 2023
- Credit FAQ: How S&P Global Ratings Formulates, Uses, And Reviews Commodity Price Assumptions, April 20, 2023

Industry Forecasts: Oil and Gas

Chart 7

Revenue growth (local currency)

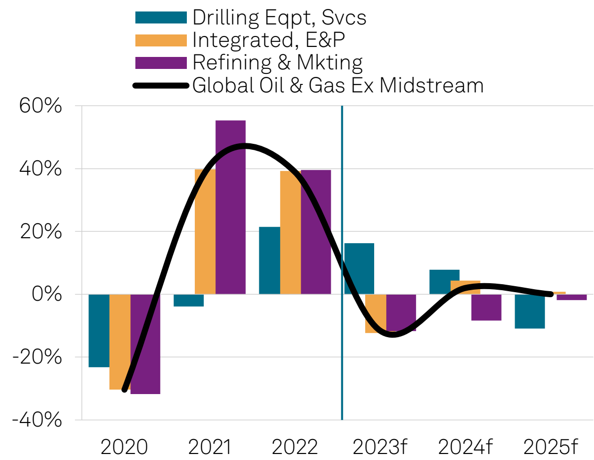


Chart 8

Capex Growth (USD, adjusted)

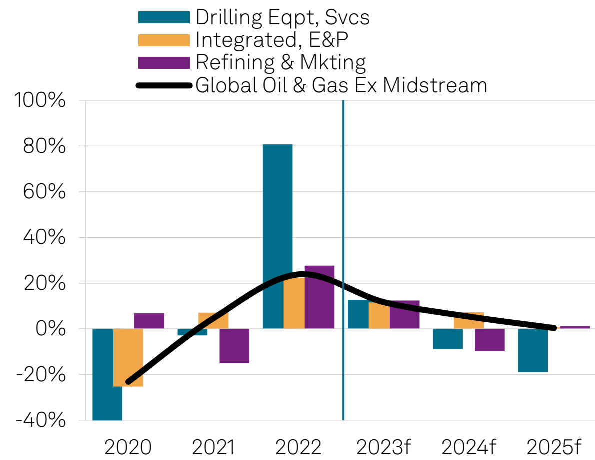


Chart 9

Debt / EBITDA (median, adjusted)

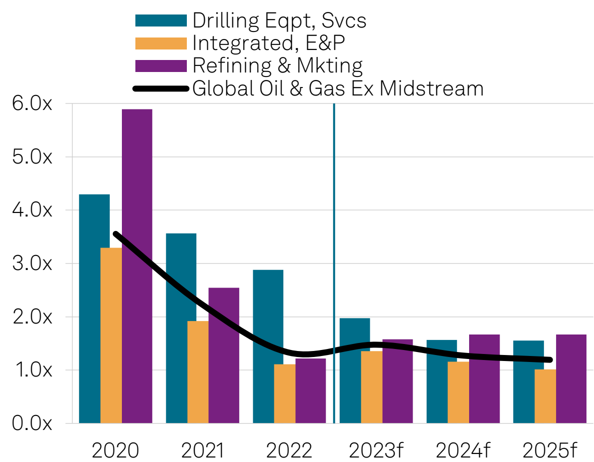
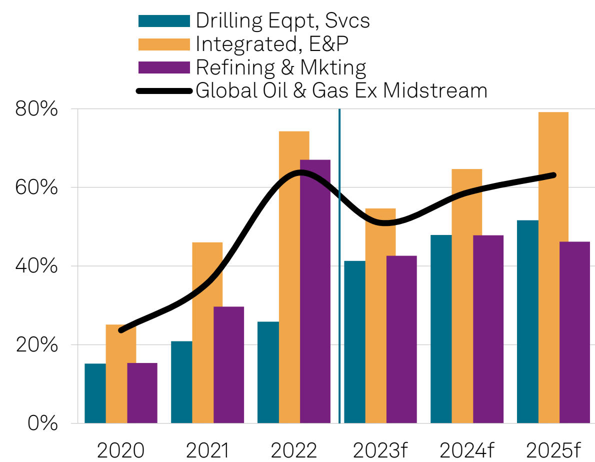


Chart 10

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: Oil and Gas

Chart 11

Cash flow and primary uses

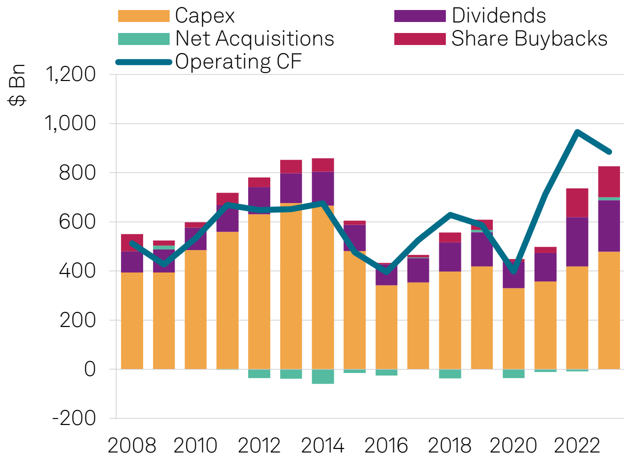


Chart 12

Return on capital employed

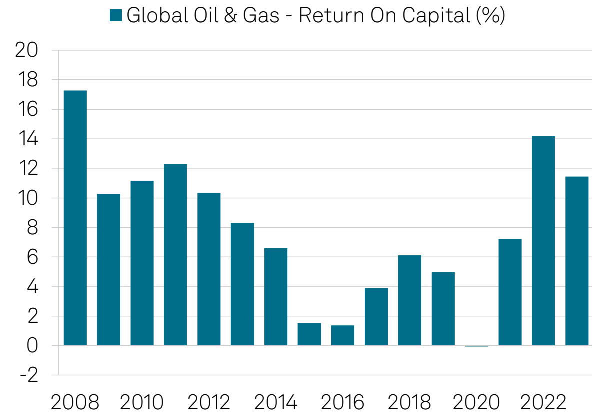


Chart 13

Fixed- versus variable-rate exposure

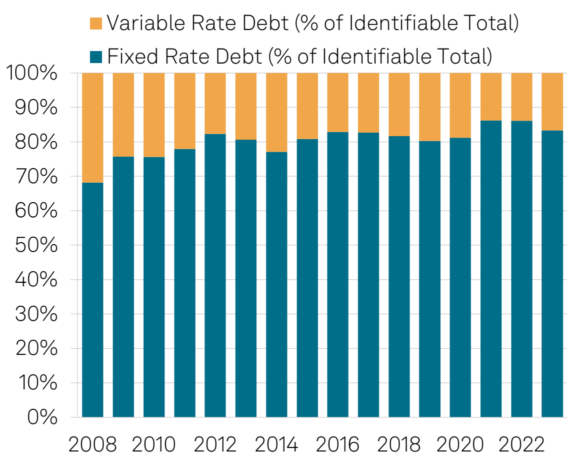


Chart 14

Long-term debt term structure

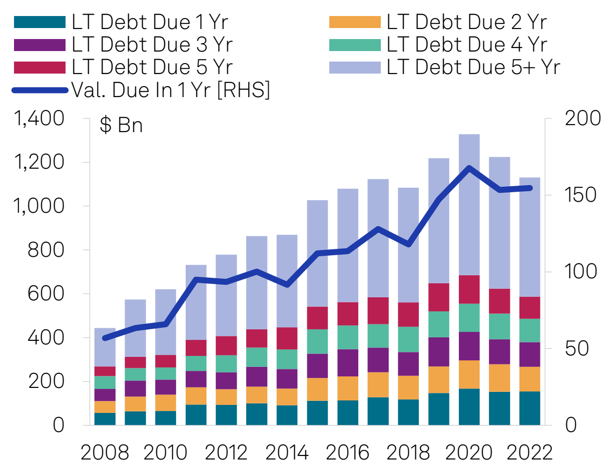


Chart 15

Cash and equivalents / Total assets

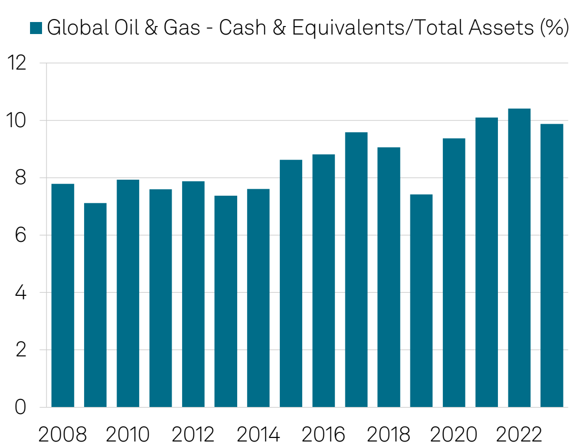
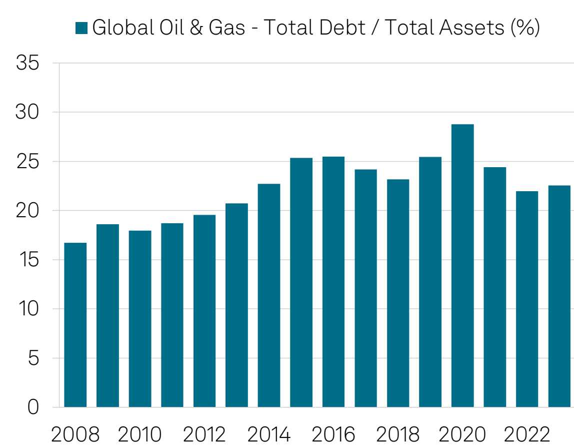


Chart 16

Total debt / Total assets



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

Real Estate

Heightened refinancing risk pressures credit quality

January 9, 2024

This report does not constitute a rating action.

What's changed?

Increasing negative rating bias globally. EMEA has the largest proportion of ratings on negative outlook at 31%, compared to 21% in the U.S. and 20% in APAC. As such, we expect downgrades will outpace upgrades in 2024 as borrowing costs and refinancing risks increase.

Tighter access to capital. Higher borrowing costs and equity price declines are limiting access to capital, and more restrictive bank lending is pushing issuers to alternative sources of funding.

Slower economic growth pressures revenue. Cost-of-living pressures will also likely dent consumer spending and confidence, which could hurt demand for real estate.

What are the key assumptions for 2024?

Significant increase in borrowing costs. We expect higher-for-longer interest rates at least through mid-2024 and expect borrowing costs will remain high.

Slowing demand. Prospects for subpar economic growth, higher unemployment, and weaker job growth are likely to pressure demand, resulting in lower occupancy and slower rental growth.

Asset values remain under pressure. A recovery in office utilization could take several years, particularly in the U.S., as vacancy remains high.

What are the key risks around the baseline?

Refinancing risk. For office REITs, refinancing options are challenging because bond spreads have widened materially, and lenders have tougher underwriting standards.

Asset valuation could dip further. Refinancing struggles could force some asset sales at wider price discounts. Lower-quality assets could see an increase in distress sales.

Downgrades could accelerate if operating fundamentals weaken beyond our expectations. REITs with large exposure to office assets or significant near-term maturities are more at risk.

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Ratings Trends: Real Estate

Chart 1
Ratings distribution

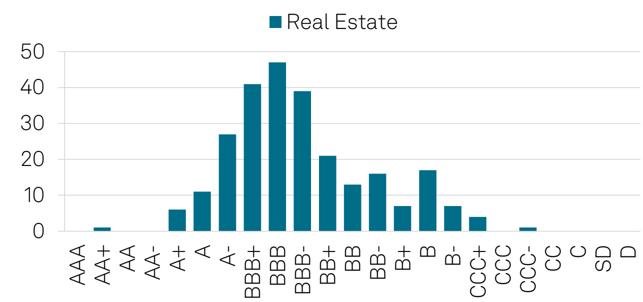


Chart 2
Ratings distribution by region

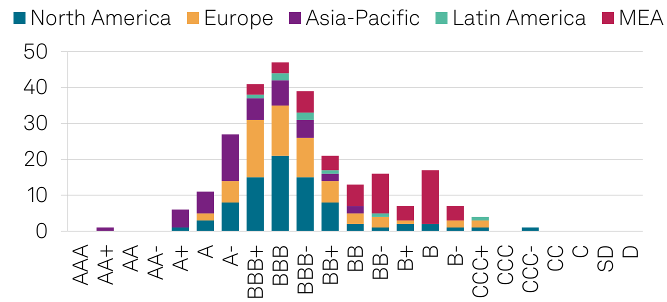


Chart 3
Ratings outlooks

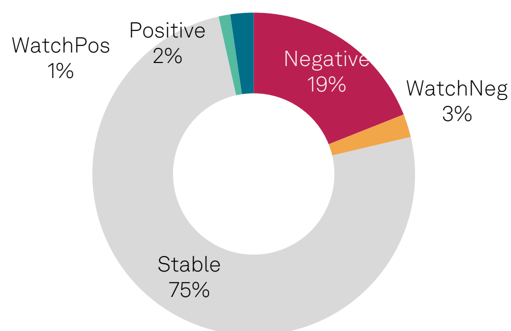


Chart 4
Ratings outlooks by region

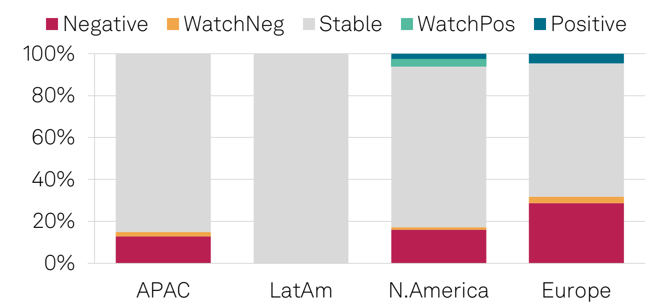


Chart 5
Ratings outlook net bias

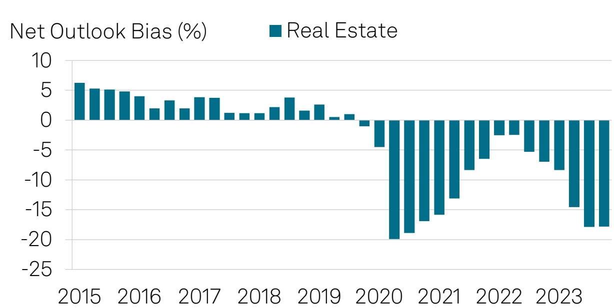
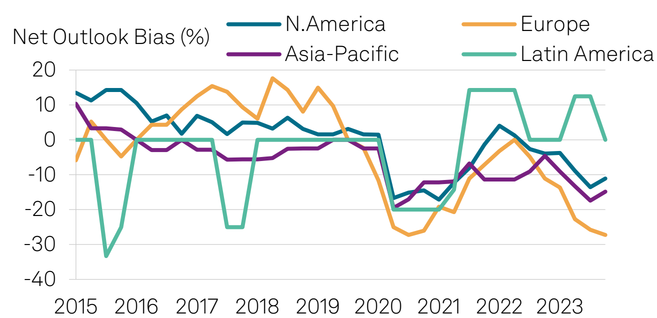


Chart 6
Ratings net outlook bias by region



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

Industry Outlook: U.S. REITs

Ratings trends and outlook

Ratings in the U.S. real estate sector remain under pressure as higher-for-longer interest rates and a restrictive bank lending environment impair credit metrics and limit capital sources. We expect conditions in North America to remain challenging in 2024 given our forecast for slower economic growth and tight financing conditions.

We maintain a negative rating bias for the sector because about 21% of our ratings on North American REITs (U.S. and Canada) have negative outlooks. The downgrade-to-upgrade ratio is overwhelmingly negative, with 14 downgrades to five upgrades in 2023, and we expect this trend to continue in 2024. The downgrades largely centered around the office sector, with seven out of the 14 involving office REITs. Of those seven, four were fallen angels. Heightened refinancing risk has led to a growing number of distressed issuers in the U.S., with about 5% of our ratings in the 'CCC' category.

The U.S. office sector is under intense pressure given a slow return to office, tighter access to capital, and a sharp increase in funding costs. As a result, the credit quality of many office REITs has deteriorated significantly. Currently, about 40% of the rated office REITs are speculative-grade compared to 20% for the broader rated REITs portfolio. We expect rating pressure to persist in 2024 given that about 55% of ratings on the office sector are on negative outlook.

Main assumptions about 2024 and beyond

1. Significantly higher financing costs

Although the 10-year Treasury yield is only about 50 basis points (bps) higher than it was one year ago, many REIT bond spreads have widened materially year over year. Moreover, tighter bank lending (with tougher underwriting) is contributing to significantly higher yields on secured debt as well.

2. Tighter access to capital and limited ability to monetize assets

The capital markets have been less accessible since the bankruptcy of SVB Financial Group in March 2023, and banks are generally trying to reduce exposure to commercial real estate (CRE). Real estate transaction volume remains low and limited price discovery is constraining asset sales.

3. Slowing revenue growth

While the U.S. economy may have averted a recession, S&P Global economists project slow economic growth for the next several years. Except for industrial REITs (which have rents that are well below market) and senior housing-focused REITs (which are benefiting from a sharp recovery from a pandemic-induced trough), we expect low-single-digit revenue growth for most of our rated REITs.

Weaker growth with higher unemployment and consumer spending could further pressure real estate demand, particularly in a prolonged high-interest-rate environment. While our macroeconomic base-case forecast does not call for a recession in 2024, office real estate is highly cyclical, and demand for office space is highly correlated with job growth. Given the slow return to office, declining tenant retention, and weak leasing activity (relative to pre-pandemic levels), along with subpar growth outlook for the next two years, the stress in the office sector will likely be drawn out for several years, because office sector performance generally lags that of economic activity.

Higher-for-longer interest rates remain a key headwind for real estate in 2024. We estimate that refinancing efforts are being executed at rates that are at least 200 bps higher than maturing debt, on average, which is pressuring coverage metrics. Moreover, the transaction market for most property types has slowed to a trickle, as potential sellers and buyers are often far apart on price. For most REITs, access to capital and other funding sources has been more limited as a result. U.S. REITs face a growing debt maturity wall in the next few years, with office and retail sectors facing a significant increase in debt maturities in 2024 and 2025 (see chart 7).

Chart 7

U.S. REIT debt maturities 2023-2027

Data as of Aug. 30, 2023. Source: S&P Global Ratings.

Credit metrics and financial policy

Higher interest rates have reduced debt-service coverage and raised refinancing risk across the sector. Given a sharp increase in borrowing costs, we expect credit metrics will erode further in 2024 (particularly EBITDA interest coverage and fixed-charge coverage) because refinancing will occur at materially higher rates than maturing debt.

Access to capital is constrained. Debt issuance remains subdued as bond spreads remain wide. Although U.S. REITs issued $37 billion of unsecured debt in 2023 compared to $26 billion in 2022, issuance remains well below 2021 levels of about $68 billion. Access to equity remains limited for most companies given the REIT sector is trading at a significant discount to net asset value (NAV) overall. While the discount to NAV has narrowed recently, it remains at about 20% as of Nov. 30, 2023, with the office sector trading at the widest discount (about 37%).

Share repurchases have also been curtailed and M&A remains limited, as REITs have focused on enhancing liquidity and debt repayment over buybacks. We expect acquisition and disposition activity to gradually increase in 2024 but note that a material gap in bid-ask spreads persists, with most potential buyers and sellers remaining on the sidelines. Office REITs that are facing declining cash flows due to weak operating results have cut or suspended dividends. Over the past few months, we have seen an uptick in M&A activity, but these transactions have largely been public-to-public mergers and thus funded with equity rather than debt.

Key risks or opportunities around the baseline

1. Growing refinancing risk

Refinancing risk is one of the key risks we are monitoring. Higher-for-longer interest rates and weaker fundamentals will continue to pressure asset values, increasing refinancing risk across all property types.

2. Further erosion of credit metrics if rates stay higher for longer than expected

Our base case is for interest rates to stay elevated in 2024, with gradual rate cuts beginning in the second half of the year. If interest rates stay elevated or move even higher, the already stressed market for refinancing would certainly worsen and thwart any plans borrowers may have to simply wait conditions out by extending their loans.

3. Resilient demand for housing and industrial assets

Worsening housing affordability and undersupply of housing supports demand for rental housing, albeit at a slower rent-growth pace. Mark-to-market opportunity on upcoming lease expirations for industrial assets will support strong rental growth amid healthy demand.

Financing conditions remain tight as lenders have been pulling back their exposure to real estate assets. For office REITs, refinancing options are even more limited than the broader sector because bond spreads have widened materially, and lenders are enacting tougher underwriting standards. In the meantime, real estate transaction volume remains low and will likely not recover until rates start to decline (or at least stabilize), perhaps toward the end of 2024, thereby limiting REITs' ability to raise capital through asset sales.

Most U.S. REITs have a staggered debt maturity profile and limited exposure to floating-rate debt. There are only a few issuers whose proportion of variable-rate debt exceeds 25% of their total debt. We believe most can absorb rate increases given existing cushion under key interest coverage metrics due to funding at relatively low rates over the last several years. REITs' unencumbered asset pools provide an important source of financial flexibility since rated REITs have a largely unencumbered balance sheet. Still, we expect lenders to reduce loan-to-value (LTV) ratios; in some cases, landlords will be required to inject additional equity to facilitate the refinancing.

Industry Outlook: European REITs

Ratings trends and outlook

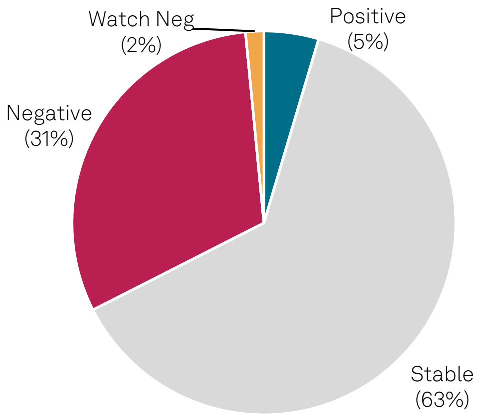
Despite recent improvements in investor sentiment, the rating bias remains negative for European REITs, with 31% of issuers carrying a negative outlook (up from 26% in July 2023), indicating the possibility of further downgrades in 2024 (see chart 8). In 2022 and 2023, we downgraded 16 European companies (25% of rated issuers), including three fallen angels (all from BBB-/Negative), mostly due to rising refinancing risks and credit ratios deviating from our rating expectations (see chart 9).

We believe valuation pressure could ease in the second half of 2024, bond issuances and investments could somewhat revive, but interest coverage will keep ratings on REITs at risk of further downgrades. We believe the situation will stabilize for companies whose capital structure and cash flows are strong enough to refinance at current rates over the long term without breaching our ratio thresholds.

Chart 8

Negative ratings outlooks and CreditWatch represent 33% of EMEA REITs

Ratings outlook distribution for EMEA REITs

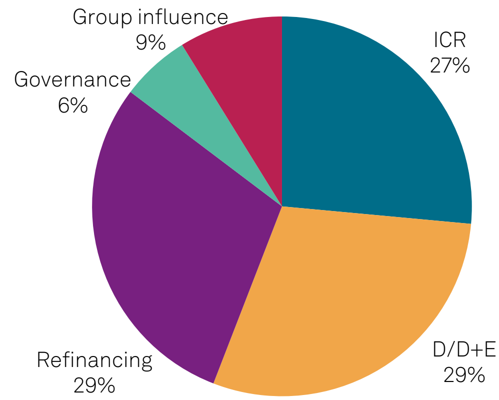


Data as of Dec. 31, 2023. Source: S&P Global Ratings.

Chart 9

Negative outlooks mostly highlight credit ratios deterioration

Main reasons for negative outlooks and CreditWatch on S&P Global-rated REITs in EMEA



Data as of Dec. 31, 2023. Source: S&P Global Ratings.

Main assumptions about 2024 and beyond

1. Higher rates will continue to weigh on refinancing in 2024 and beyond

Despite a stabilization of central rates and the recent tightening in bond yields, we expect REITs will refinance their upcoming debt maturities at materially higher rates than their current average cost of debt (about 1.5%-3.0%). We also believe raising capital from banks could remain difficult given their cautious approach to commercial real estate. We see companies with short-term bulk maturities and Nordic companies as more vulnerable given their refinancing intensity.

2. Real estate valuations could stabilize in the second half of 2024

We think property appraisal values will continue adjusting at least until the first half of 2024 despite a stabilization of central rates, given appraisals' usual lag. However, we do not assume significant value change in 2025, when we anticipate rates will decrease more pronouncedly.

3. Rental growth will likely remain healthy in the first half of 2024, before a progressive normalization

We expect rent will continue to grow throughout most of 2024 despite inflation tempering, thanks to the lagging effect of indexation and significantly lower supply of new assets. We foresee a potential deceleration by the end of 2024 as economies slow and inflation tailwinds progressively fade.

We believe the European Central Bank will maintain its deposit facility rate at the current level of 4% in the first half of 2024, after a 450 bp increase in less than 18 months. Then we expect the ECB will decrease it by a total of 75 bps in the second half of 2024, and by another 125 bps in the first three quarters of 2025, to about 2%.

While this may provide some relief to REITs' funding cost optimization, we believe long-term bond yields could remain elevated, particularly if rate cuts are delayed or if the ECB reduces its balance sheet. We acknowledge that banks are selective with new real estate clients or new transactions. They are attentive to valuations, as demonstrated by low LTV starting points on mortgage secured lending, and could potentially raise margins further. Getting new funding could remain more difficult for companies with limited bank relationships, tight covenant headroom, or limited unencumbered assets. Obtaining bank financing on new property developments, especially speculative ones that are not pre-leased or pre-sold, and riskier by nature, will likely remain a challenge.

Refinancing risks are also higher for Nordic and hybrid capital-intensive REITs. That is due to shorter debt tenors, higher exposure to variable debt, and companies' current difficulty in replacing hybrid instruments once their effective maturity falls below 20 years (for investment-grade entities); this typically occurs at the first optional call dates, most of which will fall in 2025.

Property valuations are slowly adjusting to the new interest rates, as cash flow growth has been largely offset by the high discount rate expansion. S&P Global-rated companies have reported valuation losses between 5%-20% since June 2022 (the peak). However, we expect some more devaluation to be recognized by mid-2024, especially in the nonprime office segment given the large number of assets currently for sale and the wide bid-ask spreads. We have a more favorable view of prime office, though we think they will also be impacted by further repricing given their still low yields.

Lagging indexation from inflation, a relatively strong job market, and scarce supply will support rental growth in most real estate segments in 2024. We foresee a potential deceleration by the end of 2024 as some macroeconomic indicators (like GDP and unemployment) will weaken slightly and inflation fades. We expect eurozone indexation to decrease to 2.9% and 2.0% in 2024 and 2025, respectively, from 5.5% in 2023.

Office vacancy will slowly increase. We think leasing volumes will be hit by low utilization rates and slowing economies. That said, performance between prime and nonprime assets will likely continue to bifurcate, and the scarcity of prime and energy-efficient office assets in central business districts (CBDs) will support rental growth.

Credit metrics and financial policy

Most companies have adopted stricter financial discipline since mid-2022, setting disposal targets and lowering investments and dividends to protect interest coverage and LTV ratios, which are part of their financial policies and covenant packages. Therefore, we expect them to take the necessary actions to remain within their stated guidance. However, the nature and indebtedness of their shareholders may prevent some REITs from more effective deleveraging.

- We anticipate interest coverage will remain under pressure as companies refinance their debt maturities at significantly higher costs, although most will try to repay with cash from disposals. We estimate the ratio will decline by 1.2x from 2021 to 2025, on average (see chart 10).
- LTV will plateau in 2024, at about 5% higher than 2021, based on our assumption of further value corrections (see chart 11). We expect only moderate improvement in 2025, mostly from debt reduction.
- Debt to EBITDA will likely continue to improve, because we expect revenue will grow on a like-for-like basis and most debt-funded investments are halted (see chart 12). We anticipate more free operating cash flow (FOCF) in 2024 than in the past five years.

Chart 10

Higher funding costs will pressure ICR beyond 2024

Average S&P adjusted EBITDA-to-interest ratio for S&P Global-rated REITs in EMEA

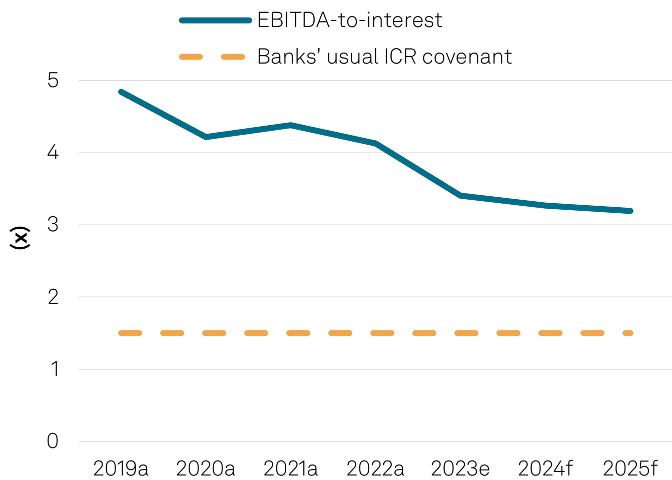


Chart 11

Value corrections could raise debt-to-debt & equity ratio by 5 percentage points from 2021's level

Average S&P adjusted debt-to-debt & equity ratios for S&P Global-rated REITs in EMEA

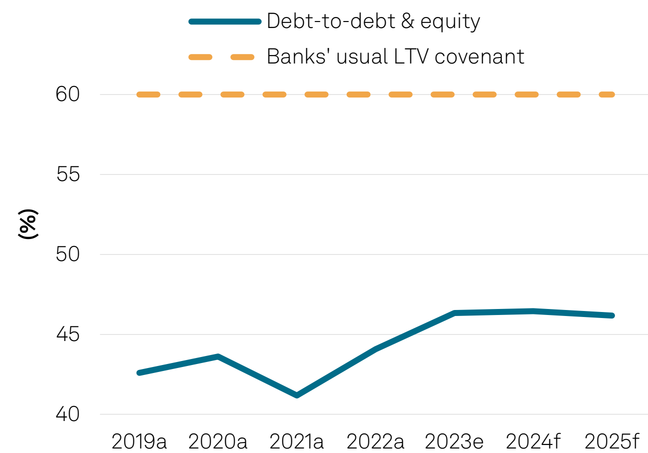
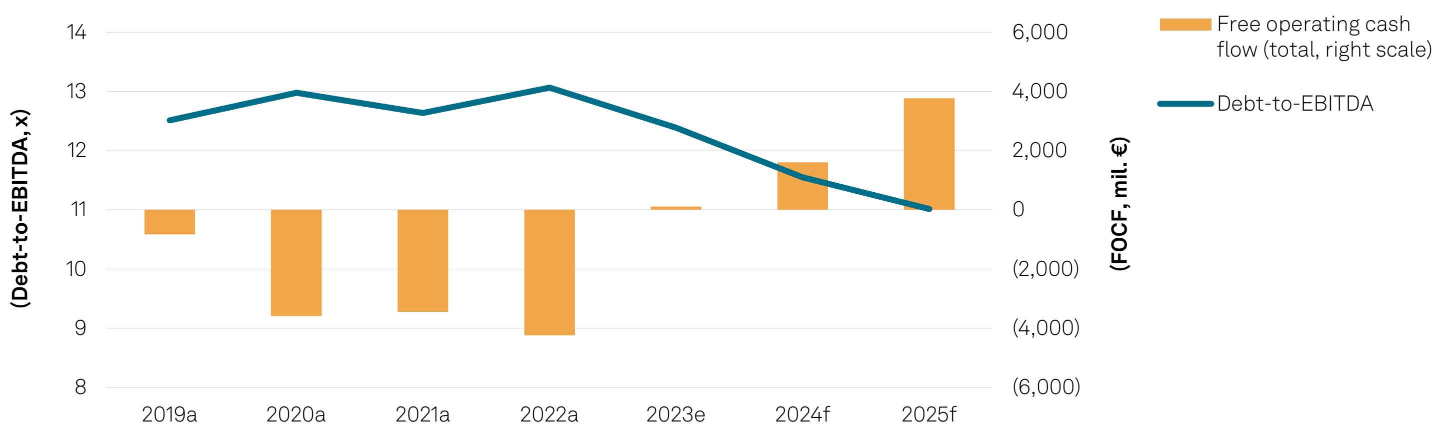


Chart 12

Growing free cash flows will support debt-to-EBITDA improvement

Average S&P adjusted Debt-to-EBITDA ratio for S&P Global-rated REITs in EMEA



a—Actual. e—Estimate. f—Forecast. Data as of Dec. 8, 2023. Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Distressed asset sales could accentuate valuations' landing

Transaction activity remains subdued in the absence of clarity on terminal rates. However, refinancing struggles could force some asset sales at wide price discounts in 2024.

2. Weaker access to financing could heighten refinancing risks further

REITs are capital intensive, and they are already facing difficult access to funding. If banks tighten their lending standards further, it would add more stress to the sector.

3. Improving investor sentiment could revive bond issuance and property investments

The real estate sector is capital intensive and sensitive to lender sentiment. Therefore, an improving market sentiment could accelerate a recovery in the sector.

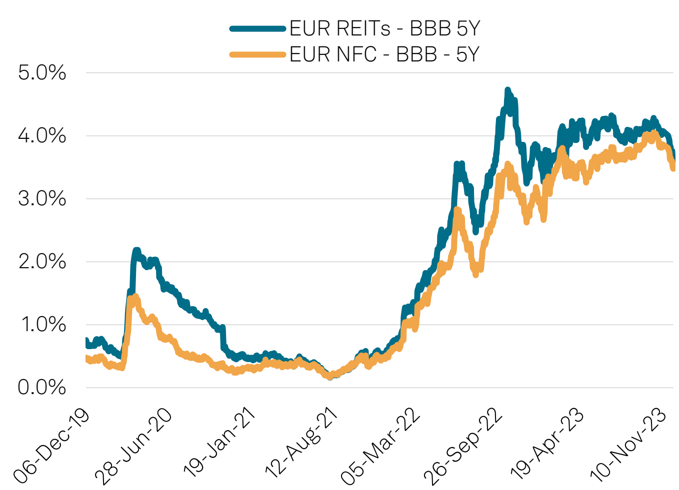
There is a price mismatch between sellers and buyers, with transactions generally on pause. While no major distressed sales have happened yet, large transactions without a price discount are difficult to realize in the current environment. This could have implications for the real estate market. If prices are significantly below market level, the pressures affecting the valuations of CRE assets could be heightened. Although this is not our base-case scenario, banks could become more reluctant to lend to REITs given the deterioration in CRE, which would be detrimental given the capital intensity of the sector.

Investor sentiment is improving slightly as we get more clarity and certainty on interest rate stabilization. This is illustrated by the improving performance of European REITs' bonds and equity prices (see charts 13 and 14). We think further improvement could accelerate a recovery, support direct property disposals, and further revive bond issuance. Moreover, a dilution of the long-standing share price discount to NAV, from the combined effect of the ongoing property value correction and rise in equity prices, could potentially unlock equity transactions.

Chart 13

Real estate bond yields remain elevated, though they recently decreased

5-year bond yields, European nonfinancial corporates versus European REITs

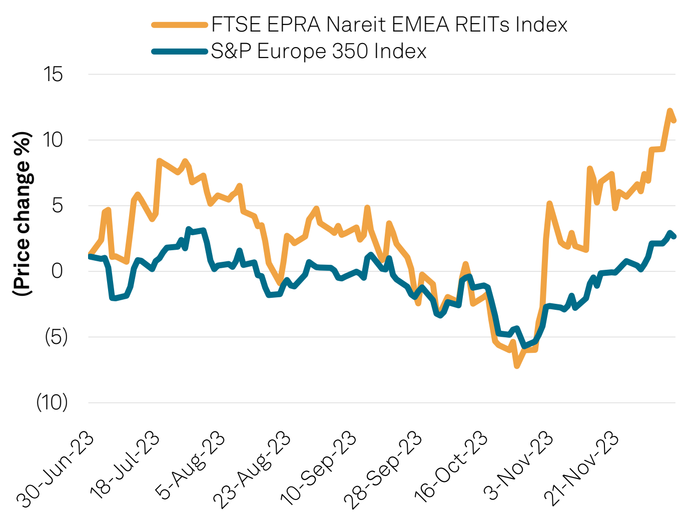


Source: S&P Global Capital IQ Pro. Data as of Dec. 8, 2023.

Chart 14

Price evolution of European REITs equity index (FTSE EPRA) versus S&P Europe 350 Index

Price change (%), from June 30, 2023 to Dec 7, 2023



Sources: S&P Global Ratings, S&P Global Capital IQ Pro.

Industry Outlook: Asia-Pacific REITs

Ratings trends and outlook

Credit metric and covenant headroom diminish as higher interest rates take hold. Heightened interest rates are reducing credit metric headroom for APAC REITs and landlords. Further cost pressures could challenge landlords in the region to maintain earnings margins while accommodating increased cost of capital expenditure (capex). Rising interest rates are translating into higher capitalization rates, resulting in asset devaluations and testing landlords' preferred targeted gearing (debt-to-assets) limits. The negative rating bias has increased to 15% by end 2023 from about 10% at the end of 2022.

The office sector is bearing the brunt of these challenges with a supply-demand mismatch in the central business districts of major Australian cities and Hong Kong. The elevated vacancy rates in office buildings are being accentuated by hybrid working and reduced demand for space.

Continued asset valuation pressure, challenging business conditions, and waning consumer confidence in 2024. Elevated interest rates, the need to repair gearing positions, and wholesale fund redemptions will likely precipitate landlords' decision to sell noncore assets. This will enable greater price discovery.

The office sector is also bearing the brunt of asset valuation declines. Despite inflationary pressures, retail landlords continue to report robust foot traffic volumes, although there are signs that discretionary retail spending is moderating. Business conditions remain challenging, and we expect elevated vacancy rates in the office and discretionary retail sectors. Cost-of-living pressures will also likely dent consumer spending and confidence.

Main assumptions about 2024 and beyond

1. Higher-for-longer interest rates will test credit metrics

Australia, Hong Kong, and Singapore have seen a rapid rise in interest rates, which could erode credit metric headroom more than in other countries. Inflationary pressures will moderate consumer and business spending while the more indebted landlords will be exposed to elevated interest rates, requiring them to shoulder a heavier interest burden.

2. Capex commitments and unitholder redemptions could exacerbate rating pressure

Higher interest rates and historically high vacancy rates in several gateway cities is pressuring earnings, reducing coverage metrics and covenant headroom. Higher-than-expected inflation-adjusted capex commitments are reducing free cash flow. Unitholder redemptions for private unlisted funds could place additional strains on weakened credit metrics and liquidity profiles.

3. We expect rental income trends will diverge between cities

Hong Kong, Japan, and Singapore benefitted from a strong rebound in return-to-office occupancy rates, while increased tourism and retail spending supported retail landlords. We expect more stable and resilient rental income trends across these countries compared to other cities, affected by a lower return-to-office adoption, supply-demand imbalance, and economic headwinds.

Credit metrics and financial policy

Japan: We expect the credit metrics of rated Japan REITs (JREITs) will remain stable in 2024. Central Tokyo's office vacancy ratio will hover around 6.5% in 2024, compared to 6.1%-6.5% in 2023. Although work-from-home habits and an increasing new supply of office space will weigh on office demand over the next two to three years, the average office utilization rate has recovered to about 80%. In our view, new supply of office space will pause in 2024. The performance of JREITs will also be supported by their high-quality, well-located portfolios, which we expect will remain resilient.

We expect retail store sales will grow steadily in a post-pandemic environment. We also predict condominium sales will remain resilient following the recovery of population growth in Tokyo. This is also supported by limited land supply for condominiums.

JREITs will continue to improve assets to enhance portfolio quality and remain selective in their investment of new properties. This will help capitalize on flight-to-quality and improve rental resilience, mitigating the effect of higher interest rates. JREITs will continue to fund investments through debt, equity, and recycled capital from asset divestments to maintain gearing ratios within respective target ranges and financial policies. We expect strong interest-coverage ratios, long average debt durations, diverse maturity profiles, and a high proportion of fixed-rate debt of rated issuers to provide our rated JREITs with ample room to weather further interest rate increases.

Hong Kong: We expect our rated REITs and landlords to maintain steady credit profiles in 2024, despite high interest rates and mild valuation declines. Solid operations and proactive treasury management policies will position our rated issuers to manage market turbulence.

In our view, our rated REITs and landlords have managed rising interest rates well by reducing their debt burdens. Through the course of 2023, the rated REITs have raised funds through various means, such as equity issuance and the sale of noncore assets. Some also embarked on early bond refinancing in mid-2023 for 2024 maturities before further interest rate hikes took place in the second half of the year.

We note a lack of transactions in Hong Kong and the illiquid nature of these assets may mean that property values have not fully reflected interest and capitalization rate movements. That said, most of our landlords have moderate headroom in their gearing-based financial policy limits, borrowing covenants, and rating triggers. The sound asset quality supports valuations and underpins their market position in the city.

Mainland China: For rated landlords in mainland China, we expect retail and office rents to come under further pressure in 2024 due to elevated supply and the uncertainty of the country's economic outlook. Despite the release of pent-up demand in travel and consumption during 2023, consumers remain cautious, especially on large-ticket items. This may constrain the potential rebound of retail rents in 2024. We anticipate office vacancy rates in first-tier cities will remain in the high-teens. In response, we expect Chinese landlords will moderate capital expenditure and acquisitions.

Pacific: Following multiple negative rating actions on our rated office Australian REITs (AREITs) in 2023, we forecast credit metrics for the sector will remain constrained in 2024. Key factors include higher-than-expected debt-funded capex commitments, unitholder redemptions, reduced earnings and covenant headroom, and asset recycling risks. Successive interest rate hikes increased interest and funding costs, reducing covenant headroom. This has challenged managements' adherence to articulated financial policies, and we expect credit metric headroom across the office sector to remain under pressure. This sector was subject to heightened negative rating activity in 2023.

Key performance indicators of our rated retail landlords remain robust, underpinned by strong leasing volumes, positive rental reversion spreads, and robust retail sales. That said, there are signs that tenant sales across some discretionary categories are starting to moderate in the September 2023 quarter. We expect credit metrics of our rated retail AREITs to remain resilient in 2024, underpinned by nondiscretionary stores and core retail categories in strategically positioned assets that will remain resilient in a downturn.

Fundamentals of the logistics sector remain sound, supported by ongoing demand for quality and strategic urban infill sites. The sector is not immune to interest rate increases, which is likely to result in valuation declines and elevated financing costs. That said, we expect low supply volumes, robust rental growth, and a disciplined approach to capital deployment will ensure that our rated industrial AREITs maintain adequate headroom in their credit metrics.

Singapore: We expect leverage for rated Singapore REITs (SREITs) to remain largely stable in 2024. This is supported by resilient earnings and the quality assets that rated SREITs own. Back-to-office momentum reduces the vacancy risks associated with remote working. Rated SREITs with downtown retail and hospitality exposure will see more upside as the recovery in tourism takes shape.

We believe rated SREITs will manage growth plans in line with their prudent financial policies. We expect an increasing focus on asset enhancement initiatives as improving existing assets generally entails less risk. REITs also have other tools to manage leverage, such as asset divestments.

Key risks or opportunities around the baseline

1. Negative office revaluations to increase gearing and reduce covenant headroom

Higher-than-expected vacancy rates, further upward pressure on capitalization rates, and sales of office assets at depressed prices could exert further downward pressure on office valuations. These could further erode covenant headroom, in particular the gearing covenant, for our rated landlords. Another key risk would be higher-than-anticipated interest costs that pressure interest coverage metrics and covenant headroom.

2. Office demand and supply imbalance will persist in 2024

Concentrated completion of new office supply, hybrid working adoption, floorplate reconfiguration, and subletting by existing tenants could contribute to a greater demand and supply mismatch in the office sector. Although increasing return-to-office adoption helped improve physical occupancy rates, we expect vacancy rates will remain high in 2024 due to excess supply that has yet to be absorbed. The risk is that vacancy rates remain sticky, especially for weaker quality assets, pressuring earnings and requiring landlords to lower rent or increase incentives.

3. Nondiscretionary retail, logistics, and hospitality assets remain well supported

Despite inflationary and cost-of-living pressures, retail, logistics, and hospitality assets continue to perform, evidenced by strong rental growth and record-low vacancy rates. Although there are signs that nondiscretionary spending might be moderating, tourism and net migration continue to support consumer and retail spending. In our view, these sectors remain attractive to investors that seek to diversify away from the headwinds facing office assets.

Japan: A larger-than-expected domestic interest rate hike due to changes in the Bank of Japan's policy rate would undermine JREITs' portfolio asset values and impinge on their interest coverage ratios. That said, we believe the low interest rate base and available covenant headroom will position JREITs to shoulder the incremental debt burden. Demand-supply imbalance may be exacerbated with additional new office supply coming to market through 2025.

Hong Kong: Net migration inflow and increasing volume of Chinese shoppers to the city are key opportunities for retail sales growth in 2024. Hong Kong retail sales grew 18.6% year over year during the first nine months of 2023, which we expect will support positive rental reversions in 2024. Retail landlords with high exposure to neighborhood malls are also benefiting from improving retail sales.

Key risks include a slower-than-expected economic recovery, which would continue to suppress office space demand in the city. A protracted pause in capital market activity, such as initial public offerings, is likely to indicate softening demand for new office space in the city. This is likely to pressure rental growth and vacancy levels. We expect average office rent reduction of 0%-5% in 2024, in addition to an estimated 5%-10% decline in 2023. We expect office vacancy rates will remain elevated over the next 12 months amid substantial new supply.

Mainland China: In the office sector, the risks are skewed toward the downside on lease renewals given excess office supply. Amid economic uncertainty, firms with maturing leases must decide if they will maintain their existing floorspace or reduce it. The outlook for retail landlords is more favorable, with retail mall footfall rising amid recovering consumer mobility. Retail leasing demand is highly correlated to business and consumer confidence. Landlords with a strong credit profile and access to local funding lines benefit from lower domestic interest rates.

One opportunity is that recent regulatory developments, such as the launch of domestically listed REITs, may provide exit opportunities for some retail landlords.

Pacific: Inflationary pressures and elevated interest rates are key risks for AREIT landlords. Despite retail malls benefitting from post-pandemic foot traffic and customer visitation levels, there are signs that inflationary pressures are starting to moderate consumer spending across discretionary retail sales categories. Protracted inflation and cost-of-living pressures will further dampen consumer spending and retail sales. Although industrial landlords benefit from strong demand and relatively low supply volumes, weakness in consumer spending is likely to extend to e-commerce sales and crimp demand for industrial storage and distribution sites over the longer term.

Office landlords experiencing higher vacancy rates are more susceptible to increased financing and interest costs. While rental income may benefit from consumer price index (CPI)-adjusted increases, it is insufficient to fully offset vacancies and nonrenewals as tenants conform to smaller floorplate hybrid working arrangements. With upward pressure on capitalization rates and office landlords divesting assets to fund capex commitments, we expect negative office asset revaluations will be more pronounced. Although flight-to-quality may offer some protection for landlords with higher quality assets, we expect gearing targets and credit metrics to come under pressure.

Singapore: Higher-than-expected interest rates will reduce credit buffers. That said, SREITs proactively hedged against rising interest rates. For rated issuers, the proportion of fixed rate debt was between 63%-78% as of Sept. 30, 2023.

Macroeconomic uncertainties may weigh on operating conditions. This may temper rental growth rates or lead to higher vacancy rates. The effect may be exacerbated in the office market, which faces elevated supply in 2024. We expect this will have a disproportionate effect on lower quality office buildings. Growing occupier expectations on sustainability accreditations may require further capital investments to bring the buildings up to a higher standard.

Industry Outlook: Latin America Real Estate

Ratings trends and outlook

All rated Latin American (LatAm) real estate operators have a stable outlook, signaling our expectations for rating stability in 2024. Higher-for-longer interest rates remain a key risk for real estate assets, especially for already distressed assets, such as office properties. However, half of the rated companies are investment-grade, with significant credit buffer to absorb downside risks; the other half are mostly in the 'BB' rating category, with the exception of one rated entity in the 'CCC' category (due to its vulnerability to external events given its unsustainable capital structure).

Industrial portfolios in the region will continue to ride the positive momentum given nearshoring and growing e-commerce tailwinds, particularly in Mexico. We expect retail portfolios will perform well due to resilient consumption trends but with limited upside in terms of expansions. We also believe office properties will remain under pressure due to hybrid work, slowing economic growth, inflation, and the expectation for interest rates to remain high.

We expect stability in our LatAm rated portfolio in 2024. The anticipated slowdown in the U.S. and LatAm economies may affect some of these companies' tenants; however, we estimate the impact in operating indicators will be relatively mild. We consider most of the rated entities to be relatively well positioned to weather a challenging year amid high financing costs. On average, we expect a rise in revenue and for EBITDA to approach 10% for these entities.

Funding needs for industrial operators will increase for growth initiatives, although financing is available and committed in most cases. For retail and office operators, funding needs will be significantly lower, given the absence of gross leasable area (GLA) growth in these asset classes. We estimate relatively stable coverage ratios despite higher financing costs, and for refinancing risks to be limited in 2024. In most cases, our rated entities maintain well-extended debt maturity profiles. Moreover, there are some planned asset recycling and divestments for this year, though pressure on office property valuations could delay some of these plans.

Main assumptions about 2024 and beyond

1. High demand for industrial properties will continue

We expect tight vacancy rates in key markets within Mexico (around 2%), while vacancy rates in Brazil will be below 10%. Despite economic and political headwinds, we expect strong demand for industrial properties near the U.S. will keep occupancy rates high while continuing to push rental rates up, benefitting industrial landlords. Additionally, we also anticipate growth strategies of several players, organic and inorganic, to continue taking place in 2024.

2. Office properties have not bottomed

We expect a gradual decline in vacancy rates during 2024, following the modest improvement from past months. In our view, the full recovery seems elusive in the medium term, and we expect still-high vacancy rates of around 18%-23% in markets such as Mexico City or Sao Paulo. This, coupled with higher-for-longer interest rates, will continue pressuring asset valuations.

3. Retail portfolios will be relatively resilient to softer consumption

Despite strong e-commerce growth since the pandemic broke out, consumers in LatAm continue visiting shopping malls. Occupancy rates at several properties is close to pre-pandemic levels and we anticipate relative stability for 2024, although economic headwinds will likely slow discretionary consumption.

Rated industrial portfolio continues enjoying local tailwinds and is looking to expand GLA. We expect occupancy rates to remain strong at around 97% because rated industrial players are concentrated in northern Mexico, where they enjoy tailwinds from the shift to nearshoring and benefit from a wider range of tenants, such as manufacturers of auto parts, health devices, electronics, logistics, and e-commerce tenants. We estimate net effective rents will be growing around 15%-20% in 2024, similar to 2023, given the very low vacancies in key markets such as Monterrey, Mexico City, and Tijuana.

Despite our expectation for an economic deceleration in 2024 in both the U.S. and Mexico, we estimate little deviation in occupancy rates because most of the tenants are multinational companies that have longer-term investment horizons and sound financial profiles. We expect investment sentiment in this asset class will remain positive, bringing financing options for industrial players to pursue more aggressive growth initiatives. A few entities have raised equity financing, while most have undrawn committed revolving credit facilities, which we expect will be used over the next 12-24 months.

Moreover, growth strategies will continue to vary across companies, depending on the target market. Some of the rated entities are seeking to expand their GLA through their own developments, joint ventures, or acquisitions on stabilized portfolios. On the other hand, our rated Brazilian players with industrial assets are largely geared toward e-commerce and logistics, rather than manufacturing facilities. Due to the increasing adoption of e-commerce by Brazilian consumers and retailers, we expect these entities to post mid-single-digit revenue growth on average.

We expect little growth in retail and office portfolios, and we believe refinancing risks are low. Investment sentiment on both asset classes remains subdued while construction costs are high, limiting growth. Rated retail portfolios are in Mexico, Brazil, and Peru, where we've seen a strong recovery in foot traffic, something we believe will continue during 2024. While these properties have virtually recovered to pre-pandemic operating indicators, such as occupancy rates, we expect limited rental growth in the case of Mexico and Brazil. This is in line with our view of softer consumption trends, especially in discretionary goods and services.

However, as roughly 90% of rental income comes from fixed rent agreements, we don't anticipate a sharp contraction even if consumption drops. The gloomier scenario for Mexico and Brazil contrasts with our view on Peru, where consumption underperformed in 2023, and we expect a soft rebound in 2024; this is in line with our view of more robust economic growth. We expect occupancy rates at Peruvian and Brazilian properties will remain around 95%, reflecting high asset quality and less exposure to discretionary consumption, while in Mexico we expect a gradual improvement toward 90% by year-end 2024.

Similar to last year, the pipeline on retail properties under development is relatively small, and we expect limited funding needs. There are no large debt maturities due in 2024 on these portfolios, so refinancing risks are low. We've seen some proactive refinancing of secured debt on mixed-use properties in 2023, and we expect some more refinancing to materialize in 2024 as well.

Office properties account for the smallest proportion of the portfolios of our rated real estate entities, mostly concentrated in Mexico City and Sao Paulo areas. We anticipate only a modest recovery in occupancy rates in 2024, given large supply in these areas, while business conditions won't significantly improve. This will continue to pressure landlords to refurbish properties and adapt them to demand trends such as plug and play, collaborative spaces, or environmental certifications, in addition to ancillary services within the property.

Credit metrics and financial policy

We expect mixed leverage trends during 2024. In the case of industrial portfolios, we expect greater use of debt and equity proceeds to fund development projects and acquisitions because most rated entities are planning to continue executing a growth strategy to capture the momentum in the sector. Nonetheless, incremental leverage will be relatively moderate, partially offset by rental income and EBITDA growth, given strong operating indicators. Moreover, we expect industrial landlords will fund their strategies with long-term debt financing, as several have committed revolving facilities with maturities within three to five years, while others have raised equity.

For retail and office portfolios, we expect a modest improvement in rental income, and in a few cases asset sales for debt repayment. Moreover, financing needs for this asset class will continue to be limited because our rated portfolio doesn't have material debt maturities in 2024 and expansionary capex, or acquisitions, will be scarce for nonindustrial landlords.

On average, we expect rated LatAm real estate entities to maintain solid credit metrics for 2023, with debt to capital of 30%-35%, EBITDA interest coverage of about 3.5x, net debt to EBITDA in the 5.0x-6.0x range, and funds from operations (FFO) to debt of about 20%.

Key risks or opportunities around the baseline

1. Economic headwinds and strong local currencies could impact operating and credit metrics

Our top-line and cash flow generation expectations could underperform if the U.S. economy enters even a shallow recession in 2024. We estimate it would indirectly impact our rated real estate portfolio, especially where tenants' operations are dependent on U.S. demand. Moreover, strong Mexican-peso (MXN) relative to the U.S. dollar (USD) will likely require extraordinary payout of FIBRAs (Mexican REITs) to certificate holders in 2024, in addition to undermining dollar-denominated rents.

2. Nearshoring remains a key opportunity, particularly for real estate industrial operators based in Mexico

Industrial properties continue being the darling of real estate asset classes in LatAm, and we expect continuity in this positive momentum through 2024, despite local headwinds such as rule of law, energy policies, and security. Several industrial operators and developers are ready to continue expanding their GLA, given record-low vacancy rates, with funds from committed revolving credit facilities (RCFs) and equity financing. Although we anticipate development risk will tick up in 2024, we expect prudent financial policies will continue in our rated portfolio.

3. Political landscape will dictate business conditions, especially for industrial properties

Political risks prevail in 2024, with upcoming election years in both the U.S. and Mexico. A key component of Mexican real estate attractiveness are its economic ties and trade agreements with the U.S. Although we see this as a high-impact, low-probability risk, the entrance of new administrations could deter new investments, fading the momentum away.

Economic headwinds pose a risk to our growth baseline for 2024. The possibility of the U.S. economy entering a shallow recession in 2024 is not off the table, likely dragging other economies, such as those in LatAm. Moreover, a prolonged period of high interest rates would reduce the economic activity beyond our current estimates in several LatAm countries, reducing internal consumption and exporting activities. These would undermine tenants' operations across the three real estate subsegments we follow in the region. However, the bulk of our LatAm rated portfolio have well-laddered debt maturity profiles with low refinancing needs in 2024.

We will also monitor foreign exchange (FX) volatility, given the high number of dollarized rents and debt in the sector, especially in industrial and premium office properties. For Mexican FIBRAs, this represents a particular risk beyond the effect on rental income because they must distribute at least 95% of taxable income to certificate holders to keep their FIBRA status and fiscal benefits.

With current MXN/USD exchange rates and estimated inflation, several FIBRAs will report abnormal income gains for the fiscal year-ended 2023, considering the effect on valuations and dollarized debt, raising distribution requirements by March 15, 2024. We consider the rated FIBRAs relatively well positioned to confront this scenario, given high levels of committed RCF (and in some cases cash reserves from equity financing). Moreover, payment in kind, with certificates, is a less conventional possibility that some companies are evaluating.

Industrial tailwinds will continue, despite local constraints and higher-for-longer interest rates. LatAm has become a more attractive destination for several of value chains considering relocation, given its competitive and skilled labor supply, multiple international trade agreements, and proximity to the U.S., especially Mexico. Demand for Mexican industrial real estate has been at an all-time high over the past couple of years and is showing little signs of slowing in 2024.

Industrial absorption rates were at record highs in 2022 and will likely exceed that record in 2023. We estimate foreign direct investments to be 40% higher in the first half of 2023 compared to the first half of 2022 (excluding extraordinary transactions), while industrial inventory under construction remains strong in several Mexican submarkets.

As a result, our rated industrial portfolio is expanding their GLA and in some cases increasing developments through acquisitions of stabilized assets. Although we consider the development path riskier, low vacancies, secured funding through debt and equity, and leverage headroom lead us to believe the rated entities are well positioned to pursue growth.

Presidential elections in both Mexico and the U.S. could disrupt the trading partnership. Although we consider this a high-impact, low-probability scenario, a reversal from any of the two nations to foster their commercial relationship could significantly reduce demand for industrial properties in Mexico, increasing vacancy rates and pressing asking rents.

The industry may also face longer-term headwinds--or tailwinds--depending on how the political landscape evolves. For example, Mexico's energy policy, electric installed capacity, land and water scarcity in certain regions, and the speed and transparency in dealing with local governments could be headwinds. On the other hand, if policies favor greater infrastructure investments in roads, highways, and ports to improve connectivity and tackle energy-source bottleneck and security issues, the positive momentum in nearshoring trends could be further magnified, directly favoring growth prospects for industrial real estate companies and indirectly affecting the rest of the economy.

Industry Outlook: Other Regions

Gulf Cooperation Council

In the United Arab Emirates, positive traction for hospitality and retail is boosted by a high number of international visitors, population growth, and overall supportive economic environment. Hospitality remains very strong (76% occupancy in the first eight months of 2023), with average daily rates (ADR) at historically high levels ($170), as the country hosts a series of global events, including COP28 in Dubai. Visitor numbers are on track to hit 17 million in 2023, fully recovering to pre-pandemic levels.

The large pipeline of new hotel rooms will preclude further occupancy improvements over the next few years, though. Mall operators benefit from a strong rebound in footfall and solid retail performance, with rental recoveries in prime malls; but secondary retail spaces remain challenging. Continued new GLA supply will limit the extent of improvements, in our view, despite good traction in international tourism and population growth.

Changes in corporate ownership rules allowing 100% foreign ownership as well as active issuance of new regulation for high tech and virtual assets companies have prompted new businesses establishment in the UAE. This resulted in rising office rents and reduced vacancies (10% in Central Business District) over the past couple of years, amid relatively limited new supply.

Saudi Arabia is on a growth path under the framework of its Vision 2030 program. Saudi authorities are taking measures to boost the tourism sector via visa reforms, hosting of high-profile events and developing new tourism destinations. Several international hotel chains have already announced massive investments in the country. We expect a significant rise in hotel rooms in the run-up to 2030, as the country now expects to reach its 100 million visitors target (domestic and international) well ahead of plan.

Office landlords benefit from a strong uptick in international corporations and government-related entities as tenants, which, given limited new supply, led to rental increases and vacancy drops. We expect such a positive dynamic to be sustained as economic growth of non-oil sector is bolstered by large investments in Vision 2030 projects. The retail segment continues to grow, with new GLA additions, and mall operators focus on enhancing their entertainment and omnichannel options.

In Qatar, downward pressure spreads across all real estate subsegments, including hotels, offices, and retail. New capacity delivered for the World Cup in 2022, particularly in the hospitality segment, has significantly increased available inventory. On the positive side, tourism is expanding significantly, while the population increased by about 2% so far in 2023, moderating the downside. We expect pressures to linger for the next two to three years.

Israel

Pressure on office rents and occupancies amid the slowdown in the high-tech industry. Since the second half of 2022 there has been a substantial decrease in the venture capital investments in the high-tech industry, mainly due to global economic challenges with tighter financing conditions, and the domestic political situation regarding the fierce opposition to controversial judicial reform including massive demonstrations and strikes in Israel. It resulted in a growing number of high-tech companies downsizing and a decrease in the number of job vacancies. It has a direct negative effect on demand and correspondingly on the rents of new contracts in the office properties, especially in the Tel Aviv area, which previously enjoyed record prices.

In the short term we do not project any major impact on the occupancies of the rated companies, which operate mainly in areas of high demand with high quality properties. These companies still show growth in rental income mainly due to the linkage to the price index and relatively stable occupancy rates due to the long-term contracts.

Nevertheless, we expect to see increasing pressure on rent level and occupancies, on the back of our weaker updated macroeconomic forecast for Israel due to the war. We also expect the supply of new high-quality office space entering the market in the coming years will put additional negative pressure on rental rates and occupancy, especially in areas already suffering from excess supply.

Increasing risk for lower retailers' profitability could pressure rents. Continued inflationary pressures due to supply chain disruptions, as well as slower growth expectation and higher interest rates, are weighing on retailers' profitability. Retailers may find it difficult to pass on the full increase in their costs to consumers, which will further reduce their profitability and, consequently, pressure rents.

While the economic impact of the war was most notable in October 2023 with the drop in footfall in commercial properties and turnover of tenants, we see increasing risks of the more general slowdown in consumer consumption and weaker macroeconomic performance, mainly impacting rent level growth.

Continuously higher interest rates lead to growing risk of asset devaluations for office and retail properties. However, higher rents due to consumer price inflation will act as a moderating factor. We note that in the first nine months of 2023, most income-producing real estate companies presented positive revaluations, due to both indexation and a real increase in rents.

At the same time, amid the uncertainty in the economy growth prospects, we see a higher risk of moderate single-digit percent asset devaluation, mainly for office properties. Overall, these trends weigh on the credit quality of Israeli real estate, as reflected in the substantial increase in the proportion of negative outlooks compared to 2022.

Related Research

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- Issuer Ranking: Asia-Pacific REITS And Real Estate Operating Companies Ranking--Strongest To Weakest, Feb. 22, 2023
- German Residential REITs Face A Mixed Outlook In 2023, Feb. 20, 2023

Industry Forecasts: Real Estate

Chart 15

Debt to capital (adjusted)

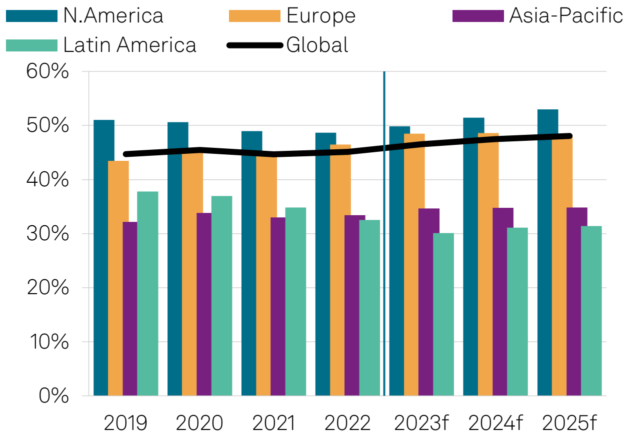


Chart 16

EBITDA interest coverage (adjusted)

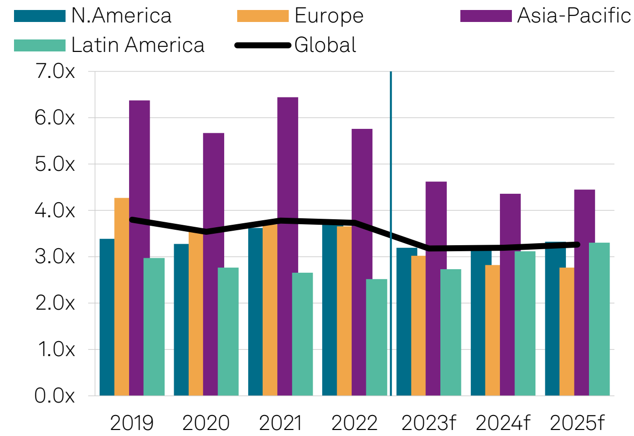


Chart 17

Debt / EBITDA (median, adjusted

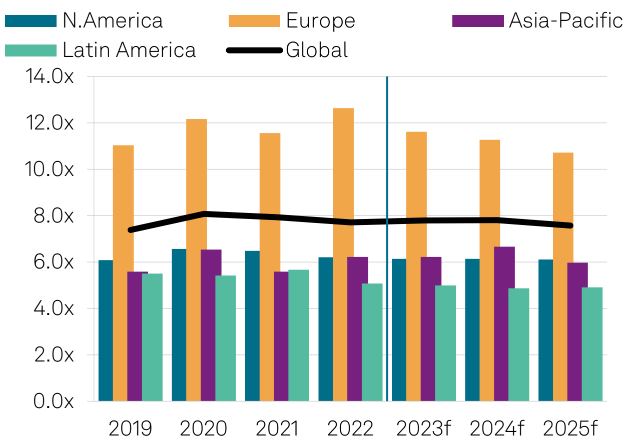
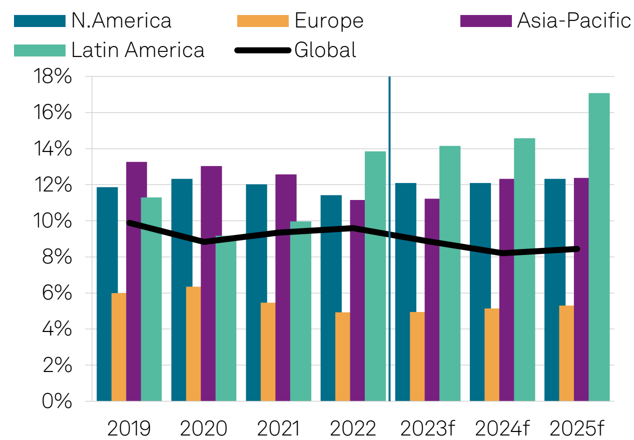


Chart 18

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
All data 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: Real Estate

Chart 19

Rental revenue growth

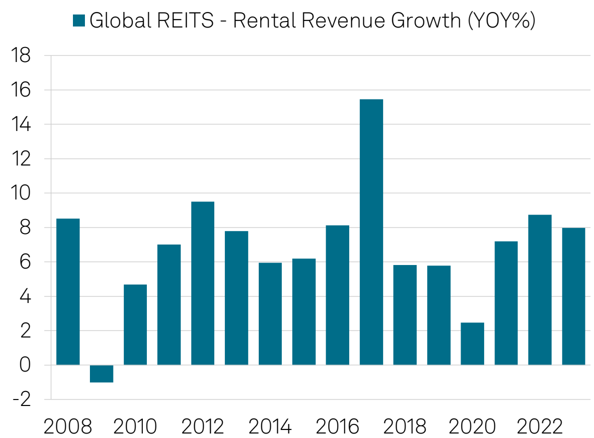


Chart 20

Return on capital employed

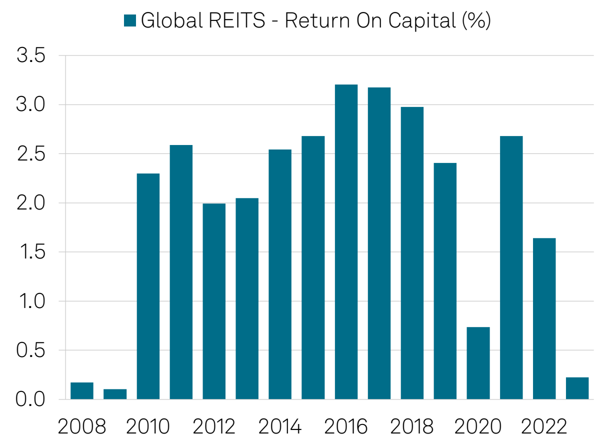


Chart 21

Fixed- versus variable-rate exposure

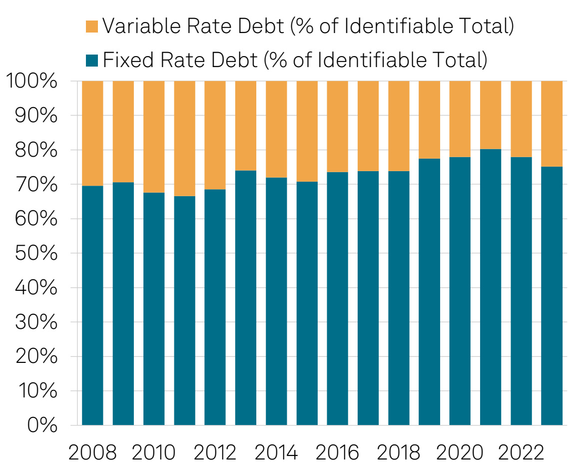


Chart 22

Long-term debt term structure

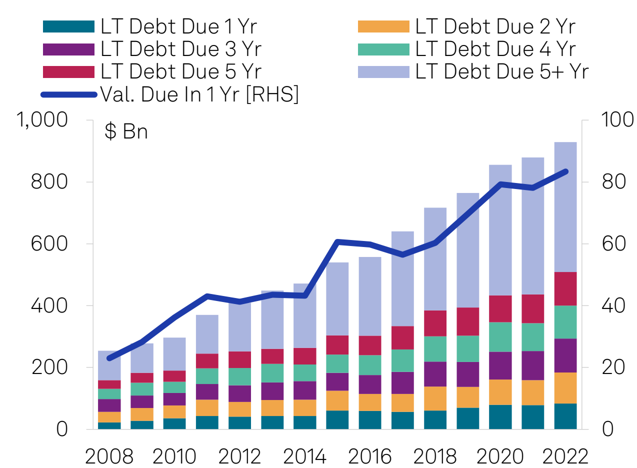


Chart 23

Cash and equivalents / Total assets

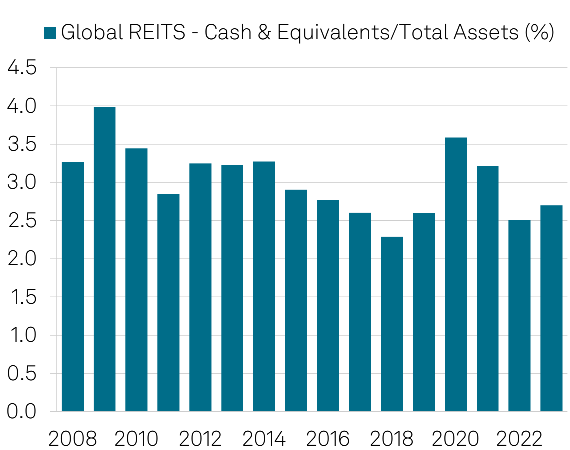
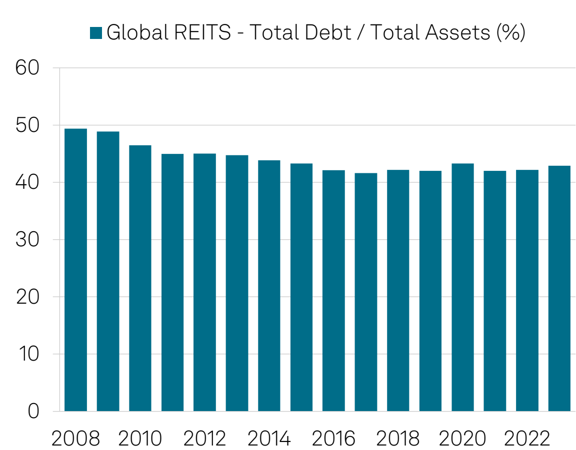


Chart 24

Total debt / Total assets



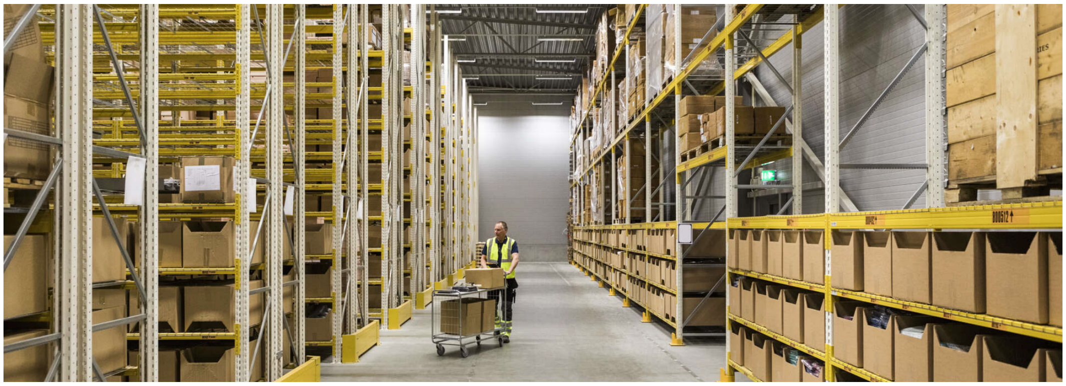
Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2023) figures use the last 12 months' data.

Retail and Restaurants

Consumers will remain cautious even as inflation eases

January 9, 2024

This report does not constitute a rating action.



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What's changed?

Cost inflation has eased. Shipping containers, energy, and other costs are dramatically lower. Wage growth is slowing gradually. Suppliers have passed forward most if not all pricing.

Focus will remain on inventories. Issuers will reduce excess inventory by limiting replenishment orders and promoting aggressively.

Consumers are increasingly cautious. Consumers across all income demographics are showing signs of fatigue, deferring discretionary spending and trading down. Bargain hunting is back.

What are the key assumptions for 2024?

Household budget pressures will increase, dampening consumer spending. Mortgage interest is up, excess savings are almost depleted, and in the U.S., student loans payments are due.

Elevated spend on experiences still rankles retailers. Consumers will continue to seek experiences, leaving less to spend on apparel, durables, and the home.

Softening demand will make it difficult to absorb fixed costs. Unlike input costs, labor and leases continue to be high and retailers will find it challenging to fully pass on these costs.

What are the key risks around the baseline?

Higher-than-expected unemployment causes more significant pullback in consumer spending. Consumers will pull back further if they lose confidence in future income.

Retailers must resort to promotions to clear inventory. Pressure on sales volumes could lead to excessive promotions and discounting to manage inventories, with profitability taking a hit.

Real rates remain elevated, increasing the risk of refinancings. Companies need to refinance meaningful maturities in 2025 and beyond and service the debt at markedly higher rates.

Ratings Trends: Retail and Restaurants

Chart 1

Ratings distribution

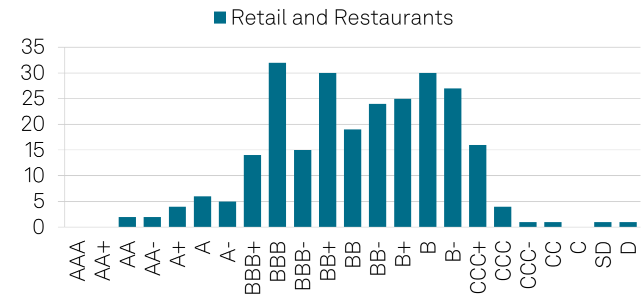


Chart 2

Ratings distribution by region

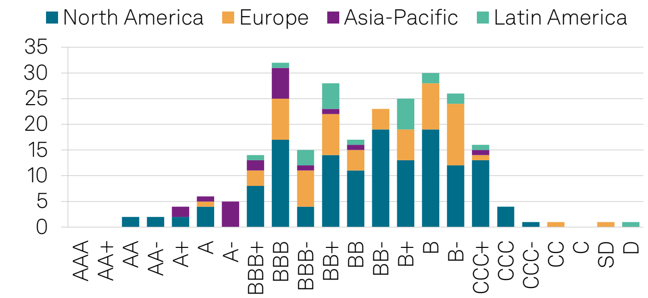


Chart 3

Ratings outlooks

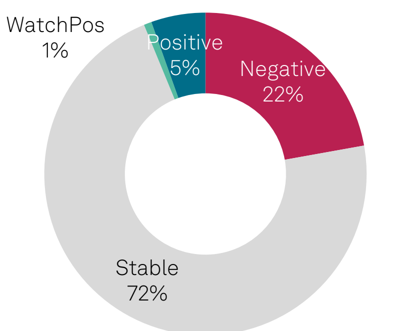


Chart 4

Ratings outlooks by region

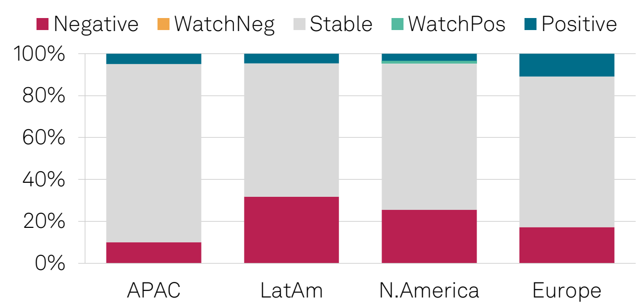


Chart 5

Ratings outlook net bias

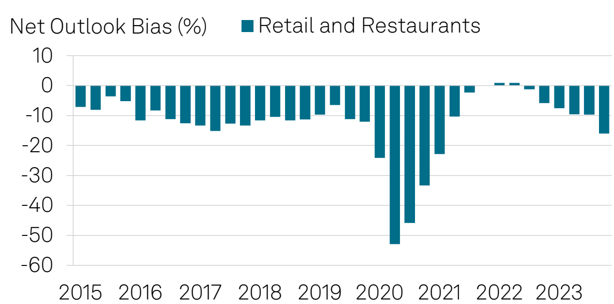
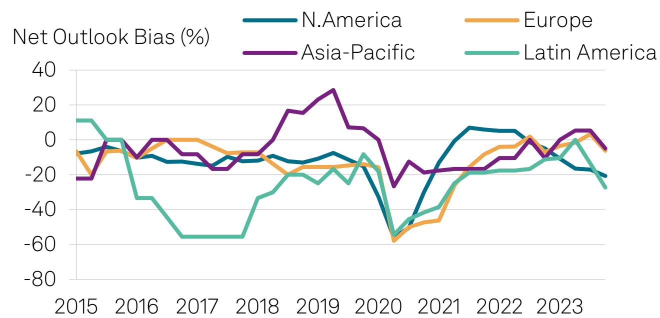


Chart 6

Ratings net outlook bias by region



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

Industry Outlook

Ratings trends and outlook

North America

In the U.S., we expect rating trends will remain on a negative trajectory due to slowing consumer spending. Despite resilience in 2023, several factors are increasing financial pressure on households, including multiple years of high inflation, depleted excess savings, reinstated student loan obligations, and higher interest rates. The savings rate in the U.S. is now below pre-pandemic levels while credit card delinquencies are now higher than in 2019. Still, the labor market remains strong and as long as consumers are confident in their future income, they will be willing to spend, even if they have to fund it with costly debt.

Consumers are being choosy with how they spend discretionary income and continue to prioritize experiences such as travel and entertainment. We expect relatively flat top lines for retailers exposed to discretionary spending and low- to mid-single-digit growth (largely dependent on prices) for those that sell nondiscretionary goods like grocers.

Well-functioning supply chains have enabled retailers to regain control of their inventories. Lower costs in transportation, shipping, and logistics combined with a return to low-single-digit price increases from suppliers will help margins. Disciplined inventory management will be tantamount to a successful 2024. Promotional activity will inevitably increase as a tool to attract consumers. Retailers that can limit excess inventory will be better positioned to avoid competitive pricing pressures. Product margin alone will not ensure good profitability.

Still-high labor and other fixed costs will be difficult to absorb with weaker revenues, pressuring operating margins. We expect retailers to be focused on costs in 2024. Hiring pauses and layoffs were announced by multiple retailers, including Amazon, Walmart, Gap, and CVS, in corporate and/or customer-facing roles in 2023.

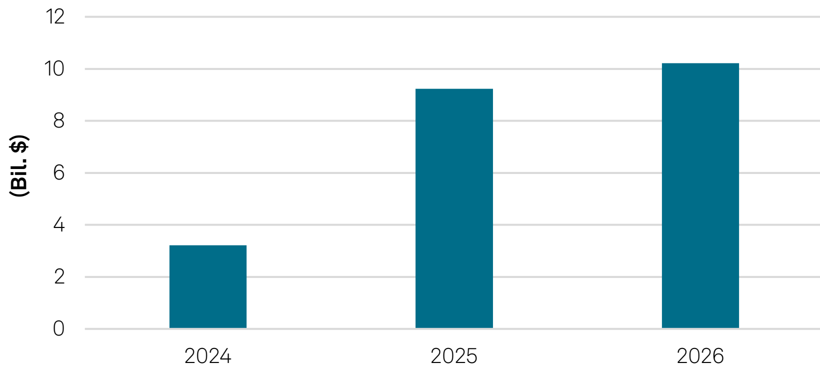
In the U.S., negative rating actions outnumbered positive by nearly two-to-one in 2023. Heading into 2024, more than one quarter of ratings have a negative outlook while only 4% have a positive outlook or are on CreditWatch with positive implications. The highest negative outlook bias is in the subsectors most exposed to discretionary spending. One-in-three ratings in apparel, department stores, and specialty retail have negative outlooks. The majority of rating actions were on speculative-grade issuers, which we expect to continue. Only one in 10 issuers with investment-grade ratings have a negative outlook, reflecting the relative stability of these companies due to their relative scale, market position, and financial flexibility.

In addition to navigating a challenging operating environment in 2024, retailers will focus on the capital debt markets, especially those with nearing maturities and floating-rate debt. Most retailers took advantage of receptive markets in 2020 and 2021, pushing maturities out several years. However, balance sheets designed for a low-rate environment may topple issuers in a high-rate environment. If rates remain high, issuers with the capacity may use cash on hand to redeem maturities to keep interest expense manageable. Those who are unable could be challenged to maintain credit metrics.

Speculative-grade issuers are most exposed because they have more floating-rate debt and less financial flexibility to absorb heavier interest burdens. In 2024, a handful of issuers may be challenged to address upcoming maturities, including Belk Inc. The number of U.S. speculative-grade retailers with maturities grows dramatically in 2025, when about $10 billion matures across about 20 issuers, and remains elevated in 2026 (see chart 7).

Chart 7

U.S. retail speculative-grade maturities



Source: S&P Global Ratings.

The year ends with 18 U.S. issuers rated in the 'CCC' category, more than double the number of credits in this rating category going into the year. Eight issuers defaulted at least once, resulting in a default rate of around 7% in 2023, similar to the pre-pandemic default rate and a dramatic uptick from the extremely low rate of around 2% in 2021 and 2022. S&P Global Ratings considers distressed exchanges as tantamount to default. Only two of the defaults in 2023 were due to chapter 11 filings, with the rest being debt exchanges or restructurings. Given the uncertain outlook for consumer spending and potential challenges to refinancing high debt levels in 2023, we expect the default rate to remain in the mid-to-high single digits in 2024.

In Canada, consumers are increasingly tightening their wallets due to multi-year high inflation, rising interest rates, and lower savings. Similar to the U.S., we are already seeing consumers pulling back on discretionary spending (e.g., at Canadian Tire Corp. Ltd.) and expect flat revenue for 2024 for retailers that sell discretionary products. As consumers continue to spend on essentials (groceries) and seek value (e.g., at Dollarama Inc.), we expect low- to mid-single-digit revenue growth for retailers in these categories. We also expect margins to face headwinds, as companies' ability to pass on cost diminishes. Even though discounting and promotions have increased in Canada, we expect companies to be more rational given market position. As corporates will be limited in passing higher costs (labor, rent) to consumers, we expect them to focus more on operational and cost efficiencies.

Europe

A soft landing of the European economy remains the most likely scenario over the near term, with real incomes set to rise because of disinflation and resilient labor markets. The pickup in real disposable income will boost consumption and support the European retail sector.

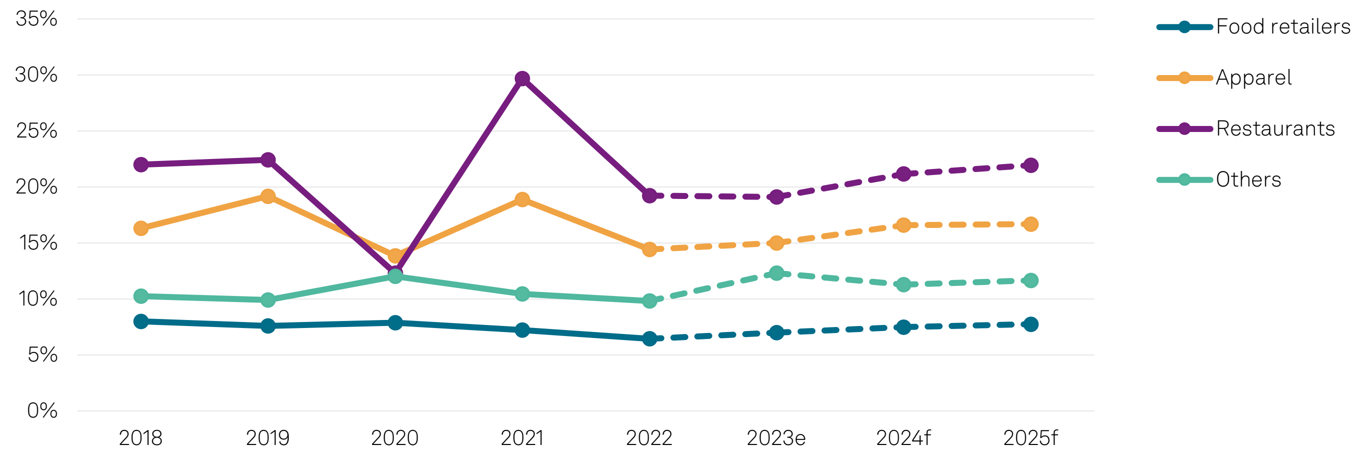
Overall, we forecast moderate top-line growth and better operating performance in 2024 but broadly stable outlooks. While we see inflation rates moderating, slow economic growth, elevated wage bills and interest payments, and an extremely competitive retail landscape will prevent a meaningful improvement in European retailers' margins and cash flows over 2024 and 2025, curtailing their rating headroom (see chart 8).

In Europe, upgrades outnumbered downgrades in 2023 as consumers have been quite resilient. Declining inflation and strong labor markets have supported spending. This also reflects retailers' stronger operating performance on the back of successful price pass-through to the end consumer, with only a moderate impact on trading volumes, as well as improved cost control and tight management of operating expenses.

Chart 8

Median adjusted EBITDA margins of European retailers

Recovery trends are uneven and varied by sub-sector



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

Larger food retailers with a strong local market presence and diversified operations, such as Ahold Delhaize and Marks & Spencer's, have executed well, resulting in upgrades. The recovery in global travel retail and the successful execution of the merger between Autogrill and Dufry led to an upgrade for Avolta. As consumers become more price conscious, value retailers such as B&M European Value Retail S.A. and Action Holding B.V. have shown strong operating results, which have led to upgrades. The downgrades in Europe were mainly on speculative-grade discretionary retailers and restaurants.

Given various uncertainties, management teams have adopted a prudent stance toward financial policies and have managed liquidity proactively. All rated retail and restaurant companies in Europe except one have adequate liquidity. Barring a handful of companies rated 'B-' and below, we see limited near-term refinancing pressure for most of the rated portfolio, and a sound ability to bear the additional interest burden. The share of negative outlooks in Europe is around 15 % and these are mainly concentrated among speculative-grade ratings. As is natural with prolonged cost headwinds and higher interest rates, most companies have tight headroom under our downgrade thresholds, especially for EBITDA margin, free operating cash flow (FOCF) after leases, and EBITDAR coverage.

Asia-Pacific

In China, we expect retail sales to slow to around 4.2% in 2024, from 5.8% in 2023. Consumer sentiment in China is weak, largely underpinned by elevated unemployment and low wage growth, which are causing consumers to pull back spending. Inflation remains low, with deflation appearing for some discretionary categories. Consumers continue to trade down, but there is still some demand for luxury goods.

Consumers are shying away from big-ticket items (anything property related, new cars, white goods, etc.) and are becoming more cautious in their discretionary and luxury purchases. Demand for smaller ticket premium items is holding relatively well. Retailers are increasing their promotional activities in an effort to stimulate purchasing. Given the weaker spending appetite, corporates are focusing on optimizing the cost base. Many issuers are cutting expenses and expansion plans to shore up margins. This dynamic in China is limiting the consumption boost that Asia-Pacific domestic economies need at a time when growth is scarce.

The retail environment is evolving quite rapidly in China, particularly in the online channel, which is becoming more diverse and complex. Online penetration for physical goods is set to grow in 2024. Consumer companies are relying more on online channels to reach their customers. Within the online channel, traditional e-commerce is facing competition from live streaming, short-form videos (about 20% of the online channel and growing), instant retail (about 3% of the online channel, with an expected compound annual growth rate of 50% in the next few years), and community group, a type of marketplace. Buying and growth that took off during the pandemic has paused.

In Japan, domestic consumption will slow gradually in 2024. The government lifted pandemic-related restrictions in early 2023, helping consumption to recover. That said, consumer sentiment is still weak largely because of rising prices of everyday items and utility costs. Headline inflation rose to around 3%-4% in 2023, hitting a 40-year high and curbing consumers' appetite for spending. We expect consumers to remain sensitive to prices, which can accelerate the trend of trading down. Retailers are working on merchandizing in response to consumer behavior, including development of private label products, and revamp of sales floor as well as store networks.

We expect price competition to pressure top lines. An increase in operational costs, including labor costs, will pressure profits for retailers. The government will continue to encourage businesses to raise wages, in our view. Cost-saving initiatives may mitigate pressure on earnings for some retailers. Incremental consumption coming from increasing foreign tourists will support some retail subsectors. Growing mobility within the region, together with weaker Japanese yen, will likely boost inbound tourism. Spending by foreign travelers account for nearly 10% of department stores' sales. This is despite the fact that the number of Chinese visitors to Japan, who boosted spending before COVID-19, is less than half of what it was before the pandemic.

In Australia and New Zealand, very low unemployment and savings accumulated during the pandemic have helped consumers cope with the broad-based inflation. However, there are clear signs that consumers are increasingly tightening their belts under the weight of persistent cost of living pressures. Uncertainty remains where consumers may begin to pull back, but we expect more discretionary based retailers are going to be affected first--as cautious consumers become increasingly more deliberate about their purchases.

As a result, corporate issuers' ability to continue passing on higher input costs to consumers to protect or conserve margins will diminish. Corporates will be competing for diminishing disposable incomes, which will likely lead to more discounting and other promotional activity. While corporates try to cope with changing consumer trends, they are also grappling with rising wages, higher rents, energy, transportation, and technology costs. To offset higher overhead expenses, we expect companies to sharpen their focus on operational and cost efficiencies. Corporates who possess solid market shares, pricing power, strong brands, low-cost structures, and balance sheet capacity are well positioned. We think these issuers may even see the current environment as an opportunity to take market share from weaker competitors.

Latin America

In Brazil and Chile, we expect some recovery for the retail sector in 2024 after a weak 2023. Domestic consumption levels have been falling for the past five quarters in both durable and nondurable goods. We believe a deceleration of inflation coupled with lower interest rates will support a consumption recovery even with sluggish economic growth. We think stronger consumption levels and lower inflation will help both the top line and margins, and thus facilitate some deleveraging.

Traditional retailers in Brazil and Chile have been facing increasing competition from pure e-commerce players and changing consumer preferences. During 2023, we downgraded Americanas to 'D' (default) as the company entered a judicial reorganization due to fraud. We also downgraded Magazine Luiza (brAA-/CreditWatch Negative/--) and Casas Bahia (brBBB-/Negative/--) on weaker operating and credit metrics. The negative outlooks reflect upcoming macroeconomic and competition challenges. In Chile, we downgraded Falabella (BB+/Negative/--) out of the investment-grade category. The negative outlook on the company reflects downside risks to our base case arising from a weaker economy, execution risks, and industry headwinds.

In Mexico, we expect a modest slowdown in consumption in 2024, after a surprisingly strong 2023, in line with our GDP growth expectations. For our rated portfolio, we expect revenue to grow around 8%-9% in 2024 with a slight EBITDA margin contraction of a few basis points. Although we anticipate continuity in a few factors that drove consumption in 2023, such as real wage growth and credit availability, a potential slowdown in the U.S. and a stronger Mexican peso could moderate the support from remittances.

General elections in both Mexico and the U.S. lead us to expect a less favorable environment for consumption in 2024, especially on discretionary goods and services. Retailers' need to enhance omnichannel capabilities will remain key to serve and attract customers, given the recent entrance of Chinese online retailers, which have gained popularity quickly, especially in soft-line categories. Additionally, we anticipate spending on dining out to slow, as it is commonly one of the first expenses consumers cut during downturns, while labor costs would continue rising above inflation levels. Hence, we believe restaurants will remain focused on efficiency and keeping a lean structure, with selective openings.

Main assumptions about 2024 and beyond

1. Demand will weaken as consumers tighten budgets.

Consumer spending will slow but not to recessionary levels. Retailers and restaurants will use promotions to entice consumers. Discounters and other retailers with value offerings will benefit as consumers continue to trade down.

2. Some costs will continue to ease, but lower volumes will weigh on margins.

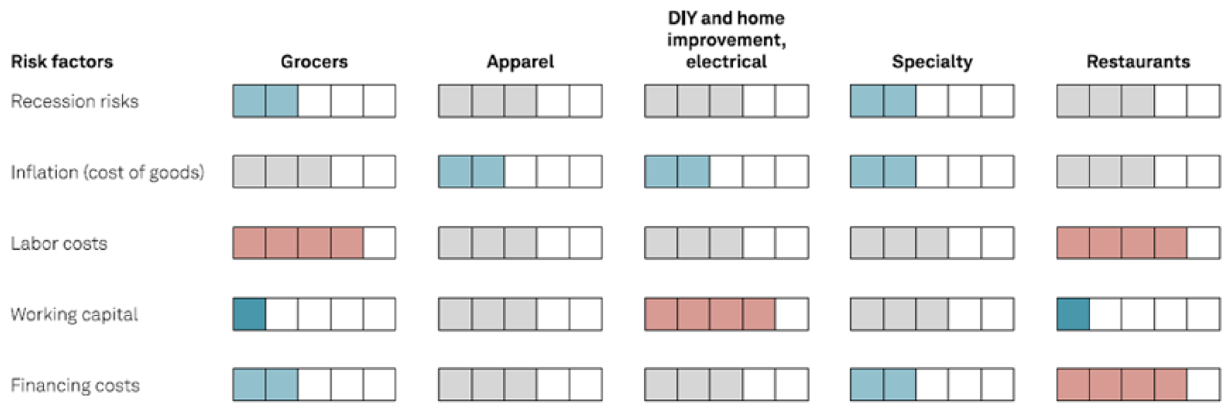
Lower commodity, shipping, freight, logistics, and warehousing costs will be a tailwind to gross margin. Investments in supply chains, including automation and inventory management, will reduce inefficiencies. We also think challenging labor markets are gradually easing, which will slow the rapid rise in wages and benefits that have pressured margins in the last two years. Still, weak demand will make it difficult to absorb overhead costs such as store footprints and corporate operations. We expect restructuring and reduction-in-force will be necessary for some retailers.

3. Limited surprises on financial policy, as the cost of debt will remain elevated.

The higher cost of debt will continue to drive balance sheet decisions, especially for issuers at the lower end of the rating spectrum, where cash flows will be meaningfully dented by the higher cost of capital. Higher interest rates will also dampen appetite for aggressive financial policies such as large transformative acquisitions or share buybacks.

Chart 9

The key risk factors that we incorporate into our base-case forecasts by subsector



Note: The five-point scale presents our materiality assessment of forward-looking risk factors, with the risk level increasing from left to right. Source: S&P Global Ratings.

Big box: Big box retailers, such as Walmart and Target, will continue to experience pressure in discretionary categories. However, these retailers should fare better than purely discretionary competitors due to their exposure to grocery and other everyday categories. In addition, their ability to effectively communicate and deliver value to consumers positions them well as consumers seek ways to stretch their budgets. We also expect these large brick-and-mortar retailers will continue to fend off pressure from Amazon by innovating omnichannel operations and use their stores as a competitive advantage.

Inventory and supply chain challenges crimped top line amid high inflation and consumer demand declined in 2022. This resulted in discounting in discretionary categories such as apparel that started some companies off on weaker footing for 2023. Most big box retailers have recovered from volatile supply chain and consumer demand, and we believe they are well positioned for continued softness ahead. In the uncertain environment, we do not expect large capex outlays, M&A, or share buybacks.

Specialty: We expect consumers will continue to seek out value next year, as they look to stretch their budgets amid slowing wage growth and ongoing price pressures. Demand for discretionary and higher-ticket product categories was pressured in 2023, and we expect it will remain weaker than other segments, as shoppers remain reluctant to splurge in the face of diminished savings and high financing costs. Soft demand in these categories, particularly consumer electronics and home furnishings, will likely necessitate ongoing promotional activity to spark demand.

Proactively managing inventory is essential to mitigate the need to offer deep discounts to clear merchandise. Product innovation could also stimulate sales growth, but given our outlook for higher unemployment and slowing income growth, we expect consumers will steer their spending to value-focused retailers and those specializing in needs-based and maintenance-related goods and services. Across both discretionary and nondiscretionary categories, we expect companies will lean into value offerings to capture trade-down as consumers remain price conscious.

Our 2024 sales forecast varies across the sector, but broadly, we expect moderate price increases and new store openings will drive sales growth. Similarly, EBITDA margin expectations vary, but we forecast slight margin improvement for the sector in 2024 as companies implement cost savings, primarily within SG&A, benefit from lower product and supply chain costs, and realize some sales leverage from top-line growth.

We expect specialty retailers focused on home categories, including decor, furnishings, improvement and flooring, will contend with soft, albeit stabilizing demand in 2024 as high household expenses weigh on discretionary spending and housing starts and turnover remain constrained by high mortgage rates. We forecast top-line growth ranging from flat to up low-single-digit percentages in 2024, following declines in 2023, and EBITDA margins improving slightly due to lower supply chain costs. These categories, which benefited significantly from pull-forward demand driven by the nesting trend during the pandemic, have struggled as consumers shift their share of wallet toward other product segments and experiences outside of the home.

We expect businesses with greater demand resiliency, including aftermarket auto parts and optical retailers, will have relatively steady operating performance in 2024. However, even within these less discretionary categories, risks remain if consumer health, particularly with lower and middle-income consumers, is pressured more than we expect, leading to higher levels of deferred purchases.

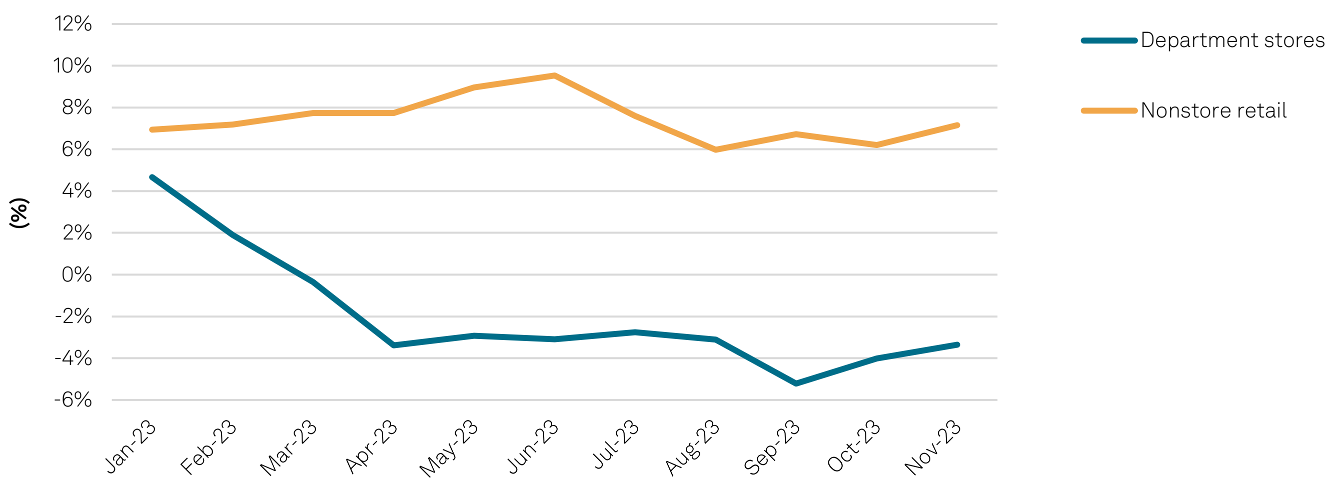
Specialty retail led the default rate within our rated coverage of U.S. retail and restaurant companies in 2023, accounting for 55% of defaults, and we believe there is a risk this trend could repeat in 2024. We rate roughly 12% of U.S. retail and restaurant companies in the 'CCC' category today, with specialty retailers representing 47% of the total. We expect companies with elevated leverage and high debt servicing costs that are facing a soft demand and high interest rate environment may engage in liability management to improve operational and financial flexibility. M&A transactions were sparse throughout the sector in 2023 (Tempur Sealy's acquisition of Mattress Firm should close in the second half of 2024) and we anticipate activity will remain light in 2024 given greater macroeconomic uncertainty and high financing costs.

Department stores: We expect department stores will continue to see dampened discretionary demand in 2024 as consumers grapple with inflation, slowing real wage growth, and higher interest rates (see chart 10). To offset volume and promotional pressure on the top line, department stores will stay focused on inventory discipline, which should support stable margins, positive free cash flow generation, and credit metrics that support the ratings. Still, risk of underperformance is high amid a soft macroeconomic environment.

Chart 10

Department store sales have been declining since March

U.S. retail sales growth, nonstore retail versus department stores



Data through Nov. 2023. Source: U.S. Census Bureau.

Two out of the five U.S. department stores we rate have negative outlooks. We believe results of the 2023 holiday season will be pivotal for these retailers because of high exposure to discretionary spending. Those that navigate successfully will still have a rocky road ahead as we expect consumer spending to remain tepid through 2025. As a result, we expect minimal M&A and modest share buybacks according to broader capital allocation and target leverage goals. For those with cash on hand, we expect 2024 maturities could be paid down to offset lower earnings and avoid higher interest rates. We also believe capital spending will be focused on remodels and minimal store growth, with further expectations for closings instead as department stores continue to find stable footing in the evolving retail space.

We expect the subsector will remain the object of investor and activist interest. Kohl's, Nordstrom, and most recently Macy's have received or been rumored to have received investor offers or pressure to engage in creative monetization of assets, most frequently real estate. In our view, the proposed transactions may change the capital structure for better or worse, but the fundamental business model and secular challenges to it would remain.

Apparel retail: Performance across specialty apparel retailers has been mixed. Our negative bias stems from exposure to enclosed malls, competition from new entrants, big box, and e-commerce, and difficult-to-anticipate consumer preferences. However, some apparel retailers improved their inventory position in 2023 and enter 2024 on better footing.

Gap notably reduced its inventory in each of the first three quarters of 2023 by at least 22% compared with the prior year period. While the company and its new CEO have work to do--particularly with the Banana Republic and Athleta brands--performance at its two largest brands, Gap and Old Navy, have shown promise recently, with near-flat comparable sales in the most recent quarter. As Gap continues to turn the corner, we expect it to build upon a 2023 reset year and grow comparable sales in 2024, with room for margin improvement in the year, despite coming off three consecutive quarters of 300-basis-point gross margin improvement year over year.

Abercrombie stood out in 2023 and outperformed the overall sector. Comparable sales grew in the teens in the second and third quarters of 2023, and its once-dormant Hollister brand has regained popularity, improving comparable sales in each of the first three quarters of the year. Meanwhile, Victoria's Secret & Co. continues to refine its position in the market after over-correcting its narrative coming out of the #MeToo movement.

In highly competitive markets like the U.K., larger national chains such as Marks and Spencer (BBB-/Stable/--) and Next PLC (BBB/Stable/--) with a good store footprint backed by a sound e-commerce offering and strong customer proposition outperformed smaller retailers. In our view, market consolidation in the apparel segment could take the form of larger players taking over smaller brands facing financial difficulties.

Spanish apparel retailer Tendam Brands S.A.U. (B+/Positive/--) posted resilient earnings thanks to its diversified portfolio of own brands and its third-party brand offering, which enables it to capture a large customer base. While Hugo Boss AG's (BBB/Stable/--) results point to a strong growth pattern with limited margin erosion, adverse working capital movement constrained the group’s cash generation. We expect H&M Hennes & Mauritz AB's (BBB/Stable/--) profitability to improve from lower input costs, including shipping, cotton, and foreign exchange rates, as well as benefits from its efficiency program.

Restaurants/pubs: We expect the environment will remain challenging for quick service restaurants in the U.S. in 2024 following industry-level traffic declines in 2023 due to the compounding impact of higher prices and difficult consumer conditions. Pricing should continue to ease next year, putting pressure on comparable sales growth. Expectation for moderating inflation should help margins in 2024, though pricing for some commodities, like beef, remain high. Our forecast for moderately higher unemployment should continue to pressure the lower income consumer, which caused lower traffic in the U.S.

Unit growth for franchisors should continue to be fueled by growth internationally, as it did in 2023. We expect to see continued outperformance at franchisors with a substantial international footprint like McDonalds, Yum! Brands, and Starbucks. Higher interest rates have translated to lower appetite for leverage, as issuing debt to fund share repurchases has been come less economical, and we expect that to continue next year as rates remain high.

Burger King France SAS' (BKF; B-/Stable/--) reliance on franchisees, allows for a greater degree of resilience against rising labor and other operating costs. This business model is margin accretive, especially during times of high inflation, when franchisees bear the increases in the cost structure and franchisors benefit from higher selling prices as royalties are indexed to revenues. This was evident from the very sharp rise in BKF's EBITDA margins to more than 35.8% in 2023 from 31.4% in 2019. Airport catering and restaurants operator Pax Midco (Areas) (B-/Stable/--) has made significant cost savings by rationalizing staff and undertaking some digitalization Initiatives, such as automated cashiers. In addition, travel restaurants can significantly increase prices without harming volumes due to the restricted choices for customers in airports or on motorways.

In the casual dining space, 2024 will be a period of normalization after the traffic declines and sharp price increases in 2023. Less promotional activity and a focus on value across casual dining will continue to put downward pressure on traffic. However, 2024 may see less pronounced traffic declines than in 2023. An emphasis on more sustainable traffic growth will continue to benefit margins. A source of margin support in 2024 will be labor. Turnover and retention improved in 2023, a trend we expect to continue in 2024 as unemployment rises. This leads us to view 2024 as a low- to mid-single-digit comparable-sales growth year, coupled with profit margin expansion.

Grocery: As grocery inflation continues to subside, we expect industry sales to be flat, continuing the trend seen in 2023 of slowing sales. Disinflation will also challenge industry margins in 2024. As shoppers contend with 20% higher average food at home prices compared to April 2021 (according to the U.S. Bureau of Labor Statistics), unit growth should be muted, though share gains from private label will benefit margins. We expect improved labor retention and higher unemployment in 2024 to hold wages steady (after wages grew in 2023).

Contrary to U.S. grocers, Canadian food retailers reported mid-single-digit same-store sales growth as of third quarter of calendar year 2023. The growth is largely because of their competitive advantage and sustained momentum in the discount banners as consumers continue to trade down and focus on value offerings. As such, we forecast grocers will maintain a mid-single-digit same-store sales growth through 2024. Even though food margins show some weakness, consolidated margins have held steady due to the Canadian grocers' well-integrated high margin pharmacy segment. Furthermore, continued private-label penetration, targeted promotions, and cost-cutting initiatives (including automation) should help sustain EBITDA and margins through 2024.

With an unfavorable interest rate environment, 2023 M&A activity was limited, with Aldi's acquisition of SEG as the most recent notable tie-up. All eyes will be on the year-plus-long pending acquisition of Albertsons by Kroger this year, and the related purchase of more than 400 of the combined company's units by C&S. Signs point to an early 2024 transaction close, with Kroger certifying "substantial compliance" with its second request for information on Nov. 15. The FTC has until Jan. 17, 2024, to accept or attempt to block the transaction, in line with an agreement with the companies.

In Europe, the grocery retail sector remains extremely price competitive. The incumbent mainstream retailers have significant competition from discounters in all the major European markets. While we expect smaller average basket sizes, the nondiscretionary nature of grocery purchases will lead customers to make more frequent grocery runs.

We also expect more consumers to switch to private labels, especially for packaged food and household goods. The high penetration of private labels in Europe--now making up 38% of total fast-moving consumer goods sales, as per Circana--means European retailers are in a good position to target trade-down shoppers, build customer loyalty, and defend their top lines and gross margins.

Many of the large investment-grade companies and national leaders like Tesco PLC (BBB-/Stable/A-3), Carrefour S.A., (BBB/Stable/A-2), and Koninklijke Ahold Delhaize N.V. (BBB+/Stable/A-2), have significantly improved their ability to generate FOCF and have seen a significant improvement in their credit metrics as a result, despite paying out higher dividends and returning surplus cash to shareholders through share buybacks.

In the highly competitive French market, the ongoing financial restructuring of Casino Guichard-Perrachon is offering some opportunities for the other market players to increase their store footprint. ELO's (BBB-/Negative/A-3) subsidiary, Auchan Retail, and French retail group Les Mousquetaires announced they were in exclusive discussions to acquire 313 hypermarkets and supermarkets from the defaulted group Casino Guichard Perrachon. The transaction is subject to a binding agreement between the parties, which is expected to be signed in the first quarter of 2024, as well as the completion of Casino's financial restructuring and the approval by France's competition authorities.

Credit metrics and financial policy

We expect issuers to adhere to prudent financial policies in the uncertain macroeconomic environment of 2024, pausing share buybacks and conserving capital in order to maintain credit measures. With a persistently higher cost of debt, a ramp-up in maturities, and slowing economic activity in the cards for 2024, the focus comes back to credit fundamentals and liquidity analysis. Liquidity and covenant concerns were relatively rare in 2023 due to balance sheets that had been optimized in 2021. In 2024, higher interest rates will make refinancing and any other necessary negotiations costly.

Until the outlook becomes more positive, which may not materialize until 2025, we expect M&A to be muted and share buybacks to be relatively modest. In Europe we anticipate share buyback activity will be mainly limited to large food retailers with strong FOCF generation like Carrefour, Tesco, and Ahold-Delhaize. In our downside scenario, we see reduced rating headroom if companies return to expansive financial policies and shareholder-friendly activity before a sustainable recovery in credit metrics.

Key risks or opportunities around the baseline

1. Consumer resilience continues to surprise.

With the labor market remaining strong, consumers could surprise us again with solid spending through 2024. If positive momentum continues broadly, growth could return to pockets that have been weak in 2023, such as apparel, specialty, and department stores. In Europe, notwithstanding higher mortgage costs in countries exposed to variable rates, we anticipate consumers will support growth.

2. Inflation is reignited.

In the U.S., we expect core inflation to approach the Fed's target of 2% by mid-2024. However, erosion of consumers' purchasing power would lead to lower confidence and spending among households.

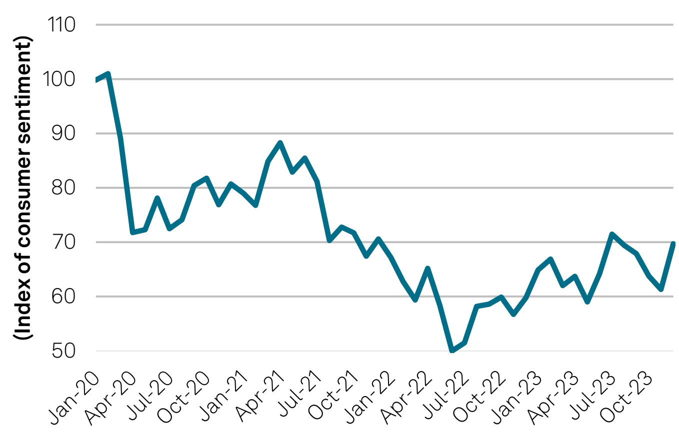
3. Leveraged credits may struggle with tight financing conditions and the high cost of debt.

We expect further credit deterioration in 2024, continuing the diverging trends of resilience at the investment-grade level and downgrades largely at the lower end of the ratings scale.

Consumer resilience continues to surprise. With the labor market remaining strong, consumers could surprise us again with solid spending through 2024. Through November 2023, U.S. retail sales remained solid overall. Consumer sentiment jumped 14% in December from its November level, driven by lower inflation expectations (see chart 11). In addition, holiday sales appear to be better than expected, and will perhaps outperform our forecast of 3.5% growth. If positive momentum continues broadly, growth could return to pockets that have been weak in 2023, such as apparel, specialty, and department stores.

Chart 11

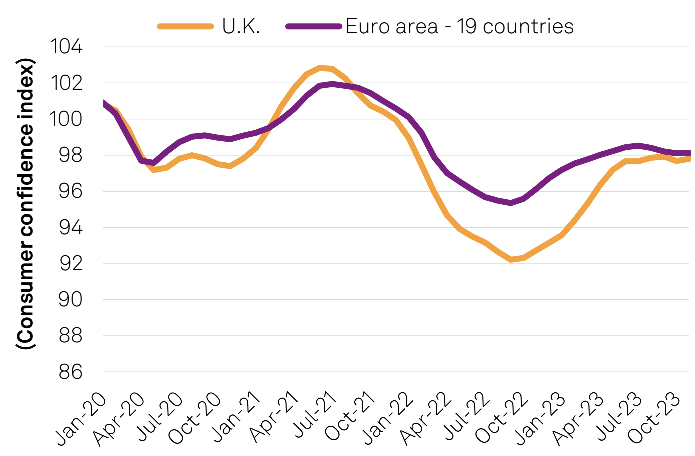
U.S. consumer sentiment rebounded in end 2023



Data through Dec. 2023. Source: University of Michigan.

Chart 12

European consumer confidence also on the mend



Data through Nov. 2023. Source: OECD.

In Europe, notwithstanding higher mortgage costs in countries exposed to variable rates, we anticipate the consumer will provide support to growth next year as real disposable incomes rise on the back of relatively high wage growth and disinflation (see chart 12).

Inflation is reignited. Retailers and their suppliers have gotten through the worst of the inflation. In the U.S., we expect core inflation to approach the Fed's target of 2% by mid-2024. However, if energy prices return to higher levels due to escalating geopolitical conflicts and slow down the disinflationary momentum, a tighter-than-expected monetary stance could hold interest rates high, slowing the economy more. Erosion of consumers' purchasing power leads to a lower confidence and spending among households.

Leveraged credits may struggle with tight financing and high debt costs. On a slowing economy and the high cost of debt, we expect further credit deterioration in 2024, continuing the diverging trends of resilience at the investment-grade level and downgrades largely at the lower end of the ratings scale. Many lower-rated borrowers will be forced to refinance at much higher rates than in previous years, and this would further strain cash flows, given that many rated companies in the retail and restaurant sector exhibit a high level of sensitivity to a drop in growth.

Related Research

- U.S. Holiday 2023 Sales Outlook: Retailers' Wishlist; Consumers Say Bah Humbug, Nov. 21, 2023
- European Retailers' Margins Are Unlikely To Regain Their Pre-Pandemic Strength, Nov. 7, 2023
- Scenario Analysis: Will Lower EBITDA Recovery Leave U.K. Pub Corporate Securitizations In The Cellar?, Sept. 18, 2023
- Crime, No Punishment: Theft Poses Risk To U.S. Retailers This Holiday Season, Sept. 13, 2023
- Credit FAQ: Hot Retail And Restaurant Topics In A Cooling Economy, June 1, 2023
- Credit FAQ: Where Does The Kroger, Albertsons Merger Stand?, May 31, 2023
- Personal Luxury Goods' Allure Endures As New Challenges Beckon, March 2, 2023

Industry Forecasts: Retail and Restaurants

Chart 13
Revenue growth (local currency)

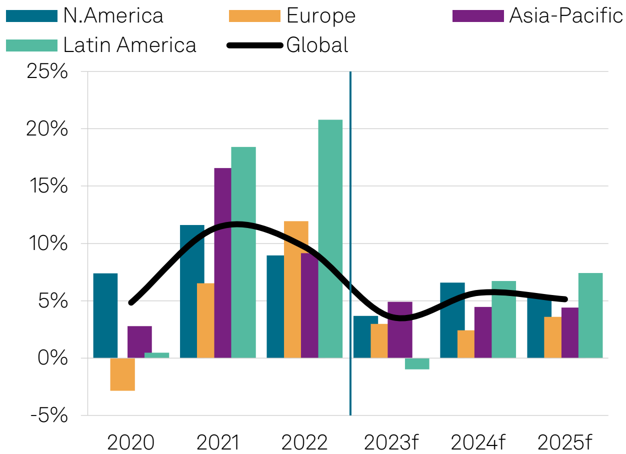


Chart 14
EBITDA margin (adjusted)

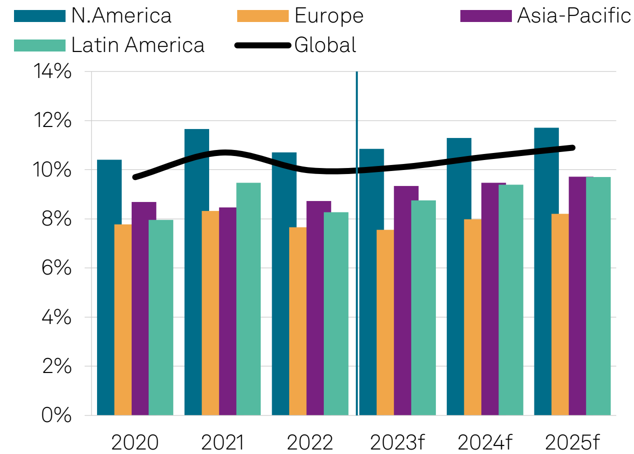


Chart 15
Debt / EBITDA (median, adjusted)

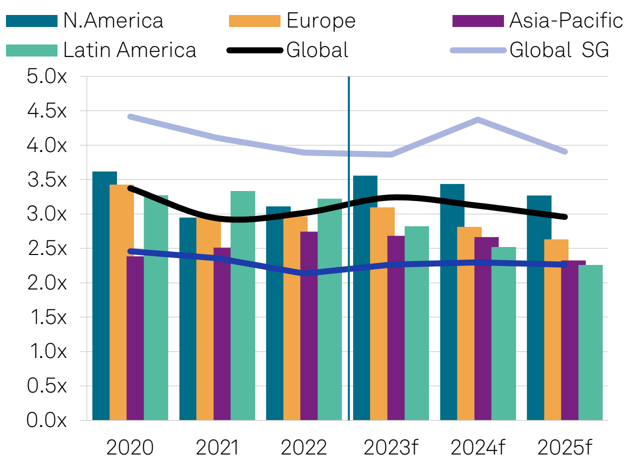
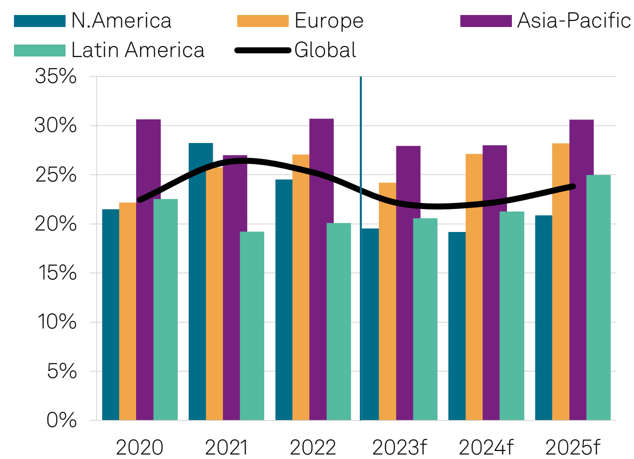


Chart 16
FFO / Debt (median, adjusted)



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: Retail and Restaurants

Chart 17

Cash flow and primary uses

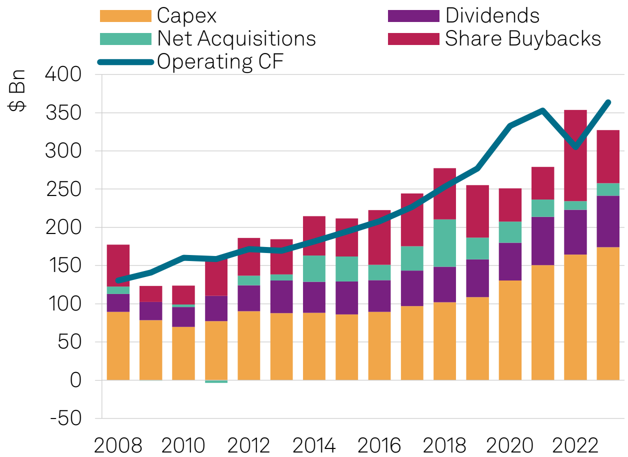


Chart 18

Return on capital employed

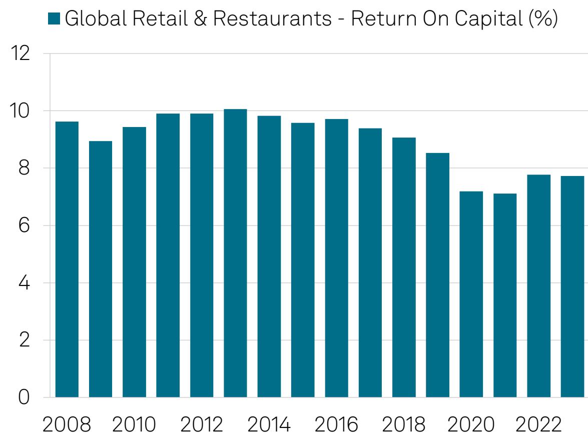


Chart 19

Fixed- versus variable-rate exposure

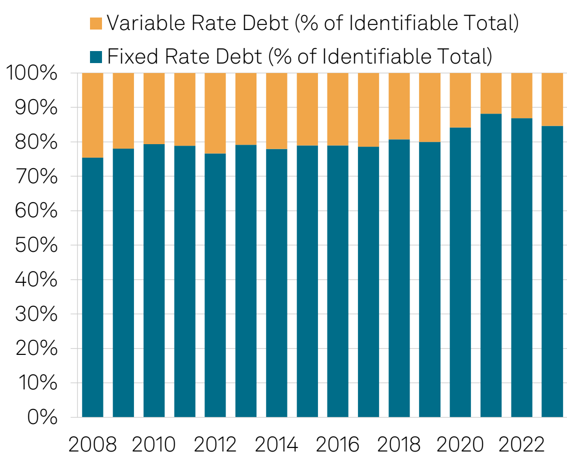


Chart 20

Long-term debt term structure

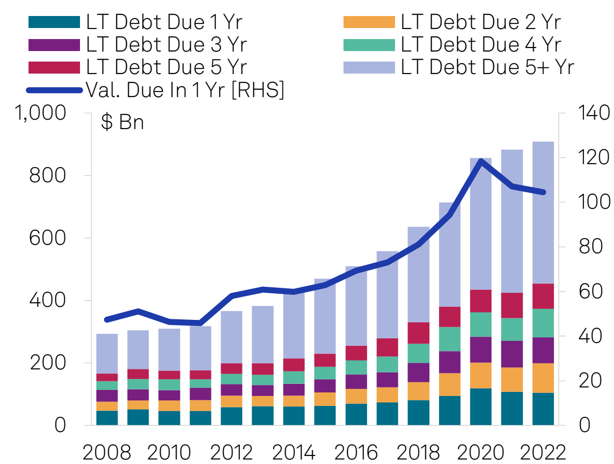


Chart 21

Cash and equivalents / Total assets

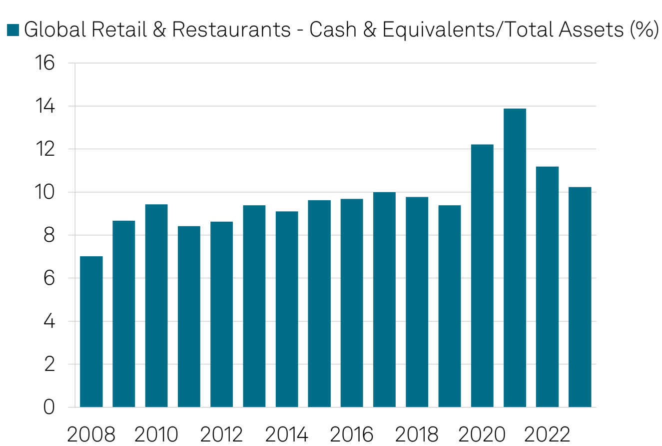
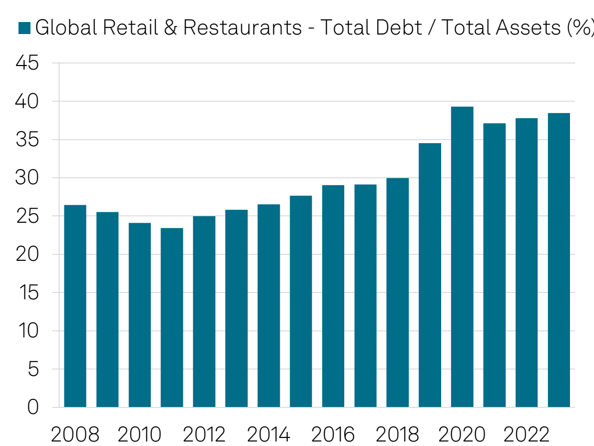


Chart 22

Total debt / Total assets



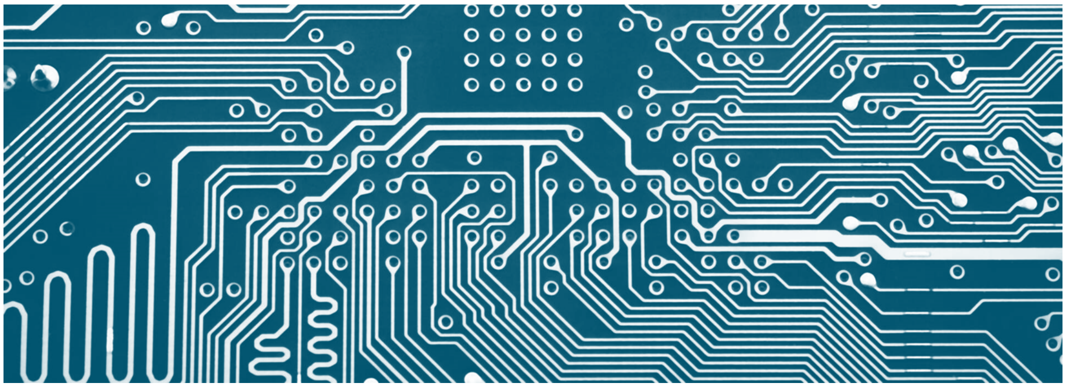
Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2023) figures use the last 12 months' data.

Technology

Technology remains resilient but ratings pressure continues

January 9, 2024

This report does not constitute a rating action.



What's changed?

IT spending will rebound in 2024. We forecast information technology (IT) spending will rebound to 8% in 2024, up from 4% in 2023 and well above global GDP growth. We expect PCs, smartphones, and servers will return to growth, thereby improving the outlook for the semiconductor industry. Software will again grow by about 10%, while IT services remain healthy.

What are the key assumptions for 2024?

Semiconductor industry will grow near mid-teens percent. After falling nearly 10% in 2023, the semiconductor industry is poised for a strong rebound in 2024 as memory fundamentals improve and the artificial intelligence (AI) investment cycle generates strong growth for some issuers, offsetting muted demand across the rest of the market.

Lower-rated issuers will remain pressured. We took many negative rating actions across the speculative-grade landscape in 2023. However, if borrowing costs remain elevated, refinancing risk will grow, potentially leading to an increase in debt restructuring and default activities.

What are the key risks around the baseline?

China. Supply chain diversification may lead to lower profit margins, but rising U.S.-China tensions may prove more difficult to navigate for manufacturers.

Higher interest rates. Trajectory of borrowing cost and business conditions remain key focus areas for issuers rated 'B-' or lower.

Mergers and acquisitions. We believe there is pent-up demand for deal making after two quiet years. An end to the rate hikes removes some uncertainties and will likely improve merger and acquisition (M&A) activity through 2024.

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Ratings Trends: Technology

Chart 1

Ratings distribution

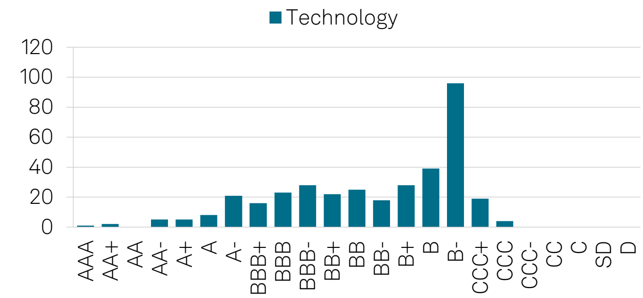


Chart 2

Ratings distribution by region

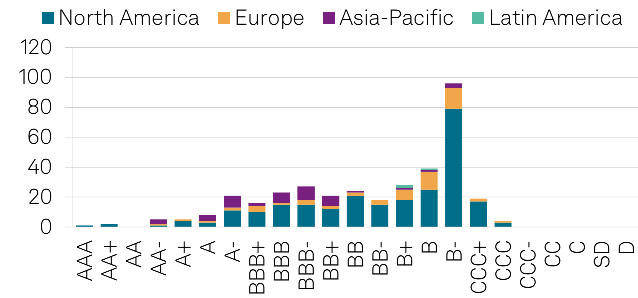


Chart 3

Ratings outlooks

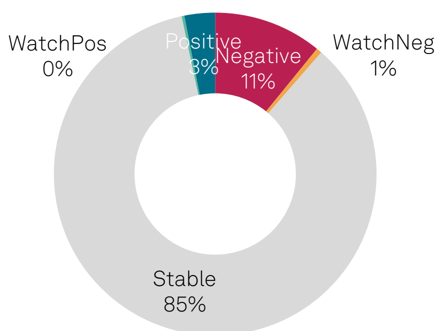


Chart 4

Ratings outlooks by region

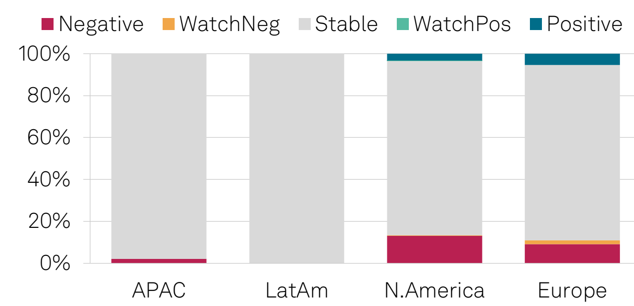


Chart 5

Ratings outlook net bias

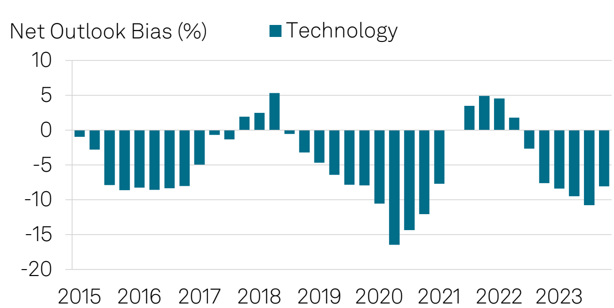
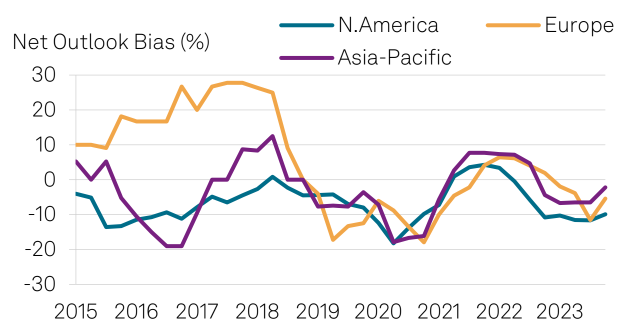


Chart 6

Ratings net outlook bias by region



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

Industry Outlook

Ratings trends and outlook

Global technology rating actions remained negative throughout 2023, continuing the trend that began in the spring of 2022 triggered by the Russia-Ukraine conflict. Although the recessions previously expected in the U.S. and Europe did not materialize, 14% of global tech issuers have negative rating outlooks, the same as at the end of 2022, while only 3% of ratings have positive outlooks, lower than the 5% seen a year ago.

Downgrades were most pronounced in the 'B' category as interest rates continued to rise through mid-2023 and remain elevated. Our base-case scenario forecasts that rates have peaked but, despite expectations for some rate cuts in the coming year, will remain elevated in 2024; therefore, we don't see much relief in store for those tech issuers with significant variable-rate debt outstanding. We will also monitor tech issuers with refinancing needs over the next year or two because repricing and refinancing risks will likely grow if debt financing costs remain elevated. Despite the negative rating actions taken through 2023, we believe rating trends will continue to lean negative in 2024.

Main assumptions about 2024 and beyond

1. IT growth will accelerate despite macroeconomic uncertainties.

We forecast IT spending growth will accelerate to around 8% in 2024, supported by a turnaround across the hardware segments including PCs, smartphones, and servers, which will also cascade to a strong semiconductor recovery. Software sales will remain resilient while IT services will grow meaningfully, partly due to ever-growing public cloud infrastructure spending.

2. Semiconductor industry is poised to recover.

After a 10% decline in 2023, total semiconductor revenue should rise 14% in 2024, led by a 40% recovery in memory, continued strong demand for AI chips, and the stabilization of the PC, smartphone, and general-purpose data center markets. We believe analog chip sales will remain weak in 2024 and microcontrollers sales are starting to deteriorate because of industrial market weakness and inventory digestion.

3. Focus remains on lower-rated issuers as ratings bias continue to trend negative.

Investment-grade issuers have healthy balance sheets and strong cash flow generation to support their growth and shareholder-return initiatives while preserving current ratings. However, while many 'B' or lower-rated issuers do not face immediate refinancing needs, we believe repricing and refinancing risks will grow if debt-financing costs remain elevated, potentially leading to a pick-up in debt restructuring and default activities.

IT growth will accelerate despite macroeconomic uncertainties. Global macroeconomic and geopolitical uncertainties, lingering impact from supply chain issues, and rising inflation suppressed both enterprise and consumer spending through 2023. We expect hyperscale cloud services will grow more than 20% as enterprise customers continue their migration to the cloud, keeping overall IT services segment growth above mid-single digits (see table 1). Software sales were mostly resistant to macroeconomic concerns and grew in the low-teens percent again, reflecting the power of the recurring subscription model--although growth rates among smaller software providers were much lower. The PC and smartphone industries struggled for a second year in a row, with shipments falling an estimated 13% and 4%, respectively, in 2023 as pandemic-related pull-forward demand hurt sales and the aftermath of supply chain disruptions and rising inflation reduced household purchasing power and consumer confidence.

Coupled with weak demand across storage and server markets reflecting overall muted enterprise IT budgets, the semiconductor industry endured a severe downturn with memory revenues plummeting between 25%-30% and the rest of the industry declining near 5%. In all, we estimate global IT spending grew near 4% on a constant currency basis in 2023, materially weaker than the estimated nominal global GDP growth near 7% (real GDP growth was near 3.3%).

Our global GDP growth forecast for 2024 is 2.8% (nominal growth near 6%), reflecting the ongoing macroeconomic and geopolitical uncertainties. Major central banks (excluding Japan) have raised policy rates by about 400 basis points (bps)-500 bps since the first half of 2022 to slow inflation. The effort to curb inflation appears to be succeeding, but macroeconomic performance has varied widely.

The U.S. economy continues to outperform prior expectations, posting nearly 5% annualized growth in the third quarter of 2023, led by strong consumer spending and an inventory rebuild, but we forecast a much weaker GDP growth of 1.5% in 2024. Europe activity has flatlined in recent quarters, and we expect only a modest recovery in 2024 at just 0.8% growth.

China's growth has stabilized, reflecting targeted government stimulus. However, household confidence remains weak, and the property sector remains under stress. We forecast a slowdown to just 4.6% GDP growth in 2024. Inflation and policy rates have likely peaked, but interest rates may take longer to decline given caution among developed-market central banks in cutting rates too soon. We note the uncertainties around the transmission of cumulative rate hikes to financial conditions and the real economy, which will erode consumer confidence and keep enterprise spending subdued.

Table 1

Global IT growth forecasts

	2022	2023e	2024e
Macro			
Global GDP growth (real)	3.6%	3.3%	2.8%
U.S. GDP growth	1.9%	2.4%	1.5%
Eurozone GDP growth	3.5%	0.6%	0.8%
China GDP growth	3.0%	5.4%	4.6%
Global IT spending (nominal)	**6.1%**	**3.9%**	**7.9%**
Revenues			
IT services	6.0%	6.0%	7.0%
Software	8.8%	12.0%	11.0%
Semiconductors	3.3%	(10.0%)	14.0%
Network equipment	5.0%	7.0%	(3.0%)
Mobile telecom equipment	5.0%	(3.0%)	(2.0%)
External storage	7.2%	(2.0%)	5.0%
Shipments			
PC	(16.2%)	(13.0%)	4.0%
Smartphone	(11.3%)	(4.0%)	3.0%
Server	5.0%	(7.0%)	6.0%
Printer	(3.3%)	(3.0%)	(3.0%)

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

Despite macroeconomic headwinds, we forecast global IT spending will grow a robust 8% in 2024, which is higher than in 2023 (near 4%), and greater than our expectations for global GDP growth (nominal) in 2024 near 6%. Enterprises are entering 2024 with a still-cautious view given the muted macroeconomic expectations, delaying some noncritical, long-term projects while continuing their transition to the cloud and ramping up their investments in nascent generative AI projects.

We believe hyperscalers will continue to generate significant revenue growth near 20% in 2024, reaching around $250 billion in revenues, and contribute to an overall strong IT services growth near 7%. Software segment will continue to outpace the overall IT industry, growing around 11% with many investment-grade issuers growing well in excess of this figure. We believe the continued strong growth among software vendors validates their strategy of providing productivity gains and lowering customers' operational costs.

Importantly, we believe hardware spending will improve materially in 2024, with PC and smartphone shipments growing for the first time since 2021 and solid growth across both servers and storage segments. In turn, we expect the semiconductor industry to rebound from its cyclical declines in 2024. We believe the memory industry is nearing the trough and will see improvements through 2024, growing 40% overall after a dismal 2023. Solid growth among logic providers, including forecasted 45% growth at NVIDIA Corp., will more than offset expected declines in the analog market.

As in the past, we view China as the wild card; it accounts for about 10% of the worldwide IT spending but plays an outsized role in the credit-sensitive hardware and semiconductor space, accounting for around 20% of global consumption. Further deterioration in its relationship with U.S. or Taiwan, or interruption to the global supply chain given its role as a dominant manufacturer, will have a disproportionate impact on overall global IT consumption.

Despite a challenging 2023, we maintain a positive long-term view of the technology industry. We think pockets of volatility within hardware and semiconductor segments are here to stay. Issuers that outsource manufacturing in geopolitically sensitive regions face the tail risk of significant supply chain disruptions. At the same time, we believe the technology sector will become less cyclical as it matures. IDC Corp. estimates that as-a-service now makes up over 40% of enterprise technology spending and that it will increase to over 50% by 2025. This spending is sticky, recurring, and less prone to shutting down even during economic downturns because both customers and providers have entered into long-term commitments.

In our view, technology is a deflationary force especially during inflationary times. Every industry will increase their investments in IT to increase sales and achieve operational efficiency. Investments in generative AI, while a blip in overall IT budget today, has the chance to be a significant driver of overall IT growth in three to five years. We believe enterprise spending on IT products and services will continue to increase as a percentage of budget as a result.

Below we discuss the outlooks for key technology products.

Software: We expect the software industry will grow about 11% in 2024, similar to 2023 (12%). As enterprises continue their digital transformation and explore use cases for AI, software remains a critical enabler of business automation and plays a key role in ensuring cybersecurity in increasingly complex workloads. We expect continued strong growth in 2024 given our belief that the current view of macroeconomic risks is somewhat more benign than at the same time last year, which we expect will result in more generous IT budgets. We expect larger investment-grade issuers to grow faster than sponsor-owned speculative-grade issuers as customers seek to consolidate their software spending with fewer vendors.

Secular trends supporting the industry remain intact, such as demand for lower ownership cost, scalability, and ease of implementation. As enterprises continue to move their workloads to the cloud, software providers enable on-premises customers to transition to the software as a service (SaaS) delivery of their applications.

Furthermore, customers can more easily scale applications, get quicker access to the latest updates, and have more predictable software expenditures as they shift their spending from capital expenditure (capex) budgets to operating expense budgets. Lastly, SaaS customers also experience lower upfront costs and less-complex implementations, making purchase decisions easier.

Despite being very early in the adoption cycle, we expect AI to support the growth of the industry over the longer term. Key software vendors like Microsoft and Salesforce are rolling out features aiming to enhance their customers' worker productivity. Enterprises are experimenting with how to incorporate AI in their operations, capture productivity gains, shorten innovation cycles, and defend against competitors who will look to capture the same opportunities.

Services: We expect the IT services industry to grow at a rate well above that of global GDP, at around 7% in 2024, as demand remains strong in areas such as digital transformation, public cloud migration, and automation. We expect hyperscale cloud providers will continue to generate robust revenue growth near 20% in 2024 as enterprises continue their transition to the public cloud and ramp up their AI investments. This is a $250 billion market that will grow well above 10% percent annually for next several years, benefitting leaders like Amazon.com Inc., Microsoft Corp., and Alphabet Inc.

IT services spending is still mired in an elongated project cycle, but we believe it has troughed and the potentially reduced scope of work for some issuers could drive faster revenue recognition into 2024. Cost optimization through more automation and vendor consolidation is likely to free up budgets for executing more digital transformational projects in cloud and AI areas.

We expect the margin and cash flow trajectory of most IT services issuers to improve in 2024 given the enhanced focus on higher-value digital services, highly variable cost base, cost reduction, and moderate capital intensity. We also see strong growth rates from higher-margin services linked to mission-critical functions or enabling operational efficiencies, including AI, digital transformation, and cyber security. Additionally, as labor and equipment cost pressures ease, lead times are steadily normalizing for most services providers and distributors as well.

The performance of value-added resellers remains exposed to budget constraints and sales cycle elongation. However, for most of these issuers, we expect some resilience because of their long-tenured customer base with growing IT budgets, and exposure to sectors that tend to outperform in downturns (e.g. health care).

For value-added resellers like Worldwide Technologies, we expect revenue expansion will continue to slow toward the 4%-6% as key customers (especially telecoms) defer capital spending amid rising macroeconomic uncertainty. Credit downside could be limited despite the macroeconomic uncertainty since most issuers have not seen order cancelations or customers moving to other providers. Despite a normalizing supply chain environment, we forecast inventory levels will continue to increase modestly through mid-2024 to support demand.

Large projects, such as enterprise resource planning (ERP), software implementations, and consulting engagements tend to have long implementation periods and involve the development or modernization of front-end application, back-end platforms, and infrastructure across areas such as customer engagement, cloud, AI, big data, analytics, and cyber security. As businesses embed more technology in their operating environment, IT services vendors will have an ever-larger role to play as trusted business partners, favoring those with the most digital expertise but also superior customer service.

Furthermore, we believe hybrid work is here to stay and IT services will accelerate the shift from on-premises to private and public cloud environments. We saw large IT services vendors such as Accenture report strong bookings in 2023 amid macroeconomic concerns, and DXC has demonstrated a strong ability to convert the pipeline to revenues. Generally for IT services providers, we expect a modest improvement in book-to-bill ratios into 2024, especially for business transformation projects.

We see two big risks ahead for IT services vendors. First, their ability to navigate labor supply challenges will be tested by high utilization rates, attrition rates, and wage inflation; companies able to attract and retain skilled workers and that possess pricing power will be the most effective in offsetting margin headwinds. Second, if economic conditions worsen more than we currently forecast, enterprises could defer large and capital-intensive projects.

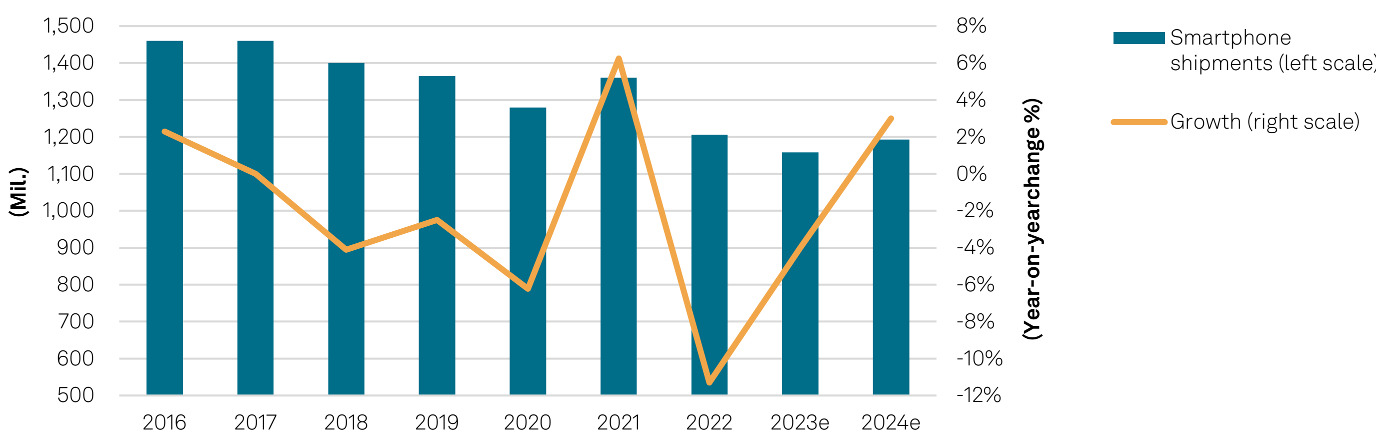
Discretionary consulting projects remain the wild card because they are less predictable due to the varying length and size of contracts, with some clients showing caution in budgeting into 2024.

Semiconductors: After a 10% revenue decline in 2023 due to macroeconomic uncertainty and inventory correction across both memory and nonmemory segments, we forecast revenues will rebound 14% in 2024. (Please refer to page 12 for further discussion of recent industry trends and longer-term outlook.)

Smartphones: We expect smartphone unit shipments will grow about 2.8% in 2024, rebounding from a decline of 4.2% (estimated) in 2023 (see chart 7). The reversal is due to better replacement demand in China, given an already stretched replacement cycle, and increasing smartphone penetration in markets such as Africa, Southeast Asia, and Latin America. Moderating the recovery would be the flattish to slightly negative shipment in the U.S. and Europe. The macroeconomic headwinds associated with high inflation and funding rate will likely inhibit consumer spending in those markets.

Chart 7

Smartphone sales will return to growth in 2024



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

Most smartphone original equipment manufacturers (OEMs) have reached inventory normalization over the past several quarters. This may portend tempering of promotions and sales discount, and allow for more flexibility in new model development and release schedule to cater to changing consumer preference. However, the overstocking issue in the past will likely make OEMs, particularly Android brands, more cautious on inventory management. It's possible OEMs may split procurement orders into smaller tranches, compensated by higher ordering frequency and delivery urgency. The transition to a more just-in-time production mode could mean new challenges to the smartphone supply chain.

We expect demand will be more weighed toward entry-level and premium models, rather than mid-range products. And with Huawei's comeback and Xiaomi's premiumization strategy, competition in the premium subsegment would intensify. This particularly threatens Apple Inc.'s sales in China, which make up about 20% of the U.S. OEM's total shipment.

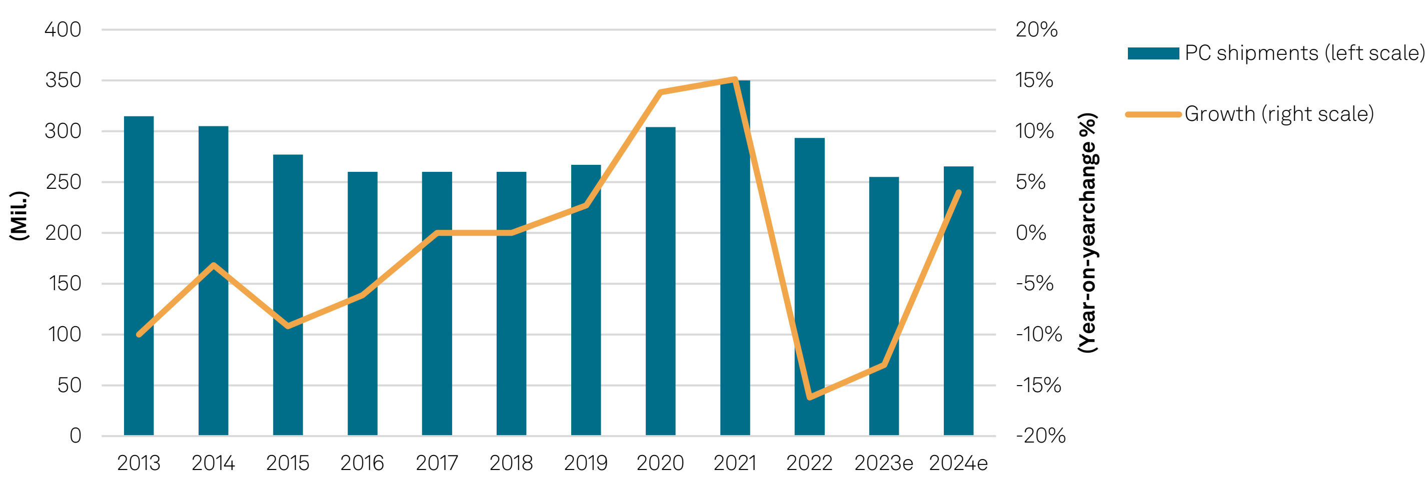
We forecast Apple's global shipment will be flattish in 2024. Samsung Electronics Co. Ltd. will likely see limited impact to its flagship models from such a development, given its minimal exposure to China. Yet in the entry-level subsegments, we think both Samsung and Xiaomi Corp. will face substantial challenges from Transsion, a dedicated feature phone maker, in emerging markets. We forecast Samsung and Xiaomi's global market share will be around 20% and 13%, respectively, in 2024.

We expect a low- to mid-single-digit percentage growth in smartphone average selling price (ASP) in 2024 due to reduced promotion and discounting after OEMs' destocking and their attempts to pass through some rebounds in component cost (such as memories chips) as demand recovers. Moderating the ASP growth is Chinese OEMs seeking domestic replacement of foreign smartphone components. For instance, these brands have increasingly adopted OLED display panels from BOE Technology and Shenzhen China Star Optoelectronics Technology Co. Ltd., even in their flagship models, rather than from Samsung and LG Electronics Inc. We also expect more Chinese demand for CMOS image sensor to shift to OmniVision Technologies, a subsidiary of a Chinese firm (Will Semiconductor), from Sony.

PCs: We estimate that for a second consecutive year, global PC unit shipments declined by more than 10% in 2023. This would take unit shipments in 2023 to below pre-COVID levels after massive growths in 2020 and 2021 (see chart 8). In 2023, macroeconomic uncertainty led enterprises to postpone refreshes while China consumer demand was tepid.

Chart 8

PC shipments should finally grow in 2024



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

At the same time, we do see signs of green shoots. Shipments declined for the eighth consecutive quarter in September 2023, but the pace of decline slowed (9% decline year over year), with indications that the PC market is nearing the bottom of the cycle, with vendors having made gradual progress toward reducing PC inventory to normal levels.

We expect global PC unit shipment growth will improve in 2024 to 4% area. Enterprise demand remains weak, but we anticipate Windows 10's end of life will spur a strong replacement cycle in 2024. We believe commercial demand will come back stronger than consumer demand, lifting overall ASP. We expect China demand will gradually recover throughout the year as well. Our forecast does not assume additional PC demand arising from yet-to-be released AI-enabled PCs; we believe this will start to impact overall demand in 2025.

Annual PC shipments jumped from around 250 million units pre-pandemic to nearly 350 million units in 2021. Despite the volatile industry trends over the past four years, we believe the PC total addressable market is now larger than that of pre-COVID; also, we believe unit shipments will likely remain well above 250 million in 2024 and beyond given the need to refresh a greater number of installed PCs.

Servers: We estimate server shipments plunged around 7% in 2023 as enterprises--and to a lesser extent, cloud providers--delayed new purchases given macroeconomic uncertainty and worked through the inventory that they accumulated through the pandemic. Excluding the small but robust demand for AI-enabled servers, we estimate traditional server shipments likely declined near double digits in 2023.

That said, we believe demand for servers has slowly improved over the past two quarters such that we now expect a meaningful turnround in 2024. We believe traditional server unit shipments will grow between 3%-5% as enterprises return to investing in cloud, edge computing, software defined infrastructure (SDI), and data analytics. We think cloud providers, while focused on building out their AI infrastructure, will also grow traditional server purchases.

We forecast AI server demand will explode in 2024, growing well north of 50%, given comments made by chip makers and OEMs, such as Dell Technologies Inc. and HP Enterprises Corp., which have reported a significant jump in AI-server orders and backlogs. These AI servers can cost upward of $250,000 due to high graphic processing unit (GPU) content, as much as a 25-fold increase over traditional server prices. While we forecast 6% growth in total server shipment in 2024, industry revenues will be significantly higher going forward because AI server shipments will grow much faster than traditional server shipments.

At the same time, we believe AI servers will only make up around 5% of total server shipments in 2024. Furthermore, we believe legacy hardware providers will underperform market growth rates as large cloud providers design their own servers through original design manufacturers (ODMs). In fact, cloud providers account for about half of all server purchases and this number is rising, according to IDC.

Storage: We expect external storage systems revenue will grow about 5% in 2024 following a decline of roughly 2% in 2023. Macroeconomic slowdown and cautious enterprise budgets contributed to the decline. It also comes after high-single-digit growth in 2021 and 2022, in which enterprises expanded their storage budgets to support emerging workloads such as AI and machine learning and to digitize workloads overall.

We think long-term mid-cycle growth for the segment will be in the 2%-3% range, which is below IT spending in general, because enterprises are increasingly meeting their storage needs using cloud services rather than on-premises hardware. In 2024, improving IT budgets and the need to support growing data and greater data protection will support a nice rebound in storage spending. Growing AI workload will also improve storage prospects, in our view, with some research firms anticipating that 20% of storage sales will come from AI-related spending by 2026.

According to IDC, storage revenues declined 5% year over year in the second quarter of 2023, with hard disc drives (HDD) falling 25%, while all-flash array (AFA) declined just 3% and hybrid flash array (HFA) grew 3%. AFA now makes up 45% of the external storage market, up from 40% in 2020 and 20% in 2016. Over the longer term, we expect AFA will continue taking share from HDD and hybrid systems as continued NAND price declines narrow the cost of flash memory relative to HDDs.

We are seeing large cloud providers leverage their scale to custom-build storage infrastructure instead of purchasing it from major branded OEMs such as Dell, HP, and NetApp Inc., so the adoption of the hybrid cloud approach--whereby some workloads remain on premises as others shift to the cloud--is critical for the viability of the external storage systems market. Meanwhile, we expect enterprise customers, who have traditionally been major purchasers of external storage systems and have growing storage needs, will leverage software to optimize their storage capacity.

Networking equipment: We expect the networking equipment market to fall 3% in 2024 after growing a robust 7% in 2023, owing to an inventory correction. Networking was one of the end markets that took the longest for supply chain constraints to ease so it is one of the last to face an inventory correction. In response to these constraints, customers put in lots of orders and built up safety stocks. The industry benefitted in 2023 from executing on large backlogs. As supply conditions have eased, customers have determined that the risk of a stock-out is now lower and doesn't warrant the cost of carrying safety inventory, so they have begun to draw inventory down.

Order trends have been negative for several quarters for companies such as Cisco Systems Inc. and Juniper Networks Inc., and we now believe there isn't sufficient backlog to generate revenue growth over the near term. As the demand environment will be muted for the foreseeable future, we expect the industry's pricing power to weaken and gross margin to fall.

We predict AI will be a long-term tailwind for the industry as infrastructure providers leverage ethernet switching to take advantage of power efficiency, scalability, and a large open ecosystem. Nevertheless, we don't expect this demand to show up in time to result in revenue growth in 2024. Increasing software content also continues to decrease volatility for the sector.

Mobile telecommunications equipment: We expect the mobile telecom equipment market to decline moderately in 2023 and 2024 due to the slowdown in 5G investments (primarily in North America) and macroeconomic headwinds. Investments in 5G have been front-loaded compared with previous technology cycles, leading to high growth in 2020-2022, particularly in North America where 5G will already represent about 60% of mobile subscriptions. In addition to coverage investments, supply chain issues that led customers to build up inventory also boosted market growth until 2022. As the supply chain normalizes, customers have invested less in new equipment in 2023 as they reversed their inventory levels. This was particularly visible in North America, one of the world's largest markets, which experienced a significant downturn in 2023, and we think the decline could continue in the next few months.

Furthermore, the economic environment has pushed some telecom providers to delay their investments, for instance in Latin America. In markets that invested early to establish initial 5G coverage, weaker-than-expected pricing uplift for 5G plans and a lack of demand from new use cases has slowed the migration to higher frequency 5G densification. Also, the overall market is negatively impacted by a decline in older technologies, including 4G, which is peaking in 2023 and will start to decline.

Despite these temporary headwinds, we think the mobile equipment market could return to modest growth beginning in the second half of 2024, as we continue to expect steady 5G investments for many years; also, the drawdown of inventory levels eventually ending will help the year-on-year comparison. This is because we think 5G technology overall is still at a relatively early stage--global 5G subscriptions only represent about 18% of all mobile subscriptions worldwide. Even if the global coverage in 5G has reached 45% of the population, there is still a lot of 5G coverage investment ahead. Investment dynamics differ by country, and many regions still have low 5G coverage, including Latin America, India, and some European countries.

Furthermore, even after coverage investments are complete, capacity investments will gradually intensify to support increasing data consumption (so far, 5G utilizing mid-band spectrum has been deployed in only about 30% of existing 4G sites globally). We expect these investments will be demand-driven, and therefore gradual, unless and until new cases are widely adopted, leading to a spike in demand. To some extent, we also expect growing demand from enterprises for advanced use cases requiring higher speed and lower latency, which could support additional investments in 5G.

Printers: We continue to take a more conservative view on printer unit growth, which we expect will decrease 2%-3% again in 2024 after declining about 2%-3% in 2023. Longer term, we expect printers will continue to lose momentum in the battle with digital alternatives. In the meantime, however, growth from low-internet-penetrated countries within Asia-Pacific (APAC) and South America--particularly China, India, and Brazil--will keep the overall industry relatively stable.

More normalized channel inventories and reduced vendor backorders are proof that COVID-19-induced supply chain issues have reduced. However, in 2023, geopolitical-induced economic restrictions on Chinese chip manufacturers, labor shortages, and an absence of raw materials caused a shortage of chips needed to produce print-related goods, further slowing the production of printers, ink, and toners.

Higher interest rates have also dragged on advertising expenditure, leading to lower printing activity. The industry also saw a competitive pricing environment in 2023 due to a weaker Japanese Yen, creating pricing pressures. While we expect these issues to carry into 2024, we also expect them to improve.

We believe a continued return to office in 2024 will shift demand from at-home printers to commercial printers, while industrial printers continue benefitting from more secular growth drivers. Units sold will also benefit from organizations seeking to modernize their IT infrastructure by continuing to enhance traditional printers, with more advanced printers that have cloud, security, AI, and other capabilities.

As a result, we expect industrial printer unit growth to be near-flat to slightly positive, commercial unit growth to be near-flat to slightly negative, and at-home unit growth to be slightly negative, even when all are compared to weaker annual figures.

The most promising factors for growth in 2024 and beyond, especially within mature economies, can also be linked to emerging applications, like 3-D printers and HP's Site Print for commercial site printing. While we expect these to have a minimal impact on the total print market in 2024, their recent success provides potential for future growth.

Semiconductor industry is poised to recover in 2024. We expect global semiconductor industry revenue to fall 10% in 2023 after 4% growth in 2022, led by a sharp decline of nearly 30% in memory segment revenue due to weaker PC, smartphone, and data center end markets. However, this is an improvement compared to our original expectation for revenues to be down 35%, which we revised given the gradual recovery that occurred in the fourth quarter of 2023. NVIDIA prospered, with revenue set to more than double in calendar 2023 as hyperscale data center customers invest heavily in GPUs and networking chips to build infrastructure to train generative AI models.

Enterprise customers' optimization of their cloud spending slowed hyperscale capex growth to 13% this year from 24% last year, and AI spending has crowded out non-AI-related IT spending; these two factors have severely constrained investment in general purpose computing chips in the data center market. PC and smartphone unit shipments, which we estimate declined 13% and 4%, respectively, in 2023, are also weighing on the general-purpose market. Excluding the memory segment and NVIDIA, we estimate the semiconductor revenues declined around 12% in 2023.

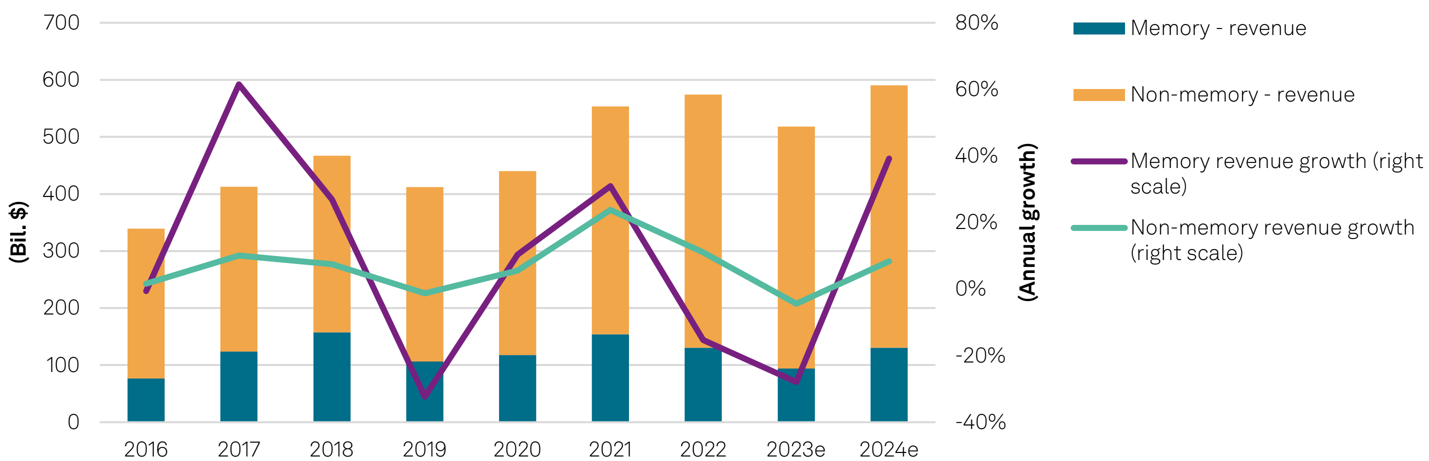
In 2024, we expect total semiconductor revenue to be up 14%, but that figure falls to 8% after removing the memory segment and just 3% after removing NVIDIA (see chart 9). We chalk this up to the stabilization of the PC, smartphone, and general-purpose data center markets offset by a weakening industrial outlook. We expect a return to positive unit growth in PCs and smartphones in 2024 after two years of declines following the COVID-related peaks in 2021, with PCs growing 4% and smartphones 3%. Furthermore, these markets were the first to reach normalized inventory levels because they were the first to correct post-COVID.

In addition, we expect the general-purpose data center market will benefit from reacceleration in cloud data center revenues as enterprise customers gain more confidence in the macroeconomic picture. We also believe the cloud players have digested meaningful inventory and must resume investment to support strong demand. We expect these markets to drive mid-to-high teens percent revenue growth for Intel and AMD. We believe Qualcomm will also enjoy a solid boost from recovering smartphone sales.

Chart 9

Semiconductor industry is poised to grow in 2024 as end markets recover

Semiconductor industry revenue by segment



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

On the flip side, analog sales will remain weak in 2024 and microcontrollers revenues are starting to turn negative because of industrial market weakness and inventory digestion. Inventory in these markets has taken longer to correct than in the PC and smartphone markets because end demand held up and kept supplies tight. The analog correction started toward the beginning of 2023, but microcontrollers are just starting theirs after a strong run over the last 12 quarters, confirmed by poor guidance from Microchip Technology Inc. and others.

Significant demand and supply constraints in the post-COVID era supported both segments, but as supply has improved and lead times shortened, customers have moderated their inventory. In addition, macroeconomic uncertainty has constrained demand from industrial customers. Pricing is stable so far, but pressure could emerge over the next few quarters. The automotive market is holding up, supported by increasing content for electrification and computing power, although growth in this market is starting to decelerate.

We see revenue growth of about 40% for the memory segment in 2024 after a two-year cumulative decline around the same amount. We expect pricing will continue to recover because the industry has maintained supply discipline in order to return margins to sustainable levels. The market will gradually improve through the year, but we believe mid-cycle conditions won't materialize until 2025. Hyperscale data centers will be a key demand driver for high-margin, high-bandwidth memory (HBM) DRAM for AI applications in 2024 and memory will support growth in general purpose workloads.

Samsung recently commented that it has received more inquiries for strategic purchases due to awareness that memory is reaching a bottom. A key watchpoint will be whether industry players can maintain supply discipline long enough to complete the inventory adjustment, or whether they will bring back idled capacity early to take market share, which would prolong the time to achieve mid-cycle margins. Capex decisions are less flexible than production ones, and they determine long-term supply. We view the signs as encouraging, with the memory players planning for only modest capex growth in 2024 from very low 2023 levels, and for spending to support technology migrations more than capacity expansion.

In the AI space, GPU demand so far has been due to the need to train AI models. That demand will remain robust, and we forecast 45% revenue growth for NVIDIA in calendar 2024, but we expect spending for inferencing (applying AI models to specific cases) to emerge more prominently in 2024. We believe this will open space for more players besides NVIDIA to win, as has been the case in 2023. Intel and AMD will likely see more demand for CPUs, GPUs, and FPGAs for inferencing; HBM and networking providers will also benefit. Custom AI chips are also likely to gain more traction, helping Broadcom Inc. and Marvell Technology Inc.

The semiconductor market continues to face significant geopolitical risk stemming from U.S.-China tensions. Further bifurcation in the semiconductor supply chain and retaliatory policies are likely, which would likely increase inefficiencies and raise prices to end users. U.S., China, Europe, and other countries in Asia will continue to incentivize local chip production, which could add volatility because it may encourage overinvestment. We believe the restrictions will push domestic Chinese technology companies to rely more heavily on indigenous suppliers, which may result in efficiencies over time with enough support from domestic customers, benefitting domestic producers like Semiconductor Manufacturing International Corp. (SMIC).

We expect more U.S. policies and regulations directed at China, a risk for both western suppliers that have large revenue exposures to China and for Chinese technology companies reliant on western suppliers. By our assessment, U.S. regulators look likely to stick with a "small yard and high fence" policy. It's possible this could change, with more restrictions and penalties if China progresses with advanced chip production using foreign equipment and materials.

Focus remains on lower-rated issuers as ratings bias continue to trend negative in 2024.

North America: Similar to last year, we expect technology investment-grade issuers will be stable, while speculative-grade companies--especially those rated ‘B’ or lower--will face heightened rating downgrade risk. We no longer include a U.S. recession in our base-case scenario in 2024. However, the Fed has indicated it will keep interest rates higher for longer, which will likely dampen economic growth, as reflected by our S&P Global economists’ below-trend growth (below 2%) assumptions for 2024-2026.

We believe the excitement about AI will continue to drive IT infrastructure spending and benefit many of our rated issuers such as Microsoft, NVIDIA, AMD, and Dell Technologies. From a ratings perspective, investment-grade issuers have healthy balance sheet and strong cash flow generation to support their growth and shareholder return initiatives while preserving their current ratings. With the exception of Intel Corp. (A/Negative/A-1), the rest of our investment-grade issuers have stable outlooks.

Higher interest rates have disproportionately hurt many of our highly leveraged issuers, including software companies that have highly recurring revenue and cash flow characteristics, because much of their free operating cash flow (FOCF) generation is consumed by the higher debt service costs. Many of our highly leveraged tech issuers have significant variable-rate term loan structures that made them ill-prepared for the rapid and significant interest cost increases over the past 18 months. Additionally, the resilient U.S. economy supported by consumer spending has not provided any material boost to overall IT spending. Enterprise and commercial customers still view the macroeconomic outlook as uncertain and have kept their IT budget tight, except for AI investments.

We've had a negative rating bias in the U.S. tech sector since March 2022, and we expect this will continue, evidenced by our 10 U.S. tech issuers rated 'B-' with negative outlooks and 14 companies rated in the 'CCC' category, where many continue to face business and cash flow pressures.

Like the U.S., the Canadian tech sector also shows a negative rating bias, with companies such as Mitel and Cascade Parent facing significantly higher interest expense. This leads to much lower cash flow from operations and weaker cash flow coverage measures. The negative outlook on OpenText reflects the debt-financed Microfocus acquisition that significantly increased the company's leverage.

While many of our lower-rated U.S. tech issuers do not face immediate refinancing needs, we believe the repricing and refinancing risks will grow if debt financing costs remain elevated. As capital market conditions remain challenging for lower-rated issuers, debt restructuring activity and defaults may tick up.

Asia-Pacific: APAC tech firms mostly have sufficient financial buffer against the market downturn and high interest rate environment. However, the financial buffer has narrowed over the past several quarters with weakening profitability and cash flow. The negative rating bias for Asia-Pacific tech firms stayed at 10%-12% for most of 2023. We believe this has reached near bottom and could improve gradually in 2024 as end demand recovers despite the tepid macroeconomic conditions, which could add uncertainty to the pace of recovery.

A majority of the negative outlooks are related to businesses that are cyclical and commodity-like, such as memory and panel suppliers. As end demand is likely to pick up in 2024 due to new products and technologies, we expect the rating pressure for those companies to ease gradually over the next few quarters. For example, SK Hynix (BBB-/Negative/--) has tight rating headroom due to continued operating losses, but its DRAM business is showing signs of improvements supported by high-end products for AI servers.

Shipment of PCs and smartphones have bottomed in 2023 and will bring relief for some rated Asian tech companies in 2024. However, downstream tech vendors in industrial and auto end markets are still correcting their inventory, and this will delay the recovery for some upstream semiconductor companies and foundries with higher exposure to these end markets.

On the other hand, the APAC IT services sector is likely to continue to benefit from strong growth in digital transformation and automation, as well as demand for more efficiency and cost control. We anticipate this will support Japanese and Indian issuers' credit profiles in 2024. In addition, we believe multiyear projects and diversified downstream market exposure will continue to generate recurring cash flows for these companies and hold up against the impact from a slower macroeconomic environment.

Europe: We expect steady performance for European tech issuers in 2024. Of our rated issuers, 83% have a stable outlook, 11% have negative outlooks or are on CreditWatch (CW) with negative implications, and 4% carry positive outlooks or are on CW with positive implications.

Rating actions also had a negative bias in 2023, although, factoring out multiple rating actions on Technicolor Creative Studios, which defaulted (we withdrew our rating at issuer request), it is more balanced at seven upgrades and eight downgrades. The downgrades were mainly the result of idiosyncratic factors including dividend recapitalizations and sustainability concerns on heavily leveraged capital structures. In contrast, the upgrades were mainly due to operation-led improvement in credit ratios for companies like SAP (A+/Stable/--), STMicroelectronics (BBB+/Stable/A-2), Capgemini (BBB+/Stable/--), Nokia (BBB-/Stable/A-3), Particle Investments (B+/Stable/--), Verisure (B+/Stable/--), and Global Blue (B+/Stable/--).

That said, the risk of a recession would increase rating downside risk compared to our base case of near zero real GDP growth in the eurozone. While a weaker macroeconomic backdrop would likely weigh on our demand expectation, our forecasts already incorporate more conservative growth expectations.

We expect a sustained growth trajectory for semiconductor issuers such as STMicroelectronics and Infineon (BBB/Positive/--), with mid- to high-single-digit growth in 2024 as they benefit from resilient automotive demand. Similarly, we expect growth to be challenging in the next few quarters for mobile telecom equipment makers including Nokia and Ericsson (BBB-/Developing/--) as 5G deployments take a pause and inventory overhang is worked through after a strong initial rollout of low-band coverage.

We believe software and IT services providers have good growth prospects that will support stable ratings. We think the efficiency and competitive benefits of their cloud migration and digitalization offerings will drive demand for their products, which we expect will remain relatively resistant to our low GDP growth forecast. However, companies struggling to make the transition to cloud services from legacy hardware and on-premises IT infrastructure management (like Atos (BB-/CW Negative/--) or those with exposure to concentrated pockets of weakening customer demand, face more material downgrade risks.

We expect greater downside risk for speculative-grade issuers. We believe European speculative-grade issuers that have near-term maturities face increased refinancing risk if debt capital markets remain volatile and less receptive to weaker issuers. Additionally, we expect mounting rating pressures for issuers rated in the ‘B’ category or lower (about 72% of European technology ratings) because the higher interest rate environment will impede FOCF generation and weaken credit ratios.

Latin America: Our base-case view for Latin American issuers in 2024 has diverse considerations. All our rated issuers have stable outlooks. However, the trajectory of each company’s operating and financial results may differ in terms of specific sub-sector trends. While IT spending dynamics have strengthened since 2022 and 2023, the sector remains exposed to soft macroeconomic conditions in the region for 2024.

For instance, we expect the leading e-commerce and payment platform MercadoLibre Inc. (BB+/Stable/--) to maintain a strong revenue growth in line with growing commerce and financial services digitalization in the region, which still lags behind other developed and emerging markets. The company is also well-positioned to translate this growth into improved profitability and credit metrics, but the exposure to Argentina could weigh on rating upside.

At the same time, Mexican IT services and data center operator Sixsigma Networks Mexico (B+/Stable/--) also continues to post steady revenue and EBITDA growth prospects and relevant investments to enlarge its footprint in Mexico, while also entering new markets, such as Colombia. Nevertheless, the upcoming 2024 federal elections in Mexico will continue to highlight the sizable contribution to revenues stemming from public-sector contracts, emphasizing the relevance of contract renewal negotiations and cash collections.

In Brazil, lower demand from corporate and retail clients due to the high interest rate environment continues to affect hardware issuers. We believe improving macroeconomic conditions would cascade to better results. IT equipment rental companies exhibit a more favorable outlook and growth prospects, which could be boosted by a higher adoption of equipment rental or leasing from both corporate and public clients.

Credit metrics and financial policy: We expect financial policy will lean conservative in 2024 for rated technology issuers under a higher-for-longer interest rate environment and a muted global economic outlook. Investment-grade issuers' balance sheets have remained mostly healthy despite weakening market conditions through 2023.

Two large acquisitions finally closed during the year: Microsoft funded the $69 billion acquisition of Activision Blizzard with cash and commercial paper borrowings with no impact to the 'AAA' rating; and Broadcom belatedly closed its $61 billion acquisition of VMware Inc. in November 2023 with roughly $30 billion of term loans. We upgraded the company to 'BBB' because of improved business mix and S&P Global Ratings-adjusted leverage that was well below previous acquisitions.

Announced M&A deals were quiet for the most part, except for Cisco's proposed acquisition of Splunk for $28 billion. If the deal receives regulatory approval we would not expect any ratings impact given Cisco's strong balance sheet.

We expect deal making to pick up in 2024 given the pent-up investor demand. While we expect rates will stay higher for longer, an end to the Federal Reserve's hiking cycle will likely improve the outlook for buyers and sellers. Buyers remained interested in deal making during 2023 but were unable to close on transactions as sellers were slow to acknowledge falling valuations. Removing some of the volatility from the global economic forecast will likely help bridge the gap between sellers and buyers.

Share repurchases slowed starting in the second quarter of 2022 and remained low through 2023. Through the 12 months ended June 2023, technology companies under S&P 500 Index repurchased a total of $211 billion of stock, down 26% from the prior year through June 2022. We estimate a similar slowdown for the remainder of 2023.

Companies with significant balance sheet capacity such as Microsoft and Apple Inc. continue to execute sizable share repurchases utilizing their excess liquidity, and therefore our ratings on them remain unchanged. We expect lower-rated investment-grade issuers, especially those in hardware and semiconductor industries, to exercise caution with shareholder returns in 2024. Given higher interest rates, we believe they will lean more toward preserving liquidity or making long-term capital investments.

Despite weaker-than-expected IT spending and rising rates, most investment-grade issuers faced limited ratings pressure through 2023. Even within the semiconductor memory end market, which faced massive revenue declines, we expect our ratings on SK Hynix and Micron will remain at 'BBB-'. We maintained our stable outlook on Micron despite our forecast for significant negative cash flow in 2023 and into 2024 because the company maintains a solid balance sheet and conservative financial policy that corresponds to an investment-grade rating.

The lone investment-grade issuer downgrade in our U.S. portfolio was Intel Corp. (A/Negative/A-1), mainly attributable to the severe cyclical declines experienced in the PC and data center end markets that began in late 2022. Although we anticipated these markets would improve gradually in 2024, Intel continues to face competitive pressures and high capital expenditure requirements that leave little cushion for its credit risk profile at the current rating.

In the speculative-grade space, rating pressure continues to build. Operating results generally fell short of expectations in 2023 for issuers in the lower end of the ratings spectrum ('B' and below) because revenue growth was weaker than expected and debt service costs increased. They had little cushion to absorb execution missteps given limited free cash flow (FCF) generation after debt service.

We expect interest burden to remain elevated for many of the sponsor-owned companies in 2024, which will further stress liquidity. We expect credit metrics will remain mostly stable for those issuers with high recurring revenues and pricing power, but those competing in a crowded market with weaker pricing power will likely incur weaker credit metrics and cash flow, with the potential for negative rating action.

Key risks or opportunities around the baseline

1. Heightening geopolitical tension and supply chain disaggregation are key risks.

Supply chain diversification creates cost inflation, and potentially hurts margins of tech vendors. Additionally, we believe U.S.-China tensions that spill over to disruptions in the supply at key advanced chip manufacturer Taiwan Semiconductor Manufacturing Co. Ltd. (TSMC), or further expansion of U.S. chip bans, may prove more difficult to navigate for our rated issuers.

2. Elevated interest rates still present challenges for speculative-grade companies.

Rates have probably peaked, and we anticipate they will retreat in 2024. However, we will monitor the pace of the decline and whether they remain higher for longer. While we expect some relief in debt service costs, we will focus on how the trajectory of market rates and business conditions will affect weaker 'B-' and 'CCC+' issuers.

3. M&A activity is poised to rebound in 2024.

Rising rates and uncertain valuations led to another year of slow deal activity in 2023, so we believe there is a pent-up demand by both companies and investors alike. We anticipate rate stabilization will lead to an improving acquisition appetite and, in turn, potentially weaken credit metrics for buyers.

Heightening geopolitical tension and supply chain disaggregation are key risks. Technology firms across the globe are looking to diversify their supply chains amid heightening geopolitical tension and regulatory restrictions. This will lead to higher costs and reduced efficiencies because these firms must manage a more dispersed supply chain and operate in regions with underdeveloped infrastructure, higher labor costs, or more limited options of local suppliers. We estimate, for example, that the operating expenses of TSMC will be 40% higher at a planned Arizona facility, versus a plant in its home market.

In China, the latest round of U.S. restrictions will push Chinese technology companies to adopt more domestic suppliers and increase the proportion of domestically produced components and equipment. This could also increase costs for domestic tech companies that must work with domestic suppliers to improve product quality and production efficiency.

Growing government support for local semiconductor industries could also lead to an excess semiconductor capacity over the next several years. Such oversupply could be particularly meaningful for mature chip production. Over the past year, the U.S. and EU separately announced legislation that will provide up to $53 billion and €43 billion, respectively, to support domestic semiconductor research and chip production over the next 10 years. Japan also announced plans to triple the sale of domestically produced semiconductors to more than $113 billion by 2030.

China is also aggressively expanding its own mature chip capacity through domestic companies such as SMIC, China's largest domestic chip manufacturer. We estimate that SMIC could increase its wafer manufacturing capacity by 50% over the next three years. China also raised another $41 billion in September 2023 for its China Integrated Circuit Industry Investment Fund (CIIF) to support its domestic chip industry.

However, most global technology issuers have sufficient cash flows, funding access, and cash reserves to mitigate the impact from oversupply risks and higher costs. Companies such as TSMC and Samsung Electronics Ltd. have material net cash positions and strong cash flows to help offset higher investments and operating costs. Moreover, such companies are likely to receive local government subsidies for the construction of new plants.

We think electronic manufacturing services (EMS) companies in Taiwan will be able to manage the supply-chain diversification better than their peers in mainland China, given their established presence in Vietnam, India, and Mexico.

Other issuers such as Lenovo, NVIDIA, AMD, and Intel will have to navigate the increasingly complex web of U.S. regulatory restrictions on semiconductor exports into China. Such restrictions will be updated as necessary to meet U.S. objectives on limiting China's access to high-performance computing capabilities, particularly for AI. This could limit their access to the large China market or, in a worst-case scenario for Lenovo, hinder its ability to manufacture AI servers.

Elevated interest rates present challenges for speculative-grade companies. Our S&P Global economists' baseline scenario is for a soft landing. We anticipate receding inflation will prompt the Fed to begin cutting rates by 50 bps-100 bps in late 2024 and further in 2025. A benign interest rate environment would be a welcome relief for companies with significant floating-rate debt and high debt-to-EBITDA ratios.

Over the past year, issuers managed onerous interest burdens but struggled with pressured free cash flows and less liquidity flexibility. Although we expect the IT spending environment will improve in 2024, slower-than-expected rate cuts or rates remaining elevated in general will continue to pressure the credit quality of tech companies that have meaningful cash flow volatility, limited liquidity, or face debt maturities over the near term.

Besides elevated rates, business-specific risks will be a key focus in 2024 for those at the lower end of the rating spectrum. For example, Polaris Parent LLC (Solera; B-/Stable/--) elected to pay the payment-in-kind (PIK) interest on its second-lien debt for two quarters to provide flexibility against elevated cash calls from one-time payments, which pressured near-term liquidity and cash flows. The company also navigated revenue headwinds from a large customer loss and acquisition integrations. We view the PIK interest election as Solera being cautious in the current business environment and increasingly willing to pursue opportunities to preserve cash.

Rating outlook changes to negative or downgrades to 'CCC+' or lower increased in 2023 as the high debt service costs take a toll on FCF generation at a time when companies are operating in an increasingly challenging environment. Interestingly, we saw several negative actions on software issuers that generally have good FCF profiles, mainly because of the unexpected and rapid pace of rate increases.

For example, we downgraded Veritas Holdings Ltd. to CCC+/Negative/-- from B-/Negative/-- because the challenging operating environment hurt new business growth. This exacerbated cash flow pressures stemming from its subscription model transition and significant interest expense on $4.2 billion of debt due in September 2025.

U.S. technology speculative-grade rating actions have been overwhelmingly negative over the past 12 months, and this trend may continue if a higher-for-longer scenario plays out. As such, FCF will be a primary focus given concerns that it may deteriorate beyond an already depressed level or remain poor if rate trends reverse.

For 'B-' rated issuers, we forecast average interest coverage of 1.45x in 2024 (versus 1.23x in 2023) and FOCF to debt of 2.85% in 2024 (versus 0.99% in 2023) (see table 2). While we embed benefits of rate cuts, modest improvements might not be enough to protect ratings, particularly if persistent macroeconomic uncertainties slow new business activity and capital investments.

Lower-rated tech companies have less cushion to withstand unexpected business underperformance, especially those that had negative FCF last year. 'CCC+' rated issuers are far more vulnerable because they tend to have very weak interest coverage of less than 1%, negative FOCF to debt, and business-specific challenges. Many of our ‘CCC+’ credits don’t face an imminent liquidity squeeze or debt maturities, providing some breathing room. Still, favorable market and business conditions are critical to maintaining adequate cash flows for debt service.

Table 2

U.S. technology credit metrics improve due to expectations for lower rates

	'B-' rated credits		'CCC+' rated credits	
	2023e	**2024e**	**2023e**	**2024e**
Interest coverage (x)	1.23	1.45	0.48	0.97
FOCF to debt (%)	0.99	2.85	(4.79)	(1.07)

e—Estimate. FOCF—Free operating cash flow. Source: S&P Global Ratings.

M&A activity is poised to rebound in 2024. Global M&A deal announcements and total deal value fell for the second consecutive year in 2023 as rising interest rates sidelined deal-making (see chart 10). Any optimism for recovery faded early in the year after turmoil in the financial services sector led to three large bank failures in the U.S. and the forced sale of Credit Suisse in Europe. Banks, and debt capital markets in general, have since increasingly restricted credit, making access to acquisition financing more challenging.

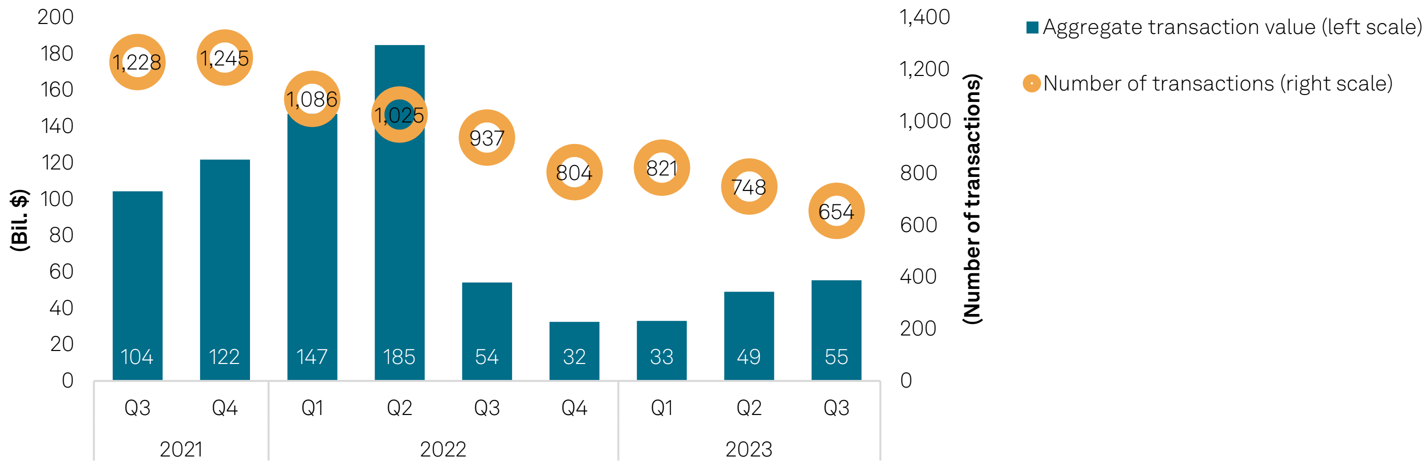
We don’t believe M&A activity will suddenly rebound, but we think pent-up investor demand and the end of rate hikes will gradually improve acquisition activity throughout 2024. Concerns over a possible global recession are being replaced by an expectation for slower growth, particularly in the U.S., with mild recessions forecast for many Western European countries, according to S&P Global economists.

While we expect rates will stay higher for longer, an end to the Federal Reserve’s hiking cycle would improve the outlook for M&A. Under a stable rate environment, buyers get a better understanding of their deal costs, even if financing remains expensive. This clarity gives them greater conviction to pursue acquisitions. We believe that during 2023, buyers remained interested in deal-making but were unable to close transactions because sellers were slow to acknowledge falling valuations. We think removing some of the volatility from the global economic forecast will help bridge the gap between sellers and buyers.

Chart 10

Deal activity has declined for the past two years

U.S. M&A deals since Q3 2021 - technology, media and telecommunications



Source: S&P Global Ratings.

A wildcard is how AI will impact tech M&A in 2024 and beyond. Potential acquirers will seek AI capabilities to enhance or merely protect their existing business positions. On the other hand, the possibility of AI meaningfully disrupting the world of business may give potential acquirers pause in taking on excessive M&A risks.

As for the technology sector, Microsoft's acquisition of Activision Blizzard and Broadcom's acquisition of VMWare Inc. were both announced in 2022 but finally closed in 2023 after arduous regulatory approval processes. The technology sector mostly lacked large deal announcements in 2023, outside of Cisco's $28 billion offer for cloud protection software provider Splunk and Silver Lake's deal for Qualtrics for $13 billion mid-year. Overall, smaller consolidation and divestitures made up the bulk of 2023 deal flow as many traditional strategic buyers turned inward, focusing on belt tightening in the face of weakening growth prospects.

The higher cost of capital has weighed heavily on unprofitable companies and the preferred targets have become older companies with more stable recurring revenue. Looking ahead, we believe subsectors that have the potential to see pick-up in M&A include companies that offer productivity and efficiency gains in areas such as customer service, supply chain tracking, and marketing. Large but fragmented markets, such as cyber security, will likely see further consolidation.

Large deals will continue to face hurdles, especially in the U.S. where antitrust concerns have been a focus of regulators. Still, we expect that an end to central banks' rate-hiking cycles, along with greater economic clarity, will lead to more transactions. We expect China will continue to be a potential roadblock for large deal approvals given the escalating geopolitical tensions and export bans the U.S. has placed on certain key technologies to China. Lastly, 2024 is an election year in the U.S.; any uncertainty heading into the election could push transactions into 2025.

Rising rates and concerns over a possible recession reduced private equity activity in 2023. Through the third quarter of 2023, the total value of private equity and venture capital investments stood at $170 billion, down 57% year over year and the lowest total through three quarters since at least 2019, according to S&P Market Intelligence. If borrowing costs and valuations stabilize, private equity firms could be enticed to accelerate acquisitions in 2024. They certainly have plenty of cash; global private equity cash reserves stood at a record $2.49 trillion at mid-2023, up 11% since 2022.

Increased acquisition activity has the potential to weaken credit metrics. We took multiple negative rating actions in the technology sector in 2023 on companies that engaged in debt-funded acquisitions and those who ran into slow top-line growth, falling short of their projections. Their leverage profile weakened considerably, and cash flow often turned negative under much higher interest expenses. While we expect deal activity to rise in 2024, elevated interest rates will keep financing costs high, and we believe stabilizing rates will allow buyers to better anticipate cash flow impact and, ultimately, manage their credit metrics.

Related Research

- Gen AI Is Writing A New Credit Story For Tech Giants, Nov. 13, 2023
- U.S. Tech Earnings Q3 2023: Cautious Enterprise Spending And Weakening Industrial Market Hinder Results, Nov. 9, 2023
- Credit FAQ: More Risks Ahead For Global Technology Companies As U.S. Restrictions Tighten, Nov. 8, 2023
- China's Chip 'Moonshot' –The Response To Restrictions, Nov. 2, 2023

Industry Forecasts: Technology

Chart 11

Revenue growth (local currency)

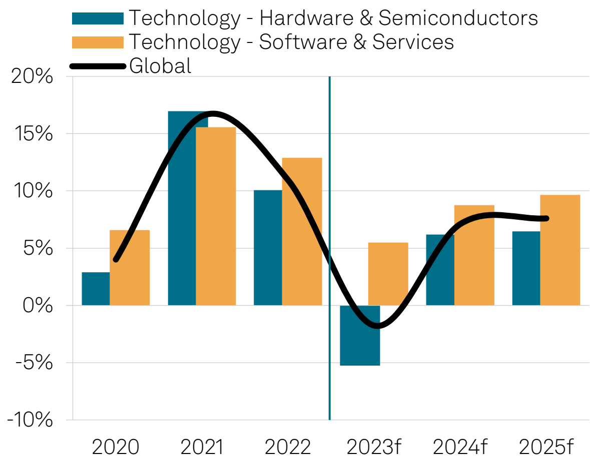


Chart 12

EBITDA margin (adjusted)

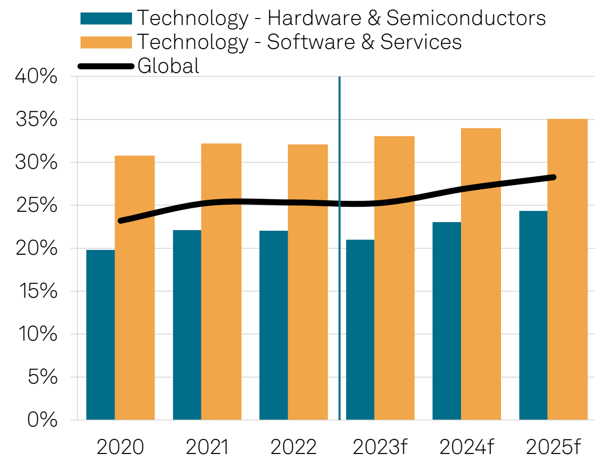


Chart 13

Debt / EBITDA (median, adjusted)

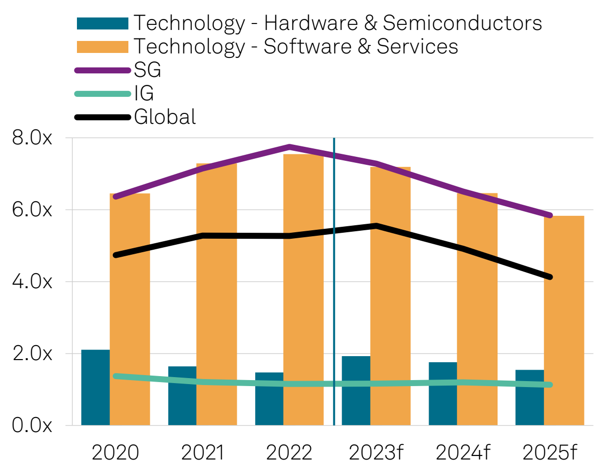
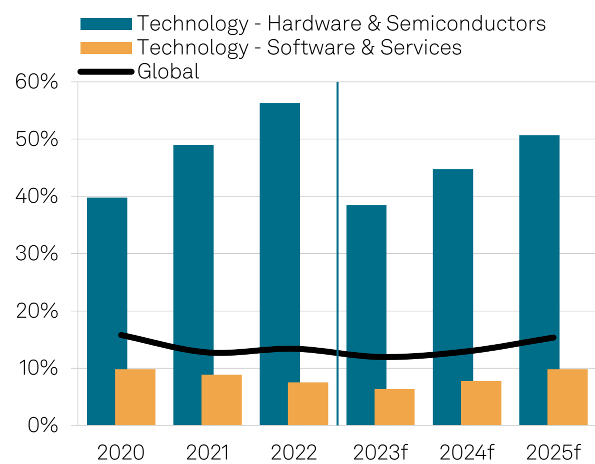


Chart 14

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: Technology

Chart 15

Cash flow and primary uses

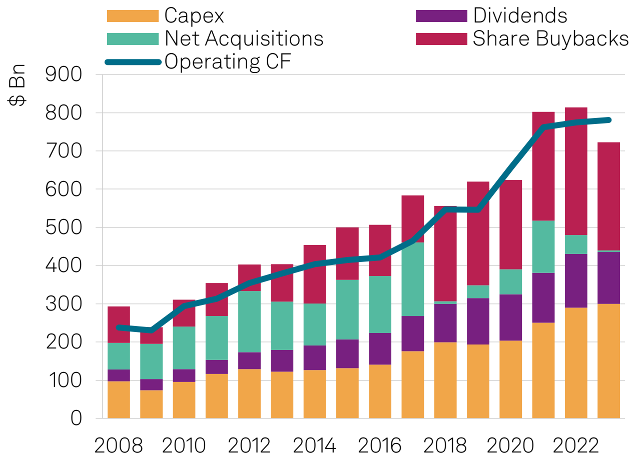


Chart 16

Return on capital employed

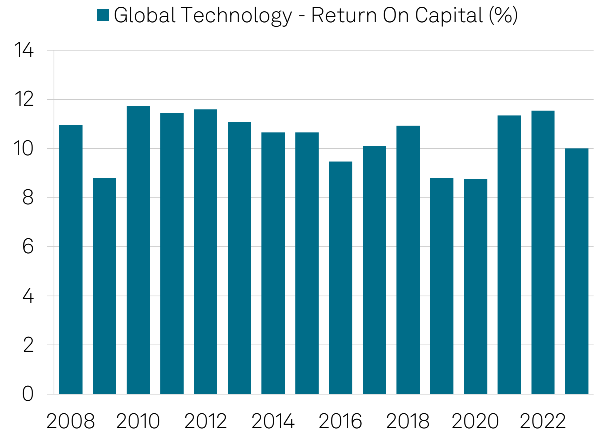


Chart 17

Fixed- versus variable-rate exposure

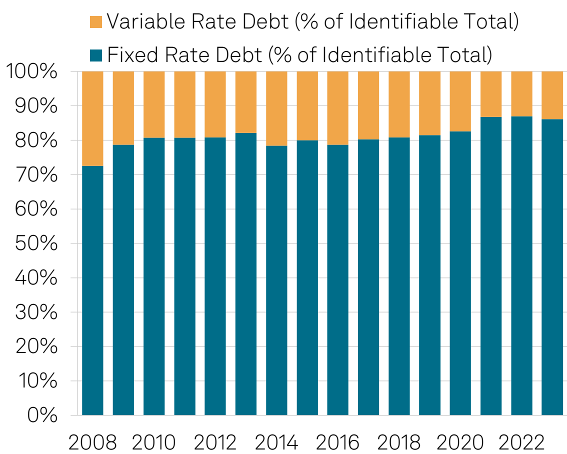


Chart 18

Long-term debt term structure

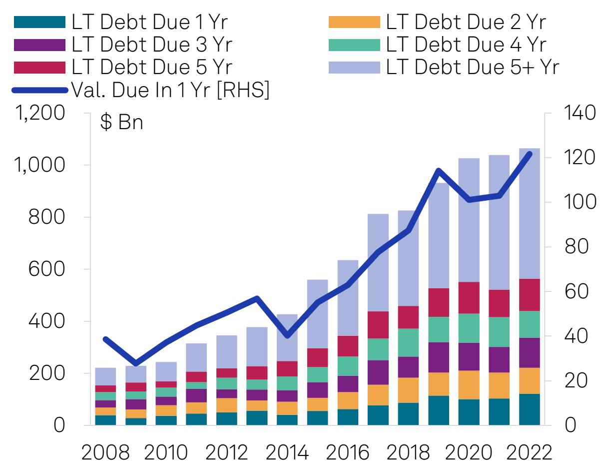


Chart 19

Cash and equivalents / Total assets

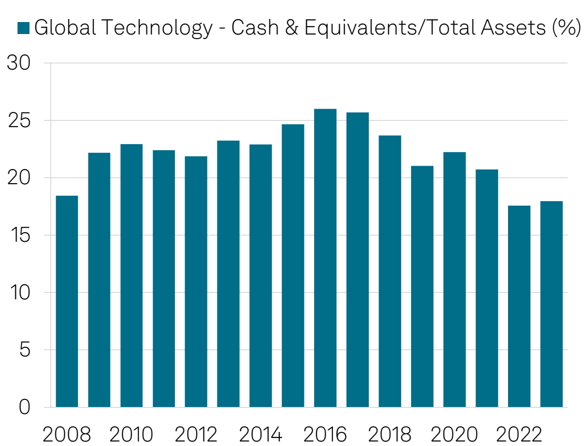
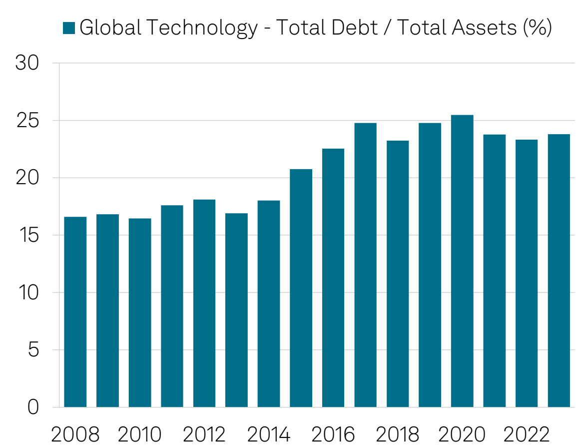


Chart 20

Total debt / Total assets



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

Telecoms

Healthy connectivity demand supports credit quality

January 9, 2024

This report does not constitute a rating action.

What's changed?

Inflation curtails profitability growth but EBITDA margins are still growing on price rises and efficiency programs.

Lower debt issuance. This reflects choppy capital markets, higher interest rates, and back-ended maturity walls.

Mergers and acquisitions (M&As) have increased in some markets. Telcos are seeking market consolidation to relieve competitive pressure.

What are the key assumptions for 2024?

Steady earnings for 2024. A 3%-4% EBITDA growth in 2023-2025 on higher revenue and margins, given stable demand.

Intense competition in some markets. Higher churn rates and lower average revenue per user (ARPU) levels, given poor market conditions.

Varying capital expenditures (capex). Cuts in capex on lower 5G and fiber spending in developed markets, unlike in markets with lagging rollouts.

What are the key risks around the baseline?

Lower cash flow if interest rates stay high. This is the case for companies with near-term refinancing or unhedged floating-rate debt.

A recession could raise competition. Discounted offerings to maintain customer loyalty could jeopardize pricing and margins.

Risks from higher-than-expected investments, M&As, or shareholder returns. These factors could erode credit metrics.

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Contributor
Tatjana Lescova

Ratings Trends: Telecoms

Chart 1
Ratings distribution

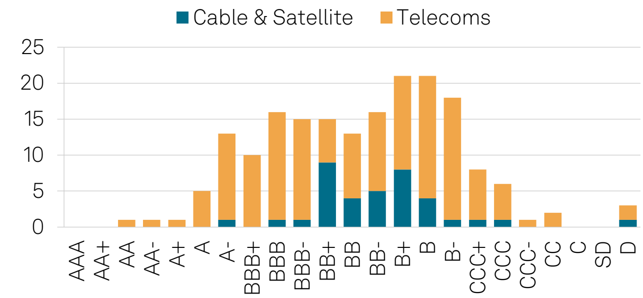


Chart 2
Ratings distribution by region

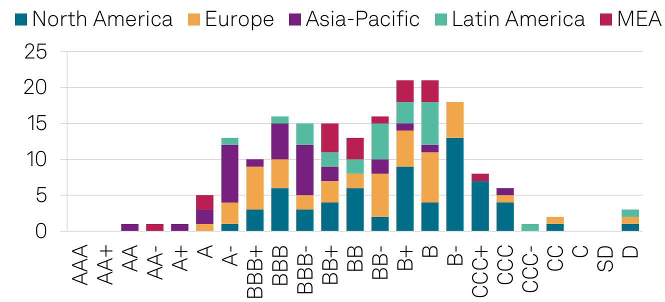


Chart 3
Ratings outlooks

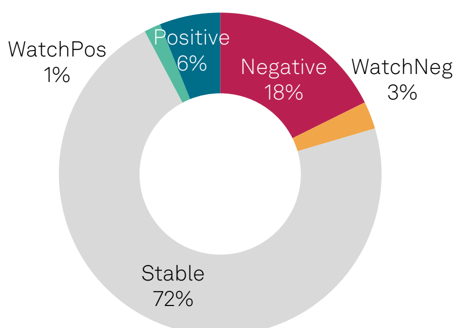


Chart 4
Ratings outlooks by region

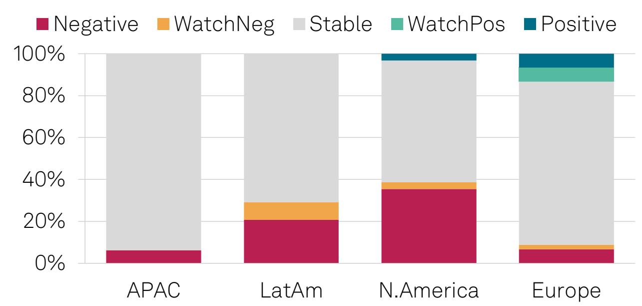


Chart 5
Ratings outlook net bias

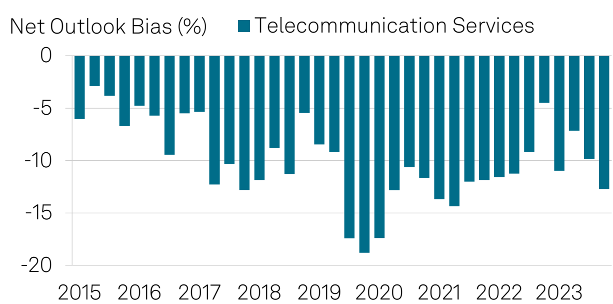
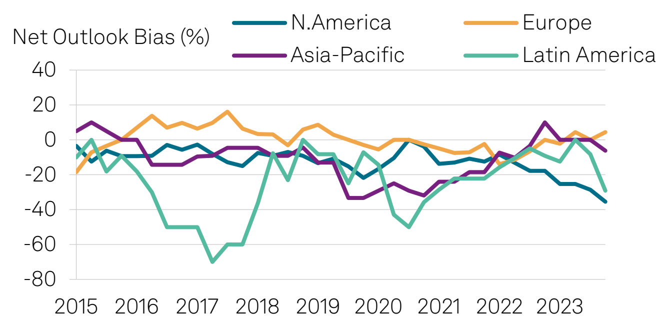


Chart 6
Ratings net outlook bias by region



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

Industry Outlook: Global

Ratings trends and outlook

Rating trends in the sector were moderately negative, with 39 downgrades, compared to 17 upgrades. The downgrade bias was mainly driven by the U.S. and Latin America (LatAm), and we expect this trend to continue. While about 72% of the telecom issuers have a stable outlook, negative outlooks increased, especially in North America and LatAm. In North America, the negative outlook bias has been mainly due to high interest rates and capital structures that can't absorb rising interest costs. In Chile and Colombia, intense competition and high capital needs hindered companies' cash flow, and consequently, increased leverage and tightened liquidity, which continued to weigh on credit metrics. Two percent of the region's rated issuers have a negative CreditWatch listing, mostly reflecting high refinancing risk and the increased potential for a downgrade.

In Europe, positive outlooks and CreditWatch positive placements have increased to 16% from 3% a year ago, and it's the only region with a positive rating bias. This is mainly because of M&As that reduce leverage or strengthen business profiles, the improvement in credit metrics, and revised sovereign outlooks in the region, such as that on Turkey. Overall, investment-grade companies constitute around one-third of the rated telecom entities, while the remaining ones are at speculative grade, primarily in the 'B' category.

For 2024, we continue expect stable trends. We expect moderate earnings growth as demand for data remains solid. EBITDA margins will be somewhat better because issuers are taking stringent cost-control measures to cope with higher operating costs and weaker global economic trends. We expect divestments will continue, given the need to create balance-sheet capacity for investments in networks or new revenue streams in business segments adjacent to traditional telco services to boost long-term earnings potential, especially in Asia-Pacific (APAC), LatAm, and the Gulf Cooperation Council (GCC). However, in the U.S., adverse trends will remain in place across telecom and cable issuers, as about 20% of the rated entities are in the 'CCC' rating category. Many of these issuers have floating-rate debt, so if high interest rates and volatile economic conditions continue, cash flow will weaken, hurting liquidity.

Main assumptions about 2024 and beyond

1. Earnings will remain steady for 2024.

We expect revenue growth averaging 2% for 2024, thanks to increased mobile data traffic, fixed mobile adoption in some markets like the U.S., lingering inflationary cost pass-throughs, and stable demand for telecom services in general.

2. Intense competition will continue.

High competition in markets with four or more players will remain in place, pressuring ARPUs and profitability.

3. Capex growth will vary regionally.

Capex will depend on the investment cycle that companies are in, with respect to the deployment of 5G and fiber technology.

Earnings will remain steady for 2024. Overall, we expect top-line growth for telcos will remain stable across regions. We expect growth in low- to mid-single-digits in most of the regions, reflecting stable demand for telecom services despite high competition, while a focus on cost-efficiency measures should support earnings growth.

In the U.S., wireless service revenue is likely to grow about 3% during this year and 2.5% in 2024 due to rate increases on legacy plans, customer migration to more expensive 5G plans, and growth from fixed wireless access (FWA). For cable operators, we expect a low-single-digit growth during 2024, reflecting broadband ARPU growth, improving wireless economics, business services, and footprint expansion.

In Canada, we expect mid-single digit growth in 2024 because of high immigration-led population growth and increasing penetration, partly offset by higher churn and increased competition, among other macroeconomic effects.

In Europe, we expect top-line growth to average 1%, slowing with inflation. Still, more sustainable competition levels should allow continued contract-based price increases on post-paid subscriptions, ad-hoc increases, and reduced promotional discounts for new customers. Combined with margin improvements, earnings are poised to grow 3%-4%

In LatAm, revenue growth will be modest, in line with the expectations for economic growth in the region.

In APAC, we expect mid-single-digit revenue growth for 2024, given increased mobile data traffic and fixed broadband adoption.

Intense competition in some markets will continue. Highly competitive market conditions, including the entrance of new players in some markets, have been disruptive for existing participants. Several telecom operators have been struggling to retain market share and have experienced churn-rate increases. To maintain market share, these companies have cut prices and extended promotional packages, lowering ARPU. This, together with cost pressures, could drag down companies' profitability and earnings. In this scenario, we will see weaker-than-average performance in countries with high competition.

In Italy, for example, Iliad Holding S.A.S. is a recent entrant and aggressive competitor that has quickly increased market share, limiting overall growth in the domestic market compared with other markets in Europe. Similarly, with the entrance of WOM S.A. into the Colombian and Chilean markets, several telecom operators have been experiencing a decline in ARPUs to defend their customer base amid intense competition.

However, in markets with three or fewer operators and with balanced market shares, we may see better performance. Such markets, sometimes as a result of consolidation, tend to be more stable and have lower churn levels. If supported by a predicable regulatory framework and higher interest rates suppressing non-sustainable pricing, competition should moderate, improving prices, and increasing growth prospects.

Capex is down overall but varies regionally. Capex will depend on the state of 5G and fiber rollout of telcos. Investments have fallen in 2023 in the U.S., Canada, and EMEA markets, where deployment is in the final stages. Fiber rollout is near completion for many markets in these regions, and 5G spending has slowed down after extensive investments for initial rollouts. We expect a 10% decline in capex among U.S. telcos, based on a slower pace of investments in wireless and wireline services.

We also expect average capex intensity in EMEA will fall and remain near 17% of revenue, down from its 20% peak in 2021, which should continue to improve cash flow and financial flexibility.

The same approach has been evident in Canada, where we expect telcos will ease capital intensity to bolster free operating cash flow (FOCF) during 2024.

In APAC, as the first wave of 5G investments is over, companies are more focused on network quality spending, while investments for new technology will remain cautious.

Meanwhile, LatAm remains in the initial stages for 5G, and capex will remain elevated. We believe that incumbent players are more likely to be the main 5G providers due to their greater financial flexibility with higher profitability margins and stronger liquidity positions, allowing for larger investments in the new technology.

Credit metrics and financial policy

We expect modest improvement in credit metrics through 2024, but the positive rating momentum will require clearer financial policy commitments. Most operators are generating modest EBITDA growth and cash flow because of cost-cutting initiatives and lower capex. As a result, we expect some improvement in FOCF and increased financial flexibility. But because of our forecast of a relatively low growth, persistently high interest rates, and lingering inflation (especially on the labor front), financial policies will need to prioritize debt reduction to translate better cash flows into rating upside, especially when refinancings arrive and capital structures reset at higher rates.

We expect asset sales to continue during 2024. Telcos started selling tower portfolios and, more recently, fixed-network assets. These sales have improved telcos' financial flexibility by strengthening their balance sheets, and could have a significant impact on reducing investment requirements, boosting FOCF in 2024. But this trend may be compromised if the sales of strategic assets impair telcos' business profiles, a risk we view more prominently with fiber sales.

Key risks or opportunities around the baseline

1. Lower cash flows for operators with leveraged capital structures if interest rates remain high.

Companies with refinancing needs or unhedged floating-rate debt face higher interest rates, which will weaken cash flow and interest coverage metrics, increasing ratings pressure.

2. A recession could heighten competition if reduced discretionary spending makes consumers more price sensitive.

Telcos may expand offers of attractive products and packages to maintain customer loyalty, hampering their ability to maintain or increase pricing, eventually eroding margins.

3. Increasing investments or shareholder returns could limit credit metric improvements.

If companies start facing pressures for higher shareholder returns or accelerated investments, credit metrics could deteriorate.

Cash flows of telcos with leveraged capital structures could fall if high interest rates continue. Telcos will have to navigate a slower economic growth environment, and high inflation and interest rates. This could pressure speculative-grade issuers in particular, for which high leverage makes liquidity management, FOCF, and interest coverage key to maintaining creditworthiness.

We have seen companies taking advantage of low interest rates in the recent past, and liability management has been essential in preventing refinancing risks. However, companies with significant short-term debt maturities or unhedged floating-rate debt face higher interest rates, which will dent cash flow and interest coverage metrics, ratcheting up pressure on ratings.

Prolonged high interest rates could also constrain access to capital markets for some companies, weakening liquidity.

A recession could heighten competitive pressure if reduced discretionary spending makes consumers more price sensitive. If telcos need to expand offerings of attractive products and packages to maintain customer loyalty, it could hamper their ability to maintain or increase pricing. Price competition could increase churn and weaken ARPU and revenue as companies will need to lower prices and bundle packages to retain customers. This could result in slower upgrades to higher-priced plans and longer handset replacement cycles, especially in the price-sensitive and predominantly prepaid markets.

Increasing investments or shareholder returns could limit credit metric improvement. We believe companies will maintain financial discipline amid the currently weak economic environment. In regions where moderate EBITDA growth and declining capex are improving cash flow and financial flexibility, we expect a balanced approach to deleveraging, investments, and shareholder returns. However, if companies start facing pressures for higher shareholder returns or accelerated investments, including debt-funded M&As, their credit metrics could weaken.

Industry Outlook: North America

Rating trends and outlook

More negative rating actions in 2024. Notwithstanding solid industry fundamentals, downgrades outpaced upgrades by five to one in the U.S. due to high interest rates and capital structures that couldn't absorb rising interest costs. About 20% of the rated telecom and cable issuers in the U.S. are now in the 'CCC' category, and the outlook bias is increasingly negative, with about one-third of our ratings on a negative outlook or on CreditWatch with negative implications.

In 2024, we expect downgrades will continue to outpace upgrades across U.S. and Canadian telecom and cable operators, as highly leveraged capital structures are increasingly stressed by elevated interest expenses, primarily among issuers in the lower end of the ratings scale. We therefore expect the percent of issuers in the 'CCC' category to increase. Many of these companies have a significant amount of floating-rate debt that will depress cash flow and liquidity.

Main assumptions about 2024 and beyond

1. Modest service revenue and earnings growth in the wireless market.

We forecast a 2.5% industry service revenue and 5% EBITDA growth in 2024 due to rate increases, customer migration to more expensive 5G data plans, postpaid net adds, and growth from FWA.

2. A low-single-digit EBITDA growth for cable in 2024.

We project modest EBITDA growth will primarily stem from higher broadband ARPU, footprint expansion, business services, and improving wireless economics for the larger operators, which will be partly offset by modestly lower broadband penetration levels due to elevated competition from FWA and fiber to the home (FTTH).

3. Telcos' capex to decline, while cable investments to increase.

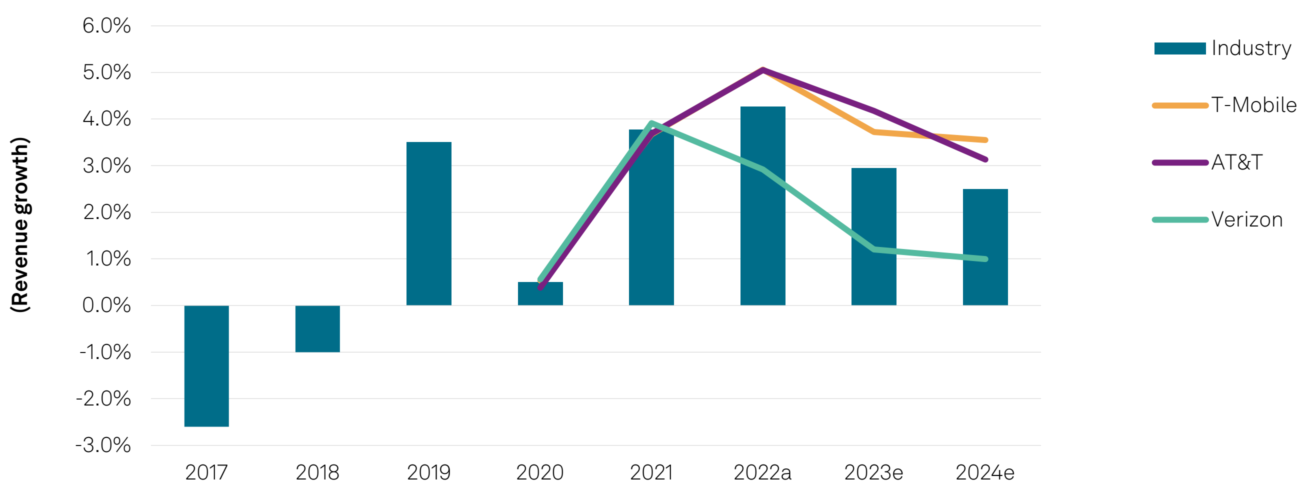
We expect capital intensity to decline in the wireless segment as carriers wind down their initial 5G network builds. In the cable segment, we expect capex to increase modestly to enable multigigabit download speeds and at least 1 Gbps upload speeds.

U.S. wireless subscriber and service revenue growth to slow in 2024. Overall, wireless postpaid subscriber trends remained healthy during the first nine months of 2023 despite maturing industry conditions, although cable took a larger share. We expect more of the same in 2024 (see chart 7), although the pool of potential customers continues to shrink, and we forecast a 7%-9% decline in postpaid phone net adds during the year. Furthermore, we expect cable's share of postpaid phone net adds will increase to almost 52% from 45% in 2023.

Excluding Verizon Communications Inc.'s reclassification of wireless "other" revenue into service revenue, we expect overall industry wireless service revenue growth of about 3% in 2023, down from 4% in 2022. Notwithstanding our expectation for slowing postpaid subscriber growth and prepaid losses, we forecast the industry's service revenue will rise by about 2.5% in 2024 due to rate increases on legacy plans, customer migration to more expensive 5G rate plans, and growth from FWA. We also expect upgrade rates will remain low in 2024 as consumers hold on to their handsets for longer periods, given the limited appeal of new devices and the migration of customers to three-year contracts from two years, which reduces monthly handset expenses. While this will continue to pressure equipment revenue, it also benefits carriers' profitability since they don't earn any money from handset sales. Coupled with cost-reduction initiatives and improved spectral efficiency from 5G wireless technology, we expect 3% earnings growth in 2024, somewhat lower than our forecasted 5% growth in 2023.

Chart 7

U.S. wireless annual service revenue growth rate



a—Actual. e—Estimate. Source: S&P Global Ratings.

Cable earnings to grow in low-single digits in 2024, aided by wireless (see chart 8). We project that modest EBITDA growth will primarily result from higher broadband ARPU, footprint expansion, business services, and improving wireless economics for the larger operators, which will be partly offset by modestly lower broadband penetration levels due to elevated competition from FWA and FTTH.

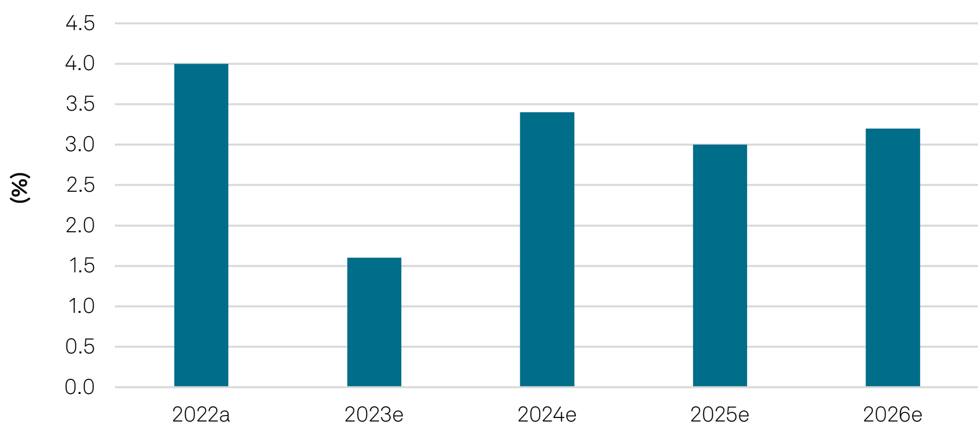
We believe attractively priced mobile wireless serves as a powerful broadband churn reduction mechanism for large cable operators. Given the capital-light nature of the service and that these operators aren't running wireless to maximize stand-alone profits, we believe they can match or exceed any discount on broadband offered by a FWA or FTTH competitor, particularly considering the average wireless spend is 3x the in-home broadband bill. We believe this will continue to limit subscriber losses, despite elevated competition.

Separately, for large cable operators, we believe wireless offerings will bolster EBITDA growth in the next three years as the drag from new customer additions is more limited, start-up costs ease, and overhead can be spread over a larger customer base. Both Comcast Corp. and Charter Communications Inc. have about 10% of broadband homes on wireless plans, so we believe there is substantial room for growth with an economically healthy mobile virtual network operator (MVNO). We believe the economics will improve over time as these companies move traffic on-network, utilizing their holdings of Citizens Broadband Radio Service spectrum licenses via stand-mounted small cells.

For smaller operators, we believe wireless will be a drag on profitability initially. It took Comcast about four years to reach stand-alone profitability. Given their more limited scale, these smaller operators may not receive such attractive terms on their wholesale MNVO arrangements, which could limit their ability to price as aggressively as Comcast and Charter. Furthermore, certain highly leveraged operators such as Altice USA Inc. don't have the financial flexibility to absorb wireless losses, which could limit their effectiveness.

Chart 8

U.S. cable industry weighted average EBITDA growth



a—Actual. e—Estimate. Source: S&P Global Ratings.

In Canada, we expect telecom revenue to rise by low- to mid-single-digits. The Canadian industry is largely vertically integrated, including significant media ownership. Following the merger of Rogers Communications Inc. (RCI) and Shaw Communications Inc. earlier this year, the three incumbent players (Bell Canada Inc., RCI, and Telus Corp.) generate more than 90% of Canadian telecom revenue. We anticipate underlying earnings growth for the sector in 2024 to stem from immigration-led population growth, sustained ARPU, strong roaming revenue, and digitization, offsetting higher competition, weakening affordability, inflation, and other macroeconomic effects. However, large restructuring charges will undermine reported earnings. We also believe lower wireless penetration (than in the U.S. and Europe) and increased immigration through 2025 will continue to support wireless revenue growth.

Canadian carriers have benefited from the convergence approach, and we expect them to further integrate their services and support bundled offerings, increasing competition. With FTTH covering a significant portion (70%-80%) of Bell's and Telus' broadband footprints, competition has surged in the broadband space, with telcos getting most of the net adds compared with cable operators. At the same time, with RCI completing the merger with Shaw and Videotron Ltd. acquiring Freedom Mobile Inc.'s wireless assets earlier in 2023, we expect competition to increase in the wireless and broadband sectors as both RCI and Videotron start providing services nationwide. We view Telus as most at risk from the increased competition in western Canada. In our view, both competitive and regulatory risks are likely on the rise in the near term.

Telcos' capex will continue to decline in 2024. We expect U.S. telcos' capex to drop by about 10% in 2024 following an approximate 12% fall in 2023. We base our forecast on the following factors:

- We expect wireless capex to decline by about 9% in 2024 as mid-band spectrum deployments are largely completed and the initial surge from 5G spending winds down. Furthermore, T-Mobile US Inc. continues to realize capex synergies from its acquisition of Sprint Corp.
- Wireline capex to decline by about 10% in 2024 following a 1% increase in 2023 as the wireline operators scale back their FTTH builds to conserve cash flow amid high interest rates. Lumen Technologies Inc. announced that its capex will decline by $200 million-$300 million in 2024 as it moderates the pace of fiber builds. Consolidated Communications Holdings Inc. plans to pass 75,000 homes in 2024, down from 222,000 in 2023. While we expect Frontier Communications Holdings LLC will maintain its fiber build pace of about 1.3 million passings, we also believe it will increase its mix of lower-cost deployments (i.e. lower cost per passing).

In line with the U.S., capex among Canadian telcos is also likely to decline as both Telus and BCE Inc. complete the majority of their fiber build and return capex to normal levels; BCE has announced it will curb capex by an additional $1 billion in 2024-2025 in response to the regulatory decision. We expect telcos' easing capital intensity to strengthen FOCF in 2024. RCI's capex, pro forma the merger with Shaw, as well as that of Videotron are likely to increase significantly but still stay within the usual capital intensity level. Overall, capital intensity among Canadian players will remain in the 16%-18% range of telecom revenues. The C-band spectrum auction spending was only $1.9 billion for incumbents (including Videotron), although cash payments are not due until the second quarter of 2024.

Cable capex will increase in 2024. We believe the coaxial network upgrade cycle that most cable operators will embark on in the next three years is necessary and will provide a path toward long-term ARPU growth while also serving to protect existing market shares. These upgrades are within the historical capital spending levels of 12%-14% of revenue and can be achieved for a relatively affordable amount of $100-$200 per home passed. These investments will enable multigigabit download speeds and at least 1 Gbps upload speeds, which are important from a marketing and competitive standpoint.

We also view rural footprint expansion favorably, provided that it doesn't increase financial leverage but rather comes in lieu of shareholder returns, which we expect for most cable providers. Government-subsidized rural footprint expansion will help drive subscriber and EBITDA growth because there's no competition from fiber in these markets, so customer penetration will likely be above average. We believe this will be the primary driver of subscriber growth in the future, given the increasingly competitive and mature conditions in incumbent markets.

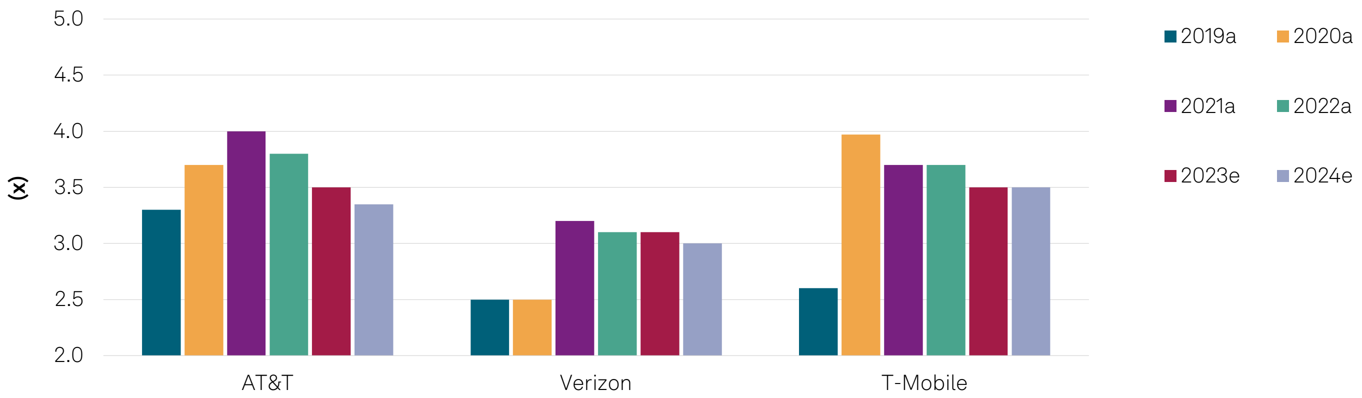
Credit metrics and financial policy

We expect modest improvement in credit metrics for large telcos. We assume earnings growth and lower capex will improve FOCF and adjusted leverage in 2024 (see chart 9). That said, our base-case forecast doesn't include any shareholder distributions beyond what has been communicated by the companies, although we believe there's greater risk that new share repurchase programs are initiated by AT&T Inc. and Verizon, which limits leverage improvement.

For T-Mobile, we expect shareholder distributions will offset earnings growth and FOCF, such that leverage remains steady in the mid-3x area.

Chart 9

U.S. wireless adjusted debt-to-EBITDA



a—Actual. e—Estimate. Source: S&P Global Ratings.

Wirelines continue to face headwinds in 2024. While the outlook for U.S. wirelines could be favorable in the longer term, we expect challenges to persist in 2024, resulting in weak credit metrics at a time when they're trying to reverse the trajectory of earnings declines. High interest rates, inflation, and exposure to legacy revenues such as multiprotocol label switching (MPLS) and digital subscriber line services will continue to weigh on credit quality of U.S. wirelines as they transition their business to FTTH.

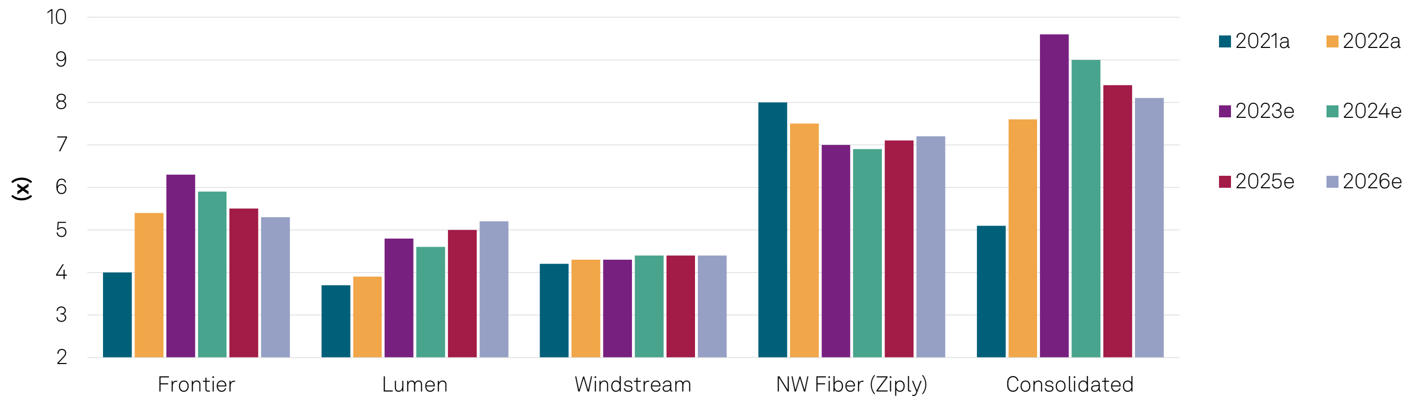
We expect overall pressures to continue in 2024 with revenue declining 4%-5%, although results will vary by provider, depending on how far along they are with their fiber builds. At the same time, we expect revenue from business services will continue to fall by high-single digits due to reduced IT spending and exposure to legacy products and services. However, our base-case forecast assumes the industry will begin to see favorable earnings trends by 2025 due to the following:

- Increasing fiber coverage should start to yield benefits even if the fiber broadband subscriber growth is not sufficient to offset losses from copper, since FTTH customers typically generate higher ARPUs, which should rise over time as they move to higher-tier data packages.
- Greater scale and cost-cutting initiatives following several years of buildout activity.
- Potential recovery in IT spending once economic growth picks up in 2025.

Despite our expectation for lower capex in 2024, we expect credit metrics, including adjusted leverage, will remain weak during the year because we assume higher interest expense will continue to pressure FOCF even if industry EBITDA grows (see chart 10).

Chart 10

U.S. wireline adjusted debt-to-EBITDA



a—Actual. e—Estimate. Source: S&P Global Ratings.

Credit metrics in the Canadian telecom industry should show modest improvement through 2024. Telcos' easing capital intensity should strengthen FOCF in 2024 and afterward for BCE and Telus. RCI continues to deleverage, and our base-case scenario assumes leverage to hit low-4x in the third year following the close of the merger. In our view, the C$2.2 billion paid by the industry for the 3.8 GHz spectrum auction (significantly lower than the 2021 $8.5 billion 3.5 GHz spectrum auction) and moderating capex partly compensate for the increasing competitive intensity, regulatory headwinds, and aggressive financial policy, which we view as risks to a consistent pace of deleveraging.

U.S. cable credit metrics should remain stable in 2024. We expect U.S. cable providers' adjusted debt to EBITDA will be relatively stable as most operators are still generating modest EBITDA growth and cash flow, with the ability to manage leverage according to their targets. However, financial flexibility will decline, given elevated capital spending associated with network upgrades and footprint expansion, which will pressure the FOCF-to-debt metric to some degree.

Key risks or opportunities around the baseline

1. High-for-longer-interest rates and looming debt maturities weigh on high-yield credits.

While investment-grade companies should be able to manage their debt refinancing, there's greater risk for speculative-grade U.S. telecom and cable issuers, specifically at the lower end of the rating scale.

2. U.S. telcos may allocate excess cash flow to shareholder returns.

We currently expect telcos to generate greater FOCF and focus on leverage reduction. However, lagging stock prices could push companies to allocate a larger share of their FOCF to shareholder returns.

3. FWA and FTTH competition causes broadband subscriber losses to increase, leading to lower earnings.

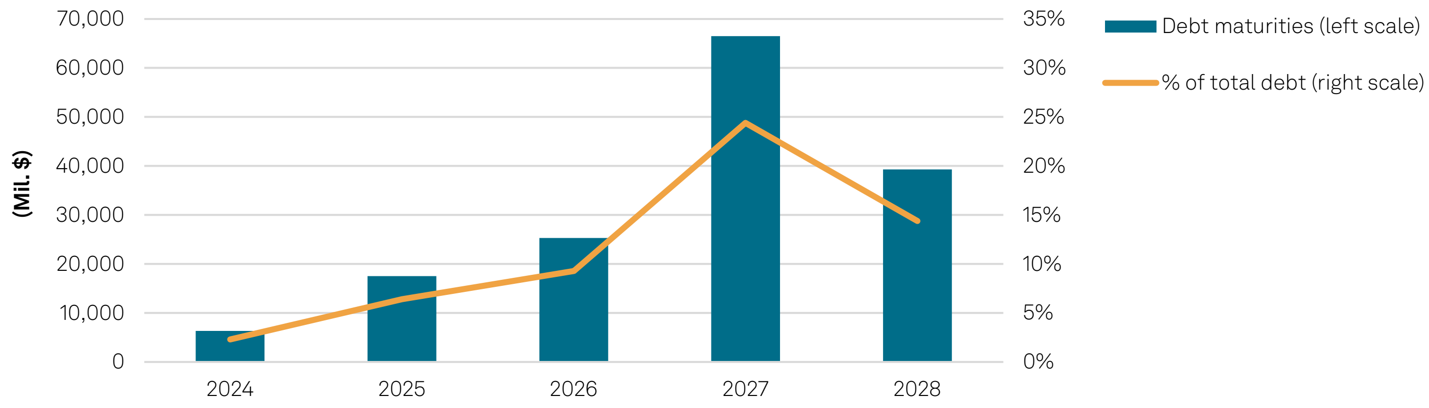
While we currently forecast a 3.0%-3.5% EBITDA growth, increasing competition from FWA and FTTH could result in high-speed data (HSD) subscriber losses, reducing earnings.

High-for-longer interest rates could strain speculative-grade rated issuers. That said, overall, we believe the speculative-grade telecom and cable sector has sufficient breathing room for deleveraging or to refinance well in advance of their debt maturities. We estimate there's about

$6 billion of speculative-grade telecom and cable debt that matures in 2024, or 2% of the total (see chart 11). The amount increases to about $17.5 billion in 2025 (6%) and to $25 billion in 2026 (9%). Among issuers rated 'B' and below, we estimate that about $5.5 billion of debt matures in 2024 (4%), $8 billion in 2025 (7%), and $16 billion in 2026 (13%). The big refinancing wall for speculative-grade U.S. telecom and cable issuers won't occur until 2027, when almost 24% of outstanding debt will need to be refinanced, and among issuers rated 'B' and below, the percent will be about 30%.

Chart 11

U.S. speculative-grade telecom and cable debt maturity profile



Source: S&P Global Ratings.

Not surprisingly, issuers that have the greatest refinancing risk are in the 'CCC' category and include:

- **Dish Network Corp./DISH DBS Corp.:** The company faces large debt maturities of $2.9 billion in 2024, $2.0 billion in 2025, and $7.7 billion in 2026, while generating a FOCF shortfall. While the company's proposed all-stock merger with Hughes Satellite Systems Corp. will bolster its liquidity position--which includes about $2 billion of cash, marketable investments, and $250 million-$300 million of FOCF--it will be very difficult for Dish to refinance its upcoming obligations at an affordable rate.
- **Lumen:** The company entered into a transaction support agreement (TSA) with a group of its creditors holding about $7 billion of its outstanding debt. The company currently has about $1.7 billion due in 2025, $498 million in 2026, and $9.5 billion due in 2027. While the TSA would enable the company to push out the bulk of its debt obligations to 2029 and 2030, giving it time to execute its turnaround strategy, the agreement still doesn't have enough support from its creditors to initiate the transaction.
- **Anuvu Corp.:** The satellite connectivity provider's adjusted leverage remains elevated, at above 10x, and higher interest rates have depressed the company's FOCF and liquidity. While there's no debt repayment due in 2024, almost half of its debt obligations come due in 2025 and the remaining amount in 2026.
- **Logix Intermediate Holdco.:** The fiber bandwidth provider has about $175 million of first lien debt due in December 2024 and another $125 million of second lien debt due in 2025.

Increasing pressure for shareholder returns could constrain the improvement in credit metrics of large U.S. telcos. Both AT&T and Verizon raised their free cash flow guidance for 2023 due to cost savings, working capital efficiencies, and better operating trends. AT&T increased its free cash flow outlook to $16.5 billion from $16.0 billion, notwithstanding the use of excess cash flow to pay down its vendor and direct supplier financing obligations, which we include in our adjusted leverage calculation. Verizon raised its free cash flow guidance to $18 billion from $17 billion despite capex coming in at the higher end of its $18.25 billion-$19.25 billion guidance.

While we expect telcos to prioritize debt reduction, given high interest rates, lagging stock prices could prompt companies to increase shareholder returns sooner than expected. Verizon's reported net unsecured debt to EBITDA was 2.6x as of Sept. 30, 2023, and management indicated it could buy back stock once this metric hits 2.25x. We believe the company can reach this leverage level by mid-2025. However, we believe there's greater risk that it initiates a share repurchase program prior to reducing its net unsecured leverage to 2.25x if equity returns don't improve. Similarly, we believe AT&T will reach its net leverage target of 2.5x in the first half of 2025, but the need to appease shareholders may force management to repurchase shares at the expense of creditors.

We could adjust our rating triggers for cable operators if business prospects weaken and competition is more intense than we expect. Although currently not part of our base-case scenario, if competition from FTTH and FWA increases, resulting in persistent earnings declines for U.S. cable providers, we could revise our rating triggers. This could be caused by higher-than-expected FWA subscriber growth and network investments, FTTH penetration exceeding our long-term expectations of about 55% of the U.S., or greater-than-expected pricing pressure from new competitors. Therefore, we will be closely monitoring operating metrics such as HSD ARPU growth, HSD subscriber trends, wireless growth and profitability, and footprint expansion initiatives.

Industry Outlook: EMEA

Ratings trends and outlook

We expect stable ratings in 2024, thanks to incremental revenue and profitability gains, and lower capex. As inflation subsides, price hikes will moderate and revenue growth is likely to slow in 2024. However, EBITDA growth and lower capex should continue to improve cash flows and financial flexibility, and the rating headroom potential, though only sufficient for the rating upside in a few cases.

We enter 2024 with negative outlooks and CreditWatch placements on 6% of our ratings (down from 18% a year ago). This is more than offset by positive outlooks and CreditWatch placements, resulting in a positive bias of about 10%. The decline in negative outlooks and CreditWatch placements partly reflects the resolution of prior outlooks to downgrades. The remaining negatives reflect weak credit ratios (Bouygues S.A.) as well as refinancing and sustainability concerns (TalkTalk Telecom Group PLC and Eolo S.p.A.).

Positive outlooks have increased to 16% and stem from M&As (TIM, PPF Telecom Group B.V., and Lorca Telecom BidCo S.A.U.), improving credit metrics (Swisscom AG, Cellnex Telecom S.A., and United Group B.V.), and revised sovereign outlooks that cap our ratings (Turk Telekom and Turkcell Iletisim Hizmetleri S.A.). Of our European telecom ratings, 78% carried a stable outlook (compared with 70% a year ago), and Europe has the strongest regional balance globally.

Downgrades and upgrades in 2023 were balanced at five each, reflecting the sector's stability, as 80% of ratings were unchanged. Downgrades resulted from idiosyncratic, rather than sector-wide, operational factors. These included leveraged financing for M&As (Eutelsat Communications S.A.), weak credit ratios and cash flow shortfalls (Proximus S.A., Altice France S.A., and TalkTalk), along with Tele Columbus AG, which we downgraded twice on its path to default. This was balanced by our upgrades stemming from deleveraging (Deutsche Telekom AG, Matterhorn Telecom S.A., and Zacapa S.a.R.L.), and for upgrades of linked entities (Hellenic Telecommunications Organization S.A. and Turkcell).

Main assumptions about 2024 and beyond

1. Revenue gains will likely slow as inflation begins to abate, and earnings rise on margin growth.

We expect revenue growth averaging 1% in the next two years, lower than in the last two years as slowing inflation dampens CPI-linked price increases. Cost control from efficiency programs, realization of synergies, and lower energy costs will increase margins and EBITDA gains, despite labor costs that will continue to climb.

2. Capex will decline to a sustainably lower level for the next few years, improving cash flow.

We think telcos' capex to support fiber and 5G mobile rollouts peaked in 2021 at 21% and will decline to about 17% in 2023. This new level should be sustainable, improving FOCF, though we expect variation around the average based on the degree of buildout progress in various markets.

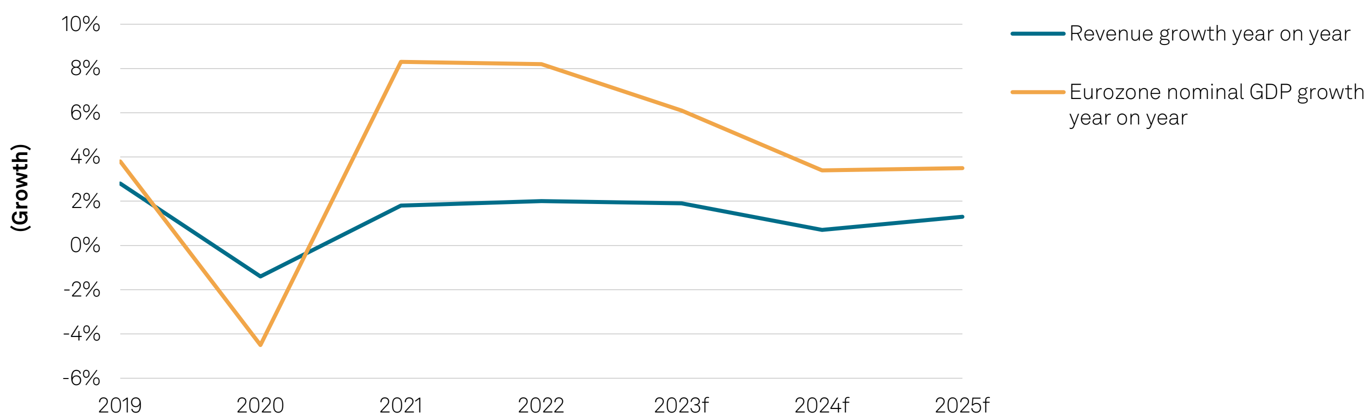
3. Improved cash flow will raise financial flexibility, but with no material rating upside, unless supported by conservative financial policy

Revenue and margin growth and lower capex should strengthen cash flow and financial flexibility for many operators. Credit impact will depend on financial policy and management prioritization between deleveraging, accelerated investments, M&As, and shareholder returns.

Revenue gains will slow as inflation begins to subside, and we expect a faster rise in earnings on margin growth. Led by the U.K., Belgium, Portugal, and the Nordics, service revenue trends have broadly turned favorable in the past two years (see chart 12). This is thanks to contract-based inflation indexation on post-paid subscriptions in several markets, ad-hoc increases in others, and a reduction in promotional activity to lift the front book--that is, price plans for new customers. We expect this will continue to support top-line revenue growth of slightly more than 1% on average for 2023-2025. Given our base-case assumption of a 3.4% nominal GDP growth in 2024 for the eurozone, telecom revenue growth will lag inflation and be negative in real terms.

Chart 12

European telcos' and cablecos' revenue growth lags GDP growth



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

Growth rates are uneven across markets. Countries with intense competition and challenging market structures will continue to see weaker-than-average telecom performance. Italy and France, for example, have four-player markets with an aggressive price competitor. In both cases, this entity is Iliad, whose Free brand has been gaining customer share at the expense of existing players. In France, Iliad has been able to drive up its ARPU without raising prices by migrating customers to its higher-end offer from its basic plan. This has limited price increases among competitors, as they risk an increase in churn if they raise rates more aggressively.

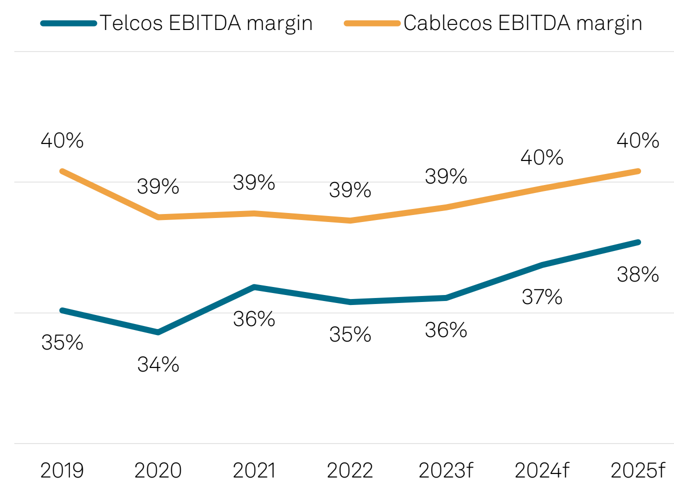
The boost from contractual price increases and reduced promotional activity will dissipate in the next two years. Our macroeconomic forecast for inflation of 2% by late 2025 means the tailwind from automatic contractual price increases will subside in the next two years. This will test telcos' ability to continue making gains from pricing. Meanwhile, we don't view the reduction in promotional offers as an ongoing growth driver. Once the discount or the discount period is reduced, the benefit is harvested and can't be reaped again in the same way that price increases can. And, in our view, such reductions are more likely than price increases to reverse if competition ramps up.

We expect a steady rise in margins despite lingering inflation. We expect European telcos to realize modest profitability gains, pushing EBITDA margins up by about one percentage point annually through 2025 (see chart 13). The fall in energy costs has boosted EBITDA, and a drop in low-margin equipment sales has improved the revenue mix. Labor costs are moving front and center in telcos' cost structures this year and in 2024, as measures of inflation (like the producer price index and consumer price index) fall, while wage growth, still above 7%, remains higher.

Wages typically constitute 15%-20% of telcos' revenue, so a 5% increase in wages erodes margins by about 1%. Wages are also stickier and unlikely to fall as energy costs have done over the past year. We therefore forecast labor costs will counterbalance margin expansion. However, the offsetting factors are the drop in energy prices; the effect of longstanding efficiency programs, including workforce reductions, digitalization, and enhancement of sales channels and customer service using artificial intelligence; and the growing shift to fiber networks, which have lower operating costs than copper networks.

Chart 13

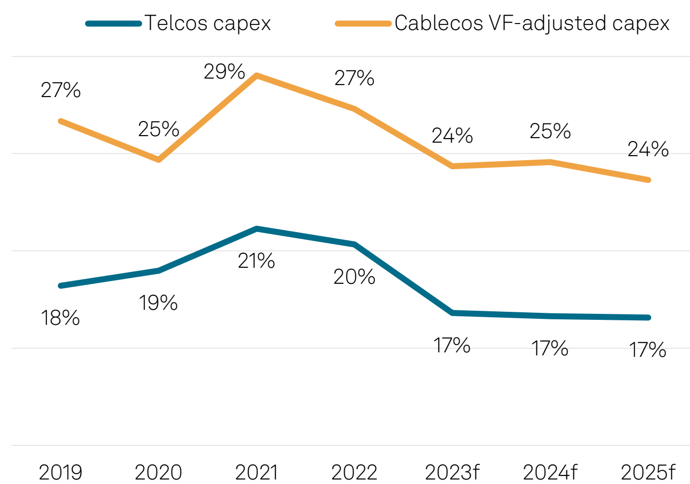
European telecoms average margins (% of sales)



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

Chart 14

European telecoms average capex (% of sales)



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

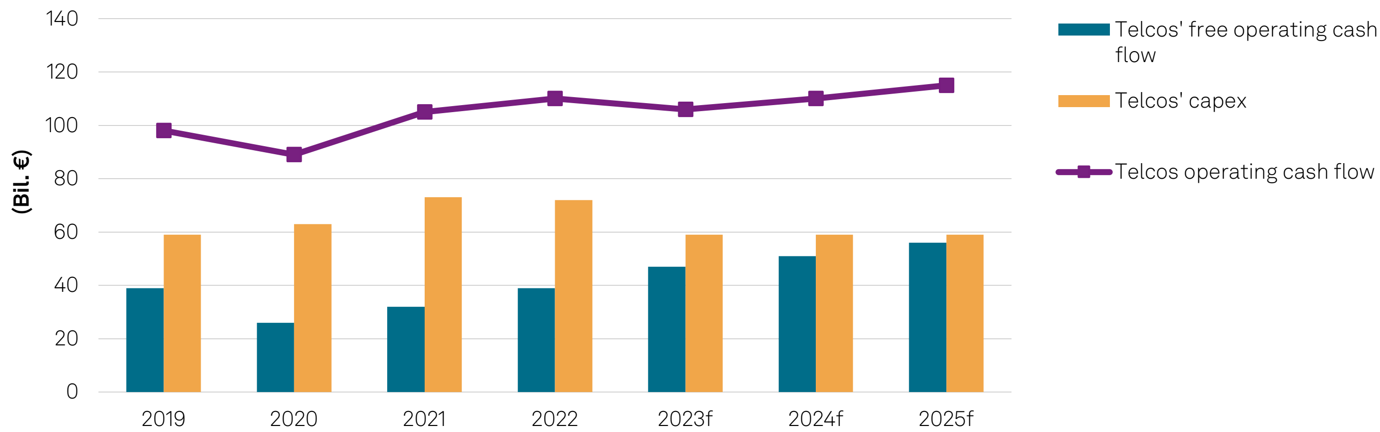
Capex will shrink to a sustainably lower level for the next few years, improving cash flow. After remaining chronically elevated for a decade due to 4G rollouts and long-term densification, fiber, and then 5G, capex has dropped sharply in 2023, averaging 17% of revenue, and will remain stable at that level through to 2025, in our view (see chart 14). But the trend is uneven among markets. The drop is mainly due to primary fiber rollouts nearing completion in large markets like Spain and France, and to a lesser extent a slowdown in 5G spending after the peak of the initial rollouts in many markets.

As operators decommission their copper networks, the lower maintenance capex associated with passive fiber networks should allow them to reduce investments. We expect incumbents like Orange S.A. will see capex intensity fall to 16% in 2023 and to 15% in 2025, and Telefonica S.A. to 14% and 12%, respectively. On the other hand, with fiber rollouts in the U.K. and Germany--two markets that are significantly behind in fiber coverage--only now reaching full throttle, capex of telcos there will remain above 20%. We forecast that British Telecommunications PLC will have a 24% capex intensity through to 2025. But in aggregate, the falling capex intensity is good news for telcos' cash flows.

Improved cash flow will raise financial flexibility, but without material rating upside, unless supported by conservative financial policy. The recent expansion in FOCF should continue, more than doubling from the 2020 level by 2025 (see chart 15). This, along with EBITDA expansion, should give telcos the financial flexibility to reduce leverage and increase the rating headroom amid tighter funding conditions. However, companies are facing competing priorities, and the credit impact will depend on financial policy and relative prioritization between deleveraging, accelerated investment, M&As, and shareholder returns.

Chart 15

European telcos' consolidated operating cash flow breakdown



f—Forecast. Capex—Capital expenditure. Source: S&P Global Ratings.

Credit metrics and financial policy

Modest revenue, EBITDA, and FOCF gains will increase the headroom for ratings, but with the exceptions of Swisscom, Cellnex, and United, we don't see metric improvement leading to positive rating momentum.

With low growth prospects and equity values, operators have scant financial flexibility to address their significant investment and shareholder return demands. Therefore, our analysis will focus on financial policy and capital allocation decisions in the next two years that will be critical as revenue growth could stall and high interest rates--which we expect to peak in 2024, but remain elevated afterward--could re-base interest costs considerably higher if leverage levels stay unchanged.

Given tighter funding conditions, we expect operators will continue to sell infrastructure assets. Tower sales have improved financial flexibility for telcos needing to deleverage, or raise funds for other uses, including investments and shareholder returns, even after lease liabilities that operators have taken on to regain access to critical tower infrastructure.

Fixed-line assets may also be sold, and often take the form of joint ventures. The motivation here has been to avoid the negative financial effects of fiber development. Deconsolidation can push capex, debt, weak initial EBITDA, and cash flow associated with an expensive greenfield fiber development off the balance sheet. However, if we think the deconsolidation may be temporary and there's the potential for reconsolidation, we may employ a proportionate approach to reflect the underlying reality--providing the distortion is material--and to avoid volatility in credit ratios arising from potential future changes in the accounting scope.

GCC telcos are actively selling their assets, as well as reshuffling their corporate structures to carve out such assets, particularly related to adjacent digital businesses, leaving the door open for future monetization. Tower infrastructure is generally owned and operated by telcos in the GCC region, with very limited independent tower operator presence. This trend may change in the next few years. In late 2022, Saudi Telecom Company (STC) received a non-binding offer from Public Investment Fund, the sovereign fund of Saudi Arabia, to acquire 51% in its fully owned tower company Tawal, valuing its more than 15,500 towers at $5.8 billion. The sale is still pending regulatory approvals. In December 2023, Ooredoo Q.P.S.C. concluded the agreement with Zain

Group and TASC Towers Holding to create the largest tower company in the Middle East and North Africa region with about 30,000 towers combined, valued at $2.2 billion. In both cases, we expect STC and Ooredoo to deconsolidate their tower operations, given the less than 50% ownership and lack of control.

GCC telcos are also developing non-telecom businesses, such as fintech, cyber security, cloud, data centers, and many others. Their businesses were either carved out or established as stand-alone entities, most recently by e&, Ooredoo, and Bahrain Telecommunications Company BSC. We expect them to grow faster than the core telecom operations, and create meaningful monetization opportunities in the future, as the GCC equity markets undergo a strong push for broadening of investable assets base and see a high number of IPOs. STC pioneered this in 2020-2021 by listing a 20% stake in its technology company, Solutions by STC, and selling a 15% stake in its licensed digital bank, STC Pay.

Key risks or opportunities around the baseline

1. Rising prices and revenues may be short-lived, opening the door to renewed competition.

We see indirect risks if poor macroeconomic conditions reduce disposable income, or if increased customer price sensitivity paves the way to aggressive price competition and higher churn rates.

2. Prolonged high interest rates that constrain access to capital markets and weaken credit ratios could punish speculative-grade issuers with more leveraged capital structures.

The sector's average debt maturity is long dated, but speculative-grade issuers with nearer-term maturities face liquidity risks if capital market access tightens. For highly leveraged issuers, for which FOCF and interest coverage are critical credit measures, higher interest rates could strain credit ratios.

3. Transaction risks exist to both the upside and downside.

Market consolidation is an upside risk if it moderates competition and improves growth prospects. Meanwhile, asset sales may weaken business profiles if strategic infrastructure is monetized, though if multiples are high enough, proceeds could provide an offsetting improvement in financial profiles.

Rising prices and revenues may be temporary, potentially reigniting competition, which remains the primary risk for the sector. Recent revenue growth, stemming from price hikes, have been digestible when inflation has raised the tide for prices on most products and services, but we don't view this a reliable long-term driver. Consistent service revenue growth has been challenging for the sector, and for Europe in particular, given high fragmentation and competition. Despite increased data traffic, which required sustained levels of relatively high operating expenditure and capex, operators haven't been able to reliably raise prices through more-for-more offers, which has led to a long-term deterioration in return on capital (see chart 27 of Appendix). If rising prices no longer drive revenue growth, aggressive operators could turn to price cuts to increase net adds and expand their market share.

Even if the revenue tailwinds from inflation persist, we think the price hikes could become untenable. Pushing all the costs to customers with reduced budgets could backfire, leading to consumer and regulatory pushback, and potentially increasing price competition by aggressive challengers. In December 2023, the U.K.'s communications regulator Ofcom proposed a new rule that would effectively ban inflation-based price indexation and require the disclosure of contractual price increases. This would increase price transparency and certainty for subscribers. Ofcom could finalize this rule in the Spring of 2024 and make it effective in the second half of the year. A backlash could also lead to government intervention and undermine any regulatory appetite for in-market consolidation and lighter-touch wholesale regulation, topics that have, or could have, relevance for several markets, including the U.K., Spain, and Italy.

A recession in Europe would ratchet up competition risks. We would expect an initial softening in the enterprise customer base resulting from reduced headcount and project spending, particularly among small- to medium-sized businesses. For retail consumers, steep drops in disposable income may not result in mass cord-cutting, but it can increase consumer price sensitivity. Customers looking for better value are more likely to churn, incentivizing low-price competition by carriers. In such a scenario, markets that we view most at risk to a flareup in competition include those with:

- An aggressive price challenger focused on growing to scale;
- A competitive market structure, typically four or more players, and a poor track record of price improvement; and
- Weak barriers to churn, including a high prepaid customer base and a low degree of convergence.

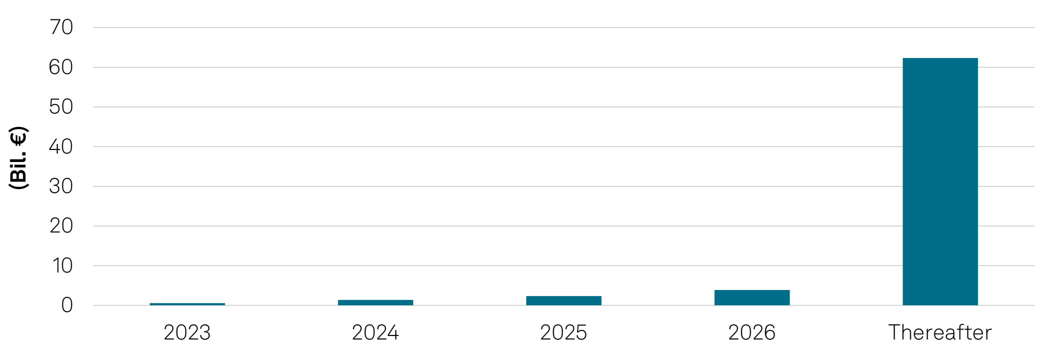
Prices and churn rates could improve in the medium term. Beyond inflation-linked price hikes, we believe upside potential exists in the medium term. As leveraged challengers refinance their capital structures at higher borrowing rates, greater debt service costs may widen cash flow shortfalls and the timeframe to break even. Among the more aggressive price players, this could force a strategic reconsideration of market exits or a shift to higher-margin, higher-ARPU offerings to shorten the time to generate cash flow. For historically competitive markets, a moderation of aggressive offers may allow prices to rise and churn rates to fall starting in 2026 as more of the maturity wall comes current.

Speculative-grade issuers with more-leveraged capital structures could take a beating from prolonged high interest rates that constrain access to capital markets and weaken credit ratios. Our first concern is for liquidity, and that speculative-grade issuers refinance opportunistically and early to avoid a maturity-driven crunch. Fortunately, most 'B' rated issuers have pushed out their maturity walls by several years during the period of ultra-low borrowing costs. With 90% of maturities now falling in 2027 and beyond, the sector has sufficient breathing room to pursue deleveraging or to refinance well in advance (see chart 16).

Chart 16

Heavily back-ended debt maturity profile buys issuers time

Single 'B' debt maturities



Source: S&P Global Ratings.

That said, debt will still mature, and our focus will be on the liquidity of issuers like Altice France (€1.5 billion of maturities in 2025), TalkTalk (€685 million in 2025), Tele Columbus (€600 million in

2025), and Telecom Italia SpA if it does not complete the spin-off of its domestic fixed-networks division NetCo from its retail division (€3.5 billion in 2024 and €2.0 billion in 2025). If debt becomes current without a defined, credible plan to address liquidity needs in the next 12 months, we will consider downgrades, including to the 'CCC' category. We could also consider taking such steps prior to the 12-month deadline if we anticipate substantial barriers to securing adequate liquidity, or if we assess a company's capital structure as unsustainable.

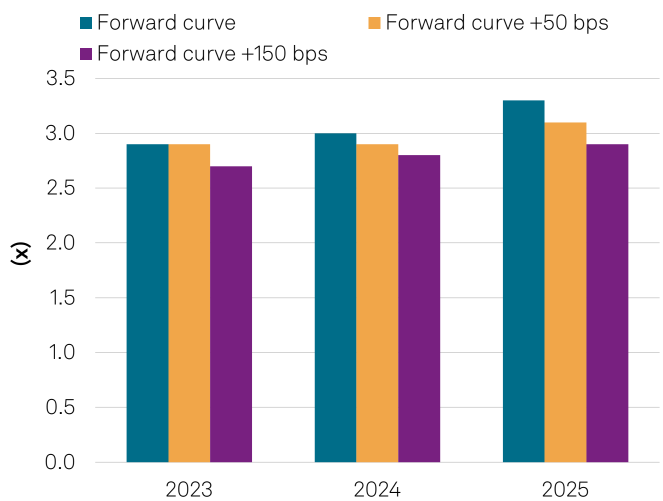
In the longer term, interest coverage and FOCF metrics--the ratios we focus on when assessing 'B' rated issuers--will weaken if they refinance at higher interest rates. However, the heavily back-ended maturity wall gives issuers time to improve their prospects, either through organic and inorganic deleveraging, or through a faster-than-expected decline in interest rates. We're therefore unlikely to reflect the impact of higher rates in our ratings until refinancings are more proximate.

In the event that rates remain high and issuers are unable to deleverage their balance sheets sufficiently, we have run stress tests to gauge the impact on interest coverage and FOCF-to-debt ratios. Although the ratios erode, the magnitude is manageable for the majority of 'B' rated issuers. For the next three years, we forecast an improvement that leaves the 2025 ratios as good or better than what we expect for 2023, even under stresses of 50 and 150 basis point increases in interest rates (see charts 17 and 18).

Chart 17

European telcos' average EBITDA interest coverage

Telcos rated in the 'B' category

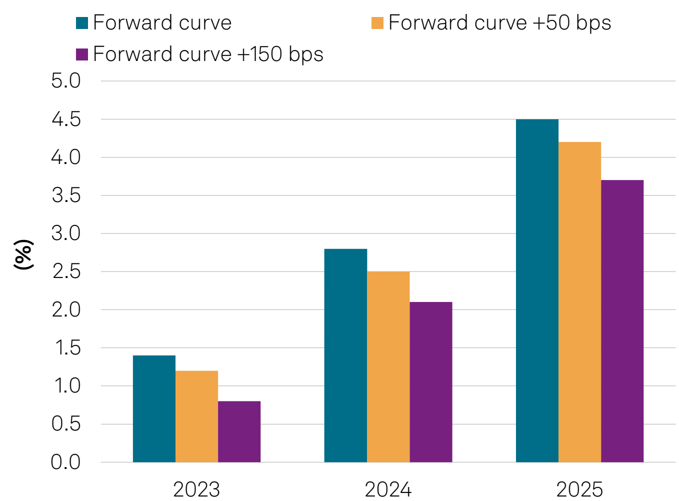


bps—Basis points. Source: S&P Global Ratings.

Chart 18

European telcos' average free operating cash flow to debt

Telcos rated in the 'B' category



bps—Basis points. Source: S&P Global Ratings.

However, for selected issuers, the stress could become considerable in the short term. Tele Columbus, for example, has already defaulted and is moving forward with a distressed exchange to recapitalize. Altice France (B-/Stable/--) faces a wider FOCF shortfall and a further delay in achieving breakeven levels. And TalkTalk (B-/Watch Neg/--) and Zacapa (B/Stable/--) are most exposed to an erosion of interest coverage to below 2x.

Transaction risks exist to both the upside and downside. Market consolidation is an upside risk if it moderates competition and improves growth prospects. Meanwhile, asset sales may weaken business profiles if strategic infrastructure is sold, though if the proceeds are high enough, they could provide an offsetting improvement in financial profiles.

M&As. European operators have long sought market consolidation to relieve competitive pressure, the key risk to telcos' credit quality, in our view. Regulators have effectively denied market consolidation for most of the past decade, with the exception of the Netherlands (a smaller market) and Italy, where steep remedies required a new and ultimately destabilizing entrant (Iliad). We view the proposed transactions in Spain and the U.K. as a test of the balance regulators are willing to strike between incentivizing investment and protecting consumers. In our opinion, the potential for approval is relatively high in Spain but will require remedies. The consolidation won't reduce infrastructure competition since it brings together MasMovil Ibercom S.A.'s asset-light entity with Orange Spain's integrated asset model. We also view the reduction in competition to be relatively modest since the incumbent is not involved and MasMovil is not a purely price-driven challenger in the market. We also expect Digi Communications N.V. will receive remedies that will allow it to scale up to shift to a mobile network operator from a mobile virtual network operator, potentially addressing consumer protection concerns. The key question is how strong a remedy package regulators will require, and whether it scuttles the deal, or cancels out the market benefits, as we saw in Italy.

In the GCC, after a few years of relative calm, telcos have resumed acquisitions. In 2023, STC's tower company Tawal acquired tower assets in Bulgaria, Croatia, and Slovenia from United Group for €1.22 billion. STC generates about 92% of revenue from its domestic market in Saudi Arabia, so expanding its geographic footprint is one if its objectives. Also, e& was very active in 2023, pursuing external growth in several markets. It announced the acquisition of a majority stake in PPF Telecom (excluding the Czech Republic operations) for €2.15 billion in Europe, its subsidiary PTCL made an offer to acquire Telenor business in Pakistan, while its $2.12 billion offer to gain a controlling stake in its 28% associate Mobily in Saudi Arabia is still pending regulatory approvals. GCC telcos deploy their capital in external growth initiatives, because their mature domestic telecom markets offer limited growth prospects. Their international subsidiaries in less mature markets demonstrate faster growth but are hampered by unfavorable currency movements. Stable regulatory frameworks and currencies in Europe offer an attractive investment opportunity for financially solid GCC telcos, which we believe will continue to expand in new markets.

Infrastructure asset sales. Telcos have steadily sold off assets since the mid-2010s, starting with mobile tower portfolios. More recently, asset sales have transitioned to fixed-network sales, fiber assets in particular, and we see risks of an adverse business impact, depending on whether the sold assets are unique and how extensive they are. For example, we view an incumbent's sale of all its fixed-network assets as likely to stress its business profile, with the downward revision in our assessment of it likely to be about one notch. The impact could be less if a challenger telco sells off its network; if the network is overbuilt by competitors and not a unique, differentiating asset; or if the operator retains other differentiating assets in the market or has diversified exposure to other markets.

To date, we have only two rated examples of a fixed-network spin-off and its business impact on the telco. One is an integrated telco Telcom New Zealand Ltd., renamed Spark New Zealand Ltd. after it split off its fixed network, which was named Chorus. The split led to a downgrade of Spark to 'A-' and a one-notch downward revision of its business risk profile to satisfactory. The other example is TDC, renamed Nuuday after it split off its fixed network, which was named TDC Net. The split led to a one-notch downward revision of Nuuday's business risk profile to fair from satisfactory.

We placed the rating on Telecom Italia on CreditWatch with positive implications while the announced sale of its fixed-line network to private-equity firm KKR awaits approval and completion. The potential deleveraging to 3.5x-4.0x could result in an upgrade to 'BB' or 'BB-'. This would also indicate a weakening of the business risk profile, similar to the case of Nuuday.

Industry Outlook: LatAm

Ratings trends and outlook

We expect generally stable ratings for LatAm operators, although about 20% of the rated issuers have a negative outlook, given weaker credit metrics due to persistently high competition, and higher inflation and operating costs. On the other hand, issuers with stable outlooks account for about 60% of the region's rated industry entities thanks to robust demand for data usage, operating efficiencies, and strong balance sheets that provide the leverage headroom to absorb weaker economic conditions. Positive outlooks mainly reflect a similar rating action on the sovereign rating on Brazil. We also continue to view growth prospects for tower companies in the region as favorable, as under-penetration remains a driver for the expansion of their respective networks, compared to more developed regions.

Main assumptions about 2024 and beyond

1. Modest revenue growth and limited profitability.

We expect revenues to remain moderate, in line with our forecast for a low trend for GDP growth across LatAm in 2024.

2. No major regulatory changes expected.

We don't anticipate regulatory risks related to spectrum license cancellations or paused renewals that would impede technological advances in the industry.

3. Divestments of fiber and tower assets continue.

Carriers have taken strategic initiatives to accelerate growth, and some of them have spun off their fiber and tower businesses mainly to reduce capex and leverage.

Modest revenue growth and limited profitability. Overall, we anticipate moderate growth among LatAm operators. We expect the industry growth to be in low-single digits for 2024, reflecting a similar economic growth trend for the region. On the one hand, we believe revenue growth for smaller players will be low as operators maintain promotional packages to regain market share, denting ARPUs as well as operating margins that have been below 20%. On the other hand, we expect larger players in Brazil and Mexico--Telefonica, Algar Telecom S.A., and America Movil S.A.B. de C.V.--will continue to grow. These companies are focusing on bundled products, including mobile and broadband (fiber) and increasing value-added services, taking advantage of the realized investments for the 5G spectrum. As a result, we expect steady revenue growth as demand for data services increases, coupled with strong operating performance and EBITDA margins above 30%.

No major regulatory changes in 2024. Although carriers are subject to extensive government regulation and could stress their operations, we don't anticipate significant changes in this regard. Actually, governments in the region are contributing to the industry's growth by not restricting spectrum bids and limiting the rises in taxes on the industry.

In Chile, Brazil, and Colombia, there are no relevant changes on the regulatory front. Yet in Mexico, the Federal Telecommunications Institute (the industry regulator) is currently working on its biannual revision of the asymmetric regulation applied to America Movil in 2013, to determine if sufficient competition in the telecom sector exists. Although we don't expect any additional measures or changes, we will closely monitor the result of this revision and its impact on the company's business and financial performance.

Divestments of fiber and tower assets continue. LatAm companies have been moving toward the separation between services and infrastructure services, reducing the investment burden stemming from constant network upgrades. Telefonica and Claro S.A. have sold these assets to develop targeted financial plans and capital allocation to foster growth and strengthen their competitive positions. America Movil (Claro) already completed the spin-off of all of its tower companies in LatinAm, creating two new companies--Operadora de Sites Mexicanos S.A.B. de C.V. and Sitios Latinoamerica S.A.B. de C.V. During 2023 the spin-off of the towers business in Austria Telekom, one of its subsidiaries, was also completed. Additionally, Telefonica (Coltel) received cash for its infrastructure assets in Colombia, Peru, and Chile. These transactions have helped companies reduce debt obligations and strengthen their financial position, but the proceeds also have a significant impact on reducing capital investments requirements going forward.

Credit metrics and financial policy

For Chilean and Colombian operators, we expect EBITDA margins to remain below the industry average, resulting from significant competition and weak operating performance taking a toll on leverage metrics and liquidity. We also anticipate cash flow will remain pressured due to high capital requirements to continue increasing network capacity and quality to improve customer loyalty. Likewise, we expect to see lower dividend payments and some capital contributions in attempts to strengthen balance sheets.

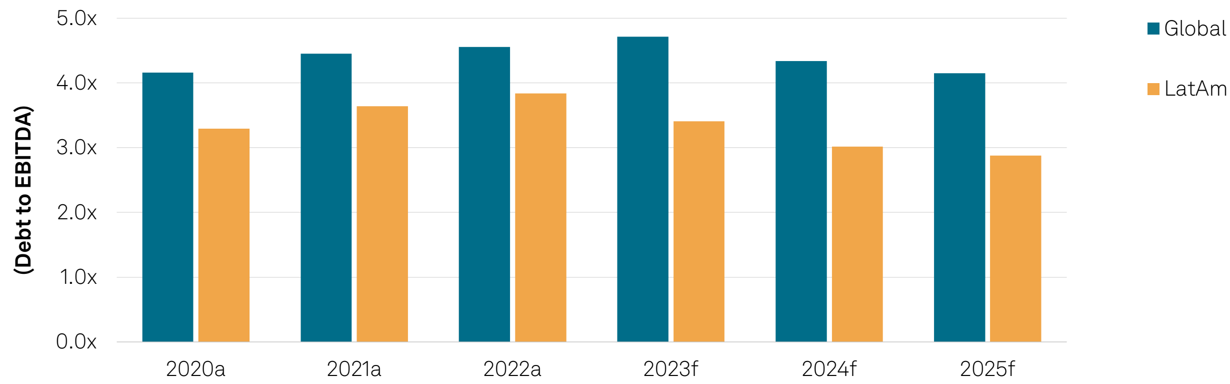
However, we expect the leading players will continue with the deployment of 5G technology. We also expect companies will continue to focus on coverage to enhance their value-added services to boost data usage and revenue growth, minimizing leverage concerns.

We believe tower companies' profitability will benefit from high cash-flow predictability, while the substitution risk remains low, in line with built-to-suit sites, price inflation-linked escalators, and an overall long-term average maturity of contracts. While the expansion will continue to require sizable investments, we expect companies to continue to access bank and market debt funding as their optimal capital structures allow for relatively higher leverage than for other subsectors within the telecom industry. At the same time, this should allow companies to continue to benefit from inorganic growth if opportunities from carrier spin-offs or market consolidation materialize in the short to medium term.

In Brazil, we expect M&As to increase in 2024 as interest rates fall and demand for broadband services start to rise again. During 2023, Vero S.A. and Americanet ltda. (Brazilian internet services providers [ISPs]) announced a business combination, creating the country's second-largest independent ISP.

Chart 19

Debt to EBITDA (average, adjusted)



a—Actual. f—Forecast. Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Competition remains stiff.

The entrance of new carriers with aggressive price strategies continues to increase competition, creating market destabilization in some LatAm countries.

2. Intense capital needs to develop new technologies.

Companies will need to increase their investments to continue increasing network capacity and quality and to improve customer loyalty.

3. High interest rates and inflation could weigh on telecom companies.

Telcos are struggling with the currently tough macroeconomic conditions, making it difficult to maintain high EBITDA margins.

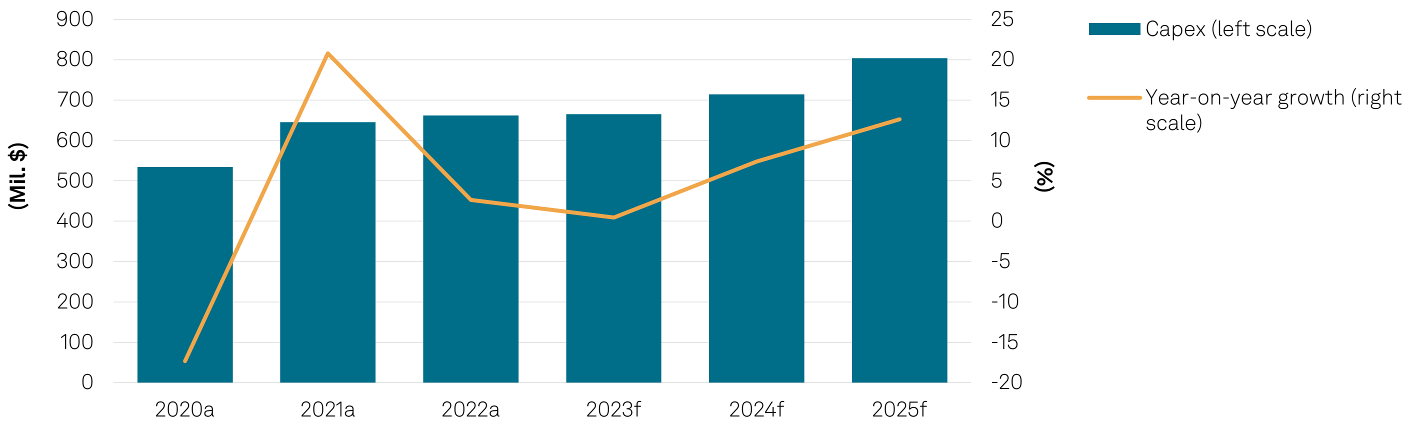
Competition remains a risk. Chile and Colombia are good examples of highly competitive environment following the entrance of Wom S.A., which seeks to become a large player in those markets. This has resulted in increasing customer churn and weakening in ARPUs. Most carriers still want to keep low service prices to maintain market share; however, this could dent profitability and cash flow, leading to higher leverage and delays in the improvement of credit metrics. Meanwhile, VTR Finance N.V. has experienced a sharp deterioration of its brand and customer satisfaction, and a drop in subscribers, revenue, EBITDA, and cash flow as a result of intense operating pressures and competition from its peers with better fiber option networks. Also, the persistently high competition in the Chilean market, coupled with weaker macroeconomic conditions, has eroded Telefonica Moviles Chile S.A.'s ARPUs and margins, weakening profitability and leverage metrics.

Investments will increase for the 5G deployment (see chart 20). In order to maintain low churn rates and good market positions, LatAm carriers focus on raising the quality of their networks by increasing coverage, quality, and speed of services. We have seen greater focus on investments in the FTTH deployment and in the 5G technology. However, most governments in the region have been focusing on getting coverage to areas that still don't have access to telecom services, as well as completing the transition from copper to fiber. These priorities have delayed the 5G spectrum license bids and haven't contributed to the investments needed for 5G infrastructure assets.

In Brazil, ISPs are still implementing the 5G coverage. Brisanet Servicos De Telecomunicacoes Ltda and Unifique Telecomunicações S.A. have started to offer these services by using capacity at their existing towers.

Chart 20

Capex growth in LatAm



a—Actual. f—Forecast. Source: S&P Global Ratings.

High interest rates and inflation could dent telcos' performance. They have already taken a toll on profitability, cash flow, and leverage metrics of the main operators. Companies have compensated for these effects by delaying investments, aggressive reductions in operating costs, or taking on additional debt.

In Chile, higher costs of capital pushed telcos to sell fiber assets and lease them back, which comes at the expense of weaker profitability. We expect more asset sales to come during the next few months, which would provide a temporary relief to liquidity but would stress margins, so we expect operators to work on their cost structures to diminish the burden.

Industry Outlook: APAC

Ratings trends and outlook

Telcos navigate cost pressure and limited returns from 5G investments. Our base-case scenario assumes a moderate earnings growth, spurred largely by increasing mobile data traffic. In some South and Southeast Asian markets, where there's saturation in the mobile market and high price sensitivity, we see fixed broadband as a bright spot in telcos' earnings as adoption grows. Uptake rates of 5G in many APAC markets remain too low to boost overall ARPU, while rising labor and electricity costs threaten to squeeze margins. Cost-cutting initiatives are therefore a common theme among APAC telcos to preserve margins.

The net rating bias for APAC telcos is now mildly negative. This is an improvement from a negative bias of over 30% around 2019 and 2020. Divestment-driven deleveraging underpins this improvement. For example, we upgraded Voyage Digital (NZ) Ltd. in 2023 given its debt reduction, which was made possible by its telecom tower sale. Similar actions by other telcos, while not having resulted in positive rating actions, increased their rating cushion. We believe such divestments are driven by the need to create balance-sheet capacity for incremental 5G investments and for building new revenue streams further from traditional telco services to boost long-term earnings potential. We expect such divestments to continue, and that telcos will move from selling towers to other passive infrastructure and non-core assets.

Negative rating actions, if any, will likely be driven by idiosyncratic factors. The first wave of 5G capex is over for APAC telcos, easing pressure on balance sheets. But as returns from such investments remain limited, telcos may explore M&As to accelerate growth, gain market share, and reduce competitive pressures. Such transactions, if debt-funded, can weaken credit quality. Sporadic and expensive 5G spectrum auctions could also raise leverage stress.

On the earnings front, telcos with exposure to emerging markets may experience squeeze from currency depreciation. This is especially prevalent among South and Southeast Asia telcos.

Main assumptions about 2024 and beyond

1. Moderately rising earnings as telcos navigate cost pressures.

EBITDA of APAC telcos will, on average, rise by a mid-single digits starting in 2024 thanks to increased mobile data traffic and fixed broadband adoption. Telcos are adopting cost-cutting initiatives and simplifying business structures to mitigate the impact of higher electricity and labor costs on margins.

2. Capex intensity should ease as telcos continue 5G investments cautiously.

While 5G investments are necessary for competitive parity, telcos will focus network spending on pockets with higher demand to maximize returns. We expect the average capex intensity (average of telcos' capex-to-revenue ratios) to be 21% in 2024, down from an estimated 23% in 2023.

3. Telcos will divest to invest.

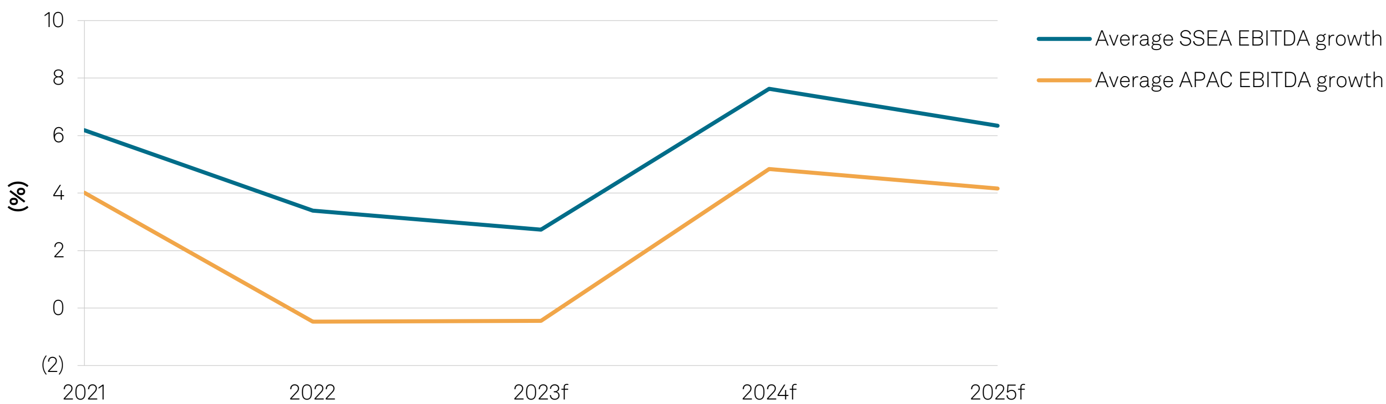
While telecom tower sales were in vogue in the past 36 months, we believe telcos will move to selling other infrastructure and non-core assets. There's also some initial momentum in bringing in strategic partners for new growth engines.

Earnings will rise moderately, benefiting from rising connectivity demand and cost-cutting measures. Demand for faster and more data will spur upgrades to higher-priced mobile rate plans. This could be for migration to more advanced networks for faster speeds, or for more data allowances.

Our base-case scenario shows a divergence in the extent of earnings growth that we expect. We forecast earnings of telcos in more mature markets such as Korea, Japan, and New Zealand to increase by a low-single digits. In contrast, projected earnings growth for telcos in less mature markets, particularly in South and Southeast Asia (SSEA), generally lean toward the mid- to high-single digit range. On average, we expect EBITDA of APAC telcos will be up by mid-single digits in 2024 (see chart 21).

Chart 21

APAC telcos' EBITDA to rise by mid-single digit annually on average



Note: Excluded Axiata Group Bhd., Advanced Info Service Public Co. Ltd., Voyage Australia Pty. Ltd., and Voyage Digital (NZ) Ltd. due to merger and acquisition activities. f—Forecast. Source: S&P Global Ratings.

The rising uptake of fixed-line broadband will remain a bright spot for several APAC markets. Fixed-line broadband is growing rapidly in markets such as Thailand and the Philippines, where the penetration rate remains low with about half or less of households having such connections.

ARPU and earnings will benefit from 5G services, even though not all telcos are charging a premium for 5G services. Data use typically rises with migration to 5G, even though the use of 5G service in and of itself doesn't consume more data. But it enables more data-heavy options, such as superior video streaming. This better user experience could, in turn, encourage more consumption and drive upgrades to higher-priced plans that offer more data. That said, more obvious benefits of the 5G migration could take longer to observe, as adoption rates remain too low to boost overall ARPU substantially. The effects may also be masked by an ongoing decline in ARPU that we have observed in many APAC markets.

The viability of fixed-wireless broadband as an alternative to fixed-line broadband is raised by 5G. This can boost earnings of telcos in markets such as Australia and New Zealand, as fixed-wireless broadband allows them to bypass low-margin reselling of national fixed-broadband networks.

The rated tower companies in India and Indonesia should benefit from demand for more towers and colocation to accommodate rising data traffic. A denser tower network is especially needed for telcos that adopt stand-alone 5G. This is to compensate for the weaker penetrative ability of the high-band 5G signals used.

APAC telcos must navigate inflation-linked rising costs, with little ability to pass them on to consumers. This is because it is rare for prices of mobile plans in APAC to be linked to the CPI, unlike in markets such as northern Europe. Among APAC telco markets that we analyze, we only see CPI-linked mobile plans in Australia. Cost-cutting measures are thus commonplace and will blunt the fallout from higher costs.

Average capex intensity should ease as telcos continue 5G investments cautiously (see chart 22). The first wave of high 5G spending has passed among the rated APAC telcos, with Bharti Airtel Ltd. as among the last ones to roll out 5G networks since late 2022. APAC telcos have found it difficult to resist investing in 5G despite limited monetizable opportunities. They need to offer 5G, even for limited consumer use cases, to retain competitive parity at least.

We expect telcos to improve their 5G network quality based on adoption rates and the success of 5G industrial use cases. This could mean strengthening 5G coverage in dense cities and central business districts, ahead of less populated areas.

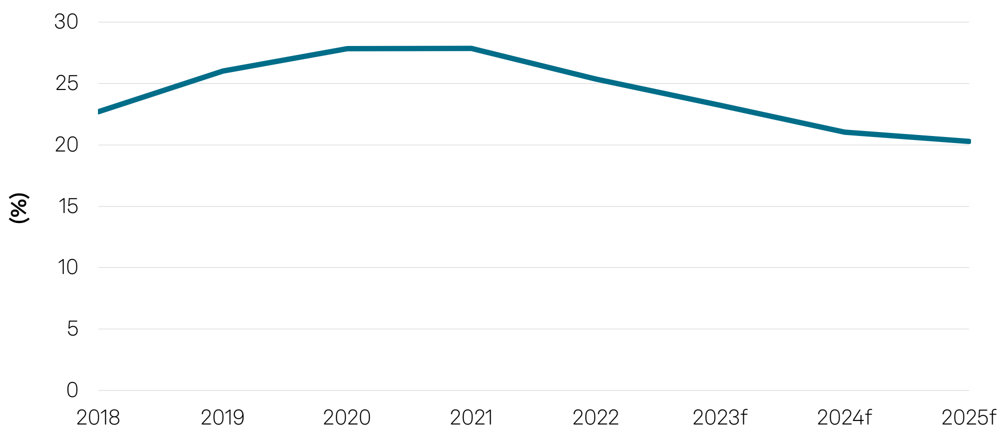
At the same time, investments to enhance fiber networks in several APAC markets have also slowed. For example, the Philippines-based PLDT Inc. completed its copper-to-fiber migration in 2023, while New Zealand-based Chorus Ltd. completed it in 2022.

As a result, we project the average capex-to-revenue ratio for rated APAC telcos to ease to 20%-21% in 2024 and 2025 from an estimated 23% in 2023.

Chart 22

APAC telcos' capex intensity to further ease

Average capex-to-revenue ratio



Note: Excluded Summit Digitel Infrastructure Ltd. because of its exceptionally high capex intensity at inception in 2019. f—Forecast. Source: S&P Global Ratings.

Telcos will sell non-core and passive assets to create balance-sheet capacity. Transactions involving APAC telcos selling tower assets should slow, after a spate of them in the past 36 months. Such transactions have increased telcos' financial flexibility. We believe telcos will move toward divesting other business and infrastructure assets. We see early signs of this as some telcos restructure their businesses, which could facilitate subsequent divestments. Proceeds from selling assets that are not key to the telcos' competitiveness can create funding capacity for capex and investments in new growth engines.

APAC telcos will be strategic about their ownership of assets, in our view. For investments not central to their competitive advantage, we expect telcos will sell them entirely or in part. For example, Singapore Telecommunications Ltd. announced its intention in May 2023 to undertake S$6 billion of capital recycling in the medium term. Thus far, this has included a partial divestment of the building that houses its headquarters, as well as the sale of its cyber-security arm.

Hong Kong Telecommunications (HKT) Ltd. and its parent PCCW Ltd. have also been divesting businesses since 2021. This includes data centers in December 2021, a majority stake of PCCW's solutions business in August 2022, and a significant minority stake in its video-streaming business in June 2023.

Some partial divestments will be to strategic partners, particularly for new growth engines in areas further from telcos' core connectivity business, where telcos may bring in partners to reduce exposure to execution risks. Such partial divestments can also reduce the strain on leverage.

Telcos will be more hesitant to sell active infrastructure assets. In our view, this may be because such assets can help telcos capture the demand and earnings potential from growing adoption of cloud services and artificial intelligence. For example, Australia-based Telstra Group Ltd. publicly stated in August 2023 its intention to retain ownership of its infrastructure arm InfraCo Fixed for the medium term. This announcement came less than a year after Telstra completed the structural separation of its businesses into discrete units, intended to provide more flexibility to explore growth and monetization options.

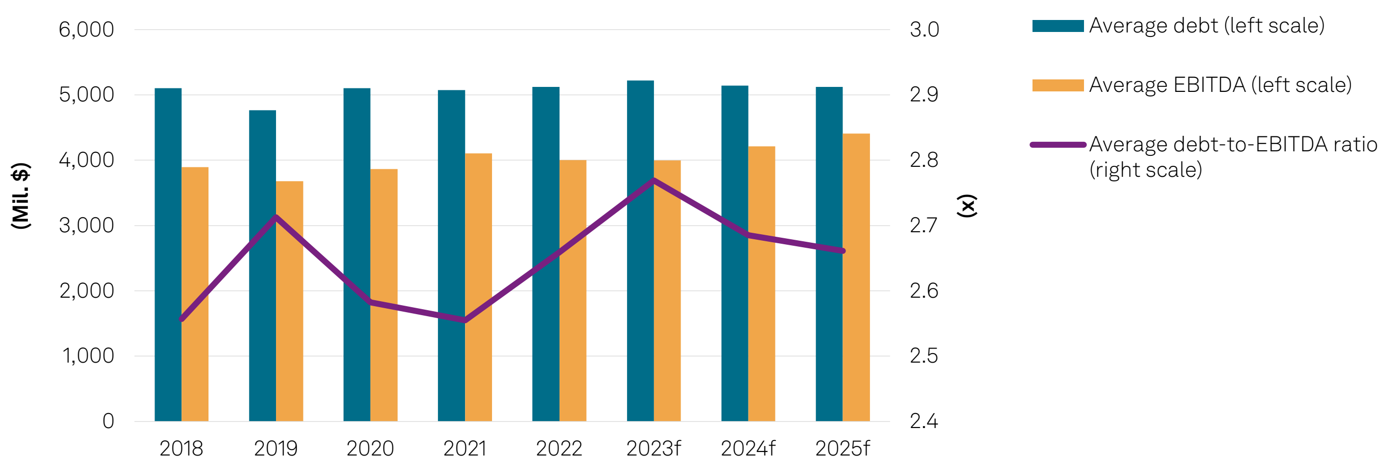
If telcos were to sell active infrastructure assets, it could weigh on their business strength. In our view, such assets could confer competitive advantage on telcos, especially if they're extensive or unique to the telco. In determining the implications for the telcos' credit profiles, we will consider, among other factors, the extent to which the assets drive their competitive advantage, the level of control retained in these assets, and any change to leverage.

Credit metrics and financial policy

Upward rating momentum is unlikely despite a moderate rise in earnings. While we expect earnings to rise by mid-single digits on average, metric improvement will be incremental at best. We estimate the average debt-to-EBITDA ratio of APAC telcos to be 2.6x-2.7x in 2024 and 2025, compared with an estimated 2.8x in 2023 (see chart 23). That's because continued investments in 5G and new growth engines will use up balance-sheet capacity.

Chart 23

APAC telcos' leverage to remain largely stable



Note: Excluded Nippon Telegraph and Telephone Corp., PT. Profesional Telekomunikasi Indonesia, Summit Digitel Infrastructure Ltd., and Voyage Digital (NZ) Ltd. due to acquisition-led debt increases or high inception leverage. f—Forecast. Source: S&P Global Ratings.

APAC telcos should tolerate higher interest rates well. The predominantly investment-grade nature of the rated APAC telcos has meant that the heightened interest-rates haven't eroded credit metrics. Most APAC telcos have well-distributed debt maturities and a sizable proportion of fixed-rate debt. In addition, some telcos like China Mobile Ltd. and Taiwan-based Chunghwa Telecom Co. Ltd. have no debt on a net basis. Persistently low interest rates in Japan also benefit the domestic telcos, at least with regard to their borrowing costs.

Leverage management remains crucial. With investments in 5G and new growth engines continuing, while returns lag, telcos must work harder to keep their balance sheets lean. With the rated APAC telcos mostly at investment grade, the focus is on financial policy. We believe that timely asset divestments to cope with ongoing capex will be the key tool telcos will use to preserve their credit metrics.

Key risks or opportunities around the baseline

1. Competition, prolonged inflation, and currency risks could weigh on earnings.

Operators in markets with new entrants could adopt more cautious pricing. Prolonged inflationary pressures could result in slower upgrades to higher-priced plans and new 5G-enabled handsets. This, coupled with cost pressures, could be a drag on margins. Telcos with exposure to emerging markets with weakened currencies could face slimmer earnings.

2. A need for more capex.

Telcos that have rolled out non-stand-alone 5G may face another investment wave as they move toward stand-alone 5G. Sporadic spectrum buys could also exacerbate leverage stress.

3. Rising investments in new growth engines could raise the earnings potential, but also leverage.

APAC telcos have been investing in new growth engines, particularly in data centers, to boost growth. Such investments, if debt-funded, can erode the rating headroom. Execution risks could also lead to higher-than-expected capital intensity.

Competition and macroeconomic factors could limit earnings upside. Consolidation (both ongoing and concluded) in markets such as Thailand, Indonesia, Malaysia, and Taiwan will likely result in stronger players, more rational pricing, and lower the risk of a new player entering into the market. In contrast, operators in markets with new entrants, such as in the Philippines, or those with growing mobile network operators, such as in Korea, could adopt more cautious pricing.

Prolonged inflationary pressure, other than weighing on telcos' cost structures, can also weaken consumer sentiment. This could result in slower upgrades to higher-priced plans and lengthen handset replacement cycles, especially in price-sensitive and predominantly prepaid markets.

Telcos such as Axiata Group Bhd. and Bharti Airtel Ltd. are more exposed than others to currency-depreciation risks. This is given their exposure to emerging markets such as Sri Lanka and Africa, where domestic currencies have weakened substantially. In addition, regulatory risks are higher in emerging markets. We believe high regulatory risks contributed to Axiata's exit from its Nepalese telco operations, which it announced in December 2023.

Capex risks diverge for APAC telcos. This is because the scale of costs for 5G spectrums is wide, ranging from no upfront fees for telcos in countries such as China and the Philippines, to more than US$5 billion for telcos in India. Sporadic spectrum auctions in countries where spectrum licenses are expensive, such as in Taiwan, Thailand, and India, pose as an event risk. This is especially so when the timing of such auctions remains uncertain.

Another wave of 5G spending could also come for telcos that have adopted the non-stand-alone 5G model, as they move toward a stand-alone model eventually. We believe that most, if not all, operators will do so to capture more meaningful monetization benefits. Stand-alone 5G can provide faster speeds, much lower latency, as well as the ability to slice networks. Network slicing is imperative to tailor networks to the needs of consumers and businesses in industrial-use cases.

Investments in new growth engines could weigh on leverage due to lag in payback. APAC telcos' investments into new growth engines have been on a rise, in a bid to boost the long-term earnings potential. Such investments, if debt-funded, can diminish the rating headroom, because these new revenue streams take time to ramp up.

As telcos move away from the traditional core-connectivity business, they may lack the know-how and execution risks could arise.

Related Research

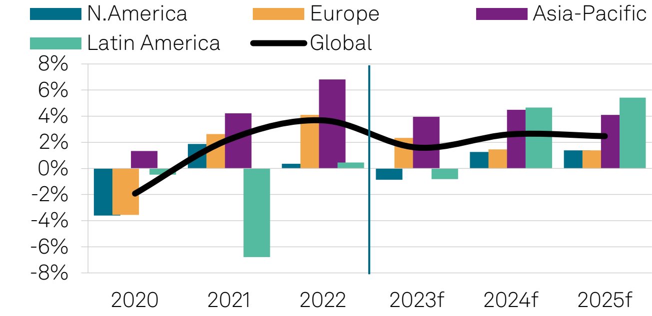
- Credit FAQ: What's On European Telecoms Investors' Minds?, Dec. 14, 2023
- Price Dynamics And Ability To Invest In New Technology Will Determine The Path Ahead For Latin American Telecom Companies, Oct. 5, 2023
- Credit FAQ: The Evolving Landscape Facing U.S. Cable Operators, Sept. 26, 2023
- Credit FAQ: Intense Competition And Investments Eat Into Chilean Telecom Operators' Metrics Amid Efforts To Bolster Returns, Aug. 11, 2023
- Asia-Pacific 5G: Telcos Face A Billion-Dollar Balancing Act, July 24, 2023
- Credit FAQ: U.S. Telecoms Face New Credit Risks From Old Cables, July 19, 2023

Industry Forecasts

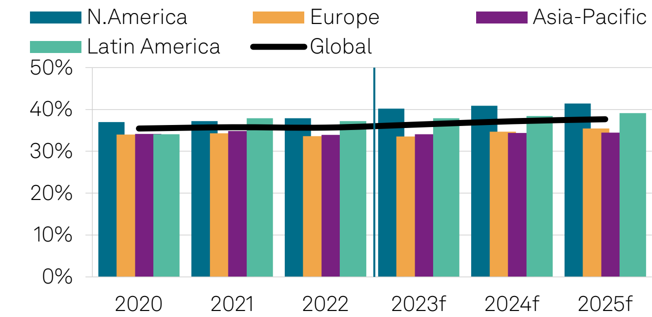
Telecoms - Fixed and Wireless

Chart 24

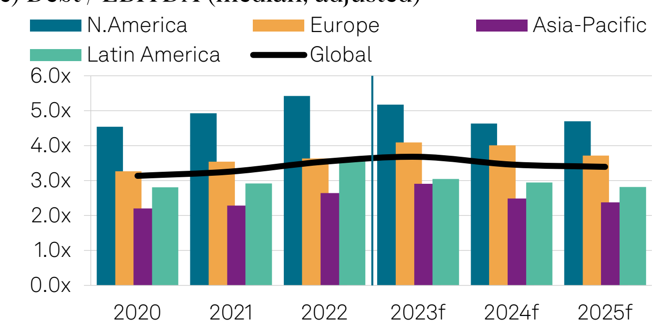
a) Revenue growth (local currency)



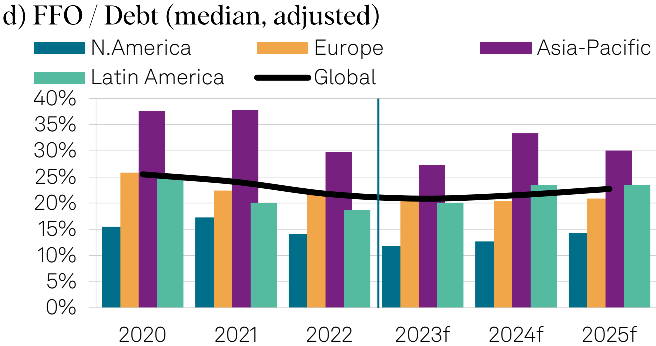
b) EBITDA margin (adjusted)



c) Debt / EBITDA (median, adjusted)



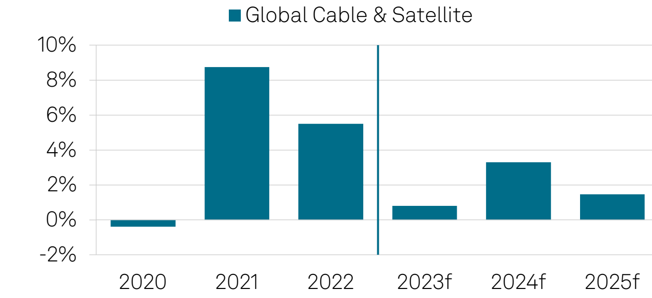
d) FFO / Debt (median, adjusted)



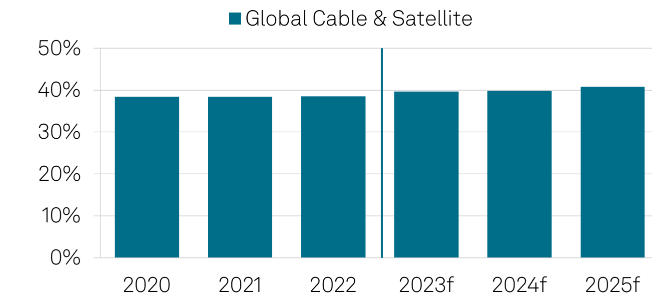
Cable and Satellite

Chart 25

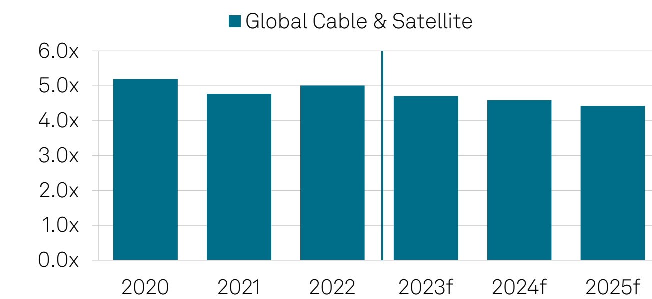
a) Revenue growth (local currency)



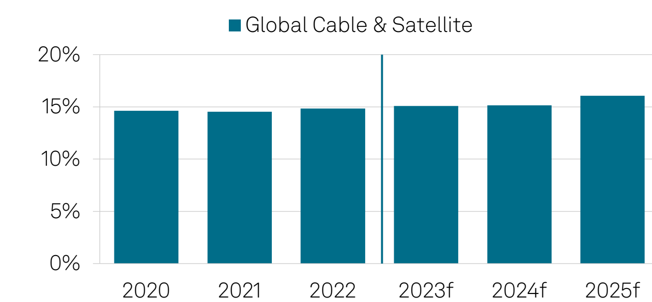
b) EBITDA margin (adjusted)



c) Debt / EBITDA (median, adjusted)



d) 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: Telecoms

Chart 26

Cash flow and primary uses

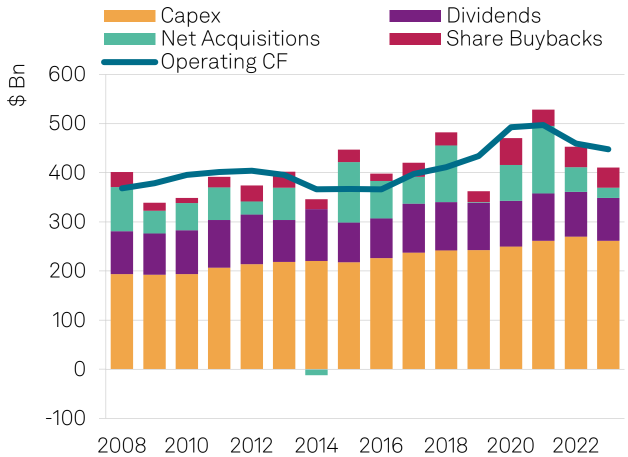


Chart 27

Return on capital employed

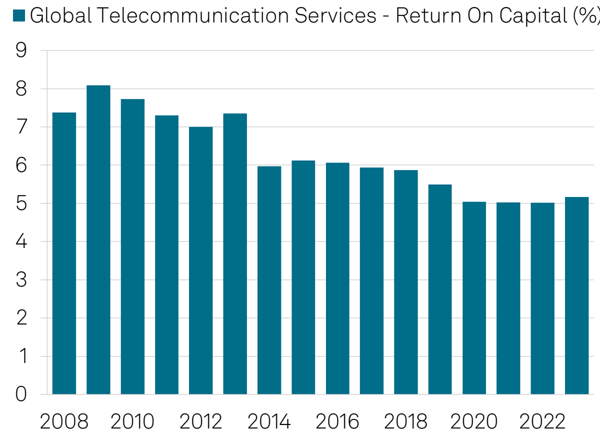


Chart 28

Fixed- versus variable-rate exposure

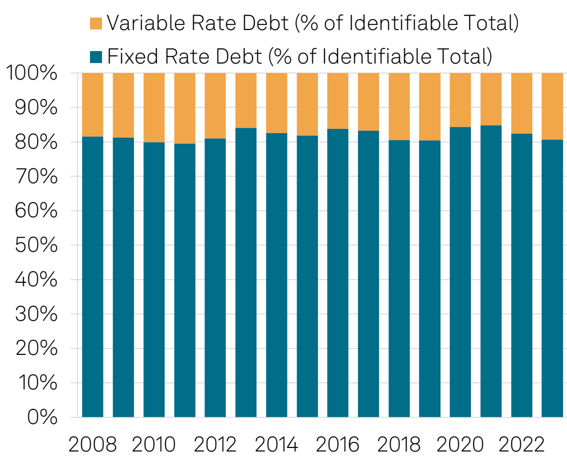


Chart 29

Long-term debt term structure

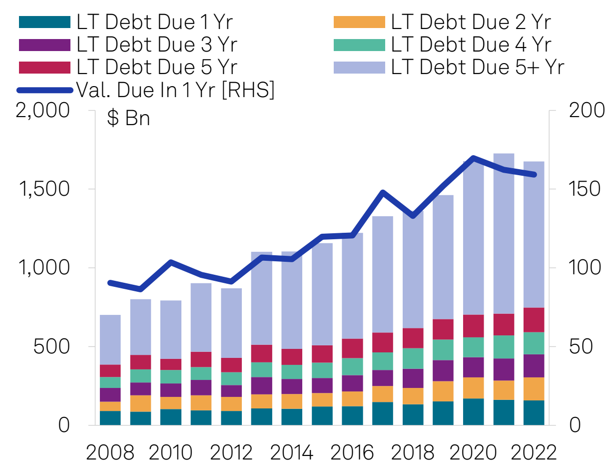


Chart 30

Cash and equivalents / Total assets

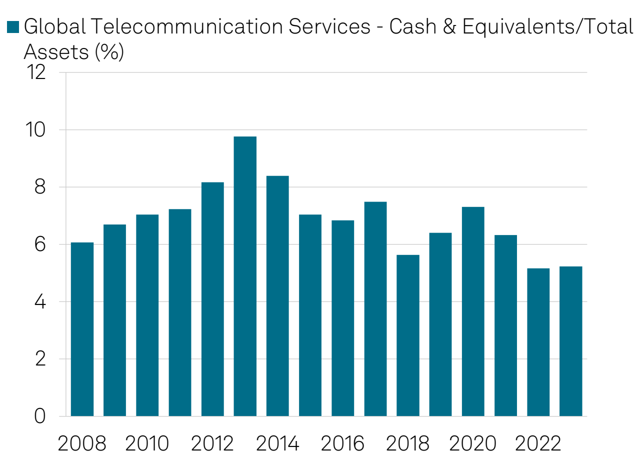
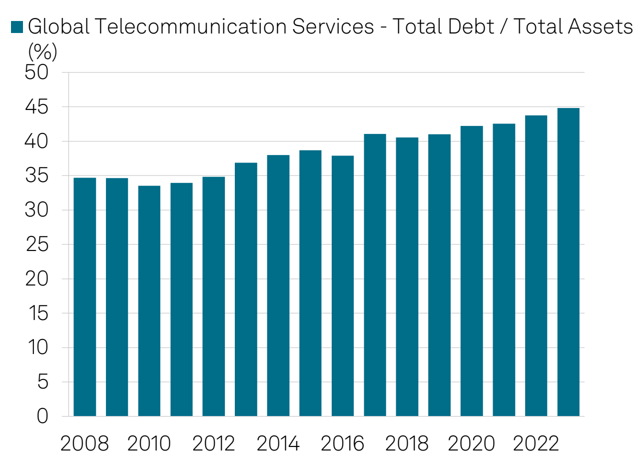


Chart 31

Total debt / Total assets



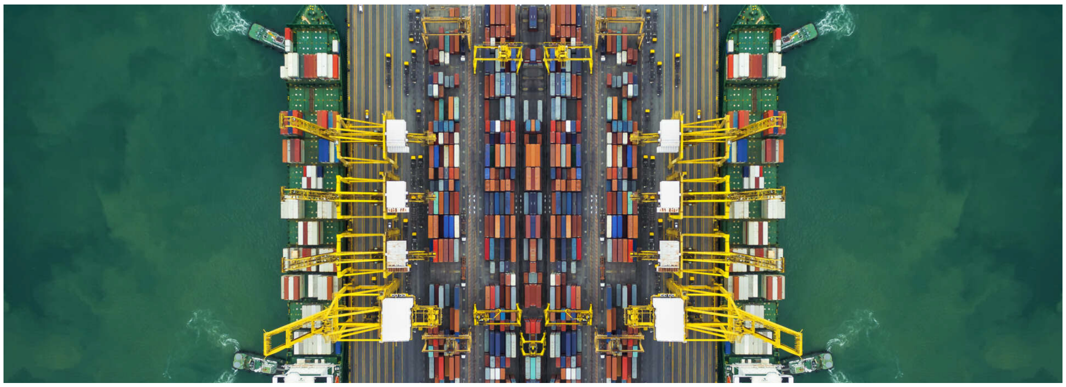
Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2023) figures use the last 12 months' data.

Transportation

Post-pandemic "normalizing" after highly turbulent years

January 9, 2024

This report does not constitute a rating action.



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What's changed?

Downside economic risks persist. Weaker volumes continue for freight transportation due to sluggish demand. But air travel demand has recovered well, in line with expectations.

Fuel costs remain high. Oil prices have become even more volatile since the wars in Ukraine and the Middle East, and we expect prices to remain elevated.

Real interest rates will remain higher for longer. There will be a marked rise in finance costs, particularly for lower-rated companies facing looming debt refinancing requirements.

What are the key assumptions for 2024?

Most economies should avoid recession, although growth will be weak. Consumers will keep prioritizing services, such as spending on travel, over goods.

Tight labor markets support demand for travel. Low unemployment rates give some support to consumer demand but amplifies wage pressures and labor supply issues.

Container shipping will remain under pressure from much lower freight rates. Container liners will struggle to avoid losses in 2024 as a widening supply and demand imbalance weighs on rates.

What are the key risks around the baseline?

A recession could materialize. We assume economic growth will slow in most regions in 2024, but unexpected weakness could squeeze demand, pricing, and cash flows.

Geopolitical events risk escalates. Escalation of ongoing conflicts could lead to further inflation, a spike in oil prices, global trade disruption, and weakening demand for travel.

Mobility transition and decarbonization further add to costs. The transportation sector is under increasing scrutiny to reduce greenhouse gas emissions and carbon costs are stepping up.

Ratings Trends: Transportation

Chart 1

Ratings distribution by region

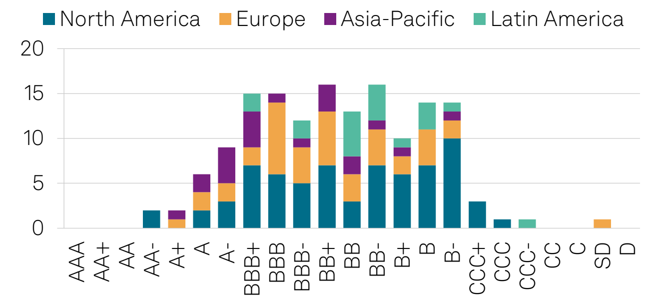


Chart 2

Ratings distribution by subsector

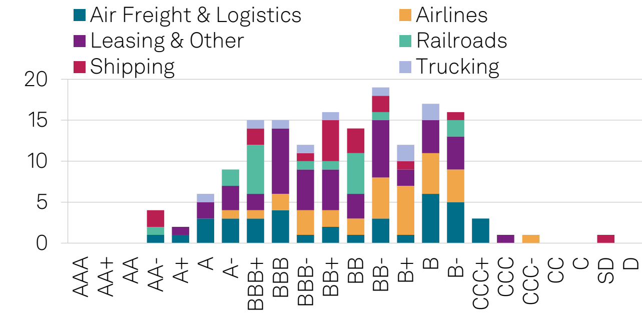


Chart 3

Ratings outlooks by region

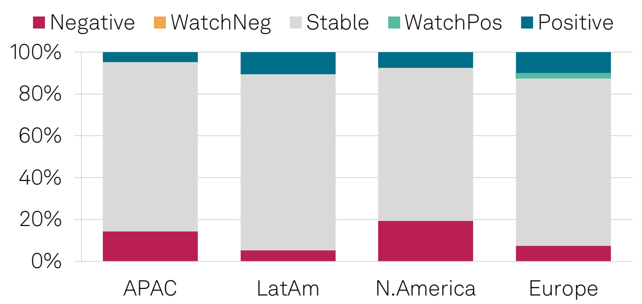


Chart 4

Ratings outlooks by subsector

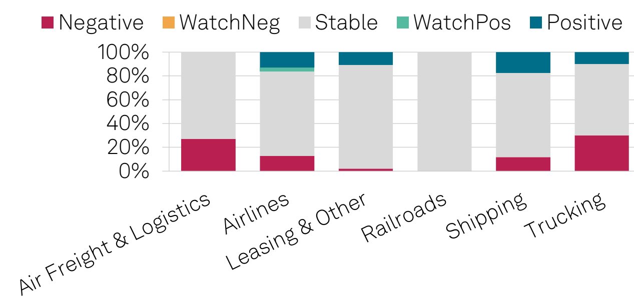


Chart 5

Ratings outlook net bias by region

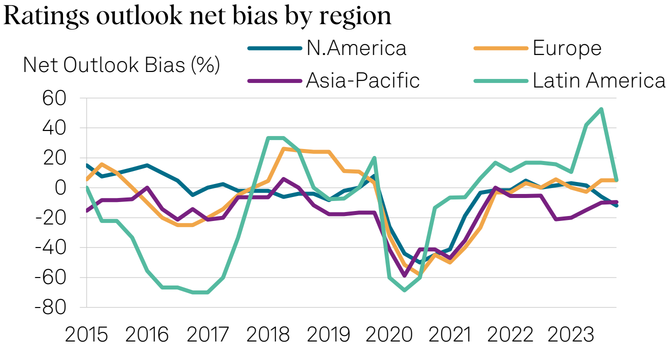
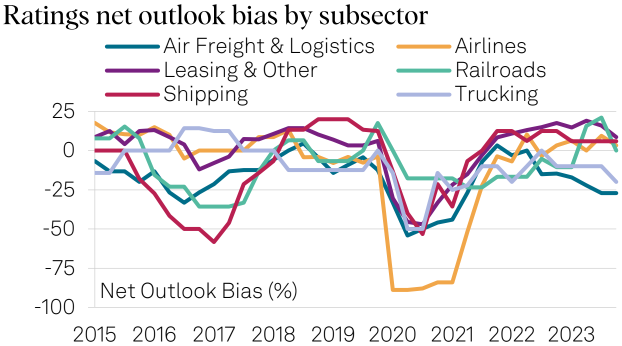


Chart 6

Ratings net outlook bias by subsector



hart 7

Ratings outlooks

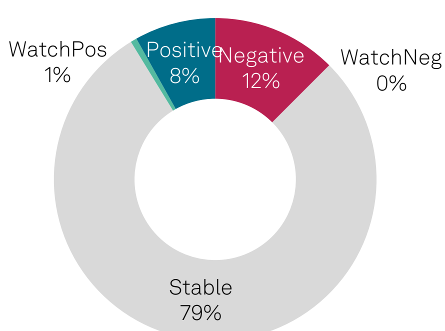
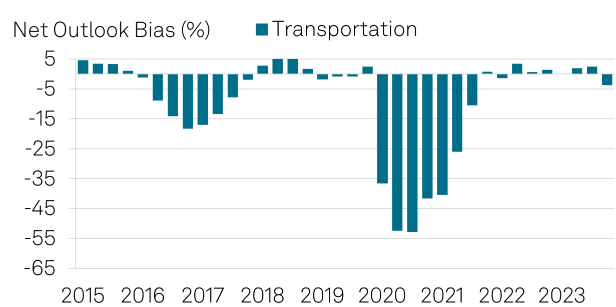


Chart 8

Ratings net outlook bias



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

Industry Outlook: Airlines

Ratings trends and outlook

Fewer upgrades in 2024. Sharply higher passenger volumes and fares are boosting airline finances--especially for larger, financially stronger airlines. This should allow them to continue to handle elevated costs, such as for jet fuel and labor. We upgraded several carriers in 2023, and most ratings are now close to pre-pandemic levels. We think passenger volumes and fares will remain robust in 2024, supported by strong demand--so far largely resilient to increased cost of living and interest rates--and constrained capacity.

However, the pace of global air passenger traffic growth is expected to slow. Subdued capacity expansion could reduce the ability for some airlines, particularly those with limited revenue diversification, to further mitigate the impact of industry cost headwinds on profitability, given the high operating leverage attributable to the sector. Moreover, we assume a slightly slower pace of macroeconomic growth globally next year.

Main assumptions about 2024 and beyond

1. Sales growth slows, but capacity remains tight.

Global passenger traffic will grow at a reduced rate as the post-pandemic recovery plateaus. Tight capacity remains due to restricted aircraft supply, delays in new aircraft deliveries, parts/maintenance constraints, and heightened engine reliability issues.

2. Fuel costs to remain high.

Jet fuel cost estimates are in line with our oil price assumptions of $85 (Brent) and $80 (West Texas Intermediate) per barrel in 2024 and 2025. The difference between jet fuel cost and oil--the crack spread--was typically below $20 per barrel historically, but this has grown since the Russia-Ukraine war (at times even spiking above $60 per barrel versus Brent).

3. Large capital expenditure (capex) plans for new fuel-efficient aircraft.

We see industry capex settling above pre-pandemic levels due to necessary fleet upgrades and some capacity expansion. Higher investment in new fuel-efficient aircraft will drive operating costs and carbon dioxide emissions per passenger down over time but weigh on cash flows. This could make it more difficult for many airlines to reduce debt to pre-pandemic levels.

Low revenue visibility and disposable income pressure leads to cautious assumptions. Our base-case forecast sees demand remain robust as consumers prioritize spending on travel over goods. We think demand for short-haul leisure travel--with overproportionate growth in the premium segment--will continue to drive passenger volumes. While a key driver of capacity growth last year in some markets, international travel has not fully recovered, and business traffic is now structurally lower (if slowly improving) as remote working becomes more normalized in certain sectors.

High fuel prices and tight capacity will support yields above 2019 levels. Airlines have demonstrated historically that they can usually recover fuel cost increases via higher ticket prices--this was certainly the case in 2023 as yields and revenue soared. However, this could become more challenging in 2024 if, for example, unemployment rises beyond our forecasts, putting further pressure on consumer spending.

Capacity remains tight due to supply chain issues and fleet downsizing. Europe's key low-cost carriers lead short-haul leisure flight capacity growth while many large network airlines still operate below pre-pandemic levels. Capacities in the Asia-Pacific (APAC) region are down about 10% (as per the International Air Transport Association), despite strong growth in key large domestic markets such as China and India. The U.S. network carriers are now primarily focusing on improving asset utilization and optimizing existing capacity rather than expanding, with modest incremental growth assumed for 2024. Latin America's (Latam) domestic capacities have recovered to pre-pandemic levels, but international travel is lagging a little. We expect carriers to largely close this gap during 2024.

Per-passenger cost will be flat or up slightly as inflation eases and volumes increase. Modest capacity growth, consistently high load factors, and expanding gauge (seats per aircraft), will help fixed cost absorption. However, global labor costs, notably in the U.S. following a significant pilot wage increase, are on the rise. While Latam airlines have faced high inflation rates since 2022, strong yields and capacity growth led to significant profit margin improvements during 2023.

Air traffic recovery in APAC is rapidly catching up with other markets. Domestic travel surged in 2023, but international travel is still lagging--particularly in China. However, recovery should continue through 2024 as post-pandemic demand for international travel increases steadily. Pandemic-induced airline restructurings have deferred debt paydown, giving rise to increased refinancing needs.

Restructuring of the largest Latam airlines is nearing an end. Latam was the only region that mostly did not receive direct government support throughout the pandemic. Brazilian airlines Azul and Gol built up financial and operating liabilities during this time, pursuing debt exchanges and lessor renegotiations during 2023. Except for Gol, Latam carriers have adjusted their finances to ensure sustainability in capital and cash flow for 2024 and beyond.

Air freight rates are normalizing. This is given softening demand and expansion in international belly cargo capacity, particularly as air traffic picks up in APAC. The challenging economic outlook is affecting global trade volumes, leading to lower demand for goods, as consumers continue to prioritize spending on services. As with the container shipping segment, the air cargo market is normalizing.

Credit metrics and financial policy

Most rated airlines improved their credit metrics in 2023 thanks to the strong recovery of air passenger demand in a very high yield environment--a key factor in driving more upgrades than we anticipated. Many airlines used free operating cash flows (FOCF) to pay back debt, but most still have more debt than before 2020. The focus on debt reduction will ease in 2024, and absolute debt levels will increase for some airlines given higher capex related to new aircraft.

Liquidity positions remain mostly improved, and we expect management teams to maintain more cautious long-term targets post-pandemic. However, as real interest rates remain higher for longer, there will be a rise in average finance costs across the sector, offsetting interest earned on higher cash balances. Most airlines predominantly hold fixed-rate debt, but lower-rated carriers facing debt refinancing requirements will be subject to sharply higher interest costs.

Dividends and share buybacks will return to modest levels for the top players, though likely after leverage targets are achieved and deemed sustainable. In the U.S., merger and acquisition (M&A) activity is expected to be subdued in part due to regulatory scrutiny, with Alaska Air Group Inc.'s planned takeover of Hawaiian Holdings Inc. as the only notable recently proposed deal.

Key risks or opportunities around the baseline

1. Economic pressures could weigh on spending.

Sustained inflationary pressures and unexpected increases in unemployment are notable risks. Tight labor markets are currently supporting strong demand--with employed consumers more likely to book a holiday--while adding to labor constraints along the aviation supply chain.

2. Geopolitical risks remain elevated; fuel prices volatile.

As the wars in Ukraine and the Middle East continue, fuel prices are likely to remain high as OPEC+ constrains supply, although fuel hedging helps buffer against volatile oil prices. Most European and APAC carriers hedge fuel, which can give a short-term advantage versus global peers (notably in the U.S.).

3. Mobility transition and decarbonization targets drive increased costs.

The aviation sector is under increasing pressure to reduce greenhouse gas emissions and use sustainable aviation fuels. Not all airlines will be equally affected--Europe's regulations are stricter and more expensive, meaning that airlines operating in the region will pay more.

The global airline sector is volatile, highly cyclical, and subject to regular disruptions. High jet fuel prices, increased interest rates, and supply-chain issues have added pressures to the sector, but disruptions are common in the volatile operating environment for airlines, and recovery is typically fairly quick. Business models particularly at larger airlines have evolved, with technology improvements and expansion of premium travel options the focus.

Environmental regulations are becoming much more costly. The EU's “Fit for 55” package includes the end of free carbon allowances by 2026 (starting in 2024). This could pressure the credit quality of weaker European airlines. Elsewhere, the U.N.-sponsored International Civil Aviation Organization's (ICAO) Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA), covers international routes globally, but we think these costs will be low or otherwise manageable. While sustainability efforts within APAC lag, the abundance in feedstock and developments in biofuel refineries in the region should facilitate adoption and reduce costs.

Industry Outlook: Container Shipping

Ratings trends and outlook

Record-high freight and charter rates in 2021 and late 2022 boosted profits and free cash flow for container shipping companies, improving their financial health. This resulted in multiple upgrades and positive outlook revisions in 2021-2022, followed by one further upgrade and one positive outlook revision on tonnage providers in 2023. Some companies used the extra cash for M&A and shareholder returns while others cut debt and ended 2023 with ample liquidity. This will help companies navigate a challenging industry and address growing fleet investment requirements due to more stringent environmental regulations.

Main assumptions about 2024 and beyond

The sector is entering 2024 burdened by weak consumer demand. This has persisted since the second half of 2022. Industry indicators and container liners' financial reports suggest that there will be little immediate respite, with continued softness in transported volumes expected to maintain pressure on freight rates.

Delivery schedules for new vessels indicate that capacity growth will be lumpy. This is due to the addition of ultra-large containerships, many of which were ordered years ago by ship owners looking for economies of scale and better environmental performance. The timing of large vessel deliveries alongside cumulative supply growth will have a significant bearing on the prospects for a rebound in rates--particularly on the Asia-Europe and Asia-U.S. lanes where mega-containerships tend to find a home.

Average freight rates have fallen since late 2022 to levels close to historical averages. We expect that rates will remain under pressure as overcapacity looms, but unforeseen disruptions that might boost rates are common in the sector. It's uncertain how long the most recent spike in rates will last driven by the conflict in the Red Sea, which is forcing many containerships to sail the much longer routes around the Cape of Good Hope. This is why liners will have to proactively manage capacity to protect their current robust creditworthiness.

Credit metrics and financial policy

Credit metrics should have remained well within rating thresholds in 2023. This is likely to continue in 2024, but with diminishing headroom for unforeseen operational issues or discretionary spending. Our base-case scenario anticipates a decrease in earnings and cash flow for container liners, in line with declining freight rates. We remain relatively cautious in our assumptions. The uncertainty over freight rate levels reduces the predictability of credit ratio projections and increases the risk that adjusted EBITDA could underperform, or that financial leverage could overshoot what can be reasonably built into our base-case scenario.

The global shipping industry faces a large regulatory workload. This is reflected by increasingly stringent emissions targets, which demand lumpy capital investments, such as with new dual-fuel capable or methanol-enabled vessels. Many container shipping companies will pursue the environmental upgrades of their fleets, as reflected in large capex programs weighing on operating cash flows. M&A activity and shareholder remuneration will be cut, however.

Key risks or opportunities around the baseline

1. Demand growth could be slower than expected.

A slower-than-expected recovery in global trade volumes, a key engine of shipping growth, would damage an industry that will struggle to bring supply and demand into balance.

2. Freight rates decline more severely without capacity cuts or positive surprises.

Slower-than-expected recovery in demand, a surge in new-build deliveries, or container liners prioritizing increasing market share ahead of profit protection would further destabilize already-fragile demand-and-supply conditions. Lasting shipping and supply chain disruptions from the conflict in the Red Sea or stringent and sustainable industrywide capacity withdrawals could help narrow the supply-demand imbalance, pushing average rates above our forecasts.

3. Counterparties fail to deliver on charter agreements.

Significantly longer time-charter profiles at attractive rates prompted our most recent upgrades of containership tonnage providers assuming counterparties (mainly container liners) are able and willing to honor their multiyear commitments. Unexpected amendments or nonpayment under charter agreements could materially weaken ship lessors' credit measures and liquidity.

Macroeconomic and geopolitical risks will weigh on global trade in 2024. Economic issues include cost inflation, interest rate hikes, and diminishing disposable incomes. Geopolitical uncertainty, previously due to the ongoing conflict in Ukraine, has increased with the Israel-Hamas war, and could exacerbate already sluggish consumer sentiment and spending.

Our rate forecast hinges on stringent supply side measures. That sort of response is not a given, but the industry has demonstrated it can positively react to pressure--as it did shortly after the pandemic's outbreak in 2020, when blank sailing and other measures offset a significant and abrupt decline in trade volumes. While strict excess capacity management, assuming it occurs, might provide some relief during 2024, it won't completely avert pressure on freight rates given anticipated slow demand and increased deliveries of new tonnage. This has shifted the balance of power toward shippers, setting the stage for difficult annual negotiations for container liners.

Buoyant industry conditions in 2020-2022 pushed charter rates and durations higher. This benefited the ship owners that prioritized gaining visibility and secure cash flows. A shift toward multiyear contracts has contributed to our positive rating actions on containership tonnage providers. Medium-to-long-term time-charter profiles comprising noncancellable and fixed-price contracts at attractive rates normally help to mitigate inherent industry volatility. This works if charterers deliver on their commitments, which we incorporated in our base-case scenarios.

Counterparty risk rises during industry downturns and rates fall below existing contract levels. If container liners' credit quality weakens, this increases the possibility of amendments to existing contracts, delayed payments, or nonpayment under the charter agreements. Some rated shipping companies were forced to amend charter terms or faced defaults under charters during the last cyclical downturns.

Industry Outlook: Railroads

Ratings trends and outlook

Ratings on the North American Class 1 railroads are expected to remain stable. These railroads account for about 85% of global sector revenue from companies we rate. In 2023, railroads faced a shift in consumer spending toward services (from goods) and high inflation, leading to weaker intermodal carload volumes. However, their diverse mix of shipment volumes, including bulk commodities with limited sensitivity to economic volatility, mitigated the earnings impact.

In 2024, operating results and profitability will slightly improve. We expect to see higher volumes due to a boost in intermodal transportation and relatively steady bulk and merchandise shipments. Improving service levels should also enhance railroad competitiveness, with trucks and support pricing that we assume will continue to exceed rail inflation. We believe that Class 1 railroads will stick to financial policies that support the current ratings and could slow debt issuance to buy back shares if it helps keep their credit measures stable.

Main assumptions about 2024 and beyond

1. Improved service quality from better staffing.

Hiring more train and engine staff in the last year has resulted in a smoother network, as evidenced by faster trains and improved dwell times. Making services more efficient allows railroads to compete for new business and regain post-pandemic freight picked up by trucks.

2. Growing intermodal volumes.

We expect more goods to be transported in 2024, following a decline over the past year as consumer spending shifted from goods to services. The destocking of high inventories leads us to expect a more normalized freight transportation environment in 2024.

3. Pricing above rail inflation to continue.

We forecast that they will maintain a strong, competitive position with a diverse mix of shipments and contracts. Rail is a comparatively more cost-efficient means of transporting long-haul shipments, and there are limited alternatives to move certain commodities. With service levels improving, we believe the railroads are well positioned to continue to pass through higher expense.

After an atypical 2023, we expect freight movement in 2024 will improve. High inventory levels contributed to the reduced amount of freight movement over the past year. The impact was most apparent in intermodal traffic, which materially declined across the sector. For 2024, we expect inventory ordering by retailers to be more aligned with broader consumer demand based on our view that the "destocking" trend has largely been completed.

In 2024, total carloads are expected to increase 2%-4%. This is a change from last year's low-single digit decline. Our assumptions for 2024 are modestly ahead of S&P Global Ratings' forecasts for 1.8% growth in consumer spending--1.5% growth in real GDP (in the U.S.). We expect an increase in imports and exports relative to 2023. In tandem with estimated pricing growth of 2%-4% (excluding fuel surcharges), we believe Class 1 revenue will grow 3%-5% in 2024 compared with an expected decline of 2%-4% in 2023.

Service metrics are improving. Railroad job cuts during the pandemic limited their capacity to handle the rebound in volumes that followed. Subsequently, some carloads were diverted to trucking due to poor rail service. We believe that after investing heavily in staff, railroads are well-prepared for increased volumes ahead. Train speed and dwell time have improved, enabling rails to win back some business lost to trucks. On certain routes, mostly short haul, it could take time to see reliability and efficiency improvements before companies secure new business. The future of excess trucking capacity and impact on truck rates is undetermined.

Material M&A activity is unlikely. Canadian Pacific completed its acquisition of Kansas City Southern in 2023--the first Class 1 merger in decades. We do not expect railroad transactions due to the strong market position of Class 1 railroads and potential regulatory hurdles (namely from the Surface Transportation Board [STB] in the U.S.). Smaller transactions, including non-rail, are possible. Strong cash flow generation allows flexibility to invest in non-organic opportunities while preserving financial measures.

Trucking remains a viable alternative to rail, notably in the U.S. The oversupply of truck capacity and resulting trough-level spot rates have persisted. Low prices have increased the competitiveness of trucks for certain loads previously moved by rail. This remains a near-term headwind mostly on short-haul routes. However, we expect trucking capacity will exit the market due to unsustainable low prices. In addition, new operators taking advantage of soaring volumes of the pandemic are now unprofitable.

Railroad competitive positioning should improve. As trucking capacity eventually exits the market, their current pricing advantage on certain routes should dissipate. We believe rising trucking rates, in tandem with improving rail service levels, should improve the railroads' ability to recoup a portion of business previously lost to trucks.

Credit metrics and financial policy

Credit metrics are expected to remain relatively stable in 2024. This includes modest improvement from issuers that faced weaker operating results last year. FFO to debt is estimated to remain commensurate with current rating thresholds. This mainly reflects our assumption for earnings growth across the sector, with no significant increases in debt. The railroads will maintain a high degree of flexibility to manage their capital allocation due to significant free cash flow generation that we expect to persist.

In periods of stress, railroads can reduce share repurchases to preserve credit metrics. This was demonstrated during the 2008-2009 U.S. recession and the pandemic. Furthermore, debt maturities are evenly staggered, which affords repayment in any given year as debt comes due. We expect issuers to continue to evaluate their capital allocation based on earnings potential and manage leverage-related metrics to the mid-range of their current financial risk profiles.

Railroad liquidity remains robust. We expect most railroads to continue generating strong FOCF, typically above $2 billion (and well above this level for Union Pacific) while maintaining large cash balances (about $1 billion to $2 billion). Cash flow will easily cover annual dividends, which we expect will increase 1%-3%. Large share buybacks tend to result in deficits funded with debt, notably during periods of earnings growth.

Historically, discretionary cash use has had minimal impact on leverage and coverage ratios. During periods of lower-than-expected earnings or higher capex, we expect railroads will manage share repurchases accordingly to minimize ratings risk. While we downgraded Canadian National Railway in 2023 due to an aggressive financial policy, we do not expect any further departures from leverage targets that could jeopardize ratings.

Key risks or opportunities around the baseline

1. Further improvement in rail service could stall.

Higher staffing levels amid slowing intermodal volumes contributed to improved service levels for most railroads in 2023. The added headcount will be key in providing consistent service, though service could be disrupted as network fluidity become tested with more carloads expected to enter the network in 2024.

2. Regulatory and political uncertainty remains.

We expect the STB will continue to evaluate whether to mandate reciprocal switching in areas of limited rail competition. In addition, safety considerations have been at the forefront of the industry throughout 2023 following the East Palestine, Ohio derailment (in February 2023).

3. Weak consumer spending and demand continue to pressure intermodal volumes.

Weaker-than-expected consumer spending and container imports, as well as elevated retail inventory levels, would most likely contribute to lower demand for goods that railroads transport via intermodal shipments. Truck pricing could take longer to normalize, prolonging their competitive advantage on certain routes.

The current railroad workers contract expires at the end of 2024. Congress imposed the current contract in December 2022 after months of contentious bargaining. While not necessarily a risk for 2024, some worker issues remain unresolved (including leave of absence and paid sick days). Given what could be considered successful negotiations in 2023 by the UAW, Teamsters, and other trade unions across the U.S., the various railroad workers unions could push for more in the next round of negotiations. Another Congress-mandated contract might be enacted to avoid a strike.

U.S. railroad regulator continues to evaluate changes in reciprocal switching. On Sept. 7, 2023, the STB unanimously voted for a proposal for a reciprocal switching agreement, which would occur when service fails to meet any of three performance standards (service reliability, service consistency, and inadequate local service). Given the potential for challenges to the proposed rule arising, the timing is unclear as to when, and if, any implementation will occur.

Industry Outlook: Transportation Equipment Leasing

Ratings trends and outlook

Sector rating activity was relatively subdued in 2023, continuing into 2024. In our view, the relative stability of this sector reflects a large share (about 40%) of issuers that are rated investment grade. In addition, the staggered nature of lease contracts over several years affords favorable cash flow visibility. Higher interest rates have emerged as a near-term risk because debt accounts for most of the funding of assets to be leased or rented--which include aircraft, trucks, cars, railcars, and marine cargo containers--and need to be periodically refinanced.

Aircraft lessors can expect increased lease rates and portfolio growth in 2024. Aircraft lessors make up about one-third of ratings within this sector globally, and in the past year, we assigned new ratings on two. We anticipate steady growth in this subsector due to robust plane demand and persistent industry supply constraints. In contrast, we assume steady or potentially weaker operating results from lessors sensitive to slowing economic conditions such as car renters and marine cargo container lessors.

Main assumptions about 2024 and beyond

1. Strong demand for leased aircraft will persist.

This is supported by order backlogs and ongoing manufacturing capacity constraints. The strong market backdrop should translate into higher lease rates on new and maturing contracts. Lessors account for about 50% of the global aircraft fleet and will remain a key component of aircraft financing for airlines.

2. Car and truck lessor pricing will ease while remaining favorable.

Vehicle shortages have eased, but we expect demand to remain steady. Car renters should continue to generate solid revenue led by consumer demand for services (including travel). However, rental prices have begun to abate as earlier supply constraints ease.

3. Higher financing costs will pressure interest coverage.

Transportation equipment lessors will continue to access debt capital markets to refinance maturities and fund portfolio growth. However, many lessors raised significant debt at record low rates in 2020-2021, making their average cost of capital relatively low with well-laddered debt maturities.

Credit metrics and financial policy

Transportation equipment lessors are diverse. They include aircraft, railcars, trucks, marine cargo containers, and short-term renters such as cars and portable storage units. Lessors serving the freight sector experienced record use and pricing from mid-2020 through mid-2022 due to well-known supply chain issues and high demand for goods, as opposed to services. The steep decline in passenger air travel during the pandemic resulted in many aircraft lessors having to restructure aircraft leases, defer payments, and repossess aircraft from airline customers.

Trends began to reverse in second-half 2022. Global air passenger traffic has almost returned to pre-pandemic levels as airlines seek newer aircraft to modernize and expand their fleets. Of the recorded large impairment charges on aircraft stranded in Russia, some companies have since received insurance proceeds.

For aircraft operating lessors, 2024 will see relatively stable credit measures. This is in line with stated financial policies. Revenue is expected to increase, led by new leases signed that benefit from the supply-demand imbalance and higher interest costs, as well as higher lease rates signed on lease extensions. However, higher interest expense will limit growth in earnings and cash flow. While this sector is capital intensive, credit metrics will benefit from lower-than-expected capital spending due to the supply constraints that results in lower debt requirements and related interest expense.

For other operating lessors, credit measures will weaken. The effects of a more subdued demand environment and added supply (notably for car renters and truck lessors) are likely to temper pricing and volume growth, as well as returns on asset sales. Hence, there will be less capacity to offset interest rate pressures. At the same time, most lessors have the flexibility to reduce capital spending to meet weaker demand, a trend that we have seen for the marine cargo container lessors. This should help maintain credit metrics in periods of slower growth.

Key risks or opportunities around the baseline

1. Higher-than-expected interest rates and credit spreads.

We assume operating lessors can absorb much higher interest costs in 2024, particularly investment-grade issuers. However, a further unexpected and sustained increase could lead to interest and cash flow coverage ratios below our downside rating thresholds. The risk is most acute for lower-rated issuers with floating rate exposure or looming debt maturities.

2. Weaker-than-anticipated economic conditions.

Unexpected weakness in 2024 could add pressure to demand, asset use, pricing, and cash flow. While most issuers can respond to this scenario, there would be less capacity to mitigate the impact of weaker-than-expected demand on earnings and liquidity.

3. Protracted aircraft supply constraints.

Aircraft lessors are well positioned to benefit from currently tight supply-demand fundamentals for aircraft. However, supply constraints of new and used aircraft capacity amid strong travel demand could support higher-than-expected lease rates on new and old aircraft.

Related Research

- Container Shipping: Overcapacity Will Test Discipline In 2024, Dec. 8, 2023
- Asia-Pacific Aviation Is On A Recovery Runway, Nov. 2, 2023
- European Air Travel Defies Economic Pressures On Robust Demand, June 7, 2023
- The Big 3 U.S. Airlines Are Poised For Credit Recovery Amid Looming U.S. Recession, April 6, 2023
- Europe's Airlines To Bear Highest Carbon Costs, April 3, 2023

Industry Forecasts: Transportation

Chart 9

Revenue growth (local currency)

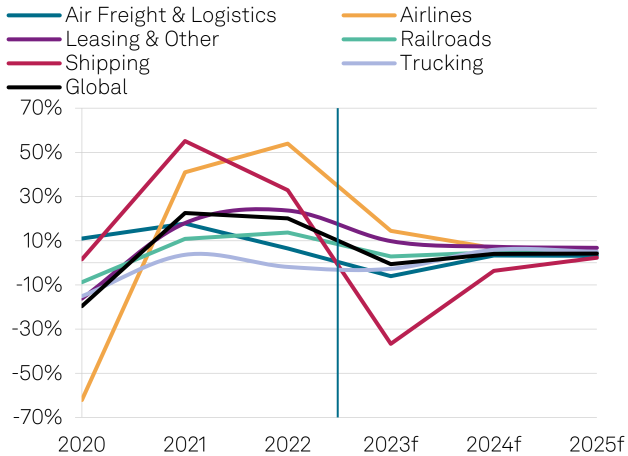


Chart 10

EBITDA margin (adjusted)

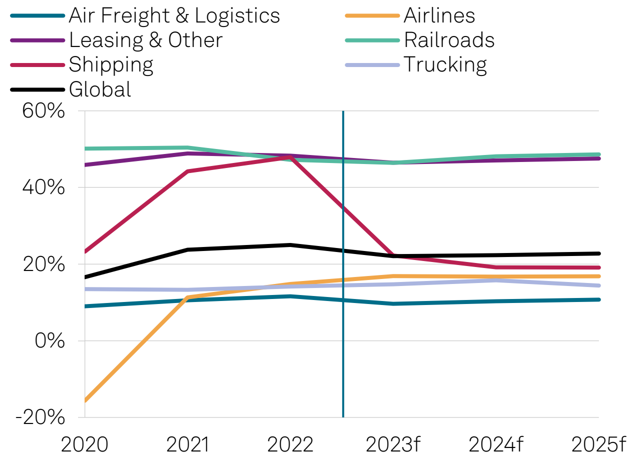


Chart 11

Debt / EBITDA (median, adjusted)

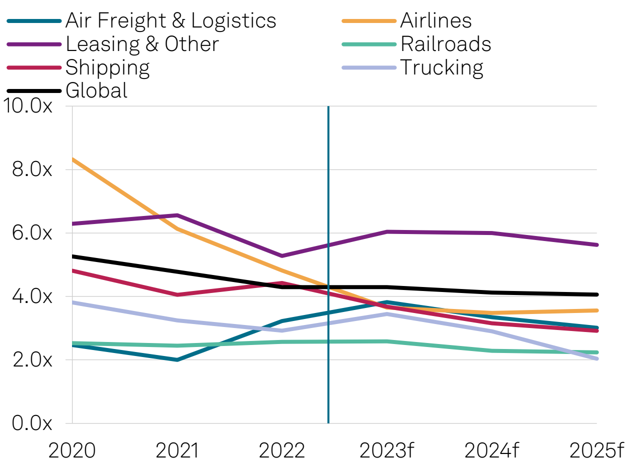
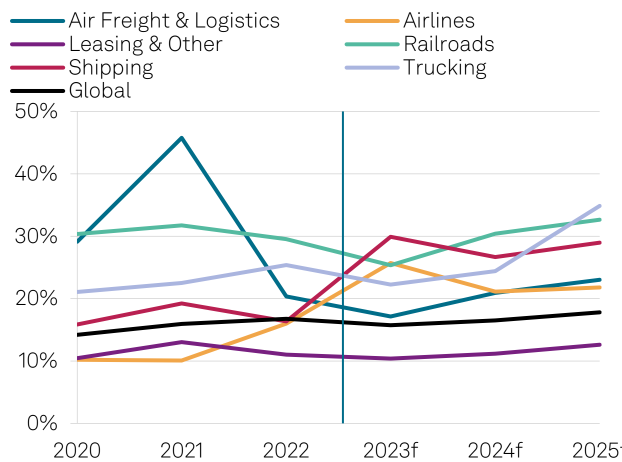


Chart 12

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: Transportation

Chart 13

Cash flow and primary uses

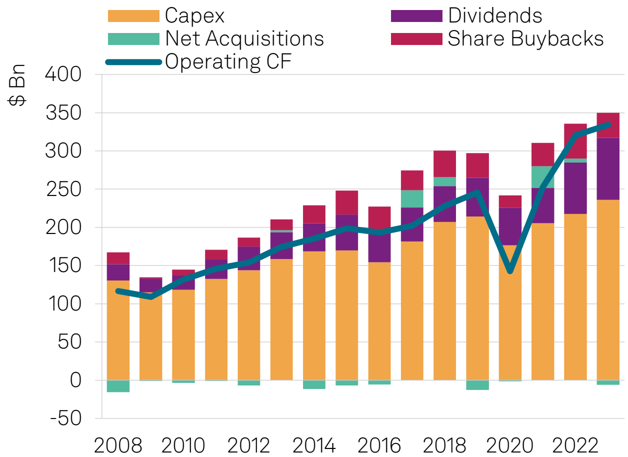


Chart 14

Return on capital employed

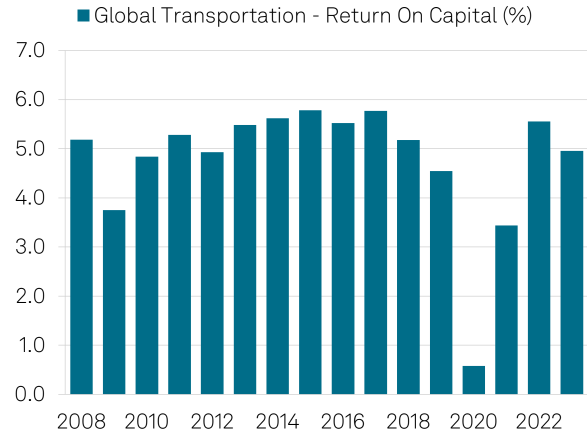


Chart 15

Fixed- versus variable-rate exposure

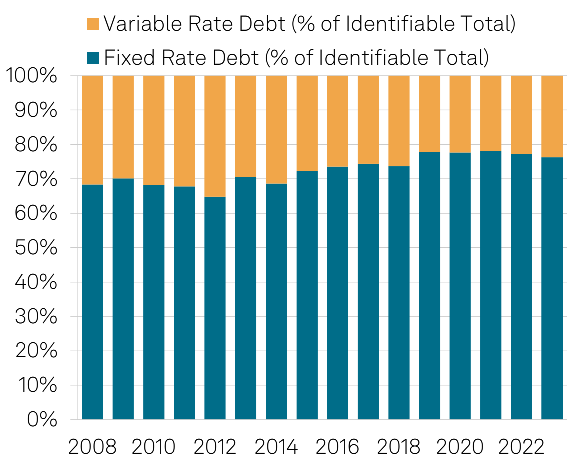


Chart 16

Long-term debt term structure

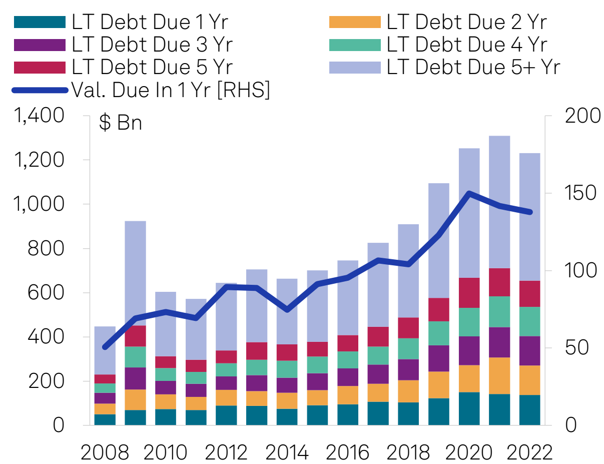


Chart 17

Cash and equivalents / Total assets

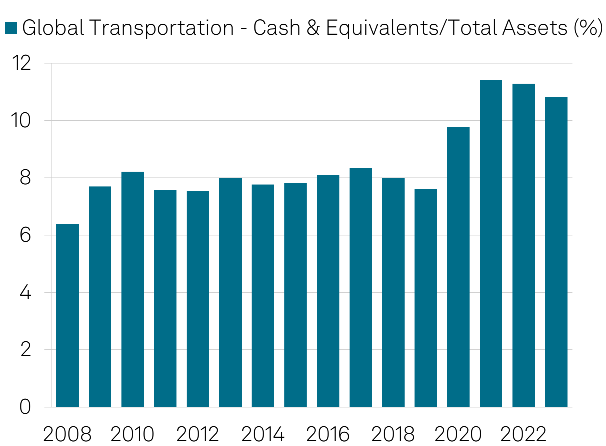
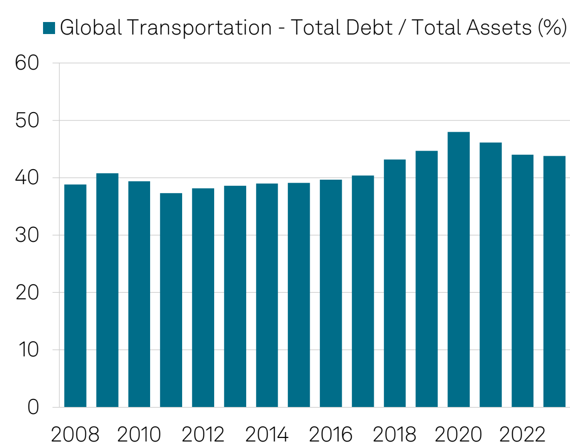


Chart 18

Total debt / Total assets



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

Asia-Pacific Utilities

Earnings recovery should temper higher transition spending

January 10, 2024

This report does not constitute a rating action.

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What's changed?

Economic outlook. Asia-Pacific's growth engine to shift from China to South and Southeast Asia.

Fuel costs. Easing fuel costs will aid earnings recovery.

Interest rates. We expect global interest rates to ease only gradually.

What are the key assumptions for 2024?

Overall power demand growth to stabilize at mid-single digits. Asia will use half of the world's electricity by 2025, with China accounting for one-third of the global total. Natural gas demand will also recover over the next two years, supported by industrial demand and normalizing prices.

Easing fuel costs and increasing renewable generation will underpin operating cash flow. Pass-through remains uneven among countries, but easing thermal coal and gas prices, plus more renewable power consumption, will aid earnings recoveries.

Leverage will stay high, mainly to fund energy-transition investments. Potential mergers and acquisitions (M&A) and vertical expansion could also pressure metrics.

What are the key risks around the baseline?

Downside risk on demand growth. Economic slowdown in the region, if more than expected, could directly dampen the momentum for power and gas demand.

More volatile fuel prices than expected. Escalation of geopolitical tensions could disrupt energy supply, pushing up prices, mitigated to an extent by long-term contracts or price regulation.

Overaggressive expansion of unregulated businesses. This could heighten the business risk and dampen overall cost pass-through if there is a lack of longer-term protections.

Ratings Trends: Asia-Pacific Utilities

Chart 1

Ratings distribution and outlook

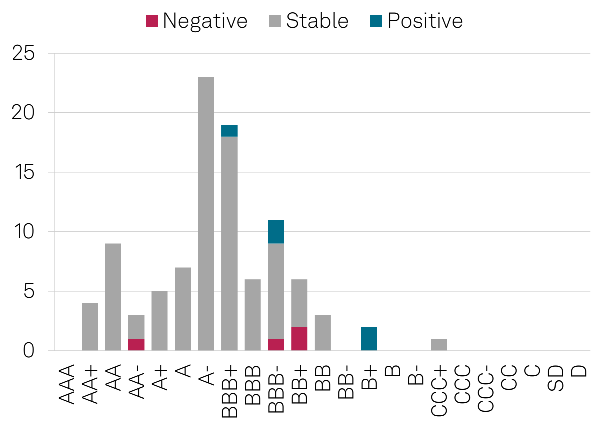


Chart 2

Ratings distribution by region

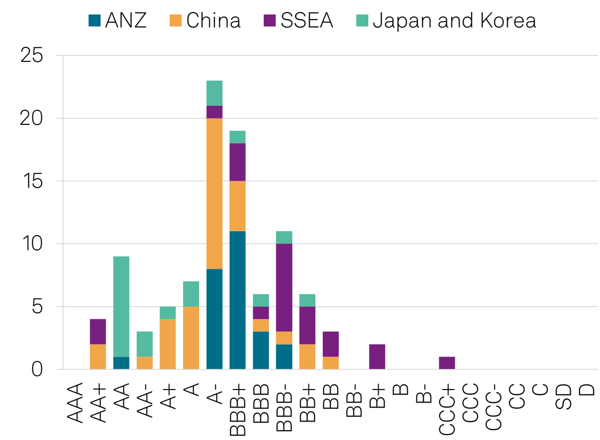


Chart 3

Ratings outlooks

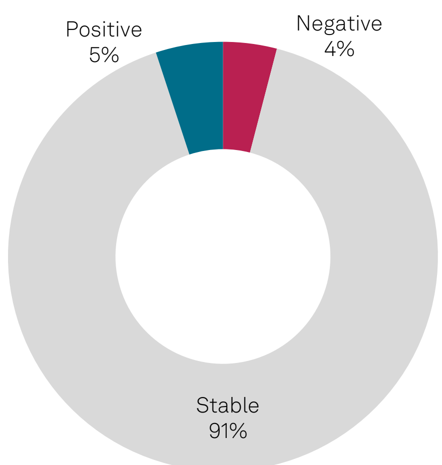


Chart 4

Ratings outlooks by region

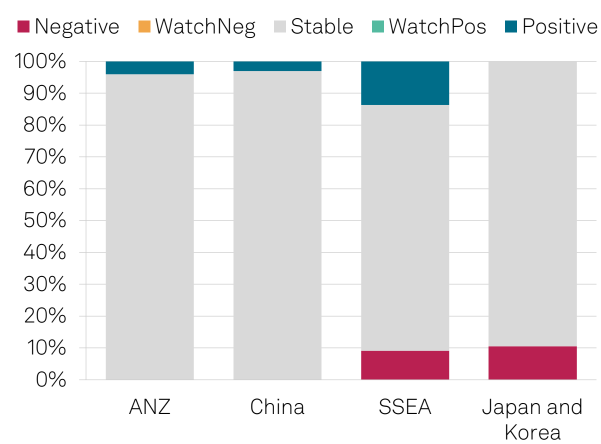


Chart 5

Ratings outlook net bias

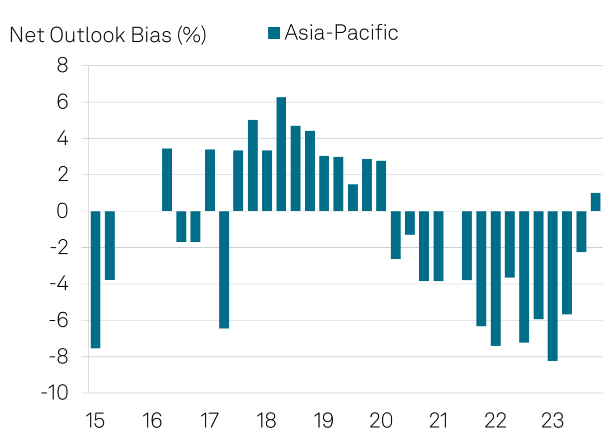
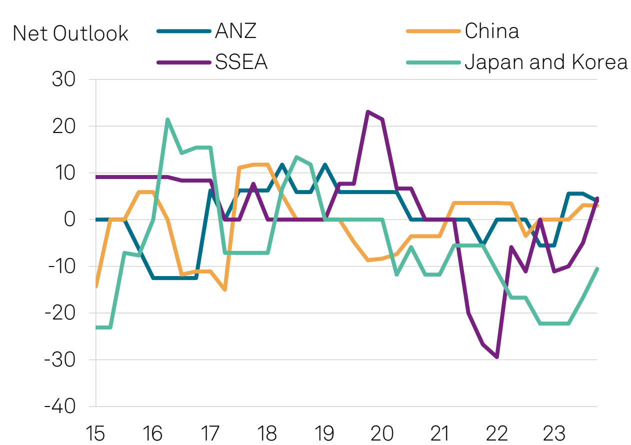


Chart 6

Ratings net outlook bias by region



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

Industry Credit Metrics: Asia-Pacific Utilities

Chart 7

Debt / EBITDA (median, adjusted)

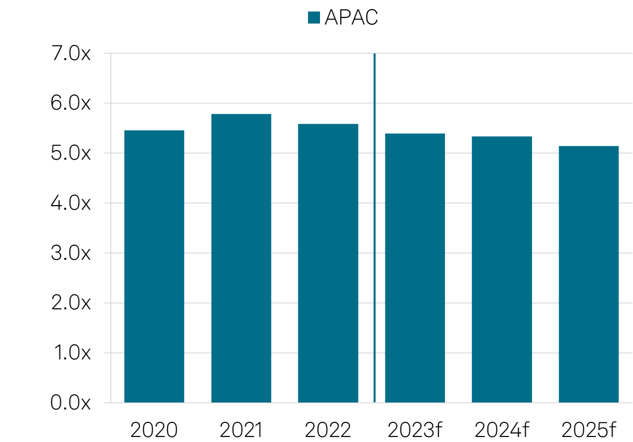


Chart 8

FFO / Debt (median, adjusted)

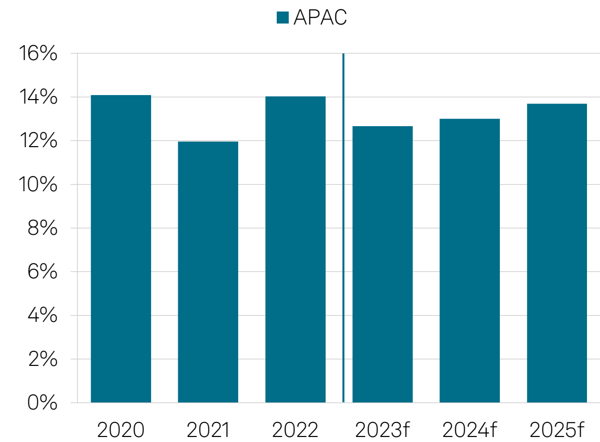


Chart 9

Cash flow and primary uses

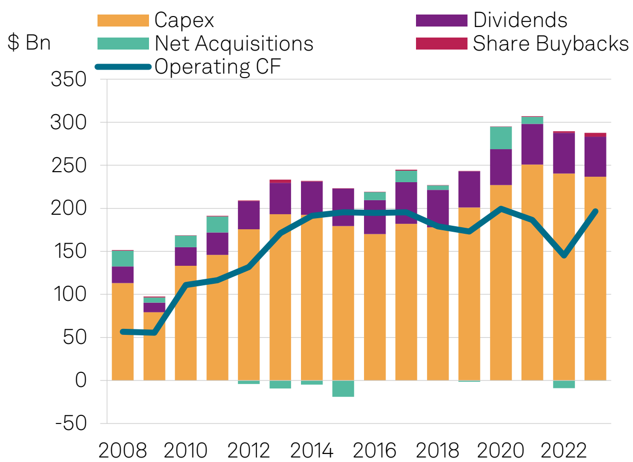
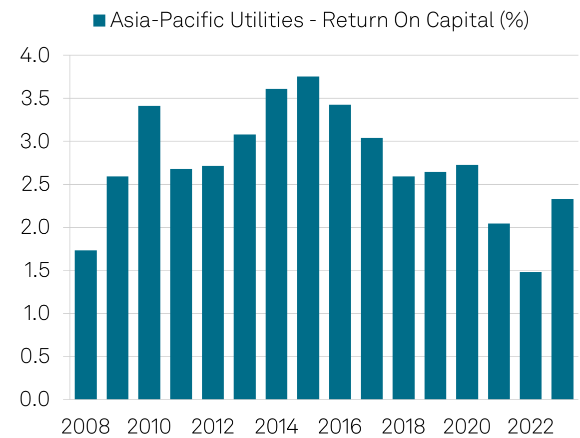


Chart 10

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
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. Most recent (2023) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: Australia and New Zealand

Ratings trends and outlook

Our stable outlook for the sector is supported by the adequate rating headroom of most rated entities. Regulated utilities will benefit from inflation-linked revenues, but margins will be counteracted by higher costs to an extent. We expect regulation to remain supportive as the industry navigates its way through the energy transition phase, particularly in the gas sector. Unregulated players in New Zealand will benefit from prudent policies on shareholders' distributions during the upcoming building phase.

Main assumptions about 2024 and beyond

1. Inflation benefits to regulated utilities revenue could partly offset cost pressure.

Inflation-linked pricing will flow to revenues, but margins will be suppressed by higher costs for labor, contracts, and procurement. In New Zealand, an annual cap to price increases can also constrain margins. Refinancing of debt will increase interest costs, mitigated somewhat by the annual adjustment to debt costs, or higher weighted average cost of capital where pricing resets are due. Softer gas demand or new connections could limit upside to gas distributors.

2. Outperformance of regulatory allowances can be harder.

Inflationary pressure on project maintenance costs will reduce cash available for distributions. We view this risk as manageable because shareholders of most of the rated entities are long-term infrastructure investors. Hence, they are less likely to extract cash.

3. Electricity prices will remain high in New Zealand.

We forecast electricity prices will remain high, based on normal hydrology and stable demand. Downside risks include extreme hydrology, reduced demand from aluminum smelters or a slow rise in alternate demand, and strong retail competition.

Credit metrics and financial policy

In our view, the financial policies of rated entities are generally supportive of credit quality. Most rated entities operate to various financial policy targets that can range from target ratios of funds from operations (FFO) to debt, risk limits, interest rate hedging, and scheduling debt refinancing ahead of debt maturities. The financial metrics of the rated portfolio have reasonable headroom against company policies, which gives leeway for any unexpected variation in operating parameters. All rated entities have flexibility in dividend distributions and, to some extent, for capital expenditures (capex).

Key risks or opportunities around the baseline

1. An accelerated pursuit of growth in the unregulated segment by regulated utilities.

Rapid growth in renewable power and demand for electric vehicle (EV) charging infrastructure will require large investments, which will bring risks.

2. Australian unregulated utilities: Renewable power investments present mixed outcomes.

Construction costs, approvals, network connections, and contract arrangements will be a risk to project deliveries.

3. More renewable power heightens risk to coal plants in Australia.

Still, we're seeing life extensions for some coal plants. Volatile pool prices, plant availability, and construction costs remain the biggest risk to the unregulated sector.

4. Merchant utilities in New Zealand gearing up for several new "green" projects.

Cost management and execution remain key risks. Some projects have been completed with no or limited risk to credit quality, while others have seen cost escalation or delays.

An accelerated pursuit of growth in the unregulated segment by regulated utilities will bring risks. Rapid growth in renewable power and demand for electric vehicle (EV) charging infrastructure will require large investments. Most of these are likely to be contracted or unregulated and be debt-funded. We expect phased growth; however, a rapid increase in unregulated investments could dilute our assessment of business risk.

Australian unregulated utilities: Renewable power investments present mixed outcomes. Construction costs, approvals, network connections, and contract arrangements will involve steady variables and be a risk to project deliveries. Planned investments for generation and transmission are substantial, spurred by the target to reduce emissions by 43% by 2030.

More renewable power heightens risk to coal plants in Australia. The pressure is escalating due to lower average prices of renewables amid an increase in roof-top and large-scale solar. Still, stability and reliability issues, as well as uncertain visibility on the roll-out of renewable capacity, is leading to life extensions for some coal plants. Volatile pool prices, plant availability, and construction costs remain the biggest risk to the unregulated sector over the next one to two years. Lifting retail price caps will provide some respite for those with plant portfolios.

Merchant utilities in New Zealand gearing up for several new "green" projects. Cost management and execution remain key risks amid tight supply of contractors and long lead times for equipment supply. While some projects have been completed recently with no or limited risk to credit quality, others have seen cost escalation or delays due to weather, supply, or design changes.

Industry Credit Metrics: Australia and New Zealand

Chart 11

Debt / EBITDA (median, adjusted)

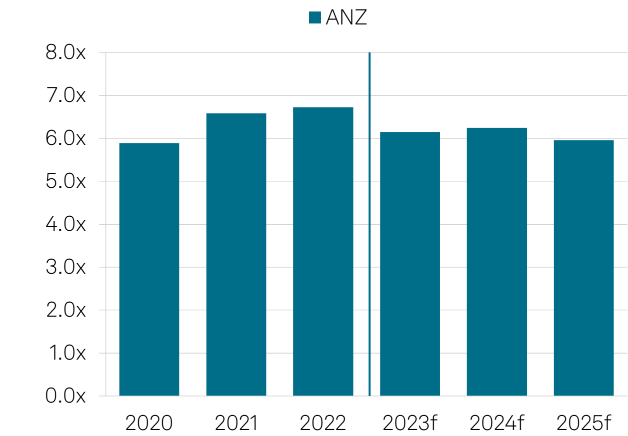


Chart 12

FFO / Debt (median, adjusted)

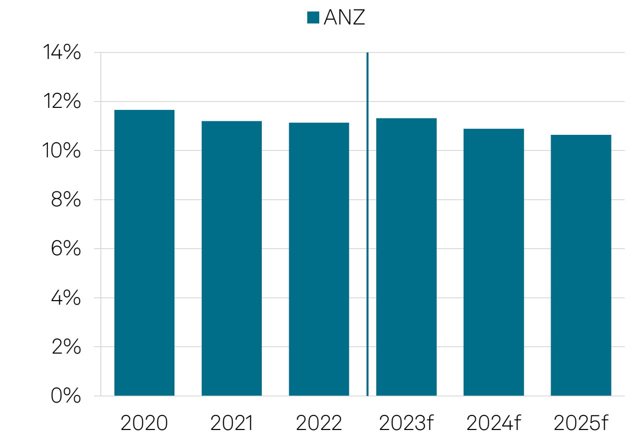


Chart 13

Cash flow and primary uses

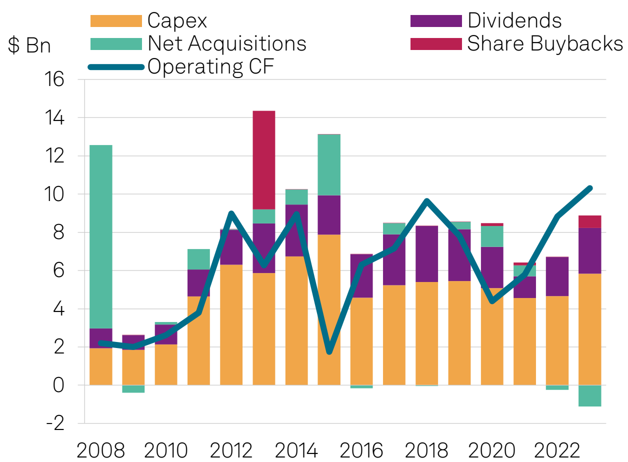
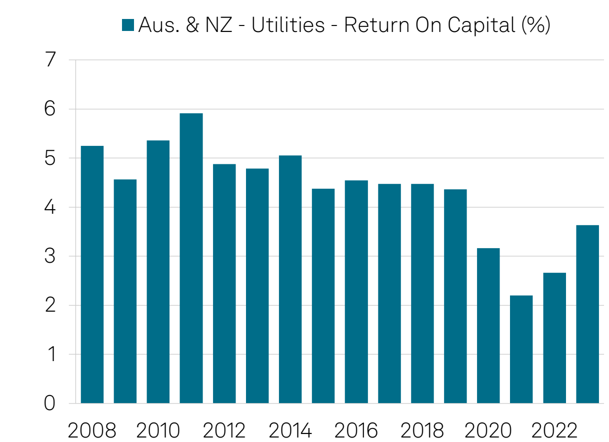


Chart 14

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.

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. Most recent (2023) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: China and Hong Kong

Ratings trends and outlook

We have a stable outlook for the sector, based on likely continued earnings recovery but large capital spending. Still, economic slowdown may drag on China's power and gas consumption growth. This could modestly hinder earnings recovery for our rated issuers. Softening fuel costs will help sustain issuers' margins. In some cases, pass-through could be delayed since local governments may prioritize affordability for end-users.

Main assumptions about 2024 and beyond

1. A slowdown in power demand growth may hurt utilization hours for China's independent power producers (IPPs).

China's power demand growth will likely soften. Coal-fired power will be the most affected. Coal units will gradually assume the role of 'peak shaving' in the power system.

2. Coal power tariffs may start to soften in 2024 as thermal coal prices normalize.

Recent weaknesses in the spot market will not materially affect the overall tariff level for 2023. Nevertheless, we expect power tariffs to start edging down in 2024.

3. China's ambitious energy transition plan will load state-owned IPPs with even more debt.

IPPs will invest heavily in renewables, and heavy debt-funded capex may weigh on the credit improvements. Plus, the additional costs of installing energy storage may narrow new project returns.

A slowdown in power demand growth may hurt utilization hours for China's IPPs. China's power demand growth will likely soften to 4%-5% year-on-year in 2024 as sluggish property and export-related sectors depress industrial production. Coal-fired power will be the most affected because the rapid deployment of renewable energy is eating into its share. Meanwhile, coal units will gradually assume the role of 'peak shaving' in the power system. This is because the lack of storage facilities for intermittent power output of wind and solar means they can't match the power demand curve. Additional revenues from such ancillary services may not fully compensate for the loss of utilization hours by coal fleets.

Coal power tariffs may start to soften in 2024 as thermal coal prices normalize. IPPs sell most of their power through annual contracts that lock in tariffs for the full year. As such, recent weaknesses in the spot market will not materially affect the overall tariff level for 2023. Nevertheless, we expect power tariffs to start edging down in 2024 since the annual contracts signed for next year may factor in potential coal price declines. Loosening power supply-demand in China may also contribute to price weaknesses.

China's ambitious energy transition plan will load state-owned IPPs with even more debt. IPPs will invest heavily in renewables over the next couple of years as COVID-related lockdowns in the previous two years have slowed the progress of clean energy development. Heavy debt-funded capex may weigh on the credit improvements brought about by declining coal costs. Plus, competition over new renewable projects is keen, and the additional costs of installing energy storage may also narrow new project returns.

Hong Kong: The five-year plan announcement in November brought clarity on transition-related spending burdens. The plan guides the power companies' capex over 2024-2028. Energy transition remains the key theme, and entails the development and upgrades of the existing power grids to accommodate a higher mix of renewables.

Transmission capabilities between Hong Kong and mainland China will also be strengthened to import more clean energy directly from the mainland. The regulatory framework will likely remain strong and ensure steady profits for the power companies.

Credit metrics and financial policy

We expect credit metrics to be stable for China IPPs over 2024-2025. Their average ratio of FFO to debt will remain about 9%, given coal power tariffs may moderately soften alongside fuel costs. The recent implementation of capacity tariffs may help stabilize the profitability of coal-fired IPPs going forward. Also, we believe IPPs will invest heavily in renewable energy development over the next few years, which will likely drive up their capex level and limit any substantial improvements in their credit profiles.

The credit metrics of China gas distributors, on the other hand, may slightly improve. Their average ratio of FFO to debt will likely increase to 24% in 2025 from 22% in 2023, because gas sales volume will continue to grow with some mild improvements in dollar margins. We expect capex levels of gas distributors to be broadly stable over the next few years.

Key risks or opportunities around the baseline

1. Weaker-than-expected volume growth may dampen retail gas earnings.

We project gas volumes will rise, but the industrial production slowdown will probably limit the recovery of China's gas consumption. Also, distributors' average dollar margins will be pressured.

2. Ineffective or delayed cost pass-through would hurt dollar margins.

We expect dollar margins for gas distributors to modestly rise. However, pass-through policy still varies across local governments, and socioeconomic considerations may influence governments' decisions in end-user price adjustments.

3. Price volatility remains for liquified natural gas (LNG).

Gas distributors are diversifying their gas procurement channels by buying unconventional gas and importing LNGs through long-term contracts and spot trading. Our improving dollar margin forecasts factor in declining LNG costs. However, any price jumps will raise the cost base of distributors.

Weaker-than-expected volume growth may dampen retail gas earnings. We project gas volumes will rise by an average 9% annually for rated issuers over the next couple of years. The industrial production slowdown will probably limit the recovery of China's gas consumption. High double-digit growth seen prior to 2022 is thus unlikely for the foreseeable future. Also, the falling mix of high-margin industrial gas sales will drag on distributors' average dollar margins.

Ineffective or delayed cost pass-through would hurt dollar margins. We expect dollar margins for gas distributors to modestly rise by Chinese renminbi (RMB) 0.01/per cubic meter (cbm) to RMB0.02/cbm in 2024 as pass-through continues to improve in various cities post-pandemic. However, pass-through policy still varies across local governments, particularly in the residential sector. And socioeconomic considerations, such as boosting economic growth or ensuring user affordability, may influence governments' ultimate decisions in end-user price adjustments.

Price volatility remains for LNG. Gas distributors are diversifying their gas procurement channels to reduce their reliance on the big three oil majors. This includes buying unconventional gas and importing LNGs through long-term contracts and spot trading. These currently account for 10%-20% of gas sources for our rated issuers with high project coverage in coastal provinces. Our improving dollar margin forecasts factor in declining LNG costs, in line with the global energy price trend. However, any price jumps caused by demand spikes or supply disruptions will raise the cost base of distributors.

Taiwan: Large capex for energy transition with stressed profitability due to high cost for renewable energy and domestic LNG prices. Following the government's energy transition policy, Taiwan Power Co. will invest heavily to expand gas-fired plants, network reliability improvement, and network connections for additional green power. This could weaken debt leverage over the next few years. Meanwhile, domestic LNG prices could remain high in 2024. This, as well as rising purchase costs for renewable energy, will continue to strain the company's profitability. While the government has twice adjusted tariffs upwards to reflect rising fuel costs since July 2022, the increments are still far less than sufficient to cover increasing costs.

Industry Credit Metrics: China and Hong Kong

Chart 15

Debt / EBITDA (median, adjusted)

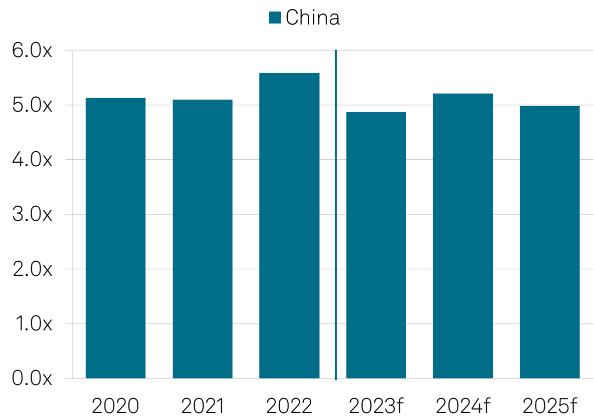


Chart 16

FFO / Debt (median, adjusted)

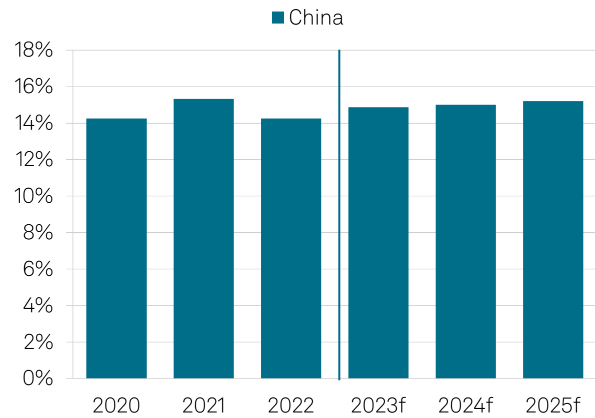


Chart 17

Cash flow and primary uses

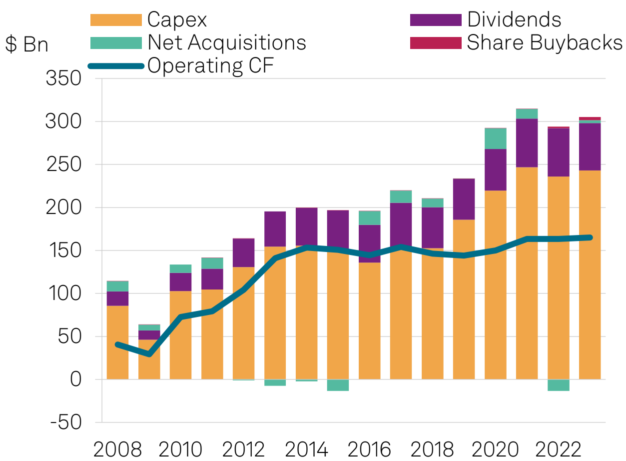
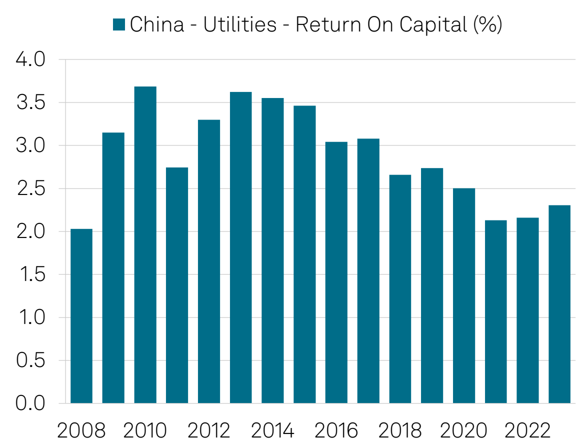


Chart 18

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
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. Most recent (2023) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: South and South-East Asia

Ratings trends and outlook

The largely stable outlook in 2024 for our portfolio of regulated utilities and IPPs has a relatively thin headroom. We expect governments to allow regulated utilities to recover full costs either through tariffs or subsidies, though the timeliness and effectiveness will vary significantly across the region. Rated IPPs will also be able to pass through fuel costs under existing contracts. Moderating fuel costs from last year's peaks can provide some relief to generation and distribution firms that face a lag in recovery. Aggressive capex, leveraged acquisitions, and an inability to recover high interest and fuel costs remain the key risk for ratings.

Main assumptions about 2024 and beyond

1. Healthy economic growth to support power demand.

We project around 5%-7% growth in annual power demand in fast-growing emerging economies such as India, Indonesia, and the Philippines. Singapore, Malaysia, and Thailand will experience increased power demand of 3% annually.

2. High capex and rising interest costs will keep leverage elevated.

Increasing investments for energy transition and high interest costs will keep capex and leverage elevated for rated utilities in South and Southeast Asia. Access to relatively competitive domestic funding will likely reduce risks from rising interest rates and dollar funding.

3. Reversal to pre-pandemic regulatory tariff frameworks for most countries.

South and Southeast Asia are able to recover tariffs deferred during the pandemic, and many have begun to. However, the Thai government retained some relief measures.

Healthy economic growth to support power demand. Relatively healthy GDP growth in South and Southeast Asian economies will drive power demand. We project around 5%-7% growth in annual power demand in fast-growing emerging economies such as India, Indonesia, and the Philippines. The more developed economies of Singapore, Malaysia, and Thailand will experience increased power demand of 3% annually.

High capex and rising interest costs will keep leverage elevated. Increasing investments for energy transition and high interest costs will keep capex and leverage elevated for rated utilities in South and Southeast Asia even as they have been scaling back traditional investments into coal plants. Good access to relatively competitive domestic funding will likely reduce risks from rising interest rates and dollar funding.

Reversal to pre-pandemic regulatory tariff frameworks for most countries. South and Southeast Asia are able to--or are beginning to--recover tariffs deferred during the pandemic. Many have reverted to pre-pandemic regulatory frameworks and tariff mechanisms. However, the Thai government retained some relief measures and approved a tariff cut from September to December 2023. A watchpoint is whether Thailand will stick with its tariff philosophy of regulated returns with full cost pass-through.

Credit metrics and financial policy

Utilities in growing markets such as India and Indonesia will operate at around 5x debt-to-EBITDA because of growth in capex. Power majors in mature and fully electrified markets such as Singapore and Peninsular Malaysia will operate around 4x debt-to-EBITDA.

Weaker performance for renewables will also weigh on leverage. Continued underperformance below P90 (meeting power generation probability at least 90% of the time) will strain cash flow and margins. Resource risk is greater for players more exposed to wind assets, such as in India and Indonesia, where performance recovery has been lagging. Lower cash flow and aggressive growth spending will likely keep leverage high, with debt-to-EBITDA ratios over 6x and interest coverage of about 1.5x.

Key risks or opportunities around the baseline

1. Rising interest cost and inflation remain key risks.

Unregulated power players are exposed to rising interest cost and inflation, and companies that require large funding needs may be more so. Generation companies will be exposed to fuel price fluctuations if they have fixed-price revenue contracts. In some markets, power purchase agreements were cancelled and contracts renegotiated to allow for fuel cost pass-through.

2. Higher exposure to merchant markets may increase cash flow volatility.

More power producers are expanding into merchant power markets, seeking higher returns at the expense of higher risk.

3. Growth investments in overseas markets can be a double-edged sword.

Many IPPs are investing opportunistically in offshore markets. However, sizable debt-funded investments can pressure balance sheets and elevate leverage.

Rising interest cost and inflation remain key risks. Unregulated power players are exposed to rising interest cost and inflation, given they are unable to pass on increases in such costs. Companies that require large funding needs for growth or refinancing may be more vulnerable. While fuel costs have eased, generation companies will be exposed to fuel price fluctuations if they have fixed-price revenue contracts. In some markets, such as the Philippines, power purchase agreements were cancelled, and contracts renegotiated to allow for fuel cost pass-through. Most of our rated IPPs in Thailand and Indonesia can pass through fuel costs under existing contracts.

Higher exposure to merchant markets may increase cash flow volatility. More power producers, for example in the Philippines, are expanding into merchant power markets. This strategy offers higher returns at the expense of higher risk via more exposure to spot-price volatility. Mitigants to such volatility range from active trading strategies to long-term contracts that offer downside protection to the floor price during lower pricing-power conditions. The ability to weather depressed power price periods or unforeseen detrimental circumstances will depend on sponsors' financial discipline.

Growth investments in overseas markets can be a double-edged sword. Many IPPs are investing opportunistically in offshore markets to increase scale and enhance geographic diversity. Some of the plans may be driven by energy transition. However, sizable debt-funded investments can pressure balance sheets and elevate leverage. Earning quality can suffer if exposures rise in countries that carry higher regulatory and country risks, such as Vietnam and Laos.

Industry Credit Metrics: South and South-East Asia

Chart 19

Debt / EBITDA (median, adjusted)

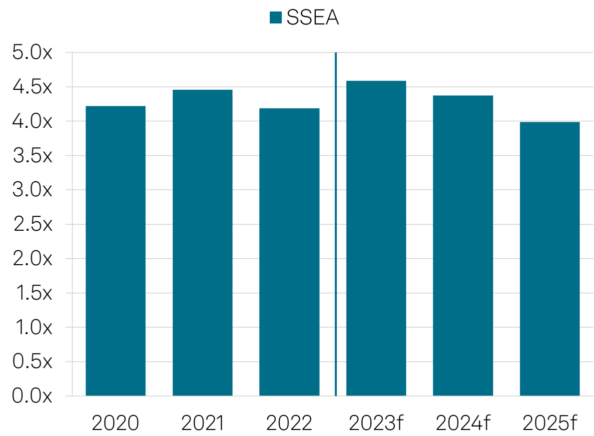


Chart 20

FFO / Debt (median, adjusted)

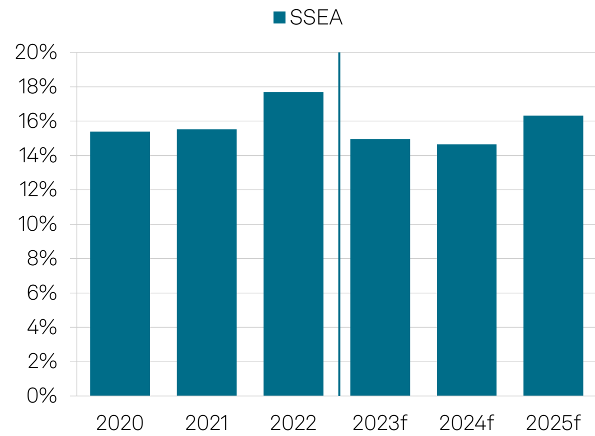


Chart 21

Cash flow and primary uses

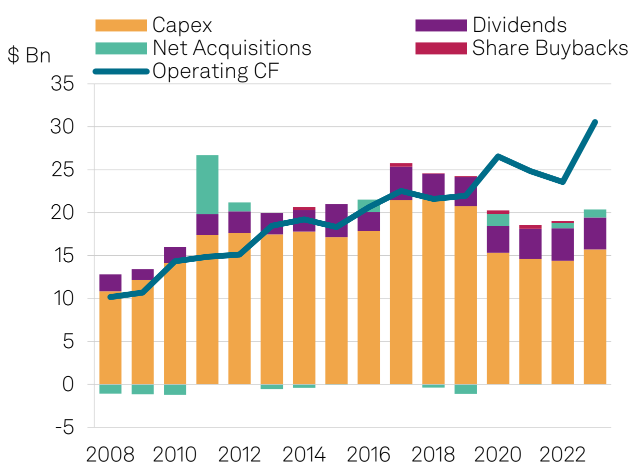
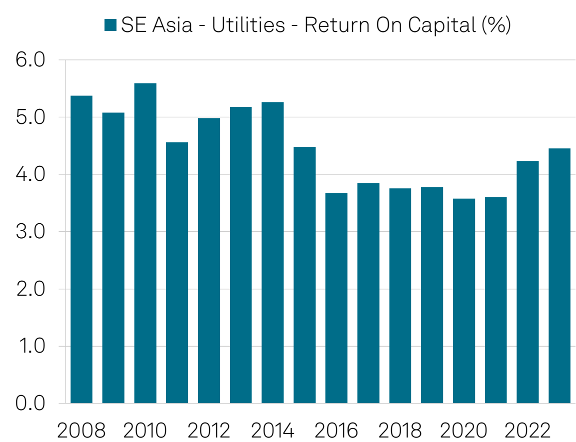


Chart 22

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.

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Industry Outlook: Japan and Korea

Ratings trends and outlook

The outlook for the Japanese utilities sector is stable. We expect strong positions in respective supply regions, favorable regulatory frameworks, transparent pricing systems, and the possibility of extraordinary support from the government in times of need. All these factors help to support creditworthiness.

South Korean utilities also have mostly stable outlooks. Korea Electric Power Corp. (Kepco) and Korea Gas Corp. (Kogas) are government-related entities with an almost certain likelihood of support in times of financial distress. The ratings and outlooks are equalized with those on the South Korean government.

Main assumptions about 2024 and beyond

1. Expectations for Japanese utilities over the next 12 months:

Earnings will recover and stay steady, but debt will likely stay elevated.

2. Expectations for South Korean utilities over the next 12 months:

Earnings and operating cash flows will stabilize to some degree in 2024, but leverage of Kepco and Kogas will likely remain elevated over the next 12-24 months.

Japanese utilities: Earnings will recover and stay steady over the next 12 months, thanks primarily to rate hikes in mid-2023, allowing electricity utilities to flexibly pass on fuel costs. After a significant rise over the past two years, debt will stay elevated due to aggressive investments in the pipeline.

South Korean utilities: With fuel costs stabilizing at lower levels, we believe the earnings and operating cash flows of South Korean utilities companies will stabilize to some degree in 2024. Still, leverage of Kepco and Kogas will likely remain elevated over the next 12-24 months, due to higher debt driven by high commodity prices, and delayed and insufficient tariff hikes.

Credit metrics and financial policy

Cash flow metrics for Japanese utilities will improve to pre-2020 levels. FFO-to-debt ratios will be around 10% for most electric utilities and slightly above 25% for city gas players. However, the metrics will improve only slowly when excluding the positive impact of the time lag in transferring volatility in fuel costs to electricity sales prices for electric utilities.

Japanese electric utilities will continue with modest shareholder returns, in our view. This is because they are increasingly aware that a sufficient financial buffer is necessary to cushion future capex, which likely accelerates, amid uncertainties around operating environments including potential fuel price volatility.

Leverage burden for key South Korean utilities companies such as Kepco and Kogas will remain elevated, since their debt spiked over 2021-2022 due to weak cash flows. We forecast Kepco's debt-to-EBITDA ratio to stay at 7-8x, and Kogas at 9-10x in 2024-2025.

South Korean utilities companies' capex burden will remain sizable for the next 12-24 months. Kepco's investments will likely increase further as the group needs to invest in construction of nuclear power plants, as well as other green projects.

Key risks or opportunities around the baseline

1. Electricity utilities' fuel prices could spiral if, for example, underlying geopolitical risks accelerate further.

Higher fuel prices would delay our assumptions that electricity utilities' earnings and finances will recover in 2024. In South Korea, another significant spike in fuel costs would directly hit credit metrics. In Japan, higher fuel prices won't cause immediate credit stress because of new pricing formulas.

2. Acceleration in investments by electricity utilities.

Free cash flow deficits could deteriorate due to aggressive investments in decarbonization, which could pose more downside pressure for issuers whose credit metrics have been dampened during the global energy crisis. Korean electricity utilities' investment burdens will also likely remain elevated due to construction of nuclear plants and investments in renewable energies.

3. Intensified competition in domestic electricity retail in Japan.

Deregulation of electricity retail leaves open the possibility of the industry facing further fierce competition--as was common until a few years ago. This could subdue profitability for the sector.

4. Expansion in unregulated businesses for Japanese gas players.

Japan's leading regulated gas players aim to accelerate investments in domestic electricity retailing, renewable energy, and overseas businesses like gas upstream projects or IPPs. Higher exposure to such areas could heighten the volatility of earnings.

5. Higher oil and gas prices and difficulties in tariff adjustments for Korea Gas.

A sharp increase of oil and gas prices, if any, could lead to an increase in working capital burdens and further debt growth for Kogas. Also, uncertainties around the timely tariff adjustments remain a key swing to Kogas' credit metrics and deleveraging efforts.

Fuel prices could spiral for electricity utilities if, for example, underlying geopolitical risks accelerate further. Higher fuel prices would delay our baseline assumptions that earnings and finances for the industry will recover in 2024.

For Korean utilities, another significant spike in fuel costs would directly hit credit metrics. Delayed and insufficient tariff hikes drove a sharp increase in their debt burdens in 2022, and uncertainties around tariff hikes remain high.

However, for Japanese electricity utilities, higher fuel prices won't cause immediate credit stress, as occurred over the past two years, because the Japanese government approved new pricing formulas in early 2023 that allows the regulated power companies to pass-through higher fuel costs more easily.

Acceleration in investments by electricity utilities. Free cash flow deficits could further deteriorate due to aggressive investments in decarbonization, which would be on top of spending on maintenance and replacement of conventional thermal power facilities and, for Japanese electricity utilities, the burden of enhanced safety measures to restart nuclear power plants. This could pose more downside pressure for issuers whose credit metrics have been dampened during the global energy crisis.

For Korean utilities, investment burdens will also likely remain elevated due to construction of nuclear plants and investments in renewable energies.

Intensified competition in domestic electricity retail in Japan. Full deregulation of electricity retail in 2016 opened the retail market to hundreds of newcomers. Many peers aggressively switched their fee plans to transfer volatility in fuel procurement prices to end customers. This means the industry might face another round of fierce competition--as was common until a few years ago. This could subdue profitability for the sector.

Expansion in unregulated businesses for Japanese gas players. Japan's leading regulated gas players aim to accelerate investments in domestic electricity retailing, renewable energy, and overseas businesses like gas upstream projects or IPPs. Recent examples include Tokyo Gas Co. Ltd.'s December 2023 announced acquisition of a U.S. shale gas development and production company for US$2.7 billion. Profit is more volatile in these businesses than in the regulated domestic gas utility business. Higher exposure to such areas could heighten the volatility of earnings.

Higher oil and gas prices and difficulties in tariff adjustments for Korea Gas. Resurgence of oil and gas prices, if any, could lead to an increase in working capital burdens and further debt growth for Kogas. Also, uncertainties around the timely tariff adjustments remain a key swing to Kogas' credit metrics and deleveraging efforts.

Industry Credit Metrics: Japan and Korea

Chart 23

Debt / EBITDA (median, adjusted)

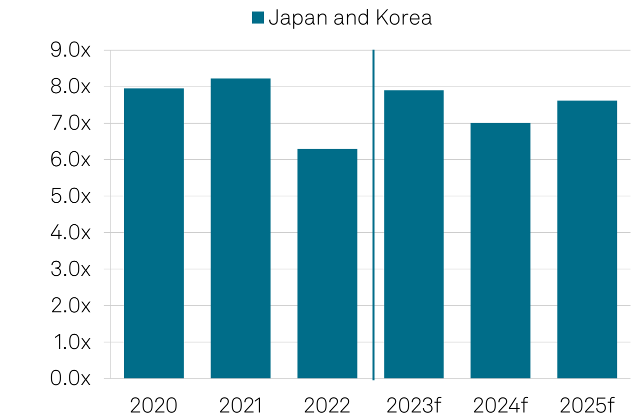


Chart 24

FFO / Debt (median, adjusted)

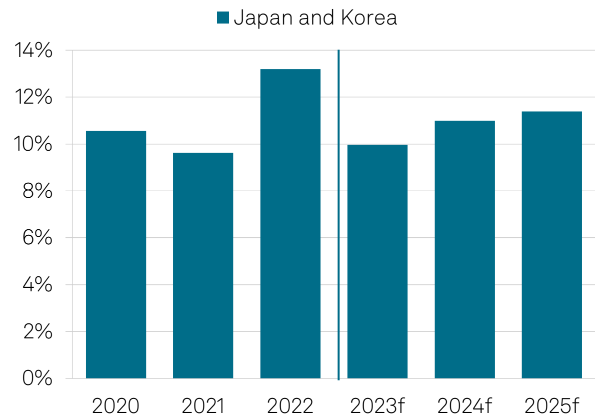


Chart 25

Cash flow and primary uses

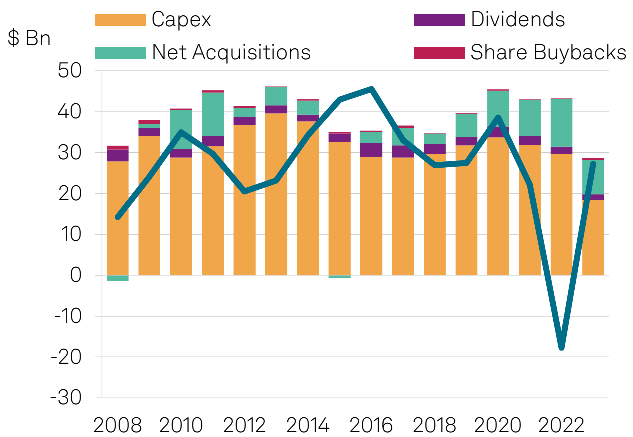
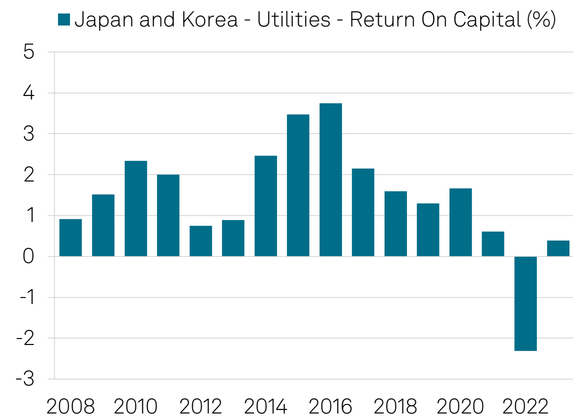


Chart 26

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
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- Industry Top Trends: Asia-Pacific Utilities, Feb. 2, 2023
- Japan's LNG Supply: On Solid Ground?, Jan. 5, 2023

EMEA Utilities

Europe's energy transition: Still on, despite crosscurrents

January 9, 2024

This report does not constitute a rating action.

What's changed?

Positively, gas is no longer scarce. Nevertheless, because of Europe's low supply buffer, power and gas prices remain elevated and volatile.

The economics of power supply decarbonization have weakened for offshore wind and power grids. This makes the transition less affordable and slower than hoped.

Higher-for-longer interest rates, high inflation on renewables, and grid capital expenditures (capex) test energy transition economics, including for nuclear. Yet most Western European grids benefit from regulatory values indexed to inflation and remuneration to interest rates.

What are the key assumptions for 2024?

Continuing high and volatile gas and power prices benefit power generators. Demand containment efforts may be tested by ongoing affordability measures and slight GDP growth.

Caution on generation and grid investments. With higher capex, we expect prudent financing.

Reduced ratings headroom outside thermal and hydro generators. Balance sheets, while typically solid, are eroded by high and growing capex, interest rates, and dividends.

What are the key risks around the baseline?

Supply chain issues, interest rates, inflation, and regulatory and fiscal setbacks aggravating energy-transition economics. Changes in assumptions or weak contracting could impair the economics of large projects and a utility's business risk or financial risk profile.

Political and regulatory risks. Pressures to accelerate the energy transition and affordability measures could weigh on ratings via higher debt and lower earnings.

Cyber risk, physical sabotage, or weather. These could weigh on issuers with thin liquidity.

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Ratings Trends: EMEA Utilities

Chart 1
Ratings distribution

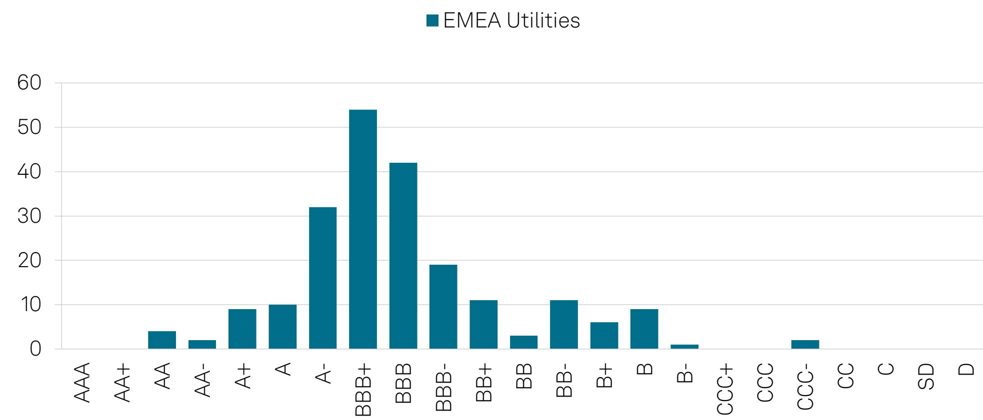


Chart 2
Ratings outlooks

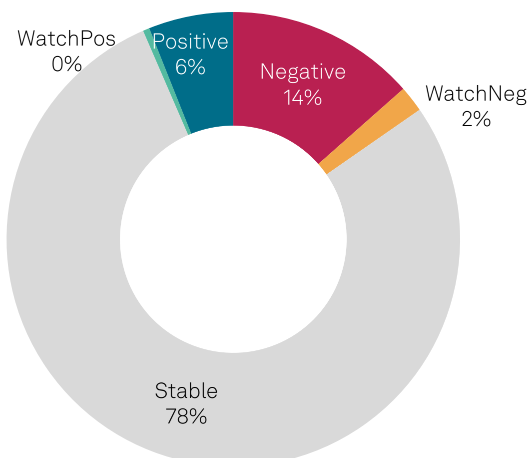
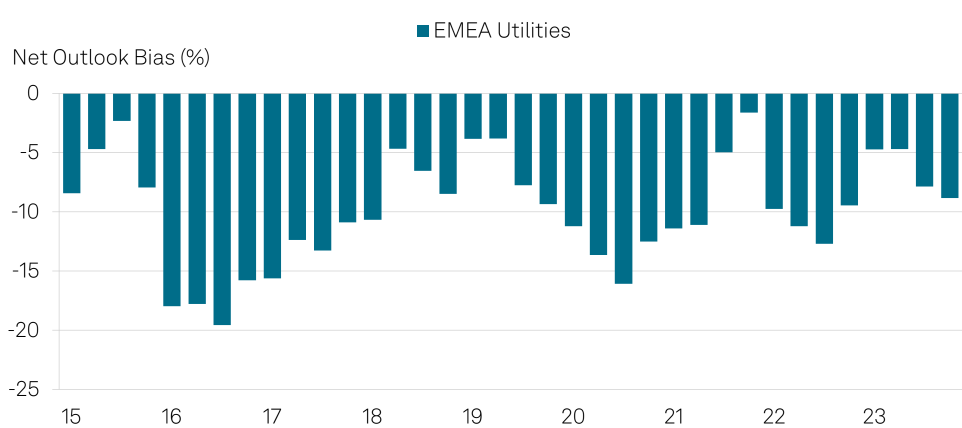


Chart 3
Ratings outlook net bias



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

Industry Outlook

Ratings trends and outlook

We maintain a degree of negative bias that primarily reflects:

- Risks and opportunities from gas and power prices, with prices elevated through 2025, even if much less so than in 2022; rising refinancing rates; and continuing issues around supply-chain and sector-specific inflation (well above the consumer price index [CPI]), notably for offshore wind and power networks.
- For networks, notably power, tensions are emerging on financial risk profiles from heavy capex, regulatory reset risks on the weighted-average cost of capital (WACC), and dependence on issuing new equity.
- For U.K. water utilities, sustained political, media, and social scrutiny are prompting a need for greater investment--although the financing mix for 2025 onward, particularly from additional shareholder contributions, remains uncertain. With two-thirds of ratings on negative outlook or a CreditWatch negative placement, the subsector has the most negative bias of EMEA utilities overall.

However, we expect inflation to subside in 2024 and approach 2% in 2025 across most of Western Europe.

We think some negative bias remains elevated, even after noticeably receding for energy companies. Still, over three quarters of utilities are on stable outlook, underpinned by solid fundamentals and, on the power side, medium- to long-term business prospects as Europe accelerates its energy transition. The very volatile power-market environment since fall 2021 has been offset by significant political support and company-specific actions to support credit metrics and liquidity.

Consistent with COP28 commitments to triple global renewable capacity by 2030, Europe's wind and solar capacities remain set to more than double over 2023-2030, despite recent offshore wind setbacks as solar installations progress steadily. We therefore expect the EU to approach, but not reach, its 2030 target of a 42.5% share of renewables (versus 23% in 2023, and 13% in the U.S.) in the primary energy mix, finalized in the Renewables Energy Directive III in October 2023. In December 2023 the European Commission stated that current national energy plans (despite boosting targets) would achieve only about 39%.

While wind additions will likely underperform expectations, solar will exceed them, continuing on from 2023's record addition of 56 gigawatts (GW). For offshore wind to accelerate again, 2024 might prove pivotal if the massive auctions expected this year--50GW according to S&P Global Commodity Insights (SPGCI), more than the entire current 33GW fleet--prove successful. As the buildup accelerates, by 2030 we expect renewables to reach 70% of Europe's power demand (despite demand increasing by one fifth), up from about 46%. This will require power transmission and distribution grid expansion costing €584 billion over 2023-2030, according to the EU's 2020 estimate. Given sector-specific inflation, however, we expect this bill to be nearer €800 billion for Europe. Based on SPGCI’s data, we expect 2022-2030 wind generation investments alone to also approach €800 billion. Overall, including all generation technologies and storage, costs will likely exceed €2 trillion across Europe, about 20x the total annual capex of our top-25 rated European energy utilities (top-25).

Against this background, we anticipate sector capex and debt to rise steadily. For our top-25, we project capex to represent 1.1x-1.2x funds from operations (FFO) compared with just under 0.9x each year in 2017-2019. Leverage in particular could increase for some power grids and U.K. water utilities, which face growing media and political pressure to raise service quality. We will monitor the extent to which higher interest rates are effectively and timely passed onto WACCs, with some European regulators (such as Italy and Belgium) already consistently applying their methodology, resulting in higher remuneration. EBITDA should also rise somewhat, although not as fast in some regions, potentially weakening credit quality.

Europe’s high energy prices support earnings for fixed-cost power generators for the next two years to the degree they are exposed to merchant activities or have rolled over hedges at favorable prices. Rating risk can notably come from:

- Poor management that exposes projects to write-downs, power purchase agreement (PPA) renegotiation, and other losses;
- Deteriorating economics for renewable capacity additions; or
- Weather-related renewables generation shortfalls.

For integrated companies, rating downside could come from a worse-than-expected dilution of regulated activities in their overall business mix.

We believe utilities can generally manage such deviations within a notch of our ratings on them, through remedial measures on their balance sheets--asset disposals and hybrid capital (utilities are by far the biggest issuers among European corporates, together with telecom companies)--or equity raises.

Flexibility from asset disposals--whether subsidiaries or stakes in renewable farms--is particularly strong at large integrated companies, while it is limited for gas and power grids.

We monitor hybrid instrument issuers’ approaches to refinancing, particularly at high single-digit rates, and whether they opt for calling the instrument at step-up date, as all European rated corporates have done to date except real-estate company Aroundtown. All issuance across EMEA utilities includes step-ups except for EDF’s June 2023 $1.5 billion U.S. issue.

Issuing common equity could be a credible avenue for regulated power and water, notably for existing government-related entities (GREs) or entities that could become GREs.

Financial policy and credit rating commitments support many ratings and stable outlooks in the 'BBB' band, which many managements appear to see as a floor, including to preserve continued and competitive access to debt markets. We expect downgrades to be limited to one notch in 2024, similar to 2021-2023, and senior debt to remain clustered in the 'BBB+' and 'BBB' range.

We factor in potential new equity to the extent we believe key shareholders are committing to it. We have observed renewed sovereign government interest in building up their presence in the sector since 2022, for instance with power networks in Germany and the Netherlands or gas assets in the Czech Republic, with the full nationalizations of EDF, Uniper, and SEFE in 2022-2023. Often-increasing budgetary constraints frequently mitigate these perspectives.

Main assumptions about 2024 and beyond

1. Continuing high gas and power prices until 2026 in an evolving market design.

Through next winter, Europe's gas and power markets will remain somewhat tight, resulting in still-elevated and volatile power prices.

2. Heavier investments, notably in power networks and renewables.

Based on recent strategic updates, we see capex for power grids rising by 50%-200% over 2023-2025, mostly to accelerate the energy transition. However, capex is moderating for some companies, notably on renewables.

3. Financial policy remains supportive despite the current uncertainty.

Despite higher capex and energy market worries, the sector generally has solid balance sheets, asset sale flexibility, and access to capital. Therefore, posting metrics within expectations at current rating levels is mostly predicated on financial policy.

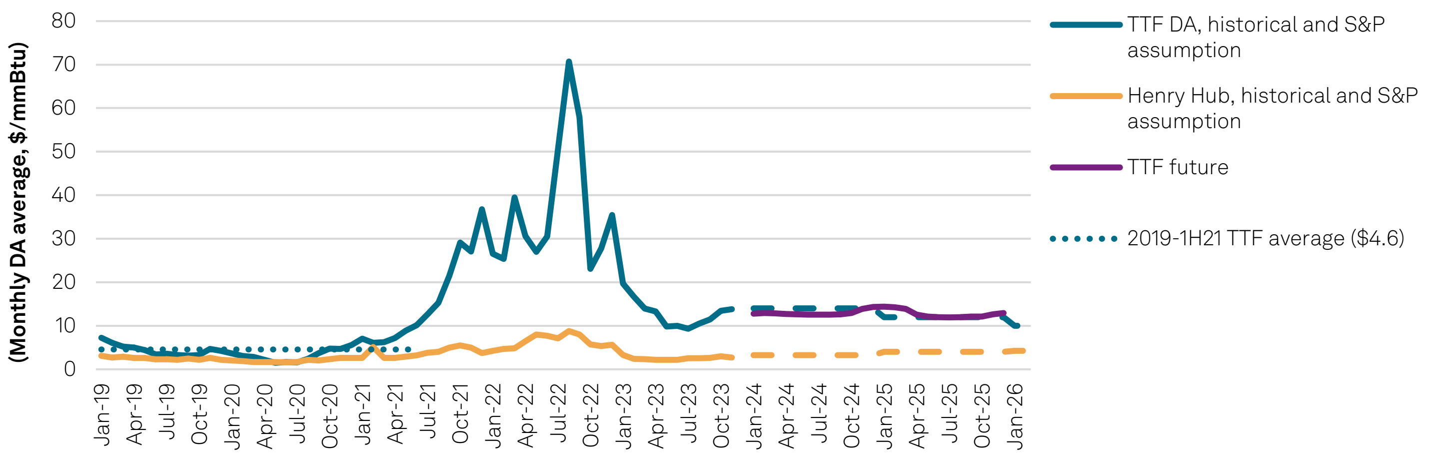
Gas prices to remain high and volatile in 2024-2025 (see chart 4). This is due to Europe’s supply-demand tightness following the loss of most Russian volumes, supporting prices that are over twice pre-pandemic levels. As its energy transition goals make long-term contracting less attractive, Europe needs to continue capturing excess spot liquefied natural gas (LNG) volumes at prevailing prices. For most of the decade, according to SPGCI, Europe will need to import at least 160 billion cubic meters (bcm) of LNG annually as both demand and pipe supplies erode.

The main European exchange-traded index, the Title Transfer Facility (TTF), remains in backwardation. Specifically, we assume it will moderate from a high $14 per million British thermal units (mmBtu) in 2024 to $12/mmBtu in 2025 and $10/mmBtu beyond (see "S&P Global Ratings Has Raised Its Henry Hub Natural Gas Price Assumptions For 2024 And 2025," published Nov. 7, 2023). For most of 2023, landed LNG hovered around $10-$15, ending the year at the bottom of this range as U.S. exports' 11 bcm monthly record almost fully covered European demand. In our analyses we therefore reflect:

- Continued demand moderation, at 20%-25% below 2019 levels, and eroding LNG import needs in 2024 continuing on 2023's 1.4% fall, as households and industries barely increase consumption and gas-to-power use reduces sharply, helped by eroding power consumption and recovering hydro and French nuclear generation (up 14% or 40 TW hours [TWh]).
- Underground storage fullness of 86% as of Jan. 1, 2024, 5% stronger than a year before and which we expect will stay comfortably above a healthy 50% by April 1 (see chart 5). Additional storage includes about 3 bcm stored in Western Ukraine and LNG tanks, and a potential release of 5 bcm globally from record-high storage on the waters.
- Prospects for a 75 bcm per year (bcmpa) regasification capacity increase over 2022-2024, focused on Italy and Central and Eastern Europe, the regions on the continent that most need to replace Russian gas. German terminals' spare capacity will remain considerable.
- Confirmed prospects for major global LNG capacity additions (more than 10 bcm, 60 bcm, and 110 bcm over 2024, 2025, and 2026, respectively, focused on North America and Qatar).

Chart 4

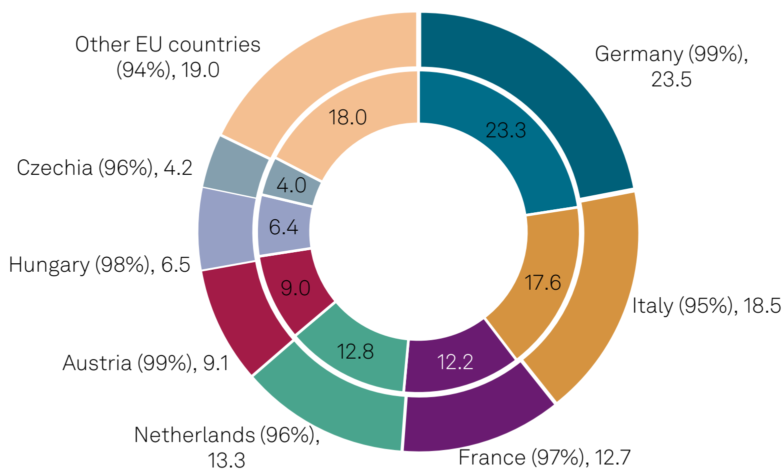
Gas prices will remain multiple of 2019 levels until 2025



Sources: S&P Global Commodity Insights, S&P Global Ratings.

Chart 5

EU countries' current storage (inner ring) versus capacity (outer ring)



Figures in billion bcm as of Dec. 1, 2023; includes countries with 4 bcm+ working storage capacity.
Sources: AGSI GIE and S&P Global Ratings calculations.

The factors weighing on prices are balanced by Asia's demand pickup since the spring (with China increasing its gas use by some 7% this year), continued robust U.S. demand, and, eroding residential and industrial demand within Europe--and above all RepowerEU's accelerating renewables generation ramp-up, the latter adding some 80-100 TWh to power supplies each year (see sidebar).

RepowerEU's renewables acceleration visibly impacts European gas demand from 2024

For 2024 and 2025, we expect additional wind and solar generation to offset grid-connected power demand growth of about 3%. Across Western Europe, the narrowing of the thermal gap (the demand for coal, oil, and gas-fired generation) primarily affects coal and lignite, as the most CO2-emissions-intensive power sources; and 2024 will mark a new milestone on their path to vanishing from the mix by 2030 as the U.K. ends its 142-year coal-fired power generation history (the world's first station was built in London in 1882) and overall nearly 15 GW of thermal capacity closes--some two-thirds in Germany alone. And in 2025, utilities will double down; the Spanish government has announced its coal exit will start in 2025, and Enel has announced the closing of all coal plants outside Sardinia by 2025. Such closures lend near-term support to gas use in its role as a crucially flexible power source.

Yet, given each year's renewable capacity additions, this respite for gas will likely be short-lived. Gas burn will be increasingly confined to times of renewable intermittencies or surges in demand during cold snaps (as early December 2023 multi-year generation records showed) or heat waves. We will monitor how, during the critical years of 2024-2025, gas plant operators in Western Europe can consolidate credit-supportive capacity revenue bases, notably in the U.K. and Spain.

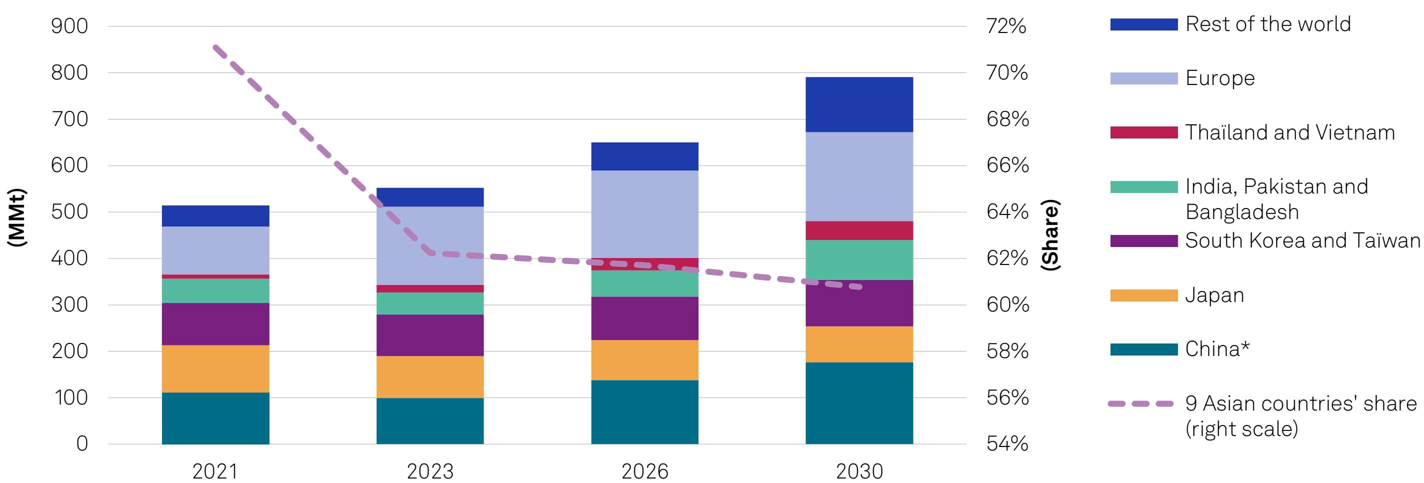
Europe is progressing with its wind and solar ambitions, with generation up almost one-tenth year-on-year in 2023 (+23% for laggard France alone). In Europe's biggest market, Germany, while total primary energy use reduced by 8% (28% below the 1990 level), renewables increased their contribution to the mix by a notable 230 basis points (to 19.4%) according to AG Energiebilanzen. This was driven by wind and solar, while coal and lignite fell by the same amount, to 40.7% of the mix. For the first time, similar to Spain, over half of Germany's power was from renewables. Europe's power mix is greener than that of the U.S., where gas retains a 42% share and coal continued to exceed wind and solar combined in 2023 (perhaps not for much longer).

We see physical curtailment risk as low because, well ahead of its 2027 target, Europe has replaced about 120 bcm of piped gas imports from Russia and does not significantly depend on the remaining 45 bcmpa piped and LNG imported from the country (see chart 6). Piped imports could suffer from 2025 as Gazprom's long-term shipping contract through Ukraine lapses in December 2024.

Chart 6

As APAC continues to dominate LNG imports, Europe's share will erode back to one-quarter

2021-2030 LNG import by country/region



MMt—Million tons. *includes Hong Kong. Source: S&P Global Commodity Insights.

Power prices will remain high and volatile until 2026. We expect €80-€100/MWh outside Scandinavia and Spain. Over 2024 and 2025, European gas prices will continue to drive (and therefore support) power prices, as should EU carbon allowance prices--the other key factor. According to SPGCI, the latter should remain broadly within the €70-€100 per ton range, even after the EU raised the 2005-2030 cut in the emissions cap to 62% from 43% in 2023, effectively doubling its speed (the linear reduction factor) for 2024-2030. Dependency on U.S. LNG imports should support a $9 per thousand cubic feet (mcf) floor for the cost of landing a cargo in Europe, very roughly structured as the Henry Hub price plus over $5/mcf including liquefaction tolling and shipping. Combining these two factors suggests a short-term marginal cost for a combined-cycle gas turbine (CCGT) with 60% efficiency in the €70-€80/MWh range, which appears to be a sustainable equilibrium in terms of affordability for most power users and incentive to build more renewables. It is also the range the French government is targeting from January 2026 for its nuclear fleet, according to its November 2023 market consultation. Across Europe, SPGCI expects wind 10-year PPA pay-as-produced prices (for 2025 starts) to be €70-€90/MWh.

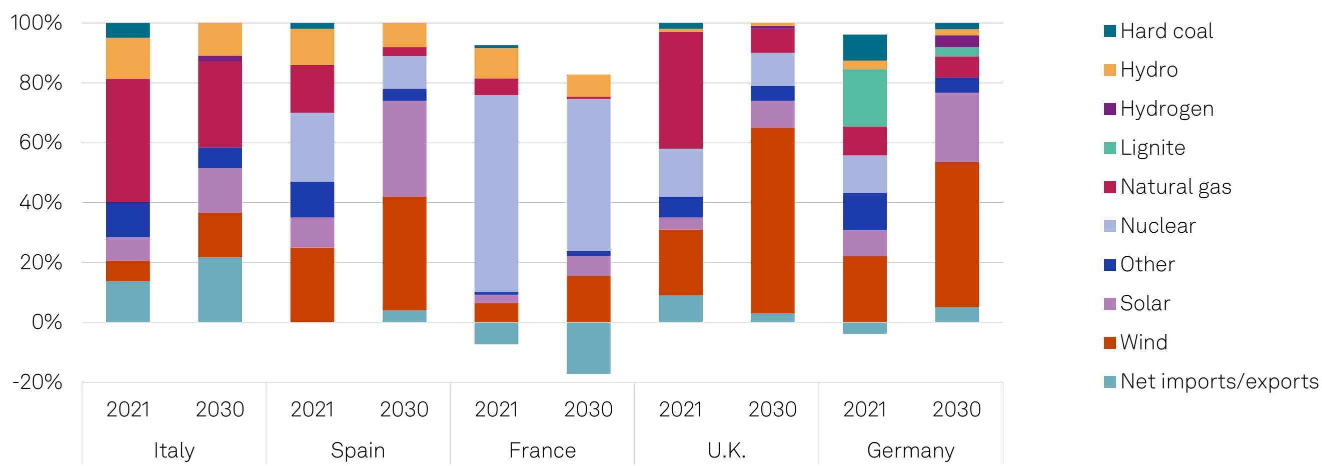
Demand, after weighing on prices by declining in 2022 and 2023 (to below-pandemic levels), should offer some price support given gradual electrification as electric vehicles (2% of current demand) and heat pumps are deployed. We see power demand growing some 3% in both 2024 and 2025, and 30% cumulatively by 2030, more slowly in already-more-electrified France and faster in Scandinavia driven by electro-intensive industries.

On the supply side, according to SPGCI's December 2023 long-term analysis, additional wind and solar capacity will increase their combined contribution to Western Europe's power mix to 55% in 2030 (67%-71% in each of the pioneering large markets of Germany, the U.K., and Spain, see chart 7) and 66% by 2035 from 33% in 2023. Wind and solar generation growth, by absorbing all of the meagre demand growth (hydro, nuclear, and fossil-fuel generation being about flat), weighs on average annual baseload power prices. We expect these prices to decrease from 2026, reaching €40-€60/MWh by 2030 in real 2022 terms in most markets, with Spain and Scandinavia particularly low and Italy remaining at a premium. At that point, continued gas-to-power demand erosion loosens power price drivers in favor of renewables, which weighs on power prices, and--together with reduced industrial and residential demand--on gas prices.

Chart 7

Evolution of the power generation mix in Europe's five largest energy markets

2021 versus 2030 forecast



Source: S&P Global Commodity Insights.

Beyond average baseload prices, we expect an increasing bifurcation in prices actually captured by the various technologies. The most flexible ones--in particular reservoir-based hydro and CCGTs--should be able to capture peak prices (even economics increasingly relies on remuneration via capacity markets for CCGT plants running for ever-fewer hours, as has occurred in Spain and the U.K. for a number of years). By contrast, captured prices for intermittent renewables should decrease even more than baseload prices, because storage and interconnections (see "Europe's Power Push: Can Project Finance Help Fund Interconnections?," published Nov. 16, 2023) grow too slowly to smoothen the absorption of wind and solar generation and lack the flexibility that would support renewable revenue. This steeply increases the number of hours with low-single-digit or negative prices, to which wind and solar are particularly exposed, notably in the U.K., Spain, and Germany. Material quantities of hydrogen for electrolysis or seasonal storage are not for this decade.

The EU's October 2023 market redesign is evolutionary rather than revolutionary, and we find it to be moderately credit-supportive overall. On the positive side, it reduces market design uncertainties, preserves market signaling and overall market functioning, promotes two-way contracts for differences and PPAs (by fostering a broader and more liquid PPA market, more accessible to weaker counterparties) as well as capacity markets (an increasingly relevant contributor to physical power market stability, if at a record €7.4 billion cost in 2023) and aims to further unify Europe's fragmented energy markets.

On the less supportive side, the redesign could crystallize the EU market's complexity and fragmentation as each country counters high prices through its own type of state intervention (typically targeted at protecting affordability for households and electro-intensive industries). In November, the French government unveiled its intention to apply over 2026-2040 a scheme that captures a significant portion of the benefits from prices above €78-€110/MWh on domestic nuclear generation revenue, without providing a corresponding floor (somewhat like the U.K.'s electricity generation levy running to March 2028).

Still, overall, as generators retain a portion of the upside from strong prices in 2024-2025, we see these schemes as providing a reasonable balance between governments' needs to finance affordability and preserving sufficient profits to power generators. Regulations that merely remove excess cash flow do not overly weigh on credit quality.

U.K. water companies and Northern Europe power grids will increase capex. Across the U.K., Germany, and Benelux, we see water utilities and power transmission system operators (TSOs) increasing capex fast, both to strengthen existing networks and expand them to connect new renewable capacities. Some power grids could more than triple their annual investments by 2025-2026 compared with 2022-2023.

While we see the related regulatory frameworks as strong, we monitor how regulators respond to capex stress on these sectors; tensions that might appear as end users realize the full extent of the increase in their energy bills (including the distribution costs, which could be about double the TSO costs); and the degree and duration of credit metrics being potentially below our guidance for current ratings. Financial policies then become paramount, and the ability and willingness to timely raise sufficient new equity might be an important credit support.

In all cases, we expect funding and liquidity management to bridge discretionary cash flow (DCF) gaps. Given likely rigid capex requirements for urgently needed energy-transition projects, we assess the degree of reliance on new equity issuance in the context of the specific ownership structure and shareholder commitments, full ownership by a single highly rated and committed sovereign being particularly supportive.

Gas grids remain exposed to long-term stranded-asset risk. In 2023, we reflected this by revising to strong from excellent the business risk profiles and correspondingly tighter minimum credit metric expectations on gas grids in the Iberian peninsula. Like in Latvia, we now differentiate Iberian gas networks' long-term prospects from those of power grids. We monitor regulatory developments in other countries too, with Germany for example having enacted a credit-supportive full depreciation by 2045. More generally, we expect gas grid operators that do not invest significantly to repurpose their business away from fossil fuels to accumulate balance-sheet headroom as free cash flow remains steady. In that light, financial policies and shareholder support are paramount in our prospective credit analysis.

By contrast, Gasunie, in the Netherlands and Northern Germany, is already preparing its transition to hydrogen. Across gas grids, we monitor closely how regulators prepare the ground, notably through sufficient remuneration of new assets and accelerated depreciation of legacy fossil-fuel assets, unless new hydrogen assets are directly subsidized by the government, as in the Netherlands.

Finally, we observe contrasting capex trends among integrated companies. Positively, most appear to cautiously approach further investments into wind and solar, and particularly offshore wind, given deteriorating economics. Solar unit capex (per GW of capacity installed) has tended to recede after a spike earlier this decade, while wind unit capex appears set to remain high for a while, but solar faces heavier long-term revenue risks. Supply-chain issues remain acute, particularly as Europe's three major wind original equipment manufacturers (OEM) continue to post weak or negative operating margins, just as competition from China-based OEMs emerges.

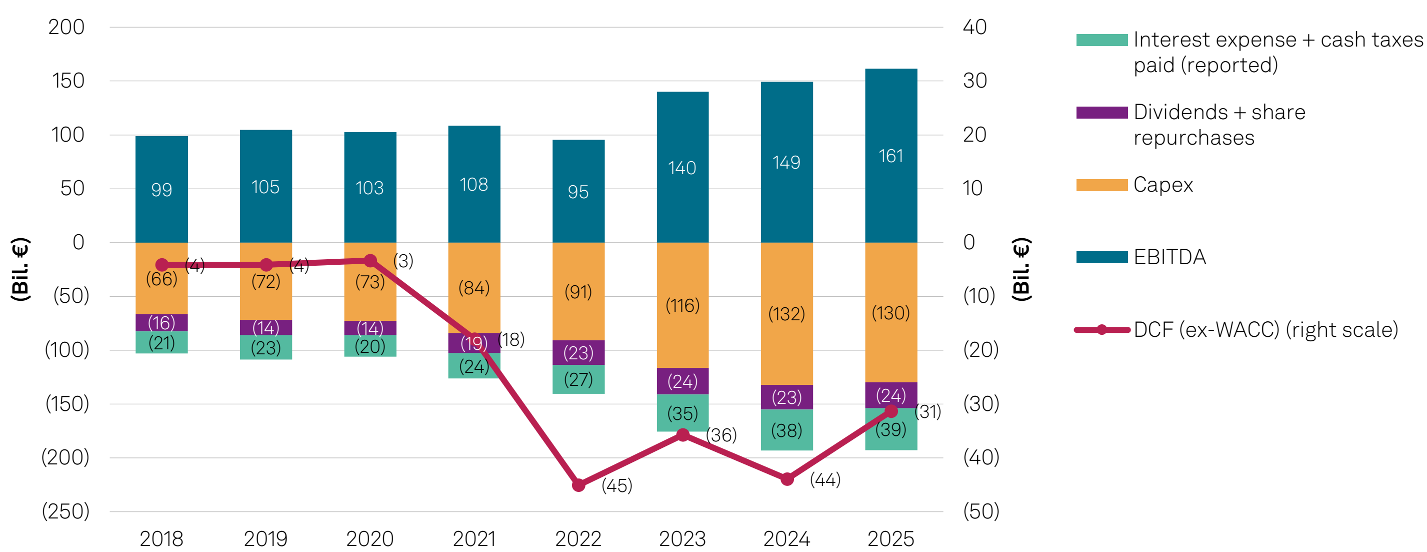
Credit metrics and financial policy

The sector has fairly solid balance sheets, asset sale flexibility, and access to capital, despite higher capex and energy market uncertainties. Overall, we expect the sector to keep posting credit metrics within expectations at current ratings. We anticipate absolute debt to continue rising for the sector, including by some €40 billion annually for our top 25 utilities; this is based on high and increasing capex and continuingly negative DCF (see chart 8). However, EBITDA growth allows leverage to remain near 4.0x, much in line with 2019-2021 levels (see chart 9). We estimate an annual increase in the sector's adjusted debt of 7%-9% over the next three years, with a significant dispersion between those increasing debt 10%-200% (notably networks) and those we expect to stabilize metrics. At the same time, a mild economic recovery from 2024, sustained gas and power prices, and new renewables and nuclear capacity commissioning will support earnings growth.

Chart 8

Top 25 European utilities | 2021-2025: capex and dividends drag DCF

Aggregate numbers mask broader spectrum of capex and shareholder distributions

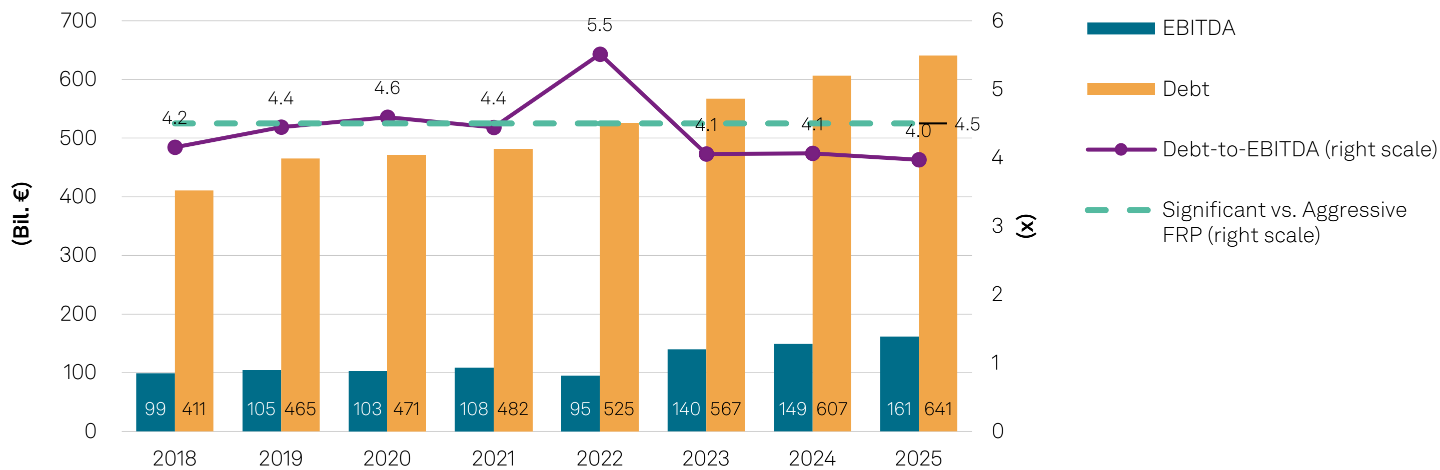


Source: S&P Global Ratings.

Chart 9

Top 25 European utilities | mounting debt keeps leverage around 4x from 2023

Over 2023-2025 utilities in aggregate have a slight buffer to "aggressive" levels



Source: S&P Global Ratings.

Overall, growth should enable utilities to pilot credit metrics within bands consistent with current ratings, to the extent their financial policies are supportive. Beyond earnings, utilities can do this through asset disposals, hybrid capital, or--particularly in the case of government-related power networks--issuance of common equity. The latter will need to be tested given currently high yields, which are reducing valuations for many “clean energy” companies especially, but not only, when they face operating or financial setbacks. While growth ambitions are significant as Europe accelerates its energy transition, some issuers enjoy capex flexibility to adapt to changing energy market conditions, inflation, interest rate fluctuations, and constraints on investments, supply chains, and permitting.

We do not foresee much improvement in credit metrics for the sector in the next few years--aside from some fixed-cost power generators--nor much deterioration apart from select power grids and water companies. Earnings upside would likely finance additional organic or external growth. Our base-case scenario for the sector incorporates no major shift in shareholder stance like debt-financed M&A, or higher shareholder distributions. Already, sustained shareholder distributions are weakening deleveraging dynamics: We expect distributions to absorb slightly over a fifth of FFO for our top 25 companies (over 30% for grids, significantly up from 2019's 18%). Another possible risk relates to increased shareholder activism, which could disrupt strategic plans and swing financial equilibria in a more shareholder-friendly way.

Key risks or opportunities around the baseline

1. Oversized price volatility or event risks disrupt operations or liquidity.

Particularly for companies where increasing capex is depressing DCF, event risks such as cyber or physical sabotage could aggravate liquidity tightness. Companies active on energy exchanges might still face liquidity squeezes.

2. Political and regulatory risks and opportunities cloud the overall investment picture.

Measures to accelerate the energy transition run against affordability constraints and limited budgetary firepower in a context of increasing concerns about security of supply.

3. Deteriorating economics complicate low-carbon power capacity deployment.

Continuing supply-chain constraints, together with persistently high interest rates and slow inflation reduction, complicate the economics of the low-carbon capacity buildup.

Event risks can selectively disrupt operations, liquidity, and credit quality. As for many other corporate sectors, rating risk often relates to liquidity. Some companies' liquidity buffers are thin relative to our minimal expectation at the adequate assessment, a tightness we reflect both in our liquidity and our management and governance analysis. We will continue to monitor liquidity as market behavior is hard to predict, especially as power mixes and market designs evolve.

For 2024, we see event risks affecting liquidity as potentially related to:

- Wholesale price volatility, as happened in 2022;
- Extreme weather;
- Geopolitical events, including wars and sanctions, which could foster volatility and even affect physical supply; and
- Cyberattacks.

We have already seen weather issues elsewhere. In 2023, devastating fires hit the U.S. state of Hawaii hard, leading to tragic loss of lives and a two-category downgrade of the local power utility. However, despite Europe's increasing exposure to extreme weather events--most recently severe storms in early November--the impact on utilities' credit quality has been muted. We expect this to continue and governments to typically play a more supportive role than in the U.S., whether for existing GREs or companies that could become such. Still, weather conditions are expected to continue deteriorating given continued global warming, also affecting LNG traffic through the Panama Canal.

Geopolitical events that might affect EMEA utilities--mostly energy--include wars (the interruption since early December of the Red Sea to LNG traffic implies a two-week detour via the Cape of Good Hope for about a tenth of global traffic, or about 40 bcmpa, as long as the much more critical Strait of Ormuz is open; Israel's 10 bcmpa Tamar gas field was closed for a month, just as Egyptian domestic production fell by 10%, limiting potential LNG supply to Europe; and sanctions to the extent they foster price volatility and affect physical supply. While we do not expect Europe to have to adjust to a supply game-changer like the stoppage of Nordstream I in third-quarter 2022--which we consider permanent--extensive damage and a prolonged outage affected Nordstream II in 2022 and the 2.6-bcmpa Finland-Estonia Baltic connector on Oct. 8, 2023. Since November, U.S. sanctions have halted the commissioning of Russia's Arctic LNG 2 project, now under force majeure since late December.

Generally, physical sabotage cannot be excluded, particularly for offshore assets like the highly developed gas pipes and power lines in the North Sea and the Baltics and gas pipelines to Italy, which are difficult to continuously monitor. Of particular relevance are Norway's gas export pipes and Scandinavia's power interconnectors with their continental clients in Germany and the Baltics.

Finally, cyber risk might materialize, particularly for power grids, especially distribution; for these, digitalization is essential to optimizing the use of existing assets in the face of growing and ever more distributed supply and demand. In turn, it may expose them to even more risk of disruption of operations than for other utilities.

Political and regulatory risks and opportunities abound. Measures to protect end-user affordability could erode related utilities' credit quality, notably via price caps, windfall taxes, and slowness to recognize higher interest rates and inflation in regulated revenues. These measures can prompt higher debt or lower earnings on existing assets; regulatory risk reemerged recently in Finland (see "Finnish Networks' Rating Headroom Could Shrink On 2024-2031 Regulatory Update," published Dec. 8, 2023).

By contrast, political support could move notably in the following directions:

- Governments' willingness to let some taxes lapse (like the emergency windfall taxes instituted in fourth-quarter 2022, most of which lapsed in June 2023).
- Restraint in terms of not overly leaning on regulators to preserve affordability by compressing grid returns on capital.
- Participating at central or local government levels in new equity injections.

In particular, we see a steady trend for regulators to grant stronger remuneration on new projects, as decided in 2023 in Germany and Belgium for 2024-2028, or bring in overall more incentivizing regulation (see "WACC Increase Will Benefit Italian Regulated Electricity And Gas Networks," published Dec. 1, 2023). Besides accelerating the energy transition, affordability is a cornerstone of Europe's REPowerEU strategy and Fair Transition Plan: protecting citizens' purchasing power will remain high on political agendas, just as renewables and grid capex must accelerate. This is against the background of increasing pressure on budgetary energy spending. Illustrating this vividly was Germany's Constitutional Court's ruling in November 2023 that cut by €60 billion the use of COVID-19-related funds for energy sector support purposes, which will need to be scrapped or financed from other sources, reducing GDP growth and energy demand; the government has already announced ending its annual €5.5 billion subsidy to power TSO tariffs in January, weighing further on power demand pressures and adding to other power tariff increase (in aggregate of about €150 annually for a typical household) beyond those needed to remunerate stepped-up capex and (as the BNetz A proposed in Jan. 2024) for gas grid accelerated depreciation.

On the other hand, even under the caps and windfall taxes instituted in fourth-quarter 2022, fixed-cost merchant power generation has proved very profitable in 2022-2023 and this likely will continue in 2024-2025. The additional earnings could support positive rating actions to the extent earnings finance the sustainable reduction of debt, or judicious and business- or credit-metric-enhancing acquisitions. In both cases, we would review the utility's financial policy to assess the sustainability of the credit improvement. Our review would also look at less typical aspects like any geographic rebalancing away from riskier markets (notably Latin America) into more credit-supportive and transition-intended Europe and North America markets; the approach to offshore wind investments; and greater group complexity from increasing minority interests at under-leveraged, fully consolidated subsidiaries or projects.

Low-carbon project economics are thornier. Supply chains, permitting, grid access, and public policies influence project pace, costs, and risks. This is especially the case for offshore wind, nuclear, and hydrogen. While long-term wind and solar continue to indicate stronger economics than carbon-price burdened fossil fuel generation, short-term prospects are more mixed, especially for wind. Both wind and solar revenue are bound to increasingly suffer because of the expected price cannibalization trend, especially Spanish solar and U.K. offshore wind. In second- and third-quarter 2023, the number of hours with negative prices beat previous records (excluding the pandemic-driven second-quarter 2020 record). Inflation and interest rates weigh on operating expenditure and capex, and therefore on free cash flow. Stock prices have reacted accordingly, with operational setbacks severely sanctioned.

Onshore wind capacity growth suffers from permitting and grid access issues. In contrast, distributed solar can expand more easily without grid access. Only recently have European countries started to strongly promote a “shared offshore grid” that would reduce capex, operating expenditure, and curtailment risks for offshore wind. Other less obvious risks include uncapped negative bidding (see "Germany's Green Energy Ambitions Spark A Transformative Decade For Utilities," published Sept. 14, 2023) and load-weakening wake effects.

We expect 2030 offshore wind targets to be difficult. According to SPGCI, Europe’s installed capacity may reach 35 GW by year-end 2023 compared to the Green Deal’s 60 GW objective and the 120 GW target set in 2023 by North Sea countries just for that region. Similarly, the U.K.’s 50 GW target means adding many projects immediately, given the 23 GW operating or under construction.

Positively, authorities in two key renewables jurisdictions indicated further price support for 2024 capacity additions. In November, the U.K. government raised by 66% the level for the allocation round (AR) 6 2024 to £73/MWh in 2012 terms (equivalent to about €100/MWh) and set aside a separate funding pot for offshore wind, the budget for which should be known in March. Likewise, in December, German regulator BNetzA confirmed high levels for capping 20-year support mechanisms, at €74/MWh for wind and ground-mounted solar and €105/MWh for rooftop solar.

We see positive momentum for prolonging existing or developing new nuclear capacities in a number of European countries, subject to appropriate funding, despite higher interest rates for capex set to exceed €10 million per MW. This could partly mitigate closures of existing capacity, particularly in the U.K. (all but one reactor) by 2028 and Spain from 2027 (half of the existing 7.4 GW capacity by 2030). In particular, France, Bulgaria, and the Czech Republic have advanced plans for commissioning new reactors from the mid-2030s (including 10-23 GW in France alone); this has also been the case in Poland, Sweden, and the Netherlands, albeit less so and against the background of fluid dynamics in coalition or minority governments.

Given its innovative proposed regulated asset-based financing, we will continue monitoring progress toward a final investment decision in first-half 2024 on the U.K. Sizewell C project, with 3.3 GW (Europe's largest). Impacts on nuclear-involved utilities’ credit quality from these massive, single-asset and risky developments depend considerably on the degree to which construction and asset-retirement risks are shared with governments; taken on by current and future power consumers; or retained by the builder or utility owning the plant, a pathway that looks increasingly challenging.

European utilities face stiff exogenous challenges. Across Europe, ambitious and proximate targets add to pressure on supply chains, permitting, and grid access. Yet, typically, wind onshore and offshore projects still now take as long as eight and 11 years, respectively, up to commissioning (and nuclear EPRs even longer). Execution risks will remain high just as equipment supply chains need to cater for global expansion, notably in China and the U.S. For now, Europe’s electrification will keep it dependent on China for a large portion of its raw materials and equipment needs, even beyond solar panels--a situation we do not think will change significantly over the next couple of years. European supply chains need to scale up in cadence with growth in investment and demand, which takes time and heavy investments. The wind chain, where Europe's market share is among the highest, remains insufficiently profitable.

We understand that, while permitting has become somewhat faster, overall project length remains too high for both onshore and offshore projects. Grid access is a particularly sore point in many cases, and while power network operators have hiked capex greatly in certain regions like Germany and Benelux, the effects will take time to clear the current project log.

As we expected, the utilities' race for renewables faces stiff competition from cash-rich and strong-DCF oil and gas companies, notably Europe-based integrated oil companies (IOCs). Compared to 2022's sustained M&A activity from various IOCs across wind, solar, biogas, and hydrogen in European utilities' core European and U.S. markets, in 2023 IOCs stepped in more directly: for example, TotalEnergies and bp accepted heavily negative bids on new German offshore wind leases. Another example is offshore bidding in Norway and Portugal, where a number of IOCs (present in Norway as members of three of the seven applying consortia, a fourth one being a single China-based company) apply to unlock these "new offshore basins" along with utilities. Overall, the risk persists that competition from the IOCs tends to deteriorate project economics in an already-fragile and capital-intensive sector.

New technologies struggle even more. Higher power prices and interest rates for longer affect floating offshore wind and green hydrogen economics even more. The former, being even more capital-intensive and technologically less mature than fixed-bottom (with only 0.2 GW installed globally to date), will heavily fail expectations set for 2030 across countries, including the U.K.'s 5 GW 2030 target (AR5 had no candidates). Globally, SPGCI recently halved expectations (to 6 GW globally), as did the Global Wind Energy Council in November.

In November, the Global Hydrogen Council and McKinsey raised their estimates of global levelized cost of hydrogen by 30%-65% above their October 2022 estimate; in the same month, German TSOs submitted a €19.8 billion mega-plan for building the core hydrogen network (of which 40% are new lines) that would find few sufficient early customers absent a government backstop to an amortization account. In 2024, construction should continue on Germany's first repurposing-to-hydrogen project and on the 1,200-kilometer (15% new) Dutch network following the start of work in fourth-quarter 2023, the most concrete step taken to date in Europe. Indeed, among big future users, Central and Western Europe remains one of the costliest places globally. The revision reflects notably higher electrolyzer capex and renewable costs.

Related Research

Sectorwide research:

- Benelux, France, Italy, Iberia | Energy Transition Shapes Credit Quality, Jan. 8, 2023
- Eastern Europe | Higher Yields Will Weaken Credit Metrics And Liquidity, Jan. 8, 2023
- WACC Increase Will Benefit Italian Regulated Electricity And Gas Networks, Dec. 1, 2023
- Europe's Power Push: Can Project Finance Help Fund Interconnections?, Nov. 16, 2023
- S&P Global Ratings Has Raised Its Henry Hub Natural Gas Price Assumptions For 2024 And 2025, Nov. 7, 2023
- Utilities Handbook 2023: Western Europe Regulated Power, Oct. 18, 2023
- Utilities Handbook 2023: Western Europe Regulated Gas, Sept. 20, 2023
- Germany's Green Energy Ambitions Spark A Transformative Decade For Utilities, Sept. 14, 2023
- Issuer Ranking: EMEA Utilities Issuers Ranked Strongest To Weakest, Aug. 4, 2023
- Industry Top Trends Update Europe: Utilities, July 18, 2023
- Europe's Utilities Face A Power Price Cliff From 2026, June 22, 2023
- EU's Proposed Energy Market Redesign Mitigates Merchant Risks And Accelerates Renewables, April 3, 2023
- Latest Infrastructure And Energy Insights Focus On Inflation, Affordability, And Tight LNG Markets, Jan. 25, 2023

Other research:

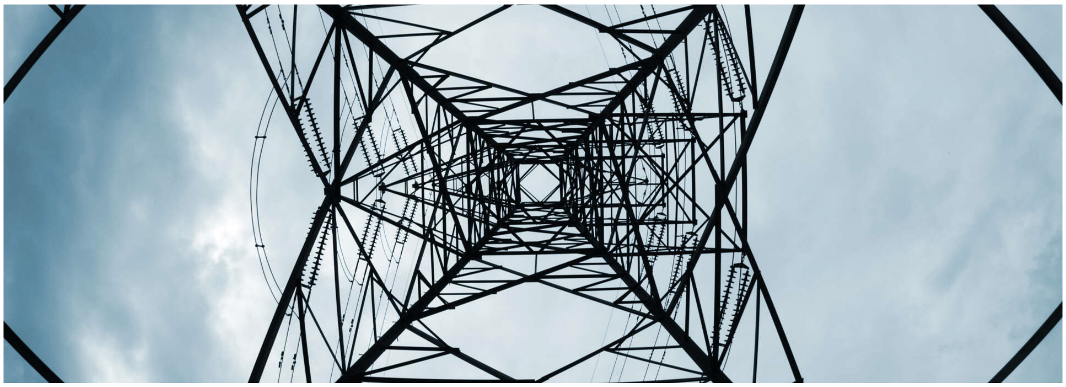
- Finnish Networks' Rating Headroom Could Shrink On 2024-2031 Regulatory Update, Dec. 8, 2023
- Croatia Gas And Electricity Regulatory Frameworks: Somewhat Supportive, Oct. 12, 2023
- Eastern European Utilities' Regulatory Frameworks Are Varied, But Most Are Adequate To Strong, Sept. 18, 2023
- Bulgarian Electricity Framework: Not Very Supportive, May 30, 2023
- Georgian Electricity Framework For Distribution System Operators: Somewhat Supportive, March 27, 2023
- Dutch Electricity And Gas Transmission And Distribution Framework: Supportive, March 7, 2023
- Georgian Water Regulatory Framework: Somewhat Supportive, Feb. 17, 2023
- Spanish Electricity And Gas Regulatory Frameworks: Mostly Supportive, Jan. 16, 2023

Latin America Utilities

Companies to withstand slow growth and high interest rates

January 9, 2024

This report does not constitute a rating action.



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What's changed?

Inflationary pressures to continue. Although we previously expected high inflation to dissipate by mid-2023, we now expect general prices to remain elevated in the next few years, preventing a sharp drop in interest rates. However, we don't expect credit metrics to weaken further.

What are the key assumptions for 2024?

Sluggish economy will constrain electricity growth. We recently lowered our 2024 GDP growth forecast for the region, and now expect below-trend growth for the next few years. This should translate into electricity demand growth of 1.5%-2.0% in 2024.

Prevailing high interest rates constrain cash flows. Inflationary pressures should keep interest rates high, and we expect debt service costs to continue weighing on companies, especially those that rely on floating-rate debt. Still, utilities have shown resilience to economic downturns.

Renewable capacity to expand. Much of Latin America's electricity capacity growth will come from renewables, but the pace of execution might not meet energy transition targets.

What are the key risks around the baseline?

Hydrology and oil prices will drive electricity prices. A strong El Niño will have varying effects on Latin American countries, alleviating spot prices in Brazil and Chile but elevating them in Colombia and Peru. Oil prices should remain volatile as geopolitical risks continue.

Interest rates may stay high. Slower monetary policy easing could reduce cash flows and keep refinancing costs high.

Sovereign risk weakness. Given utilities' regulated nature, our ratings on most are either linked to or limited by sovereign risk. While the outlooks on Brazil, Mexico, and Colombia are stable, Argentina, Chile, and Peru have negative outlooks.

Ratings Trends: Latin American Utilities

Chart 1

Ratings distribution (including project financing)

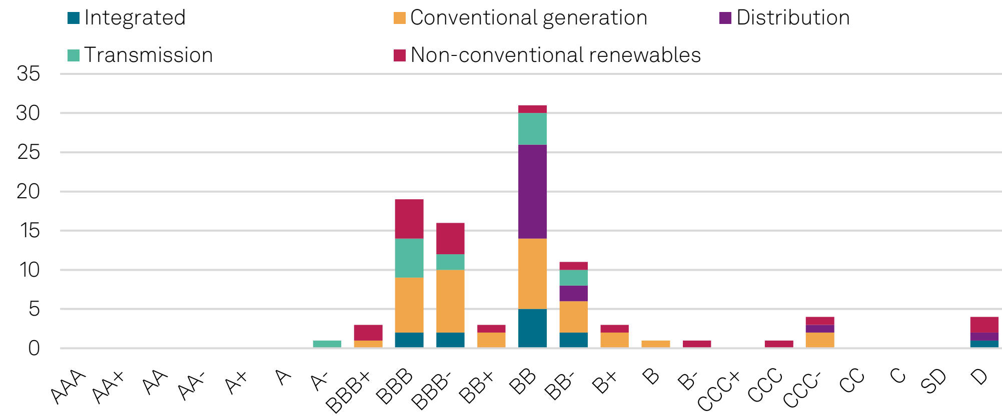


Chart 2

Ratings outlooks

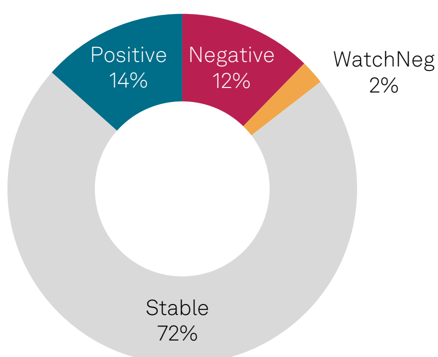
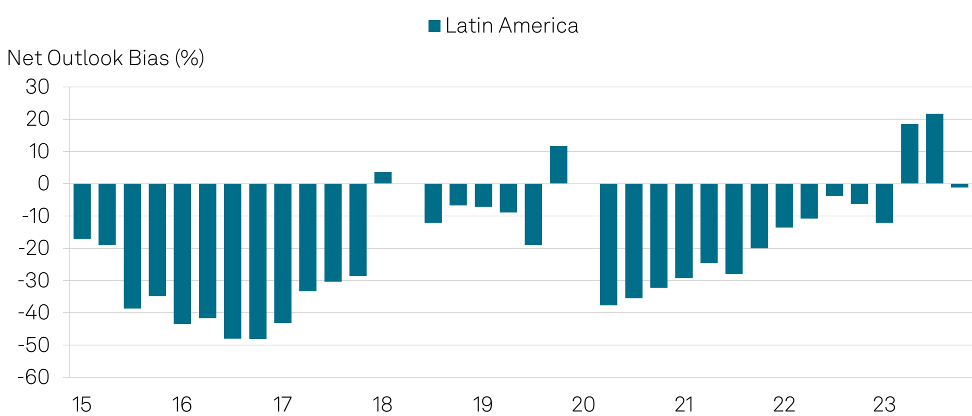


Chart 3

Ratings outlook net bias



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

Industry Credit Metrics: Latin America Utilities

Chart 4

Debt / EBITDA (median, adjusted)

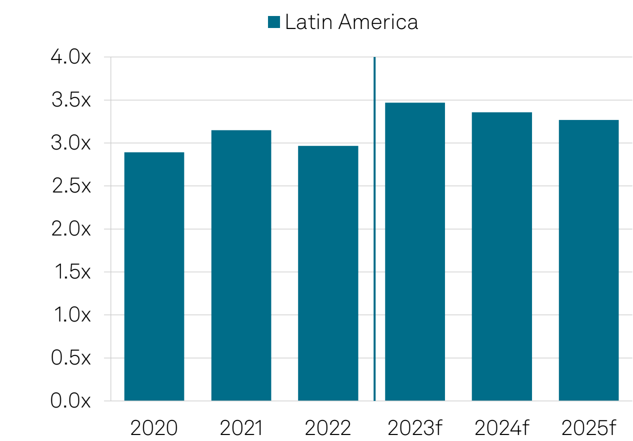


Chart 5

FFO / Debt (median, adjusted)

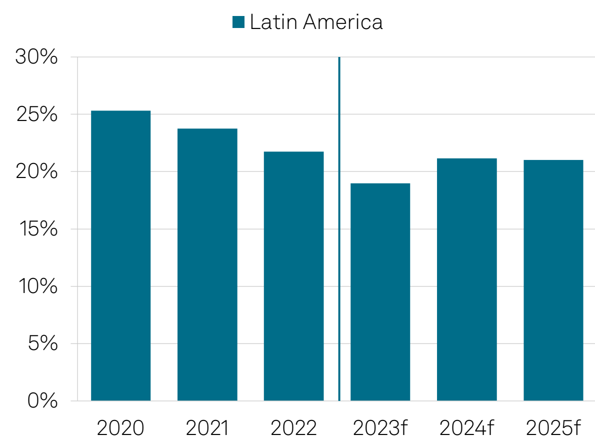


Chart 6

Cash flow and primary uses

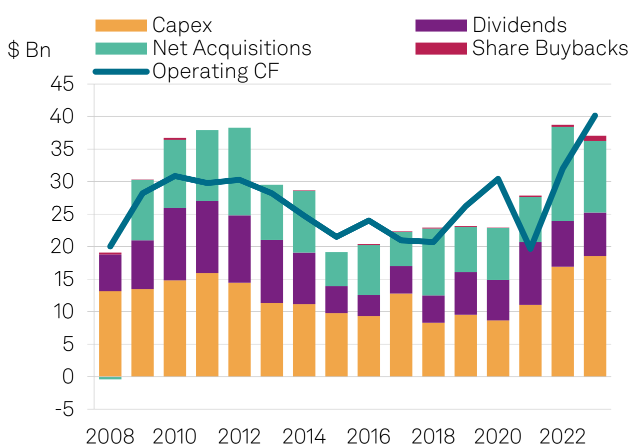
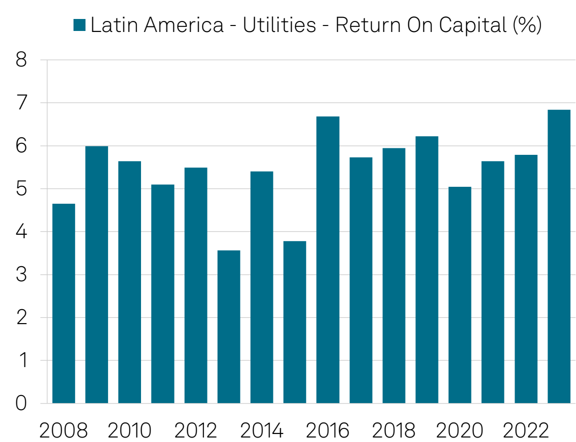


Chart 7

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
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. Most recent (2023) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook

Ratings trends and outlook

In the past few years, Latin American utilities have been able to preserve their stand-alone credit quality amid challenging economic conditions. The majority of the sector's outlook revisions and rating changes were linked to sovereign rating actions, such as those on Brazilian utilities. Currently, about 72% of rated Latin American utilities have a stable outlook, as sovereign ratings continue to determine ratings on the region's largest regulated utilities. Given that about 14% of ratings on the utilities have a negative or watch negative outlook, we think downgrades may outpace upgrades in 2024.

Main assumptions about 2024 and beyond

1. Limited electricity demand growth as economic activity stalls.

We have revised our 2024 GDP growth forecast for Latin America to 1.2% from the previous 1.5%. Our main recent upward growth forecast revisions were for Brazil and Mexico, while we revised downward our forecast GDP growth for Argentina, Chile, Colombia, and Peru. In this context, we expect electricity demand to grow 1.5%-2.0% in 2024. Additional weakening of economic activity in the region could further reduce demand and prices.

2. Persistently high interest rates keeps weighing on companies' cash flows.

We expect real interest rates to remain elevated through 2024, although disinflation across the largest economies in the region in the coming quarters should encourage central banks to start lowering interest rates or continue doing so for those that have already started. As a result, debt service should continue to consume a large portion of operating cash flows, weighing particularly on the companies that rely on floating-rate debt. Still, the utilities that we rate have shown resiliency to economic downturns and have been able to access the credit markets even during more stressed periods.

3. Increased energy capacity, especially from renewables.

In general, we continue to expect governments in the region to keep fostering green energy, except Mexico, given its plans to prioritize fossil fuel sources. But higher-for-longer interest rates and input cost inflation could trim returns on long-term generation projects, slowing the energy transition in Latin America, particularly in Brazil given the prevailing low spot prices.

As inflation eases, some countries in the region are now in a position to lower their policy rates, and some have begun an easing cycle, such as in Chile and Peru. In Brazil, interest rates are still relatively high at 11.75% after jumping to 13.75% in 2022 and 9.25% in 2021 from 2.0% in 2020 (see table 1). We now project Brazil's central bank to finish the easing cycle with rates at 9.0% by the end of 2024. However, risks around food prices remain high, and the El Niño weather pattern is affecting harvests, especially in South America.

Financing conditions may improve as monetary policies across the region ease, but we expect financing costs will remain relatively high for issuers. Nevertheless, utilities that we rate in the region have been accessing funding from the credit markets. Financing conditions in Brazil have already improved after a dry spell in domestic capital markets in the first half of the year.

Table 1

Macroeconomic outlook for Latin America

%	2021			2022			2023f			2024f			2025f		
	GDP growth	CPI inflation	Interest rate	GDP growth	CPI inflation	Interest rate	GDP growth	CPI inflation	Interest rate	GDP growth	CPI inflation	Interest rate	GDP growth	CPI inflation	Interest rate
Argentina	10.7	48.4	38.0	5.0	72.4	75.0	(3.0)	130.0	145.0	(1.5)	190.0	100.0	2.3	90.0	50.0
Brazil	5.3	8.3	9.3	3.0	9.3	13.8	2.9	4.6	11.8	1.5	3.6	9.0	1.9	3.7	9.0
Chile	11.9	4.5	4.0	2.5	11.6	11.3	0.0	7.7	8.5	1.9	3.5	5.5	2.7	3.1	5.5
Colombia	11.0	3.5	3.0	7.3	10.2	12.0	1.2	11.6	13.3	1.3	5.5	10.0	2.8	3.6	7.0
Mexico	6.1	5.7	5.5	3.9	7.9	10.5	3.3	5.5	11.3	1.8	4.1	9.5	2.0	3.2	7.0
Peru	13.5	4.0	2.5	2.7	7.9	7.5	0.2	6.4	6.8	2.2	3.2	4.5	2.8	2.3	4.0
Latam 6	**7.6**	-	-	**3.9**	-	-	**1.7**	-	-	**1.2**	-	-	**2.2**	-	-

CPI inflation data are annual averages. Interest rates are central bank policy interest rates at year-end. f—Forecast.
Source: S&P Global Ratings Economics.

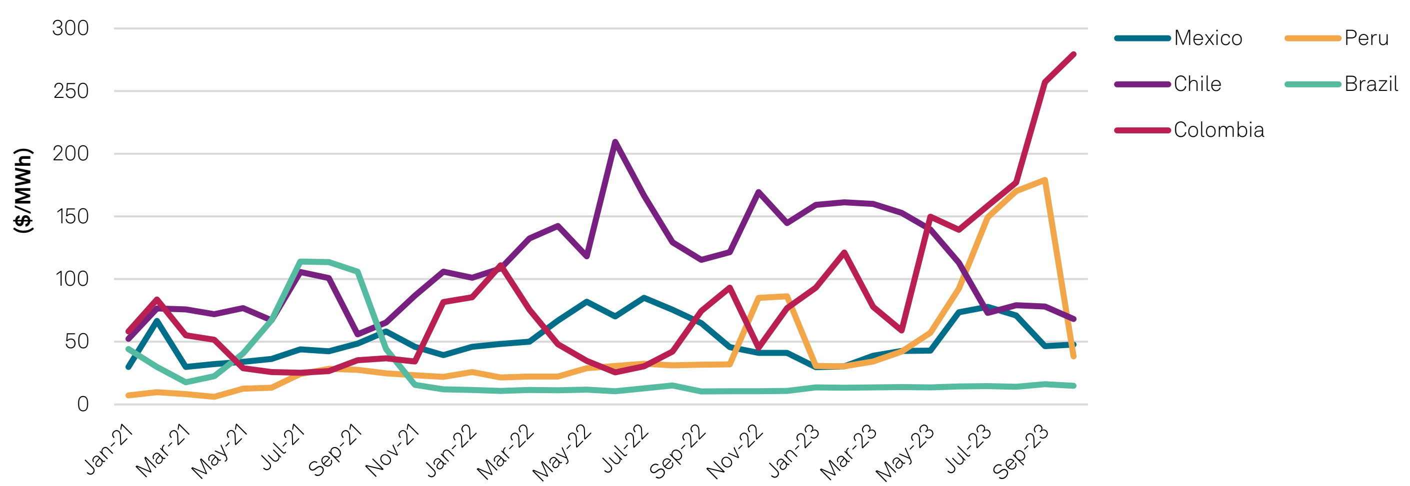
The makeup of the combined electricity market in Latin America is tilted toward renewables, with 37% of capacity in hydro, 14% in wind, and 10% in solar, while globally it's 37% in combined hydro, wind, and solar. The energy matrix is heterogeneous among the countries in the region, ranging from Brazil's 115 gigawatt (GW) hydro capacity (57% of matrix) and Mexico's 38 GW natural gas capacity (55% of matrix). This translates to a distinct energy transition path for each country.

As such, we expect hydrology conditions and oil and gas prices will remain the major drivers for electricity prices in Latin America based on our expectation that the composition of the electricity sector will remain stable in the next 12 months for most countries. Our 2024 price assumptions for WTI and Henry Hub are $80 per barrel and $3.00 per million British thermal units, respectively.

In the long term, we forecast that the transition to more nonconventional renewable energy will increase in speed and make overall prices decrease and then stabilize across the region. However, we think that staggered economic growth and political turmoil could delay investments and new additions of renewable energy, delaying reaching equilibrium prices according to each country's target.

Chart 8

Energy spot prices in Latin America



Source: S&P Global Ratings.

Credit metrics and financial policy

With a combination of still high cost of debt, a ramp-up in debt maturities, and slowing economic activity, utilities' credit fundamentals and liquidity continue to be key factors.

Despite a sluggish economic scenario and the high cost of debt, we don't expect credit quality to deteriorate in 2024, especially for those companies that rely on fixed-rate debt. If higher inflation persists, and given the regulatory lag in cost recoveries, rated utilities could face higher working capital needs. We continue to expect the largest rated integrated groups to post negative free operating cash flows, given their heavy investments, particularly in renewables and in maintaining and expanding their networks.

Still, comfortable liquidity should help utilities to navigate through the challenging economic conditions as refinancing needs increase in 2024 with higher debt maturities. Overall, we think that companies have flexibility to not only postpone investments but also reduce dividends, if needed, to preserve cash.

Key risks or opportunities around the baseline

1. Slower economic growth amid still high interest rates.

A prolonged period of slow growth and high interest rates could become more challenging as debt maturities increase, with most issuers facing still elevated debt service costs. This could be exacerbated as revenues slow, raising the real impact of still high borrowing costs.

2. Political and regulatory risk.

Given the expected subdued economic activity, lower disposable income could lead to less consumption and increased customer delinquency and energy theft in some concession areas. Also, since rates are generally linked to local inflation, the issue of electricity affordability can amplify political pressure on regulators, especially in less mature jurisdictions. Nevertheless, we don't anticipate significant government interventions, because we continue to consider regulations in the region to be generally supportive of the utilities' credit quality.

3. Electricity in the region depends on hydrology and oil prices.

The El Niño climate pattern could pose significant risks, but the impact varies throughout the region. El Niño should continue leading to lower spot prices in Chile and keeping them low in Brazil, but elevating them in Colombia and particularly in Peru in 2024, which is already experiencing the strongest El Niño in 24 years.

Argentina and Mexico, which rely mostly on thermal plants to produce electricity, could see more volatile electricity prices if geopolitical concerns deepen, for example if the war between Israel and Hamas escalates, and already intensified by the prolonged Russia-Ukraine conflict. Geopolitical turmoil could keep inflation high amid increasing economic uncertainty.

Country Highlights

Argentina

In 2024, the path for Argentina's utilities will depend on the specific policy initiatives under the recently elected government of Javier Milei. In the next year, we expect volatility and unpredictability will remain, considering the current economic imbalances in the country, including expected inflation rates of 190% and a GDP contraction of 1.0% in 2024. In this context, we think new investments in the sector will be low.

Brazil

Hydroelectricity reservoirs are currently at good levels thanks to above-average rainfall in the past two years. This has kept energy spot prices at the minimum regulatory level--Brazilian real (R$) 69 per megawatt hour (MWh)--throughout 2023. Despite higher temperatures due to El Niño, which should persist at least until the first quarter of 2024 and boost demand, we assume energy prices will remain low in that time period, between R$70/MWh and R$80/MWh, due to the high reservoir levels.

In this scenario, generation companies should benefit from greater energy deliveries, although at lower spreads because of lower energy prices. The low spot prices will have an overall moderate negative impact on thermal plants because they rank later in the dispatch order. Nevertheless, Brazil's Electricity System Operator (ONS) may dispatch thermal plants more often relative to the past two years because of heat waves that have been lasting longer, increasing energy demand from more stable sources, considering Brazil's large share of intermittent sources with the surge of nonconventional renewables. In addition, lower inflation and favorable hydrology will help ease utilities' working capital needs, but still high interest rates continue consuming a large part of companies' cash flow because most of their debt is floating.

In addition, we expect the integrated energy groups to continue making sizable investments in the next couple of years, which should lead to negative free cash flows. This is even considering that some groups will continue divesting from noncore assets, such as Neoenergia S.A. (BB/Stable/--; brAAA/Stable/brA-1+), EDP Energias do Brasil S.A. (not rated), and Companhia Energetica de Minas Gerais – CEMIG (BB-/Stable/--; brAA+/Stable/--).

We expect still mild GDP growth in Brazil between 1.5% and 2.0% from 2024 onward, which should translate to maximum electricity demand growth of about 3% per year until 2032, according to the 2032 Ten-Year Energy Expansion Plan issued by Empresa de Pesquisa Energetica (EPE; the state-owned energy research office). Relatively low demand growth, coupled with oversupply of energy, should support still low energy prices in the next few years, which discourages new energy generation projects. Considering continued intermittent capacity expansion, we believe Brazil's challenge will be to continue investing in transmission capacity to foster system interconnectivity and reliability.

In 2024, we expect the government to disclose the final terms for the renewal of 20 distribution concessions in Brazil--which are coming due between 2025-2031--for an additional 30 years. At this point, we assume final renewal terms will be in line with the Ministry of Mines and Energy's preliminary proposal published in June 2023, which indicated that distribution concessions that are complying with service quality metrics--measured by duration and frequency of service interruptions--and the economical-financial regulatory requirements would be eligible for contract extensions without payment of grant fees.

Finally, we also expect Brazil's free energy market to widen in 2024, because starting in January, all high-voltage consumers will be able to select their energy supplier. In this context, integrated energy groups have been investing in more scalable solutions to convert their captive industrial and commercial clients, as well as attract new ones, to their free client base, generally by offering discounts on energy bills.

Brazilian Water Utilities

In the past couple of years, private companies have increased their market share to more than 20% of the population served in the country, mainly through large concessions, because stakeholders remain attracted to the inherent resilience of the sector's cash flows.

Despite tightening financial conditions in Brazil during the first half of 2023, groups such as Aegea Saneamento Participações S.A. (Aegea: brAA+/Stable/--) and Iguá Saneamento S.A. (Iguá: brA+/Stable/--) were able to access the capital markets to finance funding needs for their concessions.

The privatization of Companhia de Saneamento Básico do Estado de São Paulo (SABESP; BB/Stable/--; brAAA/Stable/--) is on the agenda of the new state administration that took office in January 2023. The administration has hired International Finance Corp. as an advisor to execute the privatization in 2024.

Banco Nacional de Desenvolvimento Econômico e Social (BNDES; BB/Stable/--; brAAA/Stable/--) has continued to be an important source for long-term capital expenditure financing in the sector and we expect it to continue to be in 2024. In addition, we expect BNDES to continue to act as a financial advisor because it is in advanced stages of privatization modeling for water and sanitation companies in the states of Rondônia, Sergipe, Paraíba, and Rio Grande do Sul.

Chile

Lower fuel prices and improved hydrology from higher snowmelt reduced volatility in the Chilean energy generation sector in 2023, steadying the national grid's performance. Marginal costs declined to an average of $118/MWh in the first 10 months of 2023 from $134/MWh in the same period in 2022, but remain high compared to an average of $70 MWh in the last five years. We expect fuel prices will remain relatively stable in 2024 and we project generators will have natural gas available from Argentina. We project marginal costs to keep decreasing if there are no major hydrology events, while renewable capacity starts operating.

As of November 2023, 42.7% of the system's capacity came from nonconventional renewable sources and an additional 382 projects (about 6.4 GW) were under construction, which supports the country's plans to achieve carbon neutrality by 2050. Chile's large power players (Enel Chile S.A., AES Andes S.A., Engie Energia Chile S.A., and Colbun S.A.) will continue to build the majority of the increased capacity for the next three years.

The effect of the deployment of nonconventional renewable capacity on spot prices will also depend on the expansion of transmission lines and battery storage projects. This is because new assets are located either in the country's north or south, while most of the consumption is in the center, around Santiago. We expect transmission capacity constraints to remain until the Kimal-Lo to Aguirre transmission line is completed by the end of 2029. Meanwhile, we expect the regulator to implement measures to alleviate the transmission congestion. Those include the ability to bid for a certain zone of Chile (north, central, or south) to decrease the exposure to the decoupling effect, and the ability to bid for batteries, which should help to reduce volatility between solar and nonsolar hours.

The Chilean power generators were able to monetize the receivables pending from regulated contracts in the second half of 2023. Although this alleviated liquidity strains for some of the generators, we believe that in 2024 there could be further accumulation of receivables, which could pressure working capital requirements.

The Chilean government created the Small Distributed Generation Means (Pequeños Medios de Generación Distribuida (PMGD]) framework in 2006 for projects generating up to 9 megawatts (MW). We continue to expect the larger and geographically diversified PMGD portfolios to be better protected against adverse events, such as curtailment and construction delays. On the operational side, we continue to expect a relatively stable operating performance, because the high energy prices (close to $70 in 2023 and near $65 in 2024 and 2025) compensate for the lower-than-expected production, in part due to curtailment. The stabilized prices were--and will continue to be--much more stable than market prices, which reduces cash flow volatility and supports our view of these projects' credit quality, which is mostly investment grade.

On the construction side, we have seen average delays of more than six months in the start of operations of the assets. This is mainly due to the interconnection process which, in our view, is the main risk affecting PMGDs, considering that the interconnection contract does not include any compensation mechanism for the projects. We continue to expect the same trend in 2024, considering the large amount of PMGDs under construction.

Colombia

Colombia's energy transition process is underway. The renewable energy goal is part of the country's overall strategy to reduce greenhouse gas emissions from business-as-usual projections by 50% by 2030 and reach carbon neutrality by 2050. Nevertheless, we view the delays in the execution of nonconventional renewable projects and transmission lines as a medium-term risk for the system's capacity.

President Gustavo Petro continues to emphasize energy transition as a key priority of his administration and branded his policy as the "Just Energy Transition Plan," which will focus on electric power generation at the community level, including rural communities. Colombia's installed electric power generation capacity is currently 18 GW, with hydro accounting for 68%, gas and coal-fired power plants accounting for 31%, and the remaining from wind and solar units.

The country's energy matrix is highly dependent on climate conditions to generate hydropower. The hike in spot prices stemming from a drier season in the country could crimp liquidity and profitability of the Colombian distribution companies, which must comply with a rate ceiling since the implementation of the "opción tarifaria," which is a mechanism the government implemented in 2020 to smooth the impact of sudden increases in energy costs on electricity bills. The government is currently working on measures to alleviate the accrued receivables of these distribution companies while they're incurring higher costs.

Mexico

Nearshoring has gained attention as supply-chain disruptions during the COVID-19 pandemic made a case for manufacturers to diversify the location of their operations to minimize production disruptions. Mexico's long-standing manufacturing links with, and access to, the U.S. market make it an obvious potential beneficiary for nearshoring. In this context, additional energy capacity is a challenge to take advantage of nearshoring, especially regarding availability of clean technology, since the current Mexican administration has been reluctant to encourage the development of green energy sources.

We expect net energy capacity to increase about 20% in the next two years, versus recent annual increases of about 5%. An additional layer of complexity is the centralization of energy generation by the state-owned utility, Comisión Federal de Electricidad (CFE; foreign currency: BBB/Stable/--; local currency: BBB+/Stable/--), which leaves less room for the private sector to develop new energy sources. We will monitor if the current energy strategy remains after the presidential elections in 2024, and how this will affect the Mexican energy matrix and prices.

We continue to think that fossil fuel prices will remain the main driver for power prices in Mexico, and to a lesser extent, the inclusion of renewable capacity to the system and the overall national and regional demand and supply. In this context, we project power prices in the wholesale market to decline in the next 12 to 24 months as commodity prices decrease to about $40/MWh from an average of $50/MWh in 2022.

Finally, renewable capacity continues increasing year-over-year, and we expect nominal capacity for this technology will increase about 8 GW by 2026; although the increase will be gradual. Renewable generation edged up to about 25% of Mexico's total matrix in 2022 from 24% in 2021. We continue to expect that renewable capacity will be added to the system mainly through private companies in the next 12-24 months, while the bulk of CFE’s investments will be for combined-cycle power plants.

Peru

The political crisis and the protests in southern Peru and in the city of Lima during the first quarter of 2023 haven't weakened utilities' credit quality so far. Although we think Peru's political and social conditions have recently been more stable, the country is facing the strongest El Niño weather pattern of the past 25 years, which is dampening economic activity, especially the agricultural and fishing industries.

As of November 2023, electricity demand was 4.5% higher than the same period last year, above our assumption of Peru’s GDP growth of 0.9% for 2023. Still, we expect demand to grow in line with our assumption of 2.4% GDP growth for 2024.

El Niño has hurt hydropower generation. Hydro made up 46% of total energy production as of the end of November, below the 52% share during the same period last year. Moreover, the effects of the drought in southern and central Peru on marginal costs were exacerbated by the outage of two relevant hydroelectric plants in the system and the maintenance in Camisea’s plants that restricted the supply of natural gas. As a result, spot prices peaked in the third quarter of 2023 and averaged $82/MWh in the first ten months of 2023 versus $28/MWh in the same period in 2022. However, we assume hydrological conditions will normalize in the second half of 2024, leading to lower spot prices averaging $35/MWh for the year.

As of Sept. 30, 2023, Peru’s installed capacity was 13.6 GW, of which 55% was thermoelectric, 38% was hydroelectric, 5% was wind, and 2% was solar. In addition, the Peruvian Committee of Economic Operation System (COES) approved 8.9 GW of wind projects and 7.7 GW of solar projects to be developed through 2029. Although there is a clear target to expand nonconventional renewable capacity share in the system, recent political turmoil and lower economic growth prospects could dampen investments and additions of solar and wind plants in the next two years. In this context, reaching the expected $30/MWh optimal spot price could be delayed, considering in addition a possible delay in transmission infrastructure investments in Peru.

Related Research

- The Energy Transition And Its Impact On Latin American Power Prices, Dec. 6, 2023
- Brazil's Sanitation Regulatory Framework Remains Fragmented, Despite Recent Changes, May 8, 2023

S&P Global Ratings

Midstream Energy

Industry credit profile strong as future challenges await

January 9, 2024

This report does not constitute a rating action.

What's changed?

Canadian midstream challenges/opportunities. Canada's two largest midstream companies have pressured credit metrics from project cost overruns and a large acquisition. Their path to credit improvement is a reflection of how the broader industry could position itself.

U.S. Gulf Coast infrastructure development. New pipeline infrastructure is needed to provide for liquid natural gas projects and the growing supply of natural gas liquids out of West Texas.

M&A and asset rationalization. Small tuck-in acquisitions and asset divestitures will continue as the industry positions itself for future growth and energy transition opportunities.

What are the key assumptions for 2024?

Higher spending to support Permian growth. Capital spending will be focused on processing and logistics infrastructure to move natural gas, NGLs, and crude out of the Permian region.

Financial discipline. Companies will continue to lower leverage targets and build free cash flow.

Greater focus on shareholder returns. We expect most companies to use more excess free cash flow to reward shareholders.

What are the key risks around the baseline?

Lower demand for hydrocarbons could worsen volumes for midstream companies.

Capital markets and banking access. Refinancing maturing debt will require new capital if capital markets close or banks are unwilling to lend to the sector.

Increased regulation and renewables growth. Permitting has become increasingly difficult for new pipeline projects, GHG emissions reduction, and renewables penetration.

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Ratings Trends: Midstream Energy

Chart 1

Ratings distribution

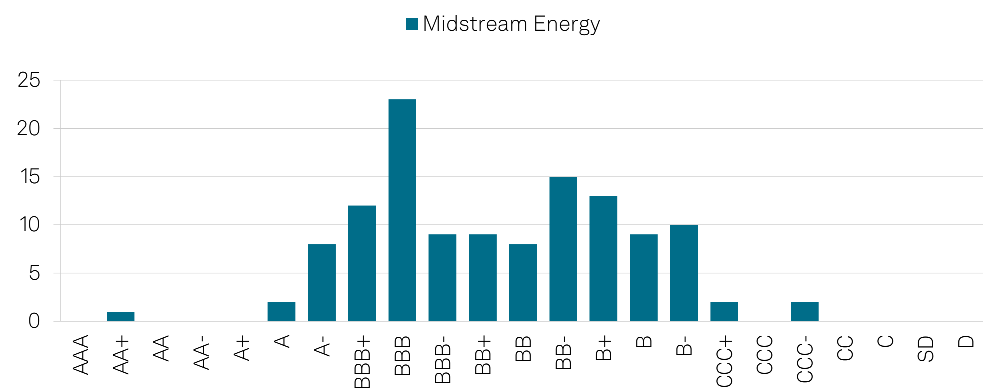


Chart 2

Ratings outlooks

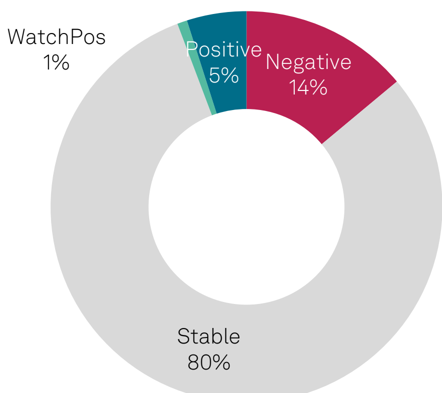
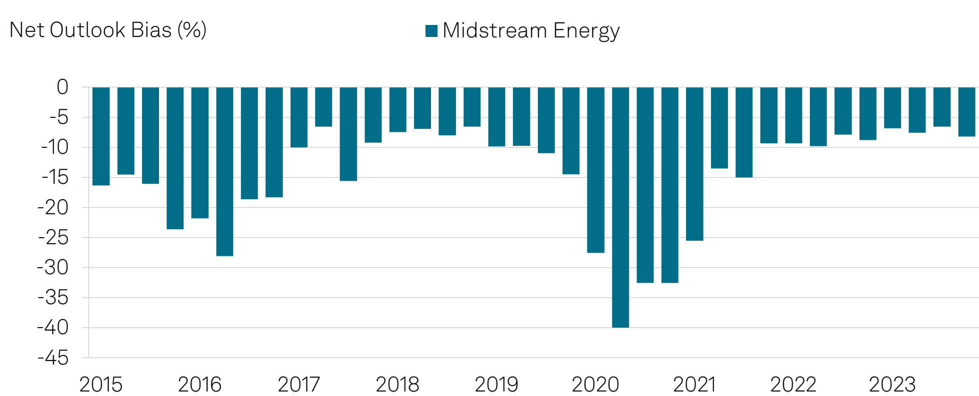


Chart 3

Ratings outlook net bias



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

Industry Outlook

Ratings trends and outlook

The midstream industry's financial discipline and focus on maintaining strong balance sheets and credit measures continued in 2023; most companies maintained financial flexibility by retaining excess cash flow to fund growth initiatives and address upcoming maturities and revolver borrowings, before rewarding shareholders. While we expect this trend to continue, we expect companies to allocate more capital to tuck-in transactions that are strategic for their existing asset base, before giving cash flow to shareholders in the form of buybacks or dividend increases. Equity and debt holders have been aligned for several years, which we believe has resulted benefits to all the company's constituents: better credit quality along with a consistent return for equity holders.

Investment grade companies, which account for about 40% of our ratings, continued to benefit from their size, scale, and geographic and asset diversity. These companies generally have more organic opportunities and can provide their customers with more optionality to end markets. We've seen investment-grade companies leverage their operations in the Permian and near the Gulf Coast to sanction new natural gas projects for liquified natural gas (LNG) facilities and increase egress for natural gas liquids (NGLs) and crude out of the region for export. Balance sheets remain strong and credit measures have improved, with some companies lowering long-term leverage targets, which is supportive of ratings.

Most speculative-grade issuers have strengthened their credit profiles, with some ratings improvement particularly among companies in the 'B' category. These companies have focused on improving their contract profiles and using cash flow to reduce debt, forgoing dividends to their sponsor companies or limiting distributions or share repurchases. We believe lower-rated issuers could see more ratings upside in the coming year given our outlook on hydrocarbon demand, or they may become takeover candidates by their larger competitors.

Currently about 80% of midstream rating outlooks are stable, 5% are positive, and about 14% are negative. Ratings improvement occurred for both investment-grade and speculative-grade companies, mainly due to improved credit profiles related to strong prices and demand, coupled with meaningful debt reduction. The sector's ratings and outlooks were relatively similar to the beginning of 2023, when 81% of ratings were stable, 9% were positive, and 16% were negative.

Main assumptions about 2024 and beyond

1. New infrastructure is needed to support growth in West Texas and the U.S. Gulf Coast

Infrastructure development for LNG and egress out of West Texas will be the main focus of the industry for the next several years. Growing gas-to-oil ratios and the richness of the associated natural gas coming out of Permian crude oil production will be addressed through strategic partnerships between midstream companies, upstream companies, and financial parties. Export facilities, dock space, and the need for natural gas as a feedstock for LNG capacity will accelerate in the next 12 months.

2. Companies continue to prioritize balance sheets as they set strategic goals

We expect companies to continue to keep long-term leverage targets at or below current levels as they shape strategic plans in an industry that is becoming increasingly bifurcated between large and small. Maintaining strong credit measures gives investors greater comfort with the specific company narrative, and companies more access to the capital markets.

3. Shareholder returns could increase absent other growth opportunities

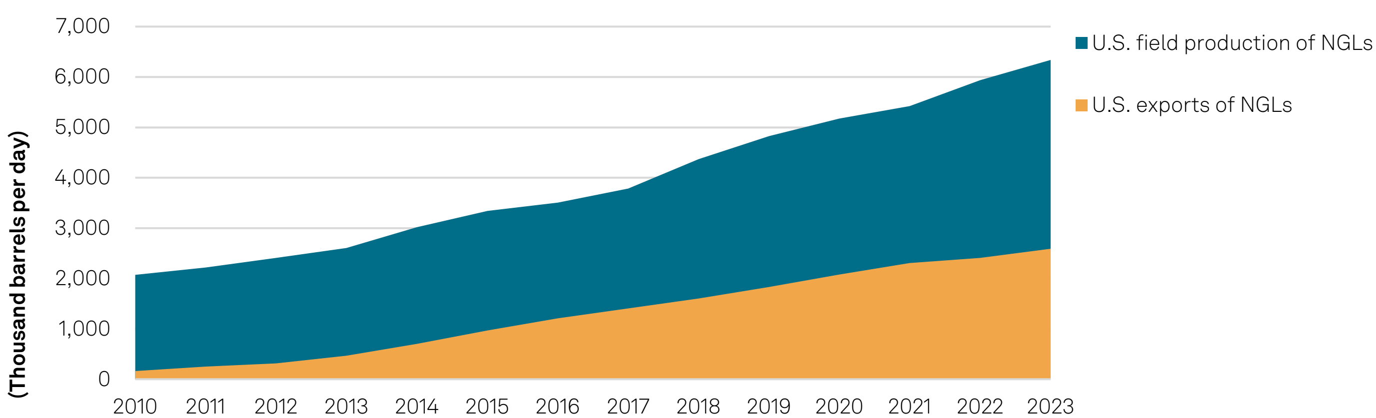
After several consecutive years focusing on debt reduction, the midstream industry could pivot to returning cash flow to equity holders. That said, we do not believe this pivot, if it occurs, is mutually exclusive of maintaining creditworthiness. Companies will increasingly have to compete with alternative energy investments for new capital as renewables and other alternative energy projects' costs fall and yields for investors improve. This should keep a more conservative bent on midstream financial policy.

The focus will be on infrastructure for Permian egress and LNG exports. Midstream companies are responding to the call for additional natural gas feedstock to supply about 10 billion cubic feet per day (Bcf/d) of LNG export capacity currently under construction in the U.S.; more than 20 Bcf/d of pipeline capacity is currently in progress. While this capacity is being built in regions that historically has been amenable to the industry in terms of permitting and right-of-way, it could become more difficult and take longer to build these assets as opposition to such projects grows. The pipeline capacity currently being contemplated is more than required, but we believe it will be filled as more LNG trains are built in the next few years. Given the long-term supply contracts from the various LNG projects, we expect the pipeline capacity under consideration will be contracted under similar long-term arrangements to ensure a consistent supply of natural gas feedstock.

We expect additional NGL transportation will also be required for consumption at Gulf Coast chemical complexes and for global export. The majority of growth in natural gas and NGLs is coming in the form of associated gas as upstream producers drill for crude oil. The gas content in wells being drilled for crude oil in the Permian and Bakken is increasing, as is the concentration of NGL content. Through Sept. 30, 2023, U.S. field production of NGLs increased by almost 7% (see chart 4). Unlike natural gas, NGLs cannot be flared and as NGL production increases, infrastructure needs become more important to support drilling activity. With a number of fractionation plants in construction and over 40% of U.S. NGLs exported, there is a growing need for takeaway capacity.

Chart 4

U.S. natural gas plant field production



Source: U.S. Energy Information Administration.

A number of large, integrated midstream energy companies are progressing on expansions of existing processing plants and new greenfield projects (see table 1). As of October 2023, Enterprise Products Partners (EPD) began converting its Seminole Red Pipeline from crude oil service to NGL service, with an expected completion of year end. The 210,000 barrel per day (b/d) crude oil pipeline, which was in NGL service prior to 2019, will retain the flexibility to convert back to crude oil service. The flexibility of being able to convert the pipeline back into crude service provides some flexibility should there be an overbuild of NGL takeaway capacity in the next few years. Based on our current expectations of production growth and the projects currently announced, we believe there will be sufficient capacity to meet the industry's needs through 2025. The only new build outside of the recently operational BANGL Pipeline is EPD's 550 mile Bahia Pipeline, which will have 600,000 b/d of capacity.

Table 1

NGL pipeline projects

NGL pipeline	Expected startup/expansion	Project
Seminole	Q4 2023	Conversion
Daytona NGL	Q4 2024	400,000 bpd expansion
BANGL	Q1 2025	200,000 bpd expansion
Shin Oak Pipeline	Early 2025	275,000 bpd expansion
Bahia Pipeline	2025	600,000 bpd new build

bpd—Barrel per day. Source: S&P Global Ratings.

Financial policy remains a key ratings driver. We view the midstream industry as mature with more limited organic growth opportunities, especially given the regulatory difficulties of completing new pipelines. This has created an environment in which midstream companies are growing modestly and largely internally funding capital spending. As a result, they use substantial free cash flow for share buybacks and dividend increases, while being deferential to debtholders; 2023 saw an increase in companies publicly communicating lower long-term leverage targets. Two examples are EPD's announcement on its fourth quarter 2022 earnings call that it was lowering its leverage target to 2.75x-3.25x and Plains All American Pipeline LP's (PAA's) announcement during its 2023 third quarter earnings call that it was lowering its leverage target to 3.25x-3.75x. Shortly thereafter, we upgraded EPD to 'A-' and PAA to 'BBB' due to improved financial policy. We also upgraded Energy Transfer L.P. (ET) to 'BBB' as a result of improved financial policy, with the expectation that ET will maintain leverage of about 4x over the next 12 to 24 months.

In 2024, we expect the trend of lower leverage targets to continue for midstream companies because of less opportunity to grow as well as equity and debt investors' desire for less leverage. In addition, we expect the industry to continue to grow dividends and distributions at a moderate pace. We expect larger midstream companies to make acquisitions but believe they will be largely tuck-in transactions that will use company equity as the main currency to transact. In general, we expect credit metrics in the midstream industry to modestly improve in 2024, which could result in further positive rating actions, especially if accompanied by public messaging that companies will operate at lower leverage over the long-term.

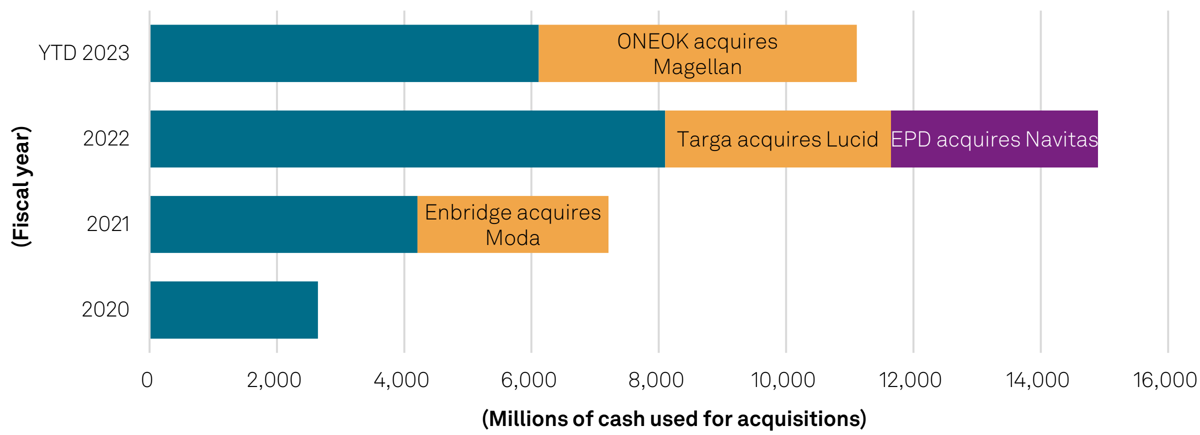
Boosting shareholder returns could come in many forms. Returning value to shareholders has generally meant dividends and share repurchase programs in the midstream sector, but we think an increase in mergers and acquisition (M&A) activity could be another path. M&A activity is hard to predict, though there has been significant consolidation in the upstream industry, which include many of the customers and shippers that use the assets owned by the midstream companies we rate. While this has "high-graded" the credit profiles of some of the counterparties, it also raises longer-term questions on surety of volumes that are now controlled by multinational energy majors. The risk is that these companies can shut down wells more easily than small private drillers if basin economics become unfavorable. These changing industry dynamics will lead some smaller midstream companies to think about getting bigger and more diversified.

Accordingly, since 2020 we have seen significant consolidation of small sponsor-owned issuers being acquired by large strategics (see chart 5). Examples are EPD buying Navitas Midstream Partners and Enbridge Inc. buying Moda Ingleside, in 2022 and 2021, respectively. In March 2020 we had around 20 issuers owned by financial sponsors or infrastructure funds; as of Dec. 8, 2023, that number is 14. The declining pool of available assets has resulted in bigger deals, like that of Energy Transfer's acquisition of Crestwood and ONEOK's acquisition of Magellan, both of which closed in 2023.

Overall, acquisitions have been supportive of credit quality by increasing scale and diversity without pressuring leverage metrics substantially. They have also contributed to an increase in average credit quality since sponsor- and infrastructure-backed issuers are typically rated in the 'B' or low 'BB' categories.

Chart 5

Cash spent on acquisitions



Sources: S&P Global Ratings, company filings.

Large scale mergers could continue in 2024, though regulatory risk, specifically FTC review, will likely be a factor. We also expect bolt-on acquisitions and individual asset sales to continue. Notable transactions in 2023 include The Williams Cos. Inc.'s acquisition of MountainWest Pipeline from Southwest Gas Holdings Inc. and Gibson Energy Inc.'s acquisition of South Texas Gateway from Buckeye Partners and other minority investors (see table 2). Plains All American has pursued small bolt-on acquisitions in its crude gathering joint venture with Oryx Midstream which could continue in 2024.

Table 2

M&A transactions 2021-2023

Acquirer	Target	Seller	Amount (Mil. $)	Funding
2021				
Enbridge Inc.	Moda Ingleside	Encap Flatrock	3,000	Cash - revolver
Energy Transfer, LP	Enable Midstream Partners LP	Public	7,000	Equity
2022				

Acquirer	Target	Seller	Amount (Mil. $)	Funding
Targa Resources Corp.	Lucid Energy Group II Borrower LLC	Riverstone Holdings	3,550	Cash - notes, TLB, revolver
Enterprise Products Partners L.P.	Navitas Midland Basin, LLC	Warburg Pincus	3,250	Cash - cash on hand & revolver
Energy Transfer, LP	Woodford Express, LLC	Quantum Energy Partners	485	Cash
The Williams Cos.	Trace Midstream	Quantum Energy Partners	950	Cash
Delek Logistics Partners LP	3Bear Delaware	3Bear Energy LLC	625	Cash
2023				
ONEOK Inc.	Magellan Midstream Partners L.P.	N/A	18,000	Cash & equity
Gibson Energy Inc.	South Texas Gateway	Buckeye (50%), Phillips (25%), Marathon (25%)	1,100	Debt & equity
The Williams Cos.	MountainWest Pipeline, LLC	Southwest Gas Holdings, LLC	1,500	Cash & assumed debt
Energy Transfer, LP	Crestwood Equity Partners L.P.	Public	7,100	Equity

Source: S&P Global Ratings.

Credit metrics and financial policy

We believe our current hydrocarbon price assumptions, production forecasts in Canada and the U.S., and expectations of growing global demand will support ratings strength and stability across North America broadly in 2024. Most companies continue to drive financial leverage lower, and we believe capital spending will be at or modestly above levels in 2023, which should allow most companies to generate positive free cash flow before dividends and share repurchases. This could lead to further ratings upside.

In contrast, the Canadian midstream industry had a more difficult year. In 2023 we saw heightened rating activity in the region, with noteworthy rating actions for both TC Energy Corp. and Enbridge Inc., which saw revisions to their respective outlooks to negative. These rating actions belied pressured metrics as a result of a significant capital program along with cost overruns at Coastal Gas Link (for TC) and a $17 billion acquisition (for Enbridge). The higher leverage at both companies was somewhat out of step with the broader North American midstream industry, which, as we noted above, continues to reduce debt. Still, some of the actions taken by TC and Enbridge may indicate how each company is positioning itself in the face of changes in the future energy mix. Both companies have made natural gas a strong focus, with Enbridge buying three regulated natural gas utilities and TC divesting its liquids business. As the industry evolves we anticipate more players will begin to align with changes in global perspective on hydrocarbon usage.

We believe growing crude oil and natural gas volumes in the Western Canadian Sedimentary Basin (WCSB) should continue to drive steady operating performance and better credit metrics in 2024. Pipeline companies are taking advantage of strong prices and growing volumes to lock in more favorable contracts, both in length and pricing. Newly commissioned projects and recent acquisitions also added to the operating margin.

Key risks or opportunities around the baseline

1. Developing economies and decisions by OPEC+ are a key demand driver.

Crude oil prices depend on the continuation of supply cuts by OPEC+ and growing demand in developing nations. Weaker commodity prices could result in production cuts that could flow through the midstream assets. An economic slowdown rather than a soft landing in developed nations could dampen demand.

2. Continued capital markets access and supportive banks are needed for growth.

Access to capital remains crucial for both refinancing existing debt and funding growth. A focus on debt reduction and strong excess cash flow has been credit-supportive, but companies with weak credit profiles or smaller operations could see some near-term challenges for a more selective pool of capital.

3. Climate change is a long-term headwind.

Global regulation to address climate change and emissions continues to be a significant headwind for the industry.

We believe global demand growth for crude oil will slow to 1 million b/d in 2024, from about 2.4 million b/d in 2023, on the heels of a strong demand recovery after the pandemic. Any significant demand weakness in developing nations like China or India could lead to weaker crude oil prices absent any action by OPEC+. It appears likely that a continuation of 1 million b/d supply cut by Saudi Arabia and additional announced cuts by Russia will be needed to balance production growth out of the U.S. We see little upside in natural gas prices if the U.S. experiences another mild winter and with European gas storage levels generally full in anticipation of the coming winter. There is likely limited risk to midstream cash flow given the industry's contract structure, but any significant price volatility could harm volume-dependent cash flow if it lasts for several quarters.

Debt levels for most issuers will be stable through 2024, particularly given the focus on conservative financial policies we have observed in the last 12 months. The exception to this is a small subset of investment-grade companies that have larger capital spending programs on specific projects. Enbridge, Energy Transfer, TC Energy, and Venture Global LNG Inc. collectively account for virtually all of the forecasted increase in midstream sector debt in the next 12 months. We think the market will largely remain open for most investment-grade companies in 2024, given investor confidence on their strong credit profiles. If debt markets are choppy, speculative-grade issuers could have a more difficult time refinancing or funding new projects, and may have to wait for a better window if they have the liquidity to do so.

That said, we see a relatively limited near-term needs for speculative grade companies to access the markets, with minimal debt in capital structures coming due over the next 18 months (less than 10% of total rated debt outstanding). However, improved market conditions and tightening high yields spreads could lead to a flurry of activity early in the year to take advantage of open capital markets. We see a significant increase in maturities as we look to late 2025 and 2026, with roughly 25% of speculative-grade issuance coming due. While companies could wait till 2025 to address these, a good amount could be pulled forward into 2024. Companies will need to weigh the potential to secure lower rates on financing by waiting until late 2024 and 2025 against the certainty of execution by addressing this earlier. Companies appear to have come to terms with rates likely remaining high through the year (S&P Global economists anticipate potential declines only in the second half of 2024), and we anticipate interest expense for the sector to increase.

The midstream industry has delivered several consecutive years of credit improvement, which we believe will continue in 2024. Companies were generally very resilient through the cycle in the past few years and self-funding model has given them significant flexibility to adapt to the risks and uncertainties in the global energy markets. We believe there is significant financial cushion in most company's credit measures to withstand a U.S. recession or significant shock without significantly impacting ratings. Renewables and the energy transition is a long-term threat for the industry, we believe the intermittency of alternative energy needs to be solved before it becomes a more significant threat. We also think that this solution is not going to occur in the next several years. We think that midstream companies will continue to adapt and look to seek greater participation in technologies such as carbon capture and sequestration, renewable natural gas, hydrogen, and the transportation and storage of renewable fuels as the returns on such technology becomes more attractive.

Regulation to address climate change is a long-term headwind. Increased government regulation around the globe to address climate change and greenhouse gas emissions are a significant headwind for the industry. While we believe a phase out of hydrocarbon use is decades away, the industry must remain vigilant in reducing emissions and hitting their long-term net-zero targets.

Related Research

- S&P Global Ratings Has Raised Its Henry Hub Natural Gas Price Assumptions For 2024 And 2025, Nov. 7, 2023
- Credit Considerations: The North American Midstream Energy Sector's Momentum Has Slowed, July 5, 2023
- Clear LNG Outlook Could Turn Murky Near End Of Decade, June 27, 2023
- Carbon Capture, Removal, And Credits Pose Challenges For Companies, Jun 08, 2023
- Investment-Grade Midstream Issuers Weathered Pandemic-Related Volatility By Focusing On Leverage Reduction, May 2, 2023
- Credit FAQ: What Would It Take To Upgrade Energy Transfer L.P. To 'BBB'?, April 26, 2023
- Issuer Ranking: North And South American Midstream Energy Companies, Strongest To Weakest, March 31, 2023
- How We Assess Hybrid Replacement Decisions When Credit Quality Improves: A Focus On Midstream Energy, March 6, 2023

Industry Forecasts: Midstream Energy

Chart 6

Debt growth (adjusted)

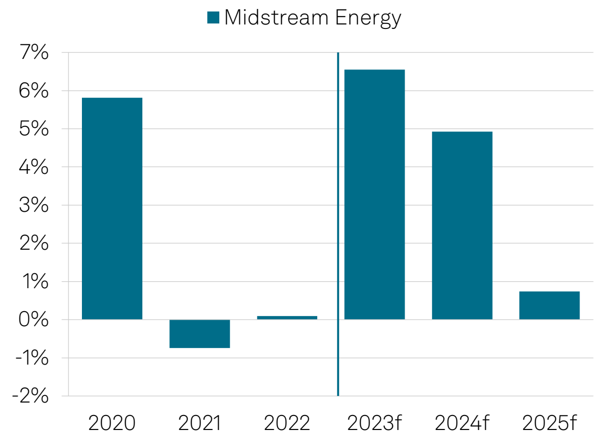


Chart 7

Capex Growth (adjusted)

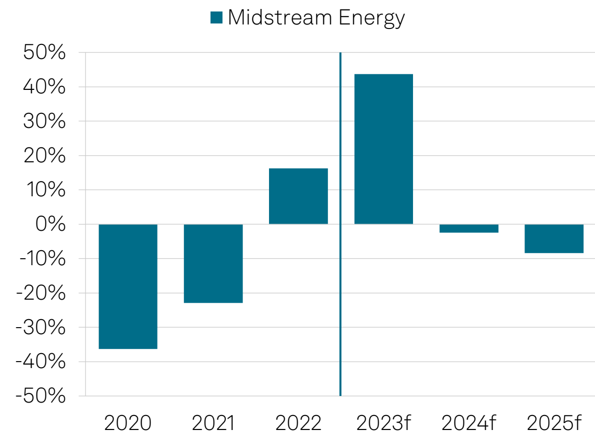


Chart 8

Debt / EBITDA (median, adjusted)

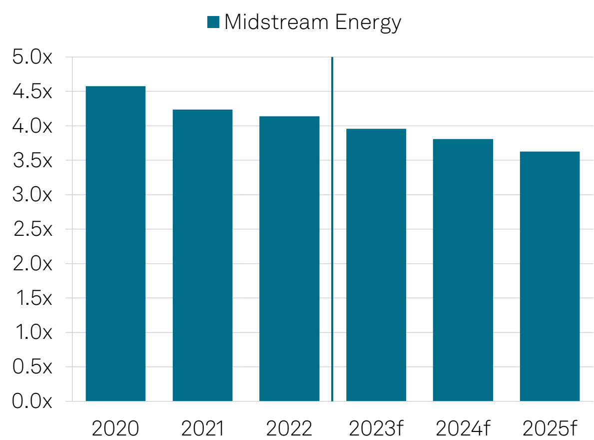
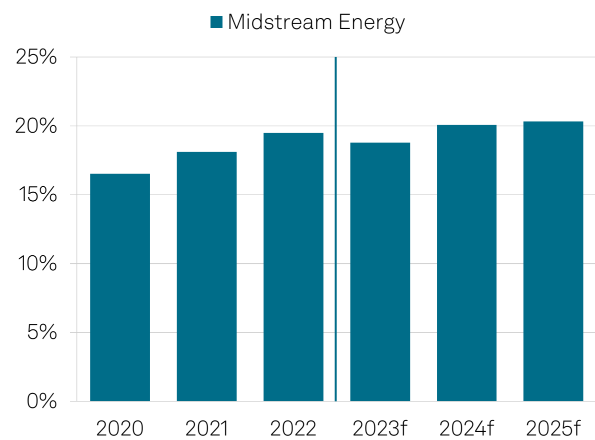


Chart 9

FFO / Debt (median, adjusted)



Source: S&P Global Ratings.
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: Sector

Chart 10

Cash flow and primary uses

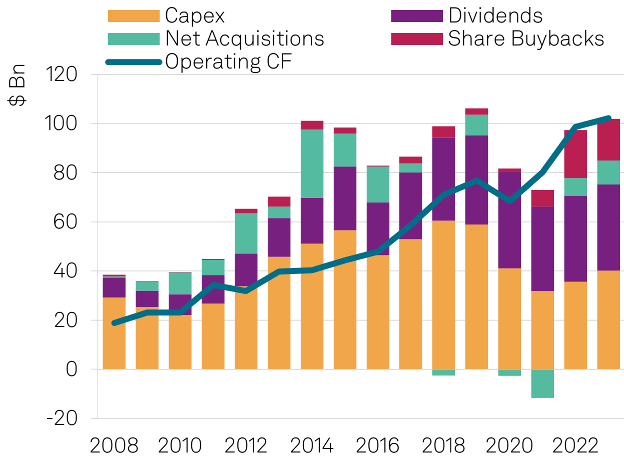


Chart 11

Return on capital employed

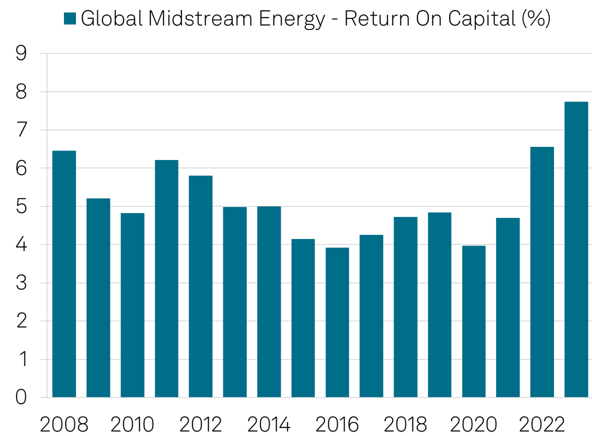


Chart 12

Fixed- versus variable-rate exposure

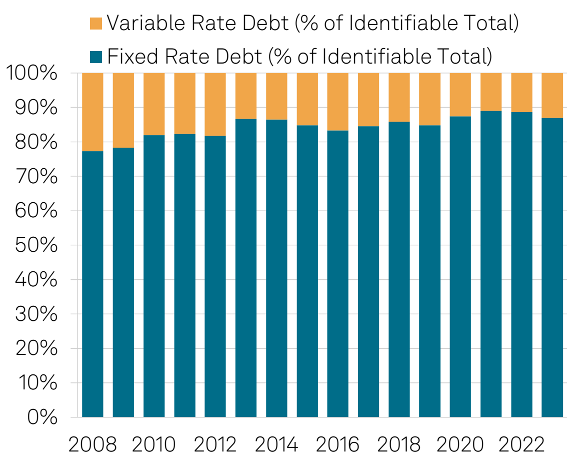


Chart 13

Long-term debt term structure

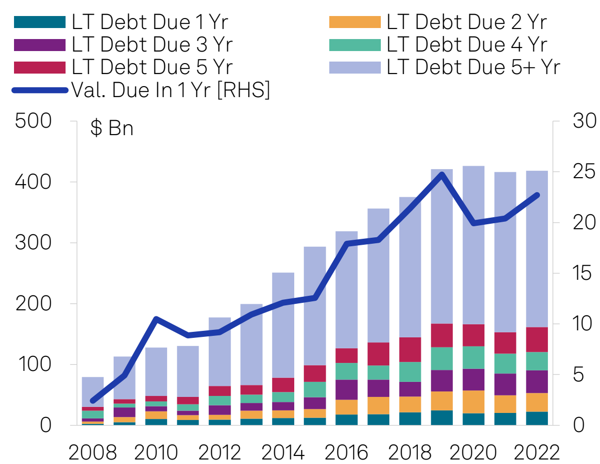


Chart 14

Cash and equivalents / Total assets

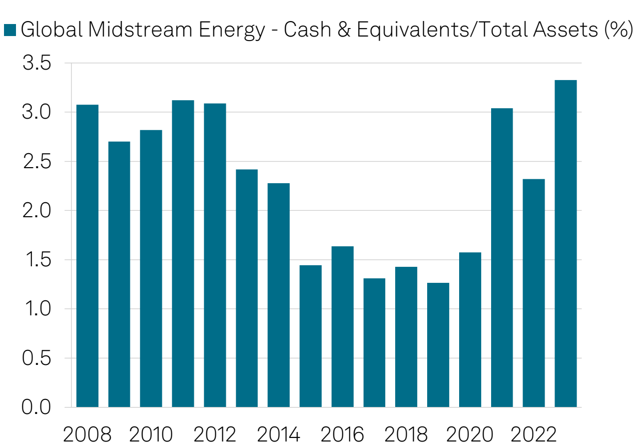
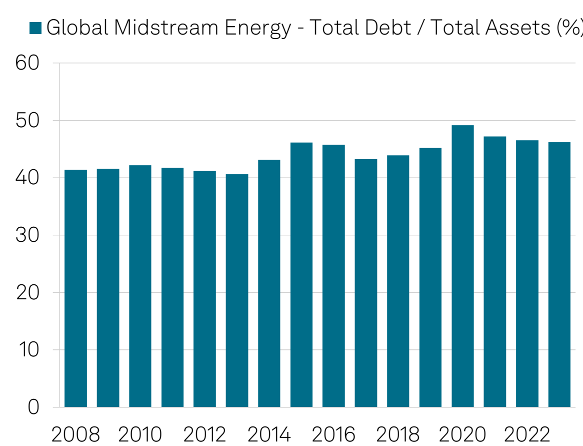


Chart 15

Total debt / Total assets



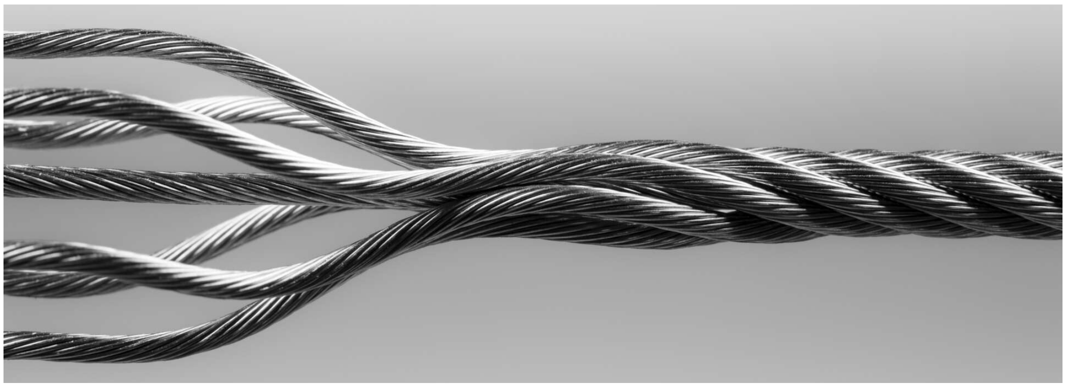
Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2023) figures use the last 12 months' data.

North America Merchant Power

Electrification will fuel fundamentals in 2024

January 9, 2024

This report does not constitute a rating action.



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What's changed?

Renewables deployment slowed. Interest rates and supply chains slowed wind deployment in 2023. Solar growth continues but was rendered ineffective in some regions without commensurate batteries/storage deployment.

Power prices have come off 2022 highs but spark spreads remain surprisingly tenacious. While supply from the Permian and milder winters have brought down natural gas and power prices, demand has stayed strong and has grown from electrification of some sectors, and also from extreme weather. Texas is a standout zone as it relates to demand.

Nuclear power tailwinds grow stronger. As expected, some asset rationalization occurred in 2023. The Inflation Reduction Act (IRA) provides strong support for existing nuclear and highlights nuclear's role in successful decarbonization.

What are the key assumptions for 2024?

Continuing coal plant retirements. Despite temporary delays due to resiliency concerns, structural factors weigh heavily against the coal fleet. A slew of regulations are coming.

Stable ratings profile. Unregulated power companies have significant excess cashflow and high cashflow conversions. Some are transitioning and may underperform if strategies go awry.

What are the key risks around the baseline?

Grid resiliency. With baseload supply shrinking and electric vehicles fueling demand, renewables/storage additions will need to scale up quickly to preserve reliability.

Battery and hydrogen scaling. Subsidies should lead to a meaningful scaling in California and ERCOT, and dampen expectations for scarcity prices, but implementation concerns persist.

Ratings Trends: North America Merchant Power

Chart 1
Ratings distribution

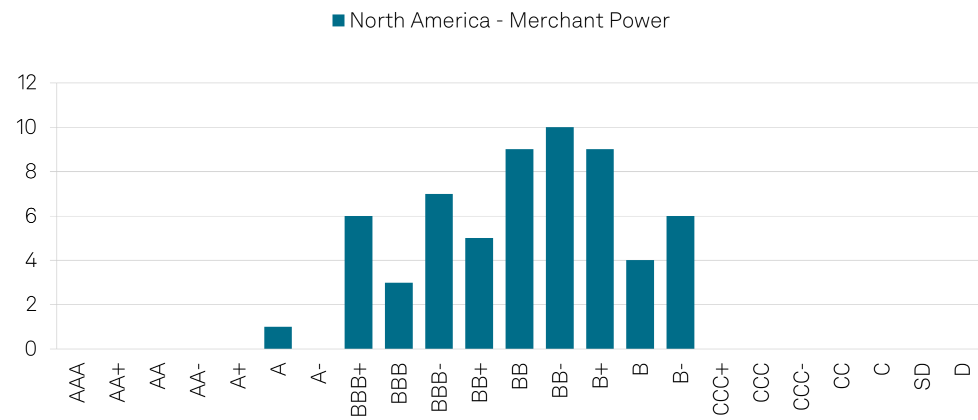


Chart 2
Ratings outlooks

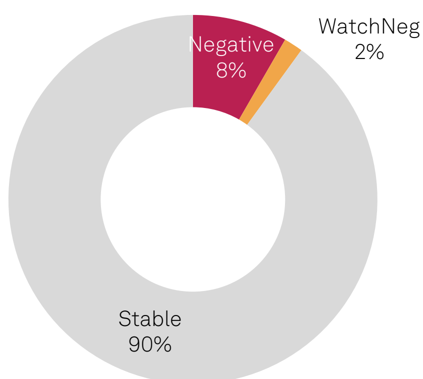
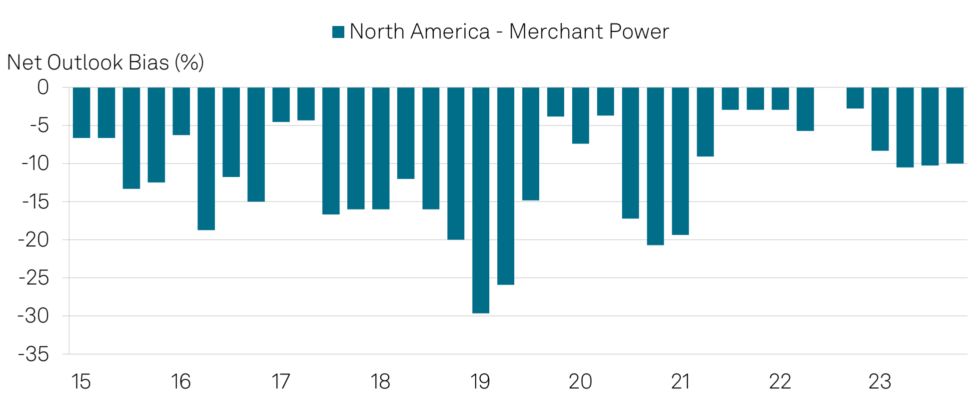


Chart 3
Ratings outlook net bias



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

Our rating distribution in the merchant power sector has strengthened in the 'BB' category where it had moved in 2021 (average ratings were 'B+' in 2018). Partly contributing to the move is the stable ratings of renewable portfolios and consolidation in the industry. Our investment-grade credit quality has also strengthened, which had faced deterioration over the past three years. Negative outlooks, which had declined to 3% at end 2022, picked up marginally to 6%, but stay persistently below levels in the past (15% as of Dec. 2021 and 24% in Dec 2020).

Industry Credit Metrics: North America Merchant Power

Chart 4
Debt / EBITDA (median, adjusted)

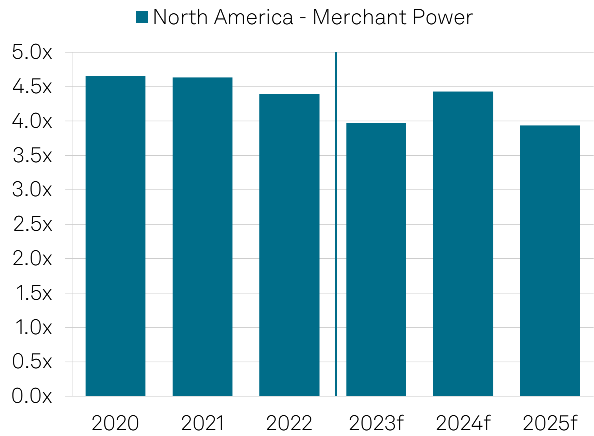


Chart 5
FFO / Debt (median, adjusted)

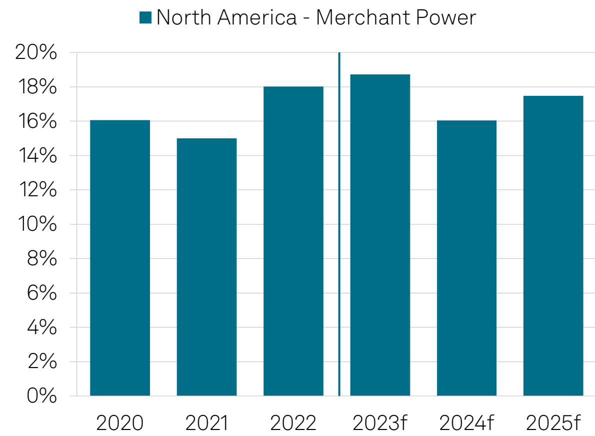


Chart 6
Cash flow and primary uses

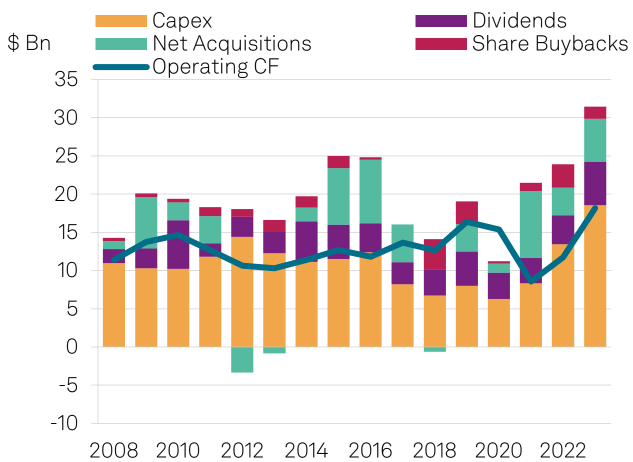
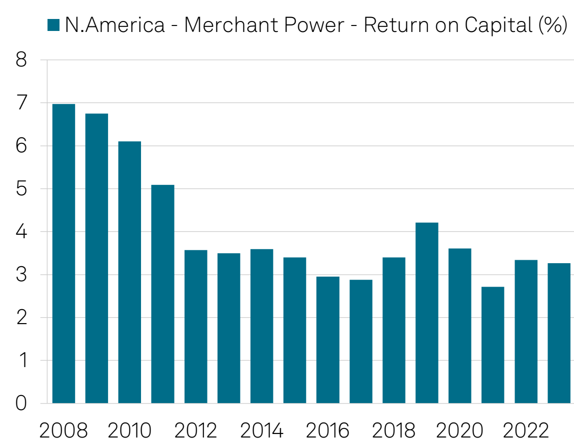


Chart 7
Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
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. Most recent (2023) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Entering 2023 we expected financial ratios to marginally deteriorate even as companies were amortizing or paying down debt. But winter events caused outages and slowed deleveraging efforts of major independent power producers (IPPs), and some IPPs have slowed their investment-grade aspirations, choosing instead to reallocate excess cashflow to share buybacks and/or acquisitions. Debt reduction still remains the stated objective for a number of IPPs, but most still target adjusted det to EBITDA in the 2.5x-2.75x range and adjusted funds from operations (FFO) to debt above 25% on a sustained basis. In contrast, two years ago, expectations for aggregate debt/EBITDA and FFO to debt were above 4.0x and 15%, respectively.

The one segment facing incremental leverage increases are the Yieldcos because of higher interest rates and a significant erosion in their share prices. Growth will be harder for these companies until interest rates moderate.

Industry Outlook

Ratings trends and outlook

1. Renewables PPA prices have nearly doubled since first quarter 2021.

Solar and wind power purchase agreements (PPAs) both showed higher contracting prices in 2023 to reflect the twin impacts of higher costs as well as meaningfully higher interest rates.

2. The nuclear renaissance is here to stay.

The IRA introduced nuclear production tax credits (PTCs), which supports nuclear power prices and plant economics through 2032.

3. Stable ratings profile.

We expect robust cashflow generation and high cashflow conversion, provided operating performance remains intact.

Renewables PPA prices have nearly doubled since first quarter 2021, temporarily stalling the downward cost curve of power prices. We note that renewable PPA prices appear to be relatively sticky at their higher levels. Solar and wind PPAs both showed higher contracting prices in 2023 to reflect the twin impacts of higher costs (labor, panels) as well as meaningfully higher interest rates. We see supply chain and permitting constraints as stubbornly persistent and remaining an overhang on near-term renewable development timeframes and returns. Utility scale solar and storage demand remains robust, although interconnection challenges have yet to clear meaningfully.

Project delays are occurring across renewable technology types and regions for numerous reasons. Typically, these are interconnection issues, high voltage transformer (HVDC) access and lead times, permitting challenges, and module access and financing challenges. Delays on transformers broadly are now about three years, and delays for HVDC transformers are even more protracted. We see this as most challenging for larger projects like offshore wind.

Also, while on the economics of projects, with the IRA expanding tax incentives, we expect some shift to the solar 10-year PTC over the investment tax credit (ITC). This will be dictated by the capacity factor of the development project. In particular, projects with weaker economics could continue to utilize ITCs. For example, if a project has a relatively high capital cost and low capacity factor, the ITC would be more economical.

The nuclear renaissance is here to stay. We expected consolidation in 2023 and more could still come. It was only three years ago that nuclear plants were economically beleaguered and retirements were being announced. We see the PTC provisions in the IRA as a game changer for merchant nuclear power. The IRA introduced nuclear PTCs, which supports nuclear power prices and plant economics through 2032, mitigating the risks that nuclear plant value will return to uneconomic levels when power prices eventually decline. The PTCs change the model for unregulated nuclear power generators from a merchant business to a nine-year contracted business, with floor pricing of $40/MWh to $44/MWh.

Moreover, starting in 2025 the maximum PTC and gross receipts threshold are subject to an inflation adjustment based on the GDP price deflator for the preceding calendar year. Also, the maximum PTC is rounded to the nearest $2.5/MWh and gross receipts threshold is rounded to the nearest $1.0/MWh. We note the phase-out price can change significantly depending on the assumed inflation rate. In particular, the rounding off to the nearest $2.5/MWh can increase the phase-out price significantly, offering unregulated nuclear a meaningful upside in EBITDA (see table 1). We see these developments as credit favorable for generators like Constellation Energy.

Table 1

Production tax credits math

	2% inflation					3% inflation				
	Maximum PTC		Gross receipts threshold		Phase out	Maximum PTC		Gross receipts threshold		Phase out
	Inflation	Rounded	Inflation	Rounded		Inflation	Rounded	Inflation	Rounded	
2024	15	15	25	25	43.75	15	15	25	25	43.75
2025	15.3	15	25.5	26	44.75	15.45	15	25.75	26	44.75
2026	15.61	15	26.01	26	44.75	15.91	15	26.52	27	45.75
2027	15.92	15	26.53	27	45.75	16.39	17.5	27.32	27	48.88
2028	16.24	15	27.06	27	45.75	16.88	17.5	28.14	28	49.88
2029	16.56	17.5	27.6	28	49.88	17.39	17.5	28.98	29	50.88
2030	16.89	17.5	28.15	28	49.88	17.91	17.5	29.85	30	51.88
2031	17.23	17.5	28.72	29	50.88	18.45	17.5	30.75	31	52.88
2032	17.57	17.5	29.29	29	50.88	19	20	31.67	32	57

PTC—Production tax credit. Source: Constellation Energy.

Recent capacity price formations in key markets are increasingly reflecting the cost of reliability. Capacity prices for New York City (NYC), or the New York Independent System Operator (NYISO) Zone J, which were at historically low levels for summer 2021 and 2022, have rebounded in the last two auctions that procured capacity for summer 2023, as well as winter 2023/24, clearing at $17.75/kW-month and $12.90/kW-month, respectively.

A key driver for higher capacity prices is the first wave of retirements for generators affected by the Peaker Rule. As of May 1, 2023, about 1 GW of peaking plants deactivated or limited their operations to comply with the rule, removing critical supply resources from a region that has near negligible incremental generation solutions in the near-to-medium term. While an additional 590 MW of capacity was scheduled to be offline beginning in May 2025 to comply with the Peaker Rule, NYISO has recently announced that this peaking capacity must remain in service beyond their anticipated deactivation dates, albeit temporarily, for reliability purposes.

We expect market conditions to remain tight until at least 2026, which is when we expect the Champlain Hudson Power Express (CHPE)--a 1.25 GW transmission project that imports hydro power from Quebec to NYC--to come online. We also note that CHPE is a summer-only resource (since Quebec is a winter peaking region), meaning it will likely not be able to deliver power during the winter months, which could put upward pressure on winter capacity prices. In earlier commentaries on offshore wind (see Related Research) we have already noted risks to offshore wind projects on the eastern seaboard. Cumulatively, the expected generation output of these at-risk offshore projects, if completed, would represent about 25% of NYC's annual energy demand in 2023.

We believe the positive momentum around capacity prices in the NYISO Zone J is sustainable at least over the next two to three years, if not beyond. This view is largely predicated on the structural makeup of this market, which continues its high level of dependency on thermal generation that is physically located in, or is interconnected to, NYC, with very little power import options.

Our capacity price forecasts for NYISO Zone J place summer 2024 and 2025 around $16/kW-month, with the winter 2024/2025 price around $12/kW-month. Our long-term capacity price for summer (starting 2026) is $12.5/kW-month, and winter 2025/2026 is $6.5/kW-month, though this price moderation could easily shift back by 2-3 years, depending on the progress that is made on CHPE and offshore wind projects.

The Pennsylvania, New Jersey, and Maryland area (PJM) remains an outlier for now. Capacity prices in the past three auctions have declined consistently to uneconomic levels for new build. In addition to the retirements that we noted elsewhere in this commentary, the regional transmission organization (RTO) also projects demand growth of about 1.4% per year in its service territory over the next decade, largely driven by electrification needs. In some individual zones, we forecast PJM load growth to be as high as 7% per year.

On the supply side, the interconnection queue consists primarily of renewables (94%, 290 GW). The historical completion rate of renewable generation resources in the PJM has also been very low, at 5%, which if unchanged would lead to retirements outpacing new entry. Under its low-renewable-entry scenario, PJM estimated that its reserve margins could decline to as low as 5% (from 23% currently). All of these factors lead to a logical conclusion that capacity prices will need to rise, and materially, to ensure reliability is not put at further risk. The novel Capacity Performance Quantifiable Risk (CPQR) scheme should also result in higher clearing prices.

We expect RTO, the Mid-Atlantic area (MAAC), and the Eastern Mid-Atlantic area (EMAAC) to clear around $45/MW-day, $75/MW-day, and $75/MW-day, respectively, for the 2025-2026 auction. The historically constrained eastern PJM could see more upside than the broader clear price. MAAC and EMAAC have cleared modestly but forthcoming retirements with long-term transmission and storage replacements present an upside opportunity. The rated companies with sizable PJM footprints are Vistra Corp., Calpine Corp, Constellation Energy, PSEG Power, and Talen Energy.

Main assumptions about 2024 and beyond

1. Divergence in strategies.

We see the emerging pure-play theme as consistent with companies increasingly diversifying to gain exposure to electrification, renewables, retail, or hydrogen. We see most companies doubling down on emission-free generation, while some companies may pivot away from generation altogether.

2. Supply chain bottlenecks to ease and domesticate.

Solar panel imports were delayed by geopolitical tensions and the implementation of the Withhold Release Order (WRO), the anti-dumping/countervailing duties tariffs (AD/CVD), and the Uyghur Forced Labor Prevention Act (UFLPA). In 2024 we expect the supply chain for solar panels, inverters, batteries, etc. start to domesticate given the favorable subsidies. Transformers continue to dominate equipment supply shortages, while inverters have under-performed.

3. Path of renewable proliferation dominates power market forwards.

Renewable proliferation continues to have two drivers: 1) The need for energy to replace uneconomic fossil plants retiring; and 2) a temporary increase in renewable PPA prices. Even as cost curves were declining, renewable PPA costs changed course and have nearly doubled since first quarter 2021 due to higher financing costs and continuing supply chains disruptions.

Coal-fired generation got a reprieve but we expect retirements to ensue in 2024. In 2022, against the run of play, tightness of generation supply pressured utilities in the Midwest-ISO (MISO) to extend the retirement dates for several coal plants, including Alliant's Edgewater and Columbia and WEC Energy's Oak Grove retirements being pushed to 2025/2026.

However, in March 2023 the Environmental Protection Agency (EPA) finalized its latest "good neighbor" policies, via its Cross State Air Pollution Rules (CSAPR), setting nitrous oxide (NOX) levels that become more stringent in 2026 and move away from "banking allowances" by 2030. The EPA estimates this could drive 14 GWs (13%) of the current coal fleet to retire by 2030. However, with effluent limitations guidelines (ELG) and coal combustion residuals (CCR) regulations to follow, we think a next large wave of coal-fired retirements by 2027 is likely.

No incumbent utility or power generator is investing new money in coal generation units or coal mines. Coal units are increasingly under-maintained and, with Eastern coal prices moving higher, the economics of coal-fired generation is deteriorating. Rising labor wages, property tax bills, and still-lofty coal prices in the East point to further pressures.

Bottom line, coal retirements will continue, particularly in the PJM region, where capacity clearing prices are too low to keep coal-plants economical and where we forecast at least 24 GW of policy-related retirements. We think the rules that contribute to the largest requirements include about 6.0 GW related to the Illinois Climate & Equitable Jobs Act in 2030, about 4.5 GW in 2026 for EPA's CSAPR rule, 3.5 GW from EPA's ELG in 2028, 2.5 GW from EPA's CCR guidelines in 2027-2028, and 2.5 GW from New Jersey's carbon dioxide rule.

As of November 2023, about 135 GW of U.S. grid-connected coal-fired capacity that existed in 2010 has retired. Another 75 GW have been committed or proposed to retire by 2030. The Midcontinent and PJM regions have the most announced retirements.

We expect U.S. solar Installations to be strong in 2024, despite continuing supply chain constraints. A combination of higher polysilicon and steel prices--that nearly doubled and tripled, respectively--as well as an anti-dumping investigation by the Department of Commerce (DoC), and the implementation of the UFLPA all contributed to stymie growth in 2022 and delay project constructions into 2023 and 2024. Suppliers largely stopped shipping modules into the country during second and third quarters of 2022, but the situation has improved markedly since then.

Our affiliate, IHS Market, estimates that total module imports for the first seven months of 2023 into the U.S. were 28.2 GW, which is already more than the total imports for the full year in 2022. This indicates that module availability has not slowed project development in 2023, leading to an expected doubling in utility-scale solar installations year-over-year.

In August 2023, after an investigation that lasted more than a year, the U.S. DOC confirmed that five companies were circumventing antidumping and countervailing duties. We note that President Biden’s 24-month tariff moratorium protects modules that are imported before June 2024 and consumed before Dec. 3, 2024, which will likely drive installations in the U.S. to about 40 GW in that year. However, once the AD/CVD tariff moratorium expires, the market will temporarily decline because the U.S. depends on Southeast Asian manufacturers for modules, who supplied almost 80% of the market in 2022. We expect installations to pick up once domestic manufacturing scales up in 2026 because of the 10% domestic content bonus.

As a result, project delays will likely be the key determinant for market growth in 2024 and 2025. That said, most companies remain bullish about long-term prospects while acknowledging the realities and pressures of a higher cost of capital.

A tightening electric grid will increasingly value resiliency in 2024. We see reliability risks as the renewables transition accelerates. We've seen reliability issues in the California Independent System Operator (Cal-ISO) and ERCOT regions each year since 2020, because baseload plants have been retired and replaced with intermittent renewables. In our analysis, the Cal-ISO pointed to the potential for 1.7 GW-1.8 GW supply shortage across 2022-2025 in extreme load scenarios even when accounting for its 11.5 GW new resource target. To illustrate the pressures on the grid: on Aug. 14, 2023, Cal-ISO declared a regional transmission grid early emergency alert (EEA) due to high demand and high exports to the desert Southwest. On this day, solar generation declined from a high of 15.5GW at 12:30 pm to less than 0.5 GW by 7:30 pm, requiring gas-fired peaking generation to scramble and plug the drop. In response to the increasing baseload shortage, California has pushed out the closure of the Diablo Canyon nuclear plant by an additional five years from its previously planned shutdown of 2024-2025.

Resource adequacy (RA) prices in Cal-ISO are reflecting the shortage. The worsening of the now notorious "duck curve" has placed emphasis on dispatchable resources, especially natural gas-fired plants, which can quickly ramp up their production to meet demand. This situation also raises an economic challenge, as the less opportunity dispatchable resources have to sell energy into the grid during a day, the less financially competitive they become, which, if unmitigated (for example, via an increase in RA prices), would ultimately lead to shutdowns and retirements.

Another driver that is affecting generation supply in Cal-ISO is the impact from once-through-cooling (OTC) compliance rules, which will remove nearly 4.5 GW of valuable dispatchable capacity from the RA market at the end of 2023. Some portion (about 833 MW) of this capacity will permanently retire, with the remainder being put into CAISO's Strategic Reserve until Dec. 31, 2026, and will only be called upon under extreme events (e.g., heat waves). Reacting to these factors, RA prices in Cal-ISO have risen substantially over the past two-years and are now at unprecedented levels. Aggressive California Public Utilities Commission (CPUC) clean capacity procurement orders and potential non-compliance penalties support strong recourse adequacy prices in the near term. We expect RA prices in the region to be about $10/kW-month through 2030s, compared to RA prices of around $2.5/kW-month, or lower, as recently as 2018.

Meanwhile, electricity demand this summer in ERCOT was well above 2021 and 2022 levels. Each month saw record demand, with August reaching a peak of 85 GW. Still, Texas experienced below-average power outage activity since July. ERCOT has previously warned of 8 GWs of coal shutdowns. As a result, scarcity events have seen meaningful price surges. ERCOT is also at risk of seeing a pronounced California-like duck curve in 2024.

In the PJM we see 40 GWs of retirements between 2022-2040, 60% of which is likely coal-fired. That compares with only 15 GWs of new capacity that we expect to see come online on an effective capacity-adjusted basis (given the majority is renewables). If we add the quickly ramping load growth of 10 GW to 15 GWs driven by data centers and EVs, the PJM could see potential single-digit reserve margins by 2028.

Bottom-line, with baseload supply shrinking and increase in demand from data centers and electric vehicle adoption, renewables/storage additions will need to scale up quickly to preserve reliability. As a sidebar, we note that demand from data centers--which some market participants expect to increase to 7.5% of national electric usage in 2030--could alone meaningfully influence power prices (current usage is about 70 million MWh, or about 2% of national demand).

Offshore wind continues to see a tough environment. We see offshore wind as challenged in the U.S. due to inflation and supply chain pressures and high cost relative to legacy generation. The industry markers we are monitoring in 2024 are the potential for utility sponsors exiting projects, attempts to restructure contracts that were struck in the 2018-2022 timeframe, and progress on frontrunning projects.

Specifically, in 2023 Ørsted canceled Ocean Wind 1 & 2 (2.2 GW in New Jersey) largely on supply chain issues, specifically a delay in monopiles that caused delay. The project was originally targeted for 2025 before the company delayed it to 2026. However, the lack of vessel availability under the new timeframe would have led to recontracting with vendors at significantly higher costs. In Maryland, Ørsted has indicated that Skipjack 1-2 (965 MW) are being reconfigured and likely to be delayed to at least 2026.

Meanwhile, in October, New York utility regulators denied requests to increase the amount of money New Yorkers would have to pay under existing contracts for power to be produced at four offshore wind projects under development. The developers had cited higher inflation, interest rates, and supply chain issues putting final investment decisions (FID) at risk unless inflation and interconnection cost adjustment mechanisms are incorporated into the contracts. The companies said they are reviewing the New York decision before taking next steps on their projects (Ørsted's 924 MW Sunrise Wind, and Equinor/BP's 816 MW Empire Wind 1; and 1,230 MW Beacon Wind). On Jan. 3, 2024, BP and Equinor announced the cancellation of Empire Wind 2 due to cost pressures.

In October 2023, New York state also released the winners of its latest renewables auction (Round 3) that resulted in conditional awards for new offshore wind projects. The New York State Energy Research and Development Authority (NYSERDA) selected three offshore wind projects totaling about 4.0 GW, targeted for a 2030 in-service date. We expect the contracts to be for 25 years, similar to those in Rounds 1 and 2. Notably, the nominal weighted average strike price of about $145.0/MWh is significantly higher than cleared prices for winners in Rounds 1 and 2. New York also initiated the process for an accelerated offshore wind auction, with NYSERDA issuing a request for interest (RFI). An accelerated auction could give earlier round projects a path to cancel the current lower-priced contracts and rebid, as seen in other states. We expect any such moves to result in cancellation fees, both from New York state and the vendors. Because of the reset, the commercial operations dates (COD), which currently are between 2025 and 2028, will also be delayed. We have noted elsewhere in this commentary that these at-risk projects are resulting in higher prices in recent New York capacity auctions.

Despite the setbacks, some projects are pushing forward. Ørsted has made the FID, commenced Revolution (704 MW, in CT/RI), and maintained its 2025 commercial operations date target. If on time, Revolution will be the second-largest offshore wind farm to be in-service behind Avangrid's Vineyard Wind, which we expect to see completely operational in 2024. As of Jan. 4, 2024, five of the 62 turbines were installed and the first one had delivered about 5 MWs of power to the Massachusetts grid.

Meanwhile, Dominion's regulated Coastal Virginia Offshore Wind project (CVOW; 2.6 GW) appears to be on track for 2026. The project has a regulator-approved $9.8 billion budget, with up to $10.3 billion deemed recoverable subject to prudency review; and a 50/50 cost sharing up to $11.3 billion.

Finally, we are watching Siemens Gamesa’s ability to meet future turbine contracts. Several offshore wind projects across the globe are slated to use Siemens Gamesa turbines this decade. These include Ørsted/Eversource's three projects totaling about 1.75 GW, and Dominion Energy’s CVOW, which plans to use 176 14.7 MW turbines.

Up in the Great White North, conflicting positions emerge regarding the energy transition. The government of Canada remains very focused on reducing its targeted greenhouse gas emissions through its proposed Clean Electricity Regulation. While most of Canada’s power grid is non-emitting, provinces more reliant on carbon fueled generation have been pushing back. Their concerns range from the lack of incentives for further natural gas generation to the ability to maintain a stable grid. The government of Alberta recently invoked the Sovereignty Act for the first time, which could be very meaningful. Similarly, the government of Saskatchewan is also looking at no longer collecting the federal carbon levy on electric heat.

At the same time, the power market in Alberta is still transitioning towards lower carbon footprint generation. This should be achieved by having more efficient natural gas-fueled assets and greater renewable penetration. Like other power markets, AESO has highlighted grid reliability as a key concern, with the government pausing the development of further renewables for six months.

In terms of pricing dynamics in Alberta, power prices continue to be very high, with an average of C$150/MWh for 2023, in line with 2022 prices. This was largely due to a combination of factors, including lower supply due to offline facilities, elevated natural gas prices, rising carbon pricing, and load growth. Both Capital Power Corp. (CPC) and TransAlta Corp. have benefited from those robust prices through their merchant exposure. As a result, both companies have made multiple acquisitions over the past year: CPC acquired the La Paloma facility and 50% interest in the Harquahala facility, while TransAlta acquired the remaining public float of TransAlta Renewables Inc. and the entire business operations of Heartland Generation Ltd. We view those acquisitions as modestly strengthening their overall fleet.

Credit metrics and financial policy

We expect ratios to strengthen from levels we expected in 2022 and 2021, despite unprecedented prices in first half 2022, partly because several companies were negatively affected by weather events like Winter Storm Uri and Elliott that slowed deleveraging plans. However, pricing has stayed strong because of rising demand and slower-than-expected increase of renewable generation. We note that debt reduction is still a stated objective for a number of IPPs. In 2021, expectations for aggregate debt/EBITDA and FFO to debt were above 4.0x and 15%. Now some IPPs have targets of adjusted det to EBITDA in the 2.50x-2.75x range and adjusted FFO to debt above 25% on a sustained basis by year-end 2024.

Key risks or opportunities around the baseline

1. Excess cash allocation to organic growth.

We see companies deploying significant proportion of excess cash to organic investments and acquisitions. However, share buybacks will continue to be a priority in 2024.

2. Interest rates will likely decline by year-end 2024 but still present a challenge.

Many companies successfully kept operating and maintenance costs flat, to declining, in recent years, with labor attrition and technology advances offsetting inflation. However, as materials costs stay elevated, these pressures will influence margins in 2023.

3. Supply chain remains disrupted but improving.

With supply of key components still disrupted, focus will be on other avenues of cost reduction. We expect companies that seek to improve their credit profile would continue to cut costs.

We expect to see increasing levels of excess cash allocated to organic growth. We see a potential pivot away from share repurchases in 2024 towards growth capex. The IRA provides incentives for renewables that have led some of the manufacturing base to return to the U.S.

Not unexpectedly, we continue to see significant deployment of capital in new storage and renewable projects. What interests us more is the level of capital spending that companies will direct towards repowering the wind fleet. With a number of installations getting to their decade-old vintage, we see the repowering of wind assets as a necessity, and not an option.

The IRA also increases the value for dedicated storage of CO2 in the power industry to $85/ton, up from $50/ton. The lower capture thresholds--18,750 tons/year instead of 500,000 tons--will expand the number of projects eligible for the tax credits. As a result, we see a spending increase on carbon capture, especially after the U.S. Department of Energy (DOE) Office of Clean Energy Demonstrations (OCED) announced up to $890 million in funding for three projects late December. Coincidentally, on the same day, the Environmental Integrity Project (EIP) issued a report that concludes that the laws and regulations governing the technology are still being developed, and the existing framework is weak to ensure that large-scale sequestration will deliver on the carbon reductions they promise.

Interest rates will likely decline in 2024 but still present a challenge. We expect interest rates to continue to slow acquisitive growth in the sector. In particular, the Yieldco segment is heavily dependent on rates because of the need for external financing of their growth. We expect this segment to continue to lag growth expectations until rates start declining.

We expect lower power prices in 2024 compared to 2023, but most companies are heavily hedged. Natural gas has declined sharply since the start of November 2023, and is down 35%, 19%, and 16% since the start of 2023 for years 2024, 2025, and 2026, respectively. The forward curve is still in contango but now well below $4.0 through 2026. Driving the natural gas move is rising production on better rig efficiency and milder winter weather, pushing inventories above the five-year average level of supply. Commensurate to this decline, power prices have declined too: PJM spark spreads are down about 17% for 2024 and 2025, and about 12% for 2026. While ERCOT power is down modestly, spark spreads in the region have actually remained resilient and expanded as power usage has increased. For instance, demand has been exceptional in ERCOT (incremental 10 GW over past two years). With likely acceleration of demand in 2025-2026 and limited new gas generation in the queue, we see a strengthening unregulated power demand for generators such as Vistra Corp. and Calpine Corp. Regional natural gas demand should increase in 2027 with the latest round of liquid natural gas (LNG) supply reaching in-service as adding to energy price expectations. The pressure from coal-fired retirements and reliability needs also helps power prices nearer-term.

The increase in renewable PPAs should also buttress prices. PJM's congested interconnection queue is adding uncertainty and pushing prices up in the market. Rising land and labor costs have been reported across most markets, adding to projects' capital expenditures--costs that developers are largely passing forward in PPA prices. Industry headwinds make it unlikely PPA prices will go down substantially anytime soon. At the same time, buyer demand for PPAs remains high due to pressure on corporations to decarbonize their energy usage.

Related Research

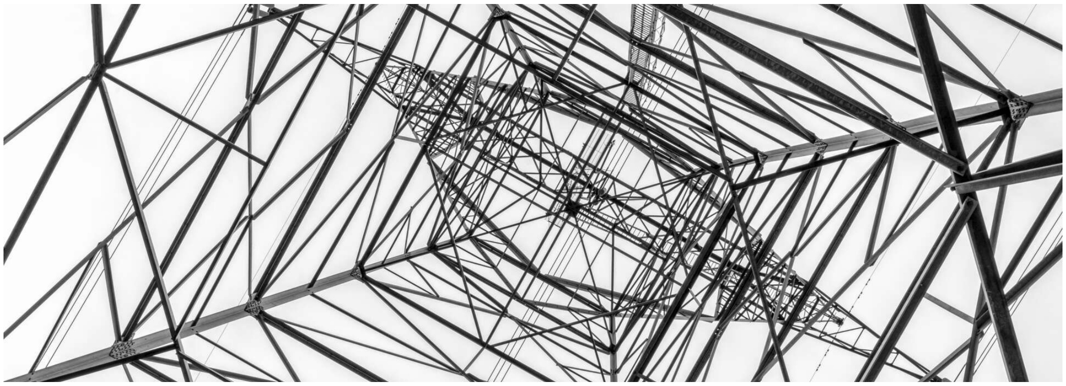
- Credit FAQ: From Coal To Hydrogen: An Energy Math Primer, Nov. 1, 2023
- Step Up Transformers: How Will North American Power Producers Adapt To An Evolving Grid?, Sept. 14, 2023
- What's A U.S. Nuclear Power Plant Really Worth?, April 13, 2023
- Issuer Ranking: North American Merchant Power Companies, Strongest To Weakest, April 13, 2023
- The Energy Transition: Offshore Wind Picks Up, Sept. 20, 2021

North America Regulated Utilities

Credit quality remains pressured

January 9, 2024

This report does not constitute a rating action.



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What's changed?

Expansion of wildfire risks across Western North America.

Common equity issuance was significantly below our base case expectations.

Credit quality erosion. For the fourth consecutive year, downgrades outpaced upgrades. It is conceivable that 2024 may be the fifth.

What are the key assumptions for 2024?

High capital spending for North America's investor-owned regulated electric, gas, and water utilities.

Robust dividends at about $45 billion, reflecting a dividend payout ratio of about 60%.

Consistent access to the capital markets is necessary for the industry to fund its debt maturities and cash flow deficits.

What are the key risks around the baseline?

Timely recovery of prudently spent capital and operation and maintenance (O&M) costs is necessary for the industry to maintain credit quality.

Minimal financial cushion. About 35% of the industry is operating with limited ability to absorb unexpected events beyond their base case.

Inflation. S&P Global's economists expect the consumer price index (CPI) to decrease to below 3% by year-end 2024.

Ratings Trends: North America Regulated Utilities

Chart 1

Ratings distribution

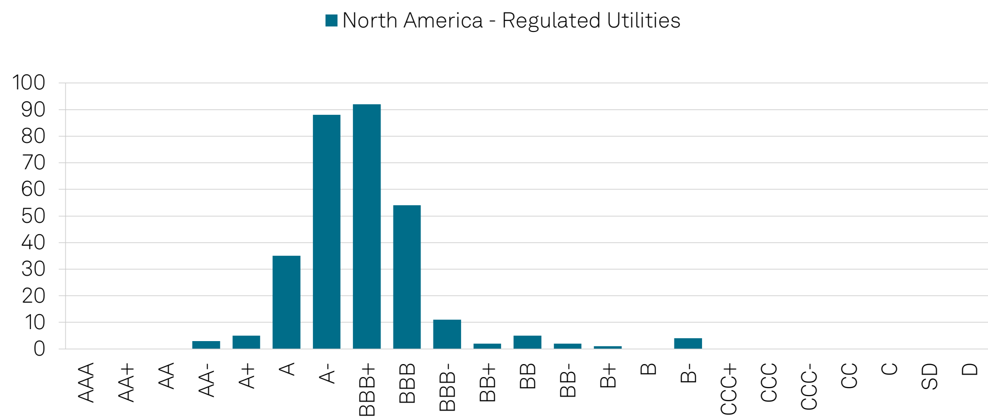


Chart 2

Ratings outlooks

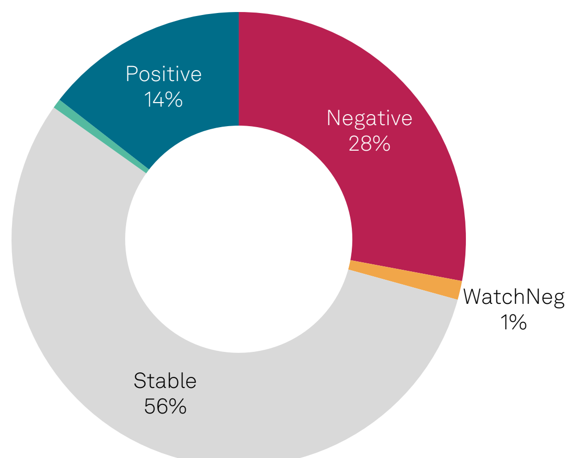
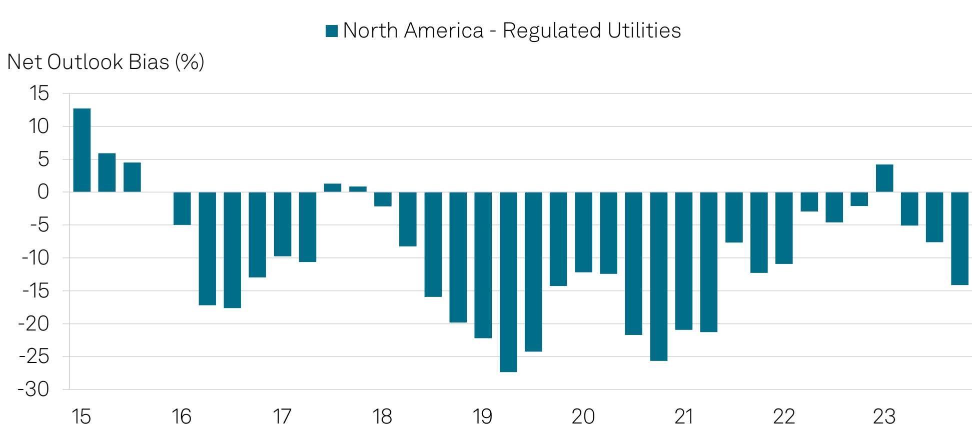


Chart 3

Ratings outlook net bias



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

Industry Credit Metrics: North America Regulated Utilities

Chart 4

Debt / EBITDA (median, adjusted)

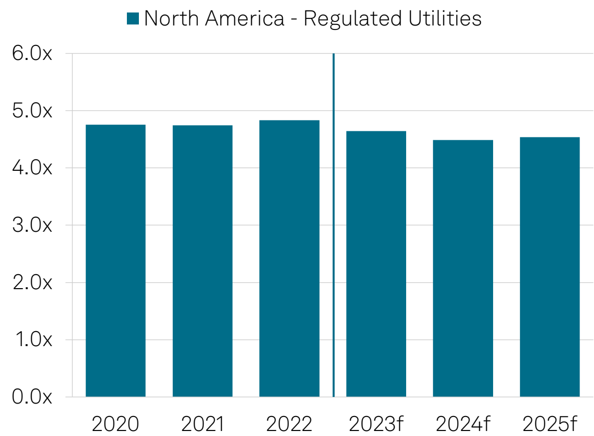


Chart 5

FFO / Debt (median, adjusted)

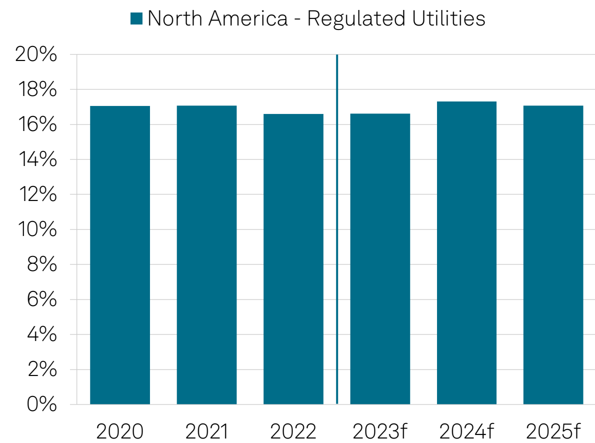


Chart 6

Cash flow and primary uses

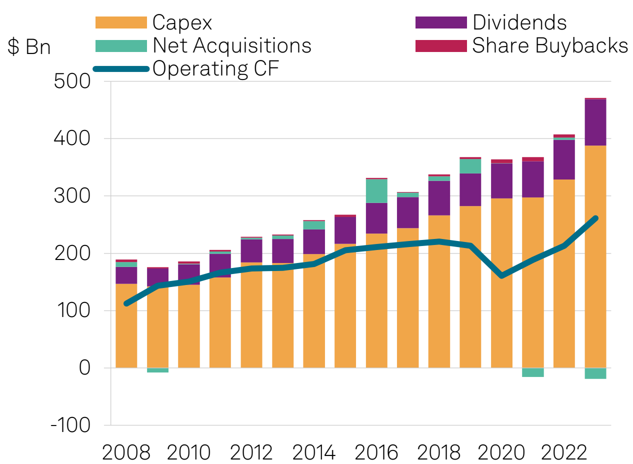
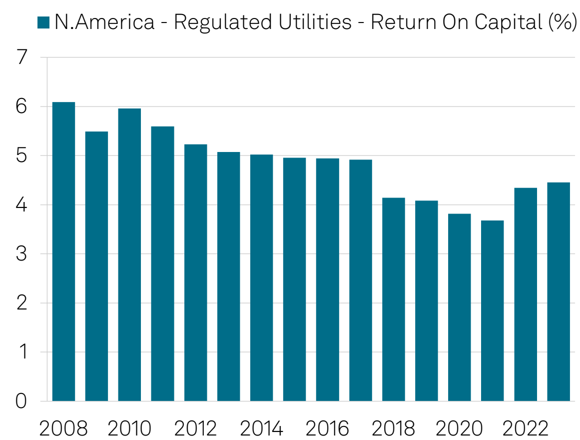


Chart 7

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
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. Most recent (2023) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

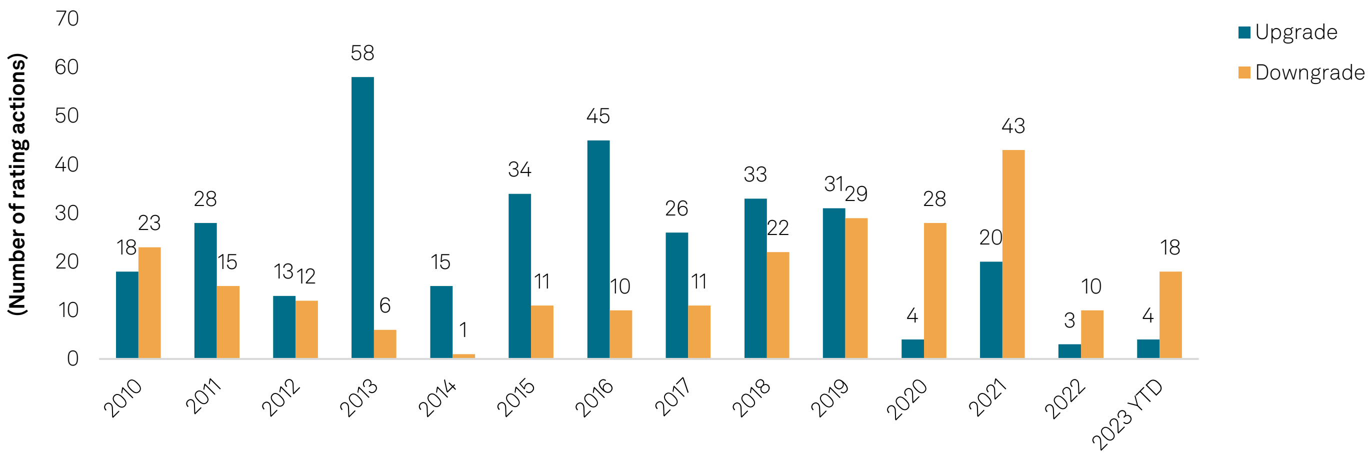
Industry Outlook

Ratings trends and outlook

For the fourth consecutive year downgrades significantly outpaced upgrades by more than 3:1 (see chart 8). Most of the 2023 downgrades were directly attributable to rising physical risks and rising leverage because of robust capital spending. We expect 2024 will remain challenging for the industry's credit quality, given the relatively high percentage of negative outlooks.

Chart 8

North America regulated utilities upgrades and downgrades



YTD—Year to date. Data as of Dec. 12, 2023. Source: S&P Global Ratings.

Main assumptions about 2024 and beyond

1. Climate change

Climate change is increasing the frequency of extreme and devastating hurricanes, storms, and wildfires, which is heightening credit risks for North America's investor-owned utilities (IOUs).

2. Record capital spending

While the industry's robust capital spending is necessary for prudent investments in safety, reliability, and energy transition, it is directly leading to high cash flow deficits. If these deficits are not funded with debt and equity in a balanced manner, credit quality will likely weaken.

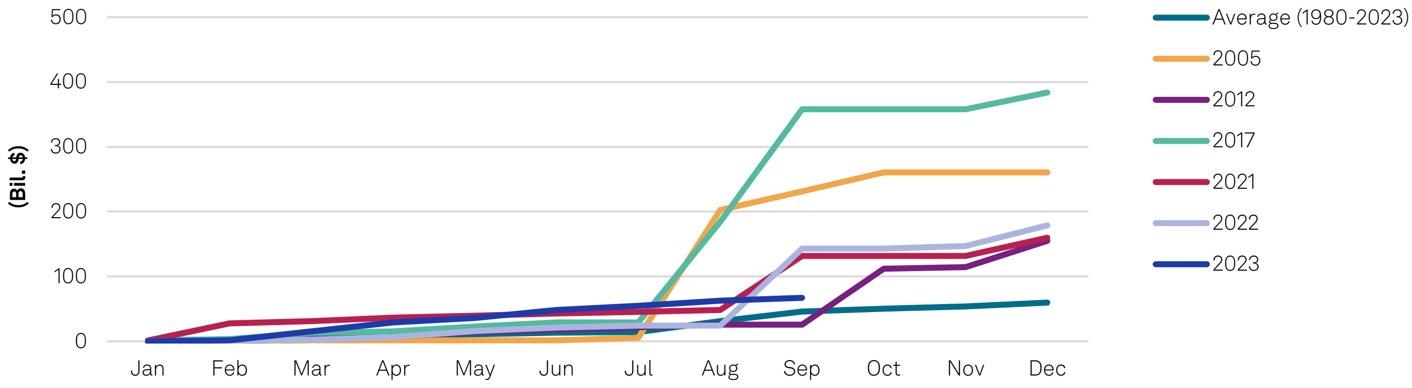
3. Management of regulatory risk

Given the significant capital spending, effective management of regulatory risk is important for the industry's credit quality. This includes constructive rate case orders, minimizing regulatory lag, earning its authorized return on equity, and managing the customer bill impact.

Utilities' exposure to physical risks is increasing. According to the National Oceanic and Atmospheric Administration (NOAA), on an inflation-adjusted basis, 2021 and 2022 represent two of the top five most destructive years for extreme weather events since 1980 (see chart 9). Our base case assumes these trends will persist, magnifying physical risks for the utility industry.

Chart 9

U.S. billion dollar weather disaster year-to-date event cost (CPI-adjusted)



Source: National Ocean and Atmospheric Administration.

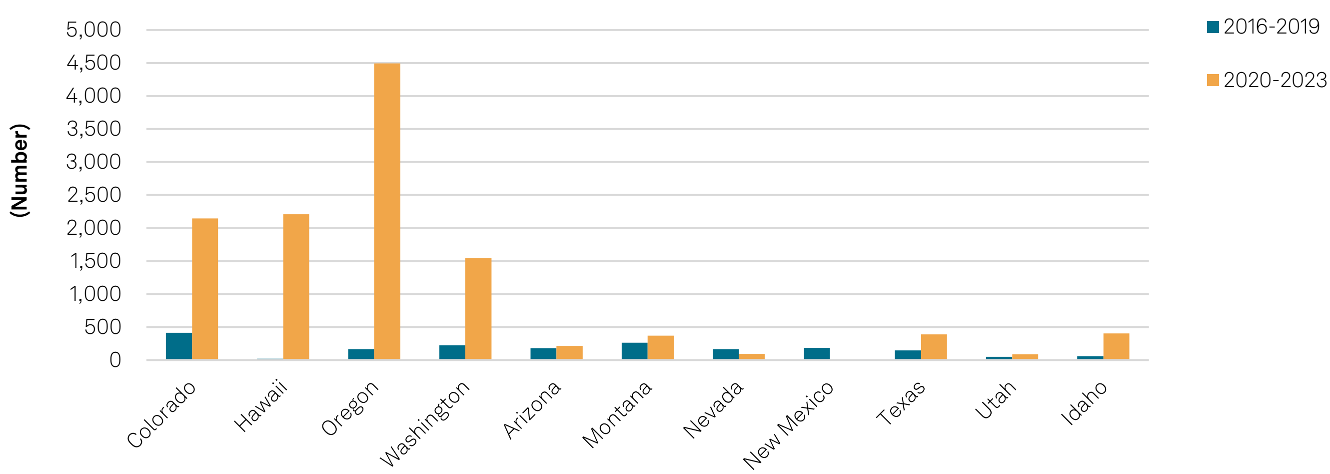
Warmer temperatures increase the humidity, leading to stronger winds and more-devastating tropical storms and hurricanes. Also, drier and hotter weather is a primary cause for more-severe wildfires--as temperatures rise, the vegetation dries up and the landscape becomes more combustible. When high winds are added, the probability of a catastrophic wildfire significantly escalates. As such, areas designated as high-fire-risk have grown across the U.S. This is already taking a toll on credit ratings.

For example, during 2023 we lowered the ratings on Hawaiian Electric Industries Inc. by multiple notches after the most destructive wildfire in Hawaii's history, with nearly 100 fatalities and about 2,200 structures damaged or destroyed. Also during 2023, an Oregon jury awarded 17 plaintiffs in a 2020 wildfire-related class action lawsuit against PacifiCorp about $5.3 million per plaintiff, which was materially above our base case of about $1 million per structure. The jury also found that a broader absent class affected by the fires could bring claims against the company. Accordingly, we downgraded PacifiCorp by two notches and revised the outlook to negative.

Furthermore, since 2020 the number of structures destroyed by wildfires in Colorado, Hawaii, Idaho, Oregon, Washington, and Texas increased by more than 100% compared to the 2016-2019 period (see chart 10). Meanwhile, Arizona, Montana, and Utah have each experienced increases of at least 20% over the same timeframe.

Chart 10

Structures destroyed by wildfires



Source: Headwaters Economics and National Fire and Aviation Management FAMWEB.

Wildfire mitigation plans. In light of these trends, we expect IOUs--especially those in the western U.S.--will develop detailed wildfire mitigation plans that reduce damages, minimize litigation risk, and expand capabilities for cost recovery. While it may take considerable time and investments for the industry to fully implement these strategies, the solutions are largely predicated on already-developed and in-use technologies.

System hardening is one investment that improves resiliency, reducing damages and risk. Because our modern economy is so dependent on electricity, system hardening also allows for the faster restoration of operations, decreasing total economic impacts. While system hardening is often expensive and can take many years to fully implement, its long-term benefits typically outweigh its shorter-term costs. Examples include undergrounding powerlines, adding cover conductors--which is the insulation of bare electrical wires with durable long-lived materials that reduce the probability of an electrical fault or spark--and replacing wood poles with steel and concrete.

To reduce the likelihood of a catastrophic wildfire, many utilities have incorporated weather stations that collect data to forecast weather conditions, including high-wind events. Some have incorporated artificial intelligence (AI) and machine learning into their data analysis, high-definition (HD) cameras, satellite and aerial imaging, remote sensing, and drones to enhance their forecasting capabilities. Utilities have also improved communication with state agencies and fire departments, coordinating specific locations that have either encountered or could be highly susceptible to a wildfire.

Critical to reducing wildfire risks is the implementation of a public safety power shutoffs (PSPS) program. PSPS is the proactive de-energizing of power lines in extreme weather conditions, especially in high-wind events. The decision to de-energize is extraordinarily challenging because it could have serious health and safety ramifications for some customers. Accordingly, an effective PSPS program establishes a consistent protocol when drastic measures are required that is approved by regulators and adequately communicated well in advance of the event. We view a PSPS program that establishes such a formal process as credit-supportive for IOUs.

Another crucial component of wildfire prevention is vegetation management, which is the removing or modifying of live and dead vegetation to reduce the potential ignition and spread of wildfire. This ongoing maintenance is essential for reducing the likelihood of debris coming in contact with powerlines, causing a spark that could lead to a wildfire. To further reduce wildfire risks, utilities have implemented enhanced power safety setting systems (EPSS) that automatically shut off power within a tenth of a second if they detect a potential ignition source. Such systems include downed conductor detection, early fault detection, open phase detection, and partial voltage force-out.

Because of the different service territories and topographies, we don't expect the strategies implemented by utilities will be uniform. As such, we expect utility wildfire mitigation plans will be customized but with the consistent goal of reducing risk.

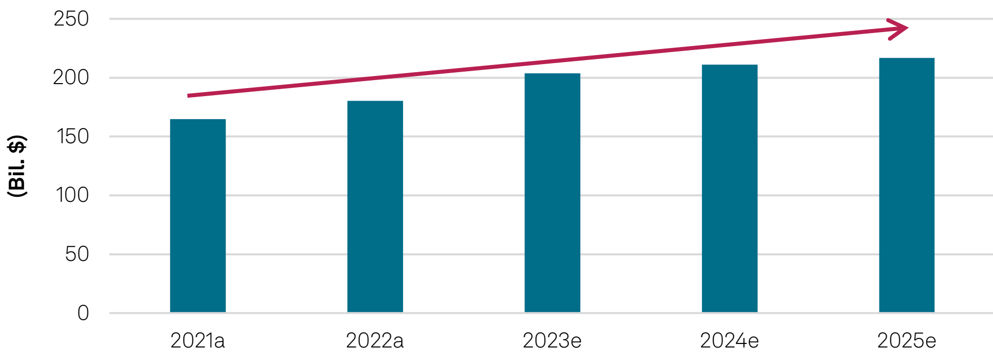
Litigation risk. Because utilities operate under potentially hazardous conditions that include safety as well as environmental risks, they have always been susceptible to litigation. However, in recent years, as the climate changes and wildfires increase, litigation and class action civil lawsuits against utilities have intensified. Currently, plaintiffs have filed civil lawsuits against nine utilities because of wildfires. Additionally, an increasing number of class action lawsuits have been filed against water utilities regarding PFAS (per-and poly-fluoroalkyl) contamination. Should the industry's litigation risk continue to increase, credit quality would likely suffer.

Securitization. More recently, utilities have increased their use of securitization, which we assess as supportive of credit quality. Securitization allows for the issuance of debt secured by a non-bypassable charge to the customer's bill, allowing the utility to fully recover its costs at a lower interest rate for customers. Because the debt is secured by the high likelihood of customers paying their bills, the associated interest costs are typically lower. We often deconsolidate such debt, resulting in stronger IOU credit measures.

Record capital spending. The industry's capital spending on safety, reliability, and energy transition continues to grow at record levels. We expect the 2023 capital spending for North America's electric, gas, and water utilities to approximate $205 billion and rise to about $210 billion and $215 billion in 2024 and 2025, respectively (see chart 11). Under our base case, we expect that the industry's capital spending will continue to grow for at least the next decade.

Chart 11

North America regulated utilities' rising capital expenditures



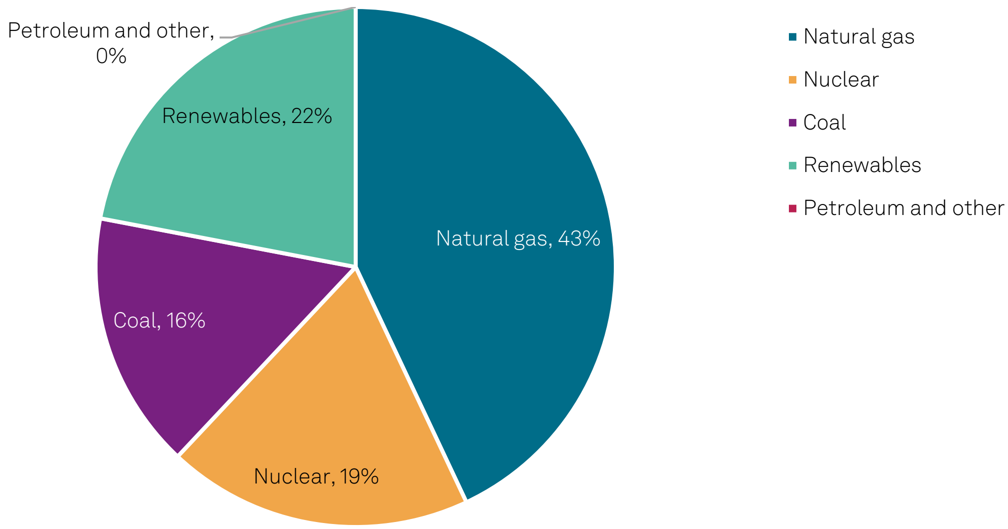
a—Actual. e—Estimate. Data as of Nov. 8, 2023. Capital expenditures represent North American investor-owned electric gas, and water utilities. Source: S&P Global Ratings.

Energy transition. The industry's reliance on coal generation has decreased by about 60% over the past decade, and we expect the vast majority of North America's IOUs will close their remining coal generation by 2035. This transition will reduce the industry's environmental risks but also requires a thoughtful multi-decade strategy to expand renewable energy and battery storage, while simultaneously aligning depreciation and the retirement of coal generation to avoid stranded assets.

Renewable energy will eventually account for more than 50% of the industry's generation portfolio. While renewable energy only accounts for about 25% of the industry's electric generation portfolio, over the next decade renewable energy will likely double (see chart 12). The industry's funding of renewable energy will benefit from the Inflation Reduction Act (IRA), which includes significant tax incentives for renewable energy and permits for the transferability of such credits. Transferability allows tax credits that cannot be used on a company's own consolidated tax return because it has insufficient income to be transferred to a third-party. We expect the IOUs will be among the primary beneficiaries of these tax credits. Ultimately, we expect utility regulators will mandate that transferred tax credits are refunded back to customers, and as such we expect the growth of renewable energy will likely be less impactful on the customer bill.

Chart 12

2023 U.S. generation (through August)



Data as of Dec. 12, 2023. Source: U.S. Energy Information Administration.

Inflation. Although the rate of inflation has slowed from 2022 levels, it remains elevated relative to historical levels. We anticipate this will result in higher O&M costs that could weaken financial performance. While some utilities have interim mechanisms that reduce the regulatory lag, most will have to file rate cases on a more frequent basis should inflation remain high over the longer term.

Because of rising costs and higher capital spending, rate case filings have significantly increased. In 2019 and 2020, U.S. annual rate case filings averaged about $6 billion but have since increased by 2.5x to an annual average of about $16 billion. This elevates the industry's reliance on managing regulatory risks. Additionally, because about 35% of the industry is managing with only minimal financial cushion--reflecting funds from operations (FFO) to debt that is less than 100 basis points above the downgrade threshold--the ability to absorb unexpected events beyond their base case is limited. Accordingly, should rate case filings be delayed or rate case orders be less than constructive, financial performance and credit quality could weaken.

Effective management of regulatory risk. We assess all of North America's regulatory jurisdictions as credit supportive or better, reflecting the industry's generally stable and predictable cash flows (see chart 13). Over the past decade, most of the industry has implemented some combination of decoupling, formula rate plans, forward test years, multiyear rate cases, interim rates, and regulatory riders to significantly improve cash flow stability while minimizing regulatory lag, which is the timing difference between when a utility incurs costs and when it's recovered from ratepayers. Our view of the industry's regulatory constructs supports the industry's mostly investment-grade ratings despite the industry continuing to operate with material cash flow deficits.

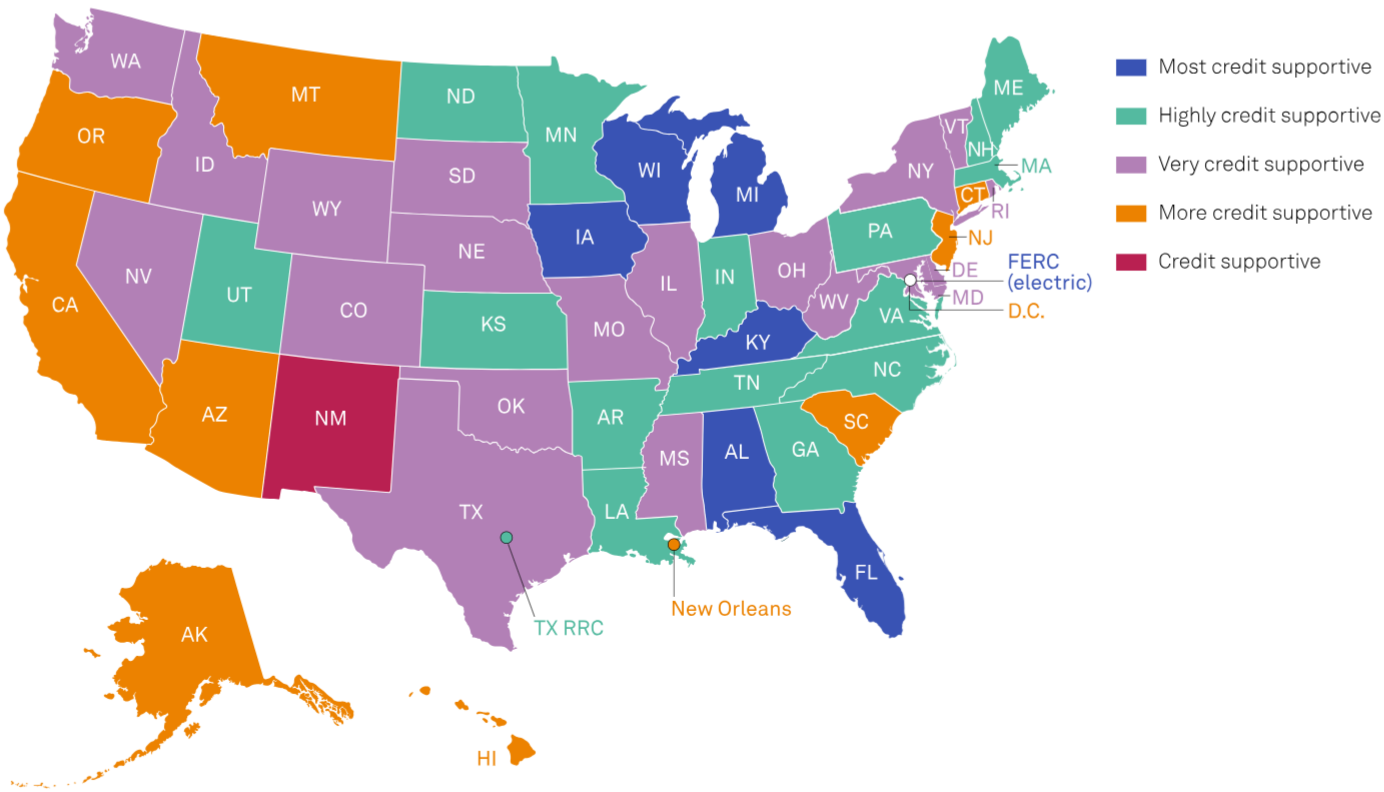
To manage regulatory risk, the industry must maintain the affordability of the customer bill. While the average U.S. electric bill accounts for less than 2.5% of the median U.S. household income, the 2022 average electric bill increased by about 13% primarily because of rising commodity prices. In 2022, the average monthly price for natural gas was $6.40/MMbtu, or nearly double the average price for the prior 13 years. Subsequently, prices have retreated to about $2-$4/MMbtu. Had commodity prices remained high, we believe it would have weakened the industry's ability to manage regulatory risk, pressuring credit quality.

In 2023, several utilities experienced negative regulatory developments that could be indicative of longer-term risks. For example, earlier in 2023 we revised the outlooks on most of Ontario's local distribution companies (LDC) regulated by the Ontario Energy Board to negative, primarily reflecting the increasing regulatory lag associated with transmission costs and wholesale market rates. The lag affected the LDC's earned return on equity and financial performance.

Chart 13

Regulatory assessment by state

As of November 2023



Source: S&P Global Ratings.

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More recently, we revised the outlooks on most of Connecticut's utilities to negative, reflecting the possibility of less cash flow predictability. In June 2023, Senate Bill 7 was signed into law, which gave Connecticut's Public Utilities Regulatory Authority (PURA) greater latitude in determining whether companies over-earn, prohibits PURA from reauthorizing the electric system improvements charge, and allows PURA's discretion over the use of decoupling. We believe this law decreases utilities' cash flow predictability and increases regulatory lag. Additionally, recent 2023 PURA rate orders for Aquarion Co. and The United Illuminating Co. (UI) significantly deviated from our base case expectations, increasing regulatory lag for these utilities. These rate orders did not approve the multiyear rate plans filed, and included material disallowances, penalties for UI, and below-average returns on equity. Should these risks persist, it could result in an increase of regulatory lag and a weakening of utility cash flow predictability for all of Connecticut's regulated utilities, which would be negative for credit quality.

Credit metrics and financial policy

Despite our expectations that the industry's 2024 capital spending will increase to about $210 billion, we expect generally consistent financial measures, reflecting FFO to debt of about 15%. Our base case is predicated on the industry funding its approximate $85 billion of cash flow deficits with about $40 billion in asset sales and equity issuance. For 2023 the industry's actual equity issuance was considerably below our expectations, resulting in weakening of financial performance. Should this trend persist in 2024, it would likely pressure credit quality.

Key risks or opportunities around the baseline

1. Interest rates stabilize.

Since 2022, rising interest rates have increased costs for North America's IOUs, weakening financial performance and credit quality. Our economists expect federal funds rate will peak in 2023 and then modestly decrease in 2024. Accordingly, we generally expect that as interest rates stabilize it will put less pressure on IOU's financial performance and credit metrics.

2. Sales growth will return.

Electricity sales growth stagnation has challenged the North America investor-owned electric regulated utility industry's ability to manage regulatory risk and credit quality. Over the next three years we expect sales growth trends to improve.

3. Complex projects increase risk.

During 2023, several offshore wind projects were delayed or canceled because of rising costs for these more challenging projects. To maintain credit quality, we generally expect the industry will focus on lower-risk and smaller projects.

Interest rates. IOUs have considerable near-term debt maturities that must be refinanced, and rising discretionary cash flow deficits that are mostly fund with debt. Because of regulatory lag, rising interest rates weakens financial performance. S&P Global economists expect the federal funds rate will peak in 2023 at about 5.5% and then modestly decrease to about 5.3% in 2024. Accordingly, as interest rates stabilize it will put less pressure on the industry's financial performance.

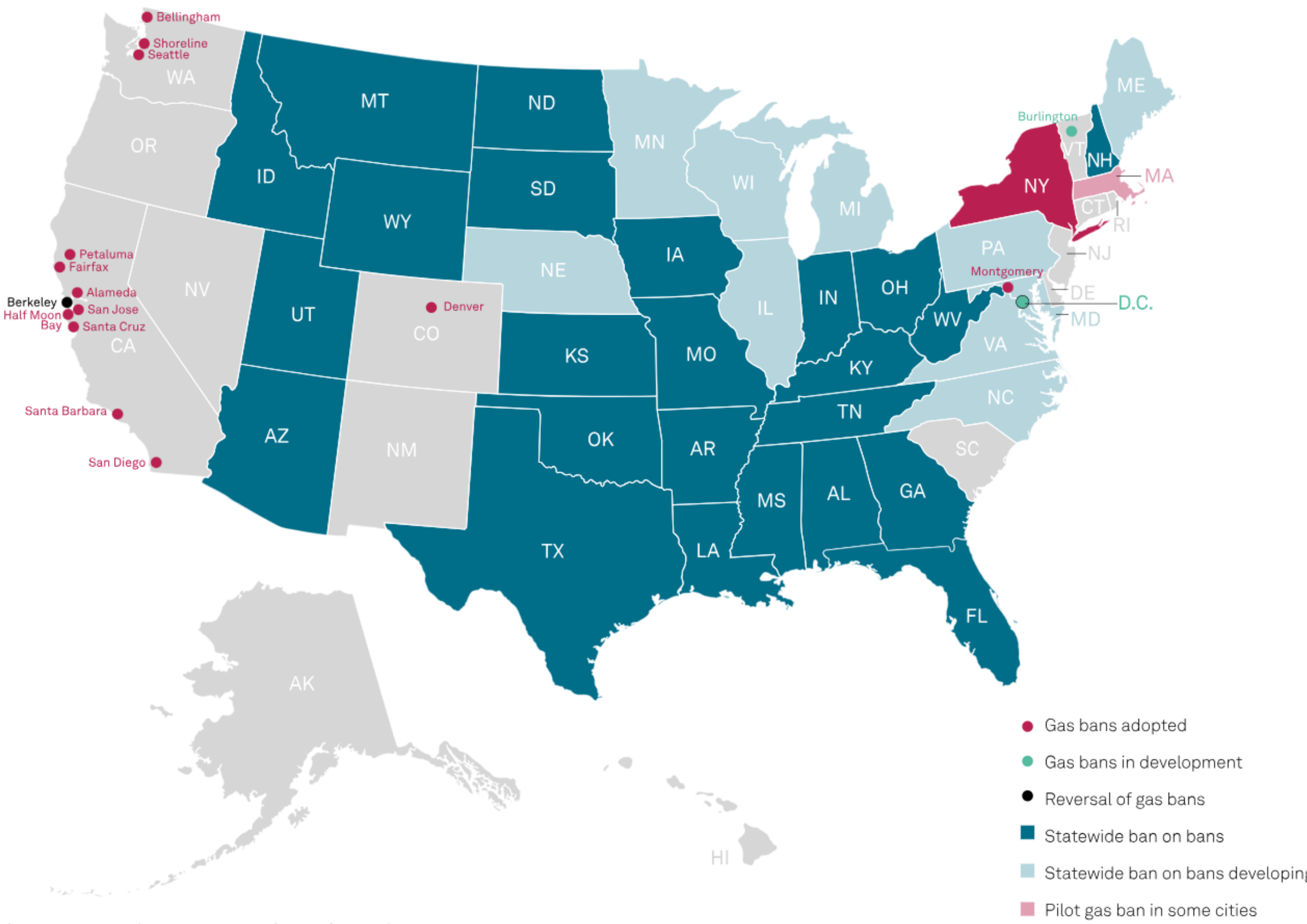
Spreads narrowing. Despite the 10-year treasury increasing by about 300 basis points over the last three years to about 4.5% from about 1.5% at year-end 2020, the average authorized return on equity has essentially remained flat at about 9.5% over this same timeframe. The narrowing of this spread directly affects the industry's financial performance. Most IOUs employ double leverage, issuing significant debt at both the holding company level and at the operating utility. The industry is reliant on cash flows from its operating utilities to service its debts at the holding company. As these spreads narrow, financial performance weakens, pressuring credit quality.

Sales growth. Electricity sales growth has been flat to negative over the past decade because of conservation, challenging North America's IOU's credit quality. Sales growth increases revenues, EBITDA, and FFO without necessitating a rate increase. This enhances the industry's capacity to maintain its financial measures without depending on a regulator's consistently constructive rate case order. We expect sales to grow in the short term, driven by the onshoring of manufacturing and data centers, and over the medium-term because of increased electrification and electric vehicles. Overall, we view this development as supportive of the industry's credit quality.

Full electrification. We expect the longer-term credit quality for some natural gas local distribution companies (LDC) will become increasingly challenging, especially for utilities that operate in warmer climates or whose cities/states have banned new gas connections, severely limiting the growth of the natural gas LDCs. While most of the city bans have occurred in the Western U.S. states, in 2023 New York State banned natural gas and other fossil fuels in most new buildings (see chart 14). Offsetting some of this risk is that a near-majority of states have imposed a ban on the ban of new gas connections. Furthermore, gas LDCs are attempting to reduce their environmental risks by decreasing their carbon footprint through investing in renewable natural gas, blending hydrogen, and initiating various hydrogen infrastructure projects.

Chart 14

Ban on new gas connections



Source: Natural Resources Defense Council.

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Technology. The industry generally embraces technology to reduce its O&M costs by leveraging in-use technologies, a practice we view as generally prudent. Examples include the industry's wide use of drone technology that reduces the cost of pole and wire inspections; battery technology, which reduces fuel costs; and advanced metering infrastructure, which reduces labor costs.

Currently, many gas LDCs and electric generation utilities are testing the blending of hydrogen with natural gas to further reduce carbon emissions. Many of these pilot programs are looking to reduce the cost of hydrogen and are testing the maximum allowable hydrogen that would be compatible with downstream appliances. We expect the industry will benefit from hydrogen tax credits or other government grants allowed under the IRA, likely incorporating about 5%-10% of hydrogen by 2035.

However, periodically the industry invests in higher-risk larger projects that rely on newer technologies, often resulting in a weakening of credit quality. For example, while Southern Co.'s recent commercial operations of nuclear power plant, Vogtle Unit 3, was a significant achievement, we already downgraded the company by two notches since it began pre-construction activities in 2009, reflecting the higher construction risks associated with this complex project. Also, we expect Ørsted--which partnered with many U.S. utilities to build offshore wind in the U.S.--to write-off as much as $6 billion associated with these higher risk projects. Additionally, we downgraded Eversource Energy by two notches since it announced its offshore wind power generation joint venture, reflecting the higher risks associated with this newer technology and longer-term project. Overall, we expect the industry will reduce its technological risks by generally maintaining its focus on smaller and lower risk projects.

Alternative minimum tax. The IRA of 2022 includes a 15% corporate alternative minimum tax (AMT) that we expect will weaken the financial measures of about 10% of the utility industry. The AMT is only applicable to corporations with at least $1 billion of income. Most fully integrated large utilities with a growing or significant renewable generation portfolio will generally be able to use the renewable tax credits to minimize or eliminate the AMT. However, the financial measures of large electric transmission and distribution utilities, gas LDCs, and large water utilities could all be weakened by the AMT.

Cybersecurity. The recent 2023 suspected cyberattacks against water and wastewater treatment facilities in Texas and Pennsylvania underscores the industry’s ongoing cybersecurity risks. Because critical infrastructure assets tend to have higher exposure, the industry’s ongoing vigilance in this area is critical to maintaining credit quality.

Municipalization. Municipalization is the transferring of a privately owned utility to a public ownership. While such occurrences are infrequent and rare, in 2023 two ballot proposals explored these options. In both instances, the city of El Paso, Texas, and the state of Maine soundly rejected such proposals. Other cities, including San Diego, continue to explore these alternatives and we will continue to monitor these developments, including their impact on credit quality.

Related Research

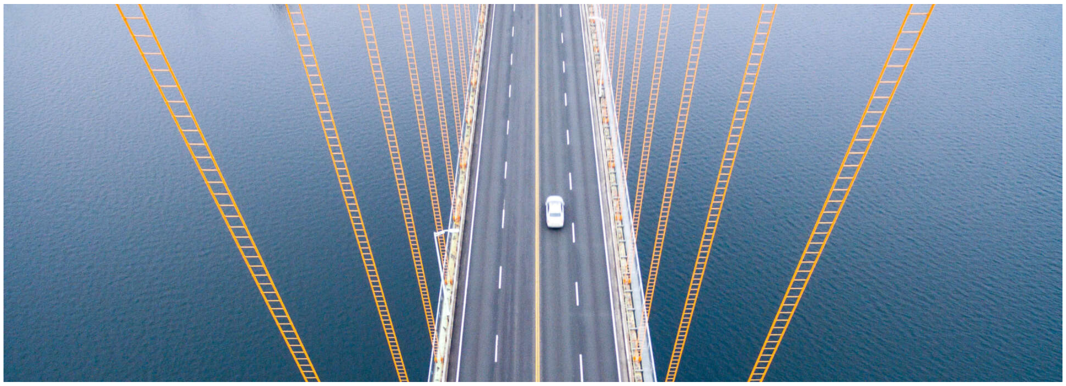
- North American Utility Regulatory Jurisdictions: Some Notable Developments, Nov. 10, 2023
- A Storm Is Brewing: Extreme Weather Events Pressure North American Utilities' Credit Quality, Nov. 9, 2023
- Regulatory Friction Is Constraining Cost Recovery For North American Investor-Owned Utilities, Nov. 6, 2023
- Plugged In: How EVs Supercharge Growth For North America's Investor-Owned Electric Regulated Utilities, Oct. 31, 2023
- A Closer Look At The Three Major California Investor-Owned Electric Utilities Amid The 2023 Wildfire Season, Oct. 24, 2023
- Credit FAQ: What's Behind Our Recent Actions On Investor-Owned Utilities In Connecticut?, Sept. 28, 2023
- Record Capex Fuels Growth Along With Credit Risk For North American Investor-Owned Utilities, Sept. 12, 2023
- Although Commodity Costs Are A Pass Through For Utilities, They Still Affect Credit Quality, Sept. 6, 2023

Transportation Infrastructure

Moderate traffic growth despite affordability risks

January 9, 2024

This report does not constitute a rating action.



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What's changed?

For now, pent-up travel demand outweighs affordability risks. Volumes for most transportation assets continue to increase despite a material rise in user fees and an erosion in disposable income. This has helped transportation assets recover to pre-pandemic levels.

Supply chains have normalized, and most countries should resume investments. However, the construction industry is still grappling with high costs, labor availability, rising interest rates, and liquidity risks.

What are the key assumptions for 2024?

Continued revenue growth is led by inflation-linked tariff increases. Companies should be able to pass through inflation to tariffs, translating into more typical financial metrics.

Limited demand impact despite low economic growth. Traffic growth will likely slow compared to the pandemic recovery as economic conditions hit consumers' wallets.

Pressure on free cash flow from high real interest rates and increased financing costs.

What are the key risks around the baseline?

Recession and affordability risks. A weaker economic performance than we currently forecast could weaken disposable income and travel demand, as well as goods transportation.

Geopolitical tensions. An escalation or spillover effects of the Russia-Ukraine war, Israel-Hamas conflict, or China-U.S. tensions could weigh on global trade, commodity prices, and travel.

Hike in real interest rates and credit spreads. We expect a prolonged period of elevated interest rates, but an additional hike in interest rates or worse financing conditions are key risks.

Cross-Sector Outlook

We continue to expect the majority of infrastructure issuers to continue to pass through inflation into their tariffs. We think this raises affordability risks after two years of elevated inflation and slower economic growth in most countries. We expect the transportation infrastructure sector's operating margin to remain stable or improve as inflation eases and revenue grows.

We forecast traffic growth to slow, aligned with historical pre-pandemic elasticity to each respective country's GDP, following a full pre-pandemic recovery for most assets as of 2023, with transit an outlier in the U.S.. At this point, we don't expect a significant negative impact on global trade and air traffic due to increased global geopolitical tensions, including the Israel-Hamas war, Venezuela's territorial dispute with Guyana, the persistent U.S.-China tensions, and the Russia-Ukraine conflict. Still, we see downside risk to investment appetite, global trade, and traffic stemming from the potential escalation of these events.

Delayed monetary easing will pressure financing costs for new investments and refinancing risk. Even though many infrastructure issuers took advantage of low interest rates in 2022 to refinance and extend debt maturities, prolonged elevated real interest rates and higher financing costs will weigh on capital spending and higher debt service costs.

Capital expenditures (capex) and debt issuance are tepid but gaining steam, as many companies will increase spending to facilitate growth globally.

Industry Outlook: Airports

Ratings trends and outlook

Over 85% of our rated portfolio (including U.S. and Canada public finance) has a stable outlook, mainly because passenger volumes are close to or have exceeded pre-pandemic levels. While we forecast slower growth compared to the recovery after the pandemic's peak, a higher baseline of traffic will support stronger cash flows in line with the sector's historical EBITDA margin performance above 50%. This should help mitigate higher interest rates so that credit metrics remain commensurate with issuers' current rating levels.

Lower GDP growth prospects and high inflation will pressure consumers' disposable income, but we still expect pent-up demand to drive passengers’ willingness to travel in 2024.

Main assumptions about 2024 and beyond

1. Passenger traffic still growing

We expect demand growth to slow given that passenger volumes have reached pre-pandemic levels. We now expect volumes to grow in line with historical correlation to GDP.

2. Execution of capex plans

Many airports that deferred investment plans--both maintenance and expansion--to maintain financial flexibility during the pandemic will now have to resume them at higher costs due to inflation and expensive financing conditions.

Asia-Pacific passenger numbers are close to or have exceeded pre-pandemic numbers in most markets, and retail revenues are rising in tandem. However, airline capacity and labor shortages remain a potential brake on growth in some markets. Capex will expand in many countries in the next one to two years, and some airports have resumed paying dividend distributions. This will offset some of the improvements in metrics.

Australia and New Zealand: Our base case remains that full passenger recovery could happen by fiscal 2025 at most airports. Airlines are adding back capacity, which should boost recovery. Pacific airports reap benefits from their strong property inflation-linked rentals and car-parking facilities. However, inflation and higher interest rates are a drag on the economy and could pinch consumer demand--we factor this into our base-case expectations. EBITDA margins will keep improving and inch toward pre-COVID-19 levels in the next 12-24 months. We expect some airports to undertake sizable capex after a couple of years of deferrals and low spending.

Hong Kong: We think revenues and margins will improve over the next 12 months. We estimate passenger numbers will return to pre-pandemic levels by the end of 2024. This recovery will drive both aeronautical and retail revenue growth in 2024. We expect capex to fall after the completion of the Hong Kong International Airport's Terminal 2 expansion by 2024.

India: Passenger traffic has already exceeded pre-pandemic levels for both international and domestic. Margins should return to pre-COVID-19 levels by at least fiscal 2025 (ends March 31, 2025), if not earlier. Margins should also benefit from an increase in retail space and offerings following the completion of terminal expansions this year.

South Korea: At Incheon International Airport, operating performance and financial metrics are likely to improve over the next 24 months, backed by a faster recovery in passenger traffic than we expected. We anticipate a full recovery in traffic to pre-pandemic levels by the end of 2024, and all revenue streams for the airport--including revenues from duty-free shops--should recover in the next two years. We expect capex to peak this year and substantially decline in 2025 once the expansion is complete.

In Europe, the rated airports portfolio has performed strongly throughout 2023. Activity has recovered gradually, reinforcing credit metrics. The portfolio now mostly has stable outlooks, which compares positively to last year, when the majority had negative outlooks.

From third- to fourth-quarter 2023, our rated portfolio had passenger traffic of 90% to 105% of 2019's activity during the same period. In terms of segments, business travel--which represented 15% of passenger traffic in 2019--has had a slower recovery and we expect it to recover to pre-pandemic levels by 2025. Short-haul leisure travel has compensated for business travel in some destinations, boosting recovery of domestic airports.

European airports started the pandemic with high leverage, typical of capital-intensive infrastructure assets, which increased further in 2020 and 2021 because most of the rated airports were cash flow negative. Generally, we expect our rated airports to conclude 2023 with adjusted net debt 15% to 20% higher than at the end of 2019. This higher leverage is the main reason our portfolio of European airports is rated one to two notches below pre-pandemic ratings.

In addition to this, some airports now face a backlog of capex that was delayed over the last three years, which they will need to finance at a higher cost. The need to make up for that underspending is likely to delay recovery in credit quality at our rated airports versus recovery of the airlines we rate. (For further information please see "European Air Travel Defies Economic Pressures On Robust Demand," published June 7, 2023.)

We'll continue to monitor the impact of the mobility transition (referring to the shift of traffic and mobility to sustainable transport with renewable sources) on European airports, mostly in terms of long-term growth expectations. We view short-haul flights as more vulnerable, particularly when railway transport is a competitive alternative. France has already restricted short-haul flights when there are high-speed railway alternatives, although the impact was limited because routes banned accounted for only 3% of French domestic flights. Spain is evaluating a similar initiative.

We view long-haul flights as more resilient to the transition given there are no alternatives to them. Ultimately and most likely, we think the mobility transition may fuel more expensive air fares, and we remain uncertain about long-haul flight growth potential over the long term because of users' preferences. For example, according to the 2023 Deloitte corporate travel study, four in 10 European companies and a third of U.S. companies say they need to reduce travel per employee by more than 20% to meet their 2030 sustainability targets.

North American ratings and financial metrics have largely recovered from pandemic lows, along with demand, although there's still some lag in international passengers and the difficult-to-measure domestic business travel. Overall, domestic passenger traffic is robust, and the 2023 U.S. Federal Aviation Administration (FAA) forecast expects annual average growth of 2.7% for next 20 years (including a bump up in 2023). This compares favorably with the FAA 2019 passenger forecast that assumed a lower rate of 1.8% for the same time period due to economic uncertainties and the subsequent impact on demand for air travel.

However, we anticipate some headwinds (see the "Main assumptions about 2024 and beyond" section below). We expect revenue growth will be balanced against increased financing costs and large step-ups in operations and maintenance expenses, as well as renewed capital spending to modernize and expand capacity. Debt capacity returned to very strong levels but remained generally weaker than pre-pandemic levels given increased debt issuance for large capital programs. The U.S. airport industry had approximately $140 billion in outstanding debt as of year-end 2022 (up 9% from 2021 and 17% from 2020), with many large hub airports continuing to issue new-money debt in 2023. Year-to-date, 20 airports across all hub sizes have issued a total of $10.7 billion of debt with an average principal amount of $544 million.

Our economic outlook no longer includes a recession for the U.S. but projects a shallower, more protracted slowdown, which could translate into softening U.S. domestic airline travel. After declining in fiscal years 2020 and 2021 (ending Dec. 31), median growth in passenger traffic was 66% in fiscal 2022, and we expect passenger traffic will fully recover to pre-pandemic levels in fiscal 2024. Airports with high pre-pandemic passenger growth or serving warm weather and leisure domestic destinations generally experienced stronger recoveries than those serving international markets or metro areas more heavily affected by the decline in regional business travel.

Looking ahead to 2024, we will monitor the staying power of airport demand and activity levels. After air travel demand surged in the post-pandemic economic recovery and airfare prices spiked globally, domestic U.S. demand has shown signs of easing from strong 2022 levels, with average annual airfare prices moderating in 2023 compared to 2022. While "revenge spending" after the pandemic's peak triggered economic strength during summer 2023, leisure spending began to level off toward the end of August. This spending pattern has applied to air travel as well.

However, leisure spending levels vary by region, income levels, and even airline. The trend of air travel demand will be a key credit factor because continued growth will support the multitude of rising costs. Conversely, weakening or stagnating demand will challenge management teams to maintain financial margins commensurate with credit quality.

Similarly, we will evaluate North American airlines' growing capital programs. Capital spending to maintain assets or improve long-term capacity has resumed after a short pause. In particular, airport operators have accelerated terminal projects at the behest of airlines scrambling to regain market share. In tandem with its expectation of passenger growth over the next 10 years, Airports Council International-North America estimates U.S. airports have $151 billion of capital needs over the next five years (a 31% increase from the 2021-2025 period), most of which consist of terminal projects. S&P Global Ratings-rated airport issuers have indicated to us that these terminal upgrades or enhancements are critical for them to stay competitive both globally and domestically, to accommodate more airlines and passengers, and to continue toward the industry-stated goal of decarbonization by 2050.

The credit profiles of Canadian airport authorities (CAAs) have stabilized during 2023, although a number of ratings remain below their pre-pandemic levels. Passenger growth for most CAAs recovered to 85%-90% of 2019 levels in 2023. We expect this ratio will reach at least 95% in 2024, while recovery in international and business segments continues to lag the strong rebound in domestic travel to date.

We expect the Canadian economy will slow further in 2024 and forecast growth of 0.8% for the year, before it picks up to 1.4% in 2025. The Canadian economy has cooled rapidly in recent months, and we maintain our view that this is just the beginning of a drawn-out, sluggish growth path for the next several quarters as the cumulative lagged effect of higher interest rates and a slowdown in global demand work through the economy.

We will continue to monitor the possible impact of economic headwinds on demand for air travel. No impact has materialized in passenger volumes so far, and we expect any impact to be temporary and that CAAs will take decisive action to mitigate weaker financial performance, if required. Investment in capex is beginning to increase at a measured pace as CAAs focus on deferred spending and optimizing existing facilities before undertaking larger capital projects. In addition, we expect CAAs to focus on reducing their debt burden to increase capacity for future borrowing needs.

Latin America: Mexico and the Caribbean passenger traffic continues to grow above pre-pandemic levels, still boosted by domestic and short-haul demand to and from the U.S., while Brazil has fully recovered to pre-pandemic levels driven by domestic traffic. Despite inflationary pressure on disposable income, we continue to forecast traffic growth to be aligned with GDP, driven by customers' willingness to travel.

Most of the expansion investments will be concentrated in Brazil and Mexico. We expect investments to construct new terminals in the existing facilities of Guadalajara and Monterrey in Mexico, and to meet the growing unattended demand still stemming from the cancellation of the new Mexico City Airport in 2018, since the existing asset was already saturated. In addition, we expect the execution of investments committed under the new regional airport concessions granted in 2020-2022 in Brazil.

Credit metrics and financial policy

Overall, a combination of increased EBITDA and lower absolute debt contributed to stronger credit metrics in 2023. However, we project prolonged high interest rates and financing costs to fund either the execution of capex or debt refinancing will slightly push metrics down in 2024 and 2025.

Asia-Pacific: We expect Australian and New Zealand airports' credit metrics to remain stable on the back of passenger growth and improving earnings. The higher interest rates in Australia could lead to some uptick in overall interest costs on a portfolio basis, but the impact on financial metrics should be manageable. In the Pacific, most airports' metrics are now above their downside triggers and have recommenced dividend distributions to shareholders.

A substantial proportion of interest-rate exposure has been fixed for the Airport Authority in Hong Kong (which operates the Hong Kong International Airport), allowing the airport to manage the modest increases in interest rates we expect over the next one to two years. In India, leverage should steadily improve in the next two years, but remain higher than pre-pandemic levels. Recent tender offers to repurchase U.S. dollar debt with cheaper domestic funding will help cut interest-rate costs, and we consider foreign exchange exposure manageable. Key credit drivers for Indian airports are timely tariff implementation that incorporates investment in expansion capex, and dividend payouts in light of stronger cash flow.

Europe: We expect credit metrics for our European rated airport portfolio to strengthen gradually in 2023-2025 thanks to traffic growth, supportive tariffs, and companies' deleveraging efforts. After 2025 we expect metrics to moderate, reflecting a significant increase in capex, potential resumption of dividends, refinancing amid higher interest rates, and most significantly, traffic growth commensurate with European GDP dynamics and environmental regulations.

North America: The spend-down of U.S. financial assistance to U.S. airport operators is largely complete, with a return to business-as-usual rate-setting practices and the corresponding financial metrics. We expect financial performance and coverage levels to continue to improve from pandemic lows back to strong levels (greater than 1.25x).

Debt levels will continue to increase with expanding capital programs. However, as revenues also grow under largely cost-recovery business terms with airline tenants, we expect overall debt capacity (measured as debt to net revenues) to remain strong. Significant federal aid allowed airports to bolster cash reserves as demand recovered with unrestricted days' cash on hand generally staying steady or improving to 400 to 800 days, a range we consider very strong and comparable with pre-pandemic levels.

In Canada, revenues have grown at a quicker pace relative to volumes because increases in airport improvement fees and aeronautical rates implemented since 2020 are now having a material impact on financial performance as activity levels rise. Despite the notable improvement in financial metrics, the accumulation of debt in the past three years as well as higher costs and economic headwinds will make the path to pre-pandemic rating levels challenging for some CAAs in the next year.

Key risks or opportunities around the baseline

1. Economic conditions to guide mobility

Our base-case scenario includes our expectation of a soft landing for the U.S. and European economies. Should macroeconomic conditions deteriorate, consumer spending on air travel could be under pressure, particularly if ticket prices remain elevated. In addition, the mobility transition may weigh on Europe's long-term growth prospects. Lower economic and traffic is a risk for most markets but in particular Greater China, India, and South Korea. Similarly, a weaker U.S. economy could erode or stagnate demand, making it a challenge for management teams to maintain financial margins commensurate with credit quality.

2. Geopolitical risks

The conflict in the Middle East is likely to have a limited impact, mostly on the affected areas. For Turkey and Kazakhstan, the Russia-Ukraine war and sanctions-related partial closure of the Russian airspace has supported air traffic, because many cargo airlines used these countries to bypass Russia, and in the absence of direct flights between Russia and the EU, the remaining passenger traffic has to use connecting flights, mainly in Turkey.

3. Growing capital requirements and costs

The highest construction cost inflation seen in decades, along with higher labor costs, will continue to weigh on project budgets and timelines and could result in higher debt levels across the sector. In particular, labor costs and shortages and outsourcing costs are a key risk in Hong Kong and South Korea. In the U.S., although weakening economic conditions could cool inflationary impacts, the massive federal investment in infrastructure could keep input and labor prices elevated in many markets over the next few years. Furthermore, the Infrastructure Investment and Jobs Act (IIJA) requires that all infrastructure projects funded by related federal grants include manufactured end-products that are manufactured in the U.S. and the component costs must be greater than 55% of the total costs, which will further increase total airport project costs.

Ratings Trends: Airports

Chart 1
Ratings distribution

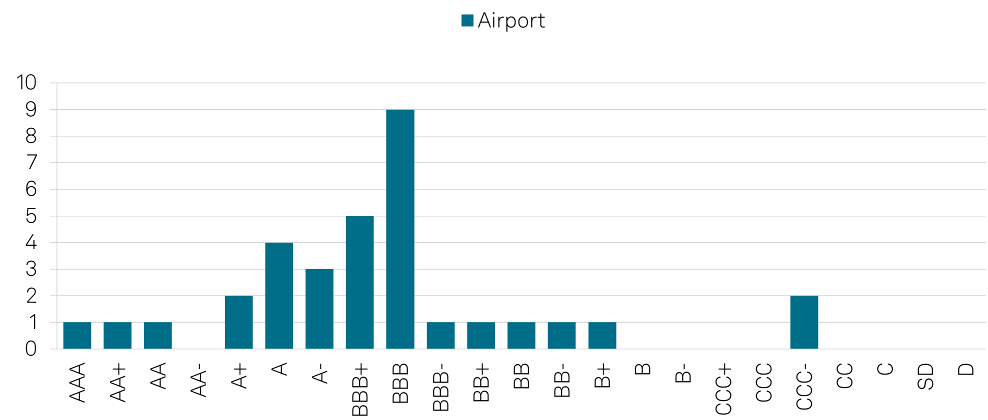


Chart 2
Ratings outlooks

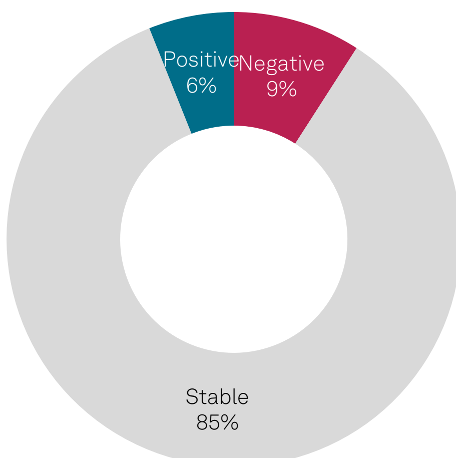
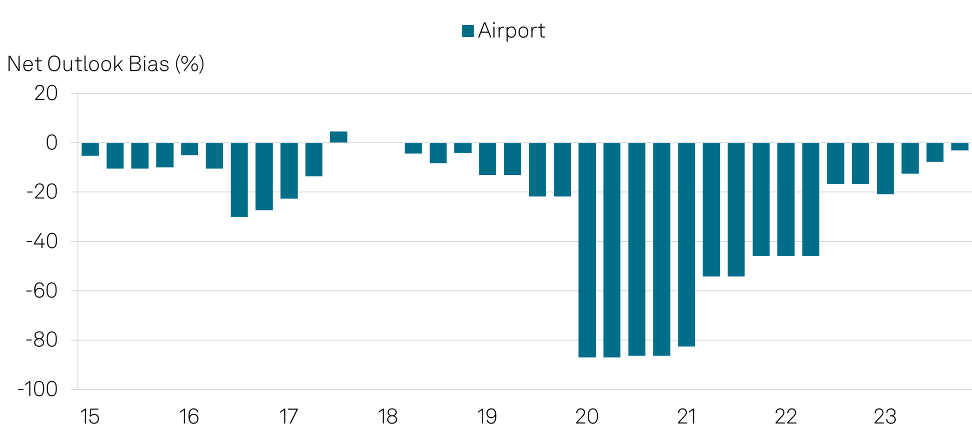


Chart 3
Ratings outlook net bias



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

Industry Credit Metrics: Airports

Chart 4

Debt / EBITDA (median, adjusted)

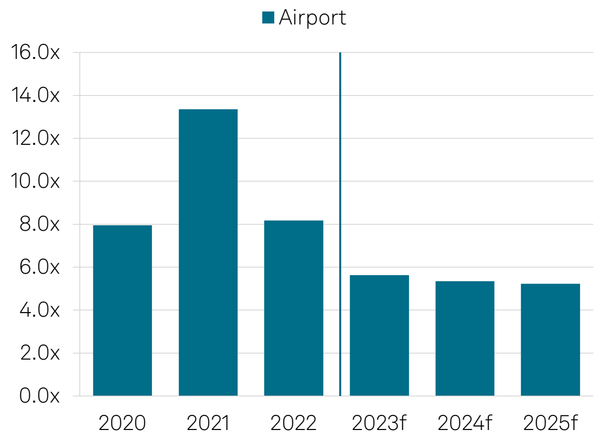


Chart 5

FFO / Debt (median, adjusted)

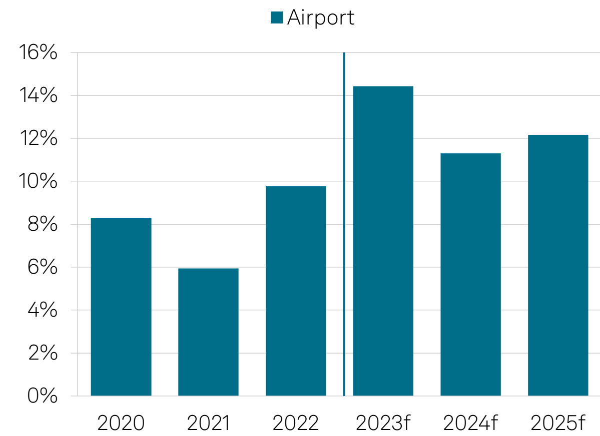


Chart 6

Cash flow and primary uses

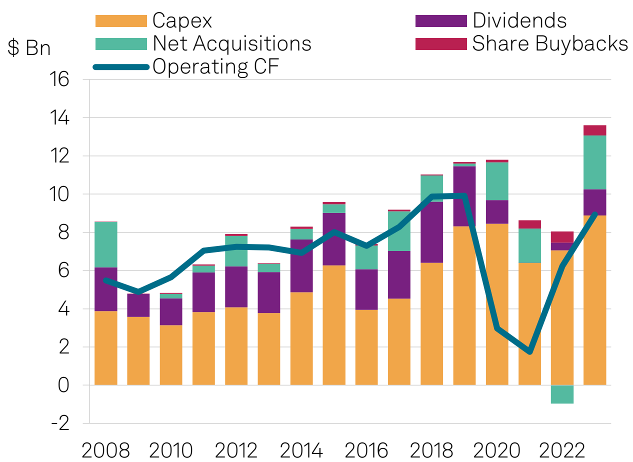
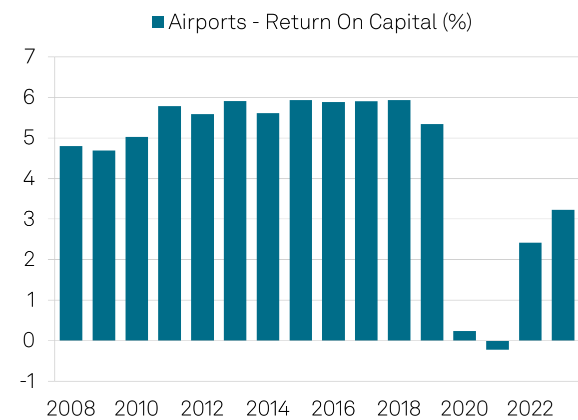


Chart 7

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.

Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historical exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO--Funds from operations. Most recent (2023) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: Ports

Ratings trends and outlook

Ports in general have a larger buffer in their credit metrics to withstand potential downturn risk from an economic slowdown. As a result, about 60% of our rated portfolio has a stable outlook and 25% a positive one. In EMEA, the few negative outlooks are more connected to external factors rather than the asset's stand-alone performance. Given ports' relevance to their local economies, most of our rated ports have strong links to the credit quality of their respective sovereign, either because of material ownership or because the rating on the country caps the issuer credit rating.

Main assumptions about 2024 and beyond

1. Global trade to continue in spite of economic slowdown

Slowing global growth and high inflation will weigh on trade in the coming 12 months, leading to flat to negative volumes. The exception is in the U.S., where we expect positive growth in cargo and containers as recession fears abate and port operators rebound from a lower 2023 base. The risk of escalating geopolitical tensions poses threats to supply chains, which could, in turn, result in lower volumes across containers and other cargo segments.

2. Pricing increases will be limited given the difficult economic conditions

Because volumes have a negative bias, price increases like we've seen in 2023 will become more difficult to implement. We believe that many ports will be focusing on operational efficiency to maintain profitability.

3. Capital investment to boost future growth

In general, ports are well placed to absorb macroeconomic strains due to their relatively lower leverage compared to airports, and so are able to perform expansion capex without quickly diminishing capital buffers.

Trade volumes in both Australia and New Zealand have slowed in the past 12-18 months amid challenging global economic conditions. We expect container volume growth in Australia to be flat to negative on the back of constrained domestic demand, mainly due to high inflation and interest rates weighing on households.

For those ports that are exposed to export trade, softer economic conditions in China will also lead to a decline in export volumes from China to Australia and New Zealand. Export volumes from Australian coal should remain stable but could be further affected by weather events like the extreme rainfall in 2022. Capex will remain elevated across most of the Australian ports. Some ports are investing in improving logistics, automation, and upgrading infrastructure, whereas others are significantly investing in property projects.

The sector will be stable over the next 12-18 months in China (including Hong Kong). Trade volume growth should continue to diverge between different regions due to the route and cargo mix. We expect tariffs to remain generally stable with potential for modest adjustment. Any significant tariff hike is unlikely as the export pressure remains high and, in mainland China, policy is directed at keeping logistics costs affordable.

Trade volume growth in the Guangdong-Hong Kong-Macao Greater Bay Area will be subject to the recovery in demand from the U.S. and Europe. Hong Kong trade volumes are likely to bottom out, but we think a strong recovery is unlikely in the next 12 months. An increasing proportion of domestic volumes and non-containerized cargo could modestly reduce port operators' margins.

India's container ports to outperform most others in the region. Cargo volumes have been growing despite challenging global market conditions, primarily led by containers. Improving operational efficiency supports stable margins.

European ports' strong competitive position will allow them to withstand credit headwinds in 2024. This has also been the case in previous weaker economic cycles and during recent trade disruptions, from the pandemic to effects of geopolitical conflicts. Thus, we see them as well positioned to accommodate the expected slow growth of trade volume next year given the region's uncertain economic conditions.

As freight rates and volumes in the region near 2019 levels, the downside risk will likely relate to escalating geopolitical conflicts, either through potential disruptions in the port services or stronger downward pressure on volumes due to deteriorated business and consumer confidence. Although we don't expect a lot of headroom for tariff escalation despite the persistent inflation, margins for cargo operations should remain robust due to ports' efficiency and competitiveness. At the same time, exposure to other activities of a less stable nature, such as logistics, could hurt margins.

Most of our European portfolio has low leverage ratios that can accommodate discretionary expansion plans even amid difficult economic conditions and higher financing costs.

We expect a stable trend for our ratings on North American ports in 2024 after a post-pandemic contraction in cargo and container growth in 2023 for many operators. Most global supply chains recovered and returned to typical seasonal volume fluctuations. Some industries experienced shifts in source manufacturing trade patterns, but U.S. port operators are already inherently exposed to volatility due to normal business and economic cycles, fluctuating trade patterns and supply chains, drastic variations in commodity prices, and changes in bilateral and multilateral trade policies.

Despite these factors, many of the not-for-profit ports we rate have very strong enterprise value due to their critical role in various industries and the overall health of the U.S. economy. They also have strong financial metrics--particularly debt service coverage (DSC) and low debt levels compared with other transportation sectors. As a result, the U.S. port sector has generally demonstrated financial strength for many years, which has provided a cushion to absorb volatility on the path toward long-term growth and the maintenance of creditworthiness.

With 2023 volumes at the largest U.S. ports likely down 10%-12%, we anticipate moderate growth in 2024, with a return to more predictable performance by port operators as risks of recession abate. Port congestion, supply chain issues, and logistics delays are no longer an issue as trade patterns return to normal, although continuing conflict in the Middle East could disrupt shipping through the Suez Canal, with ripple effects.

The shift of international trade back to U.S. West Coast ports from U.S. East Coast ports has been influenced by drought conditions in the Panama Canal region and resolution of West Coast labor issues in August 2023. Attention now shifts to labor negotiations for U.S. East Coast ports, since the current collective bargaining agreement expires on Sept. 30, 2024. The last U.S. East and Gulf Coast labor action was in 1977 and, like on the West Coast, the progress of labor negotiations is not easily predicted.

We will also monitor drought conditions in the Panama Canal region, which has limited slots for cargo lines using that facility. Longer term, we still have moderate uncertainty regarding Asia trade due to the continuation of U.S. tariffs on Chinese imports and continued export control restrictions that have added tension to the already strained relationship between the world's two largest economies.

Latin America: We expect flat volumes for Brazilian ports in 2024, because higher exports of agricultural and protein will be partially mitigated by lower import volumes. Similar to other regions, potential pressure on global trade will limit the ability to adjust tariffs. In Peru, the negative effect of the El Niño climate pattern should hit both agricultural and pisciculture production, hampering export volumes.

Credit metrics and financial policy

In general, we think the lower leverage of ports relative to other transportation infrastructure asset classes should allow them to better withstand the difficult economic conditions without changes in credit quality. In all market regions, ports' credit metrics have sufficient buffer to absorb capex increases.

Ongoing higher inflation is likely to increase operating and financing costs in Australia and New Zealand. Higher inflation-linked increases across the rated portfolio for landlord ports (ports where a port authority rents or leases to private companies) have supported revenues and credit metrics. In India, sustained high capex due to growth expansion in international ports and the logistics segment could increase credit risks. Geopolitical tensions could hurt trade volumes, but we think credit metrics have sufficient buffers given recent deleveraging efforts.

We anticipate flat to slow growth in operating revenues in 2024, supporting very strong financial metrics for North American ports, especially for larger container ports. We generally rate these ports in our 'AA' category, and they maintain stronger financial metrics because of their larger size, activity volumes, and pricing power. Some also receive some form of tax revenue to support their operations.

Key risks or opportunities around the baseline

1. Slower economic growth in the U.S. and China, weakening demand from other economies

Known or still developing risks to the global economy below our baseline could weaken the port sector. These risks include weakening economic conditions and lingering inflationary pressures. A further pick-up in Chinese domestic consumption could offset some pressure on exports, but China and Hong Kong trade volume remains heavily driven by exports. Weak end-user demand from advanced economies could drag on throughput growth. This may be partially offset by intra-Asia trade involving intermediate goods.

2. Geopolitical risks

Disruptions to global supply chains from geopolitical tensions is a key risk for Chinese ports. Overseas trade counterparty demand from the U.S. and Europe could also be at risk. Furthermore, China-U.S. tensions remain a key risk since the U.S. may seek goods from alternative countries. Manufacturing migration to other markets such as Southeast Asia and Latin America could pose a longer-term risk for China's trade patterns, even if it takes some time to materialize.

3. Emerging risks

Port operators and their shipping tenants will need to manage labor relations, the movement by shipping lines to reduce carbon emissions, and evolving cyber and physical risk issues requiring spending for asset hardening and resiliency efforts.

Ratings Trends: Ports

Chart 8

Ratings distribution

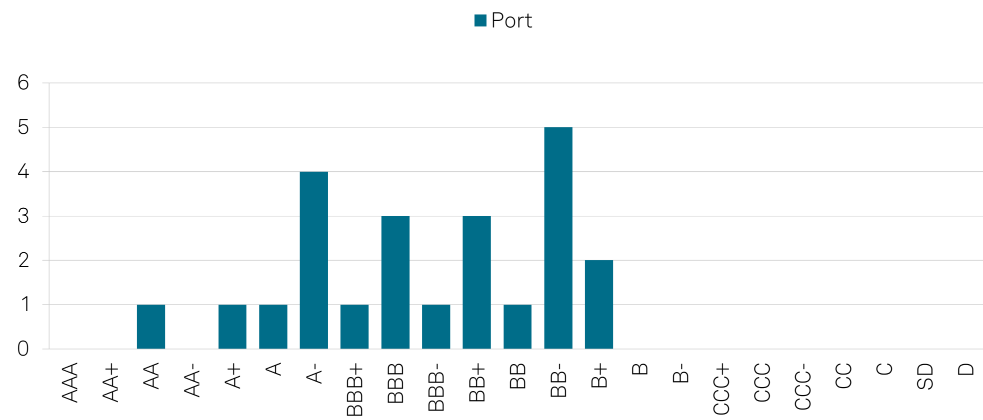


Chart 9

Ratings outlooks

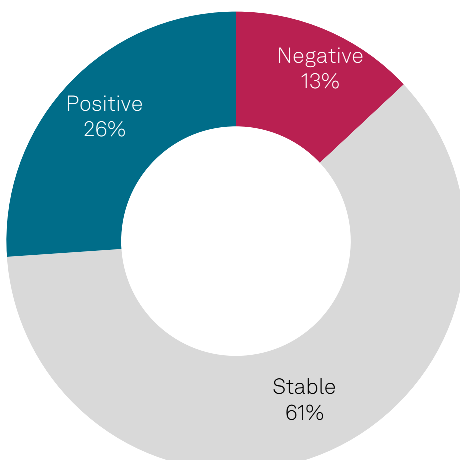
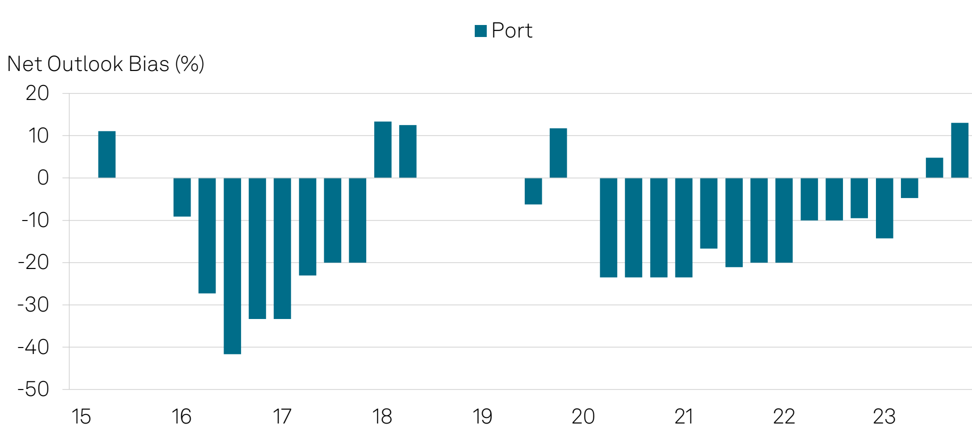


Chart 10

Ratings outlook net bias



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

Industry Credit Metrics: Ports

Chart 11

Debt / EBITDA (median, adjusted)

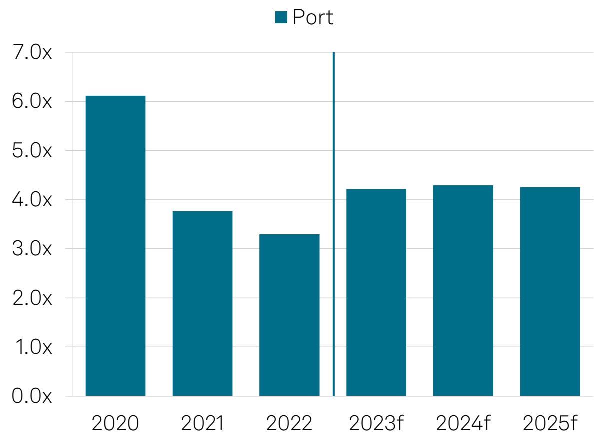


Chart 12

FFO / Debt (median, adjusted)

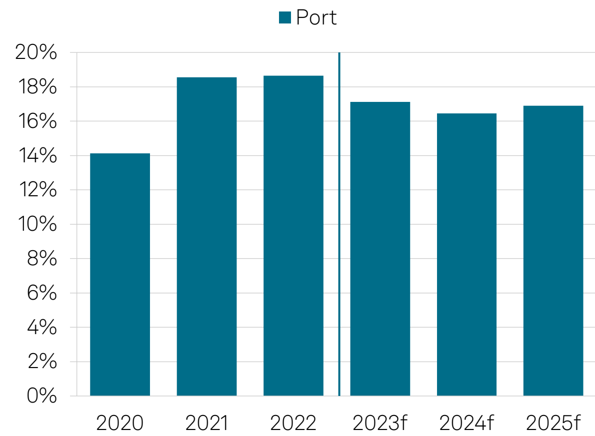


Chart 13

Cash flow and primary uses

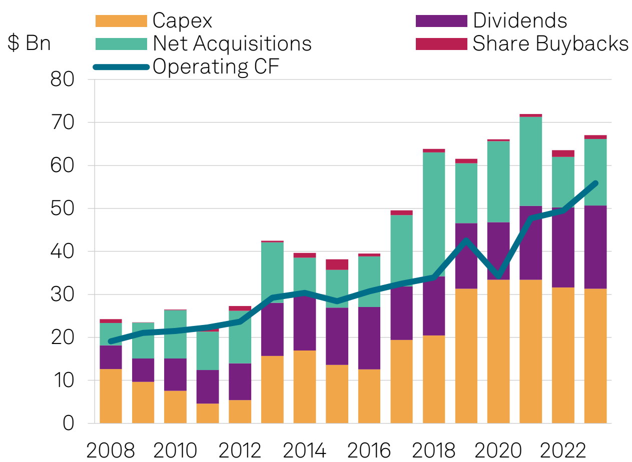
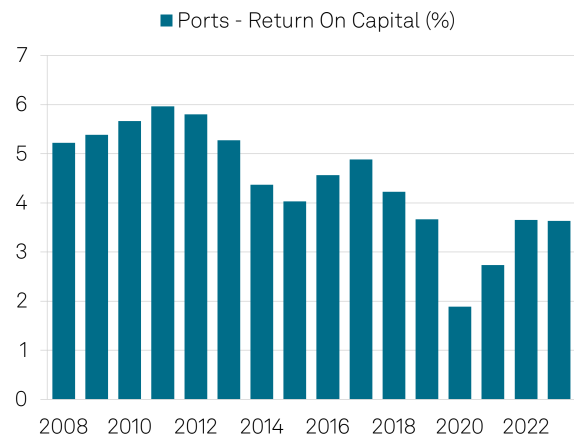


Chart 14

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.

Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historical exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO--Funds from operations. Most recent (2023) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: Roads

Ratings trends and outlook

Compared to airports, road concessionaires have recovered more quickly from the pandemic. Most assets' EBITDA already recovered to near 2019 levels in 2022. As a result, over 11% of the portfolio has a positive outlook, including several commuter toll roads in the North America, Elizabeth River Crossings Opco LLC and Autopistas Metropolitanas de Puerto Rico LLC, given their strong traffic and revenue performance. Meanwhile, most European and Latin American rated operators have stable outlooks, reflecting strong operational performance and headroom in financial metrics.

Main assumptions about 2024 and beyond

1. Inflation-linked tariff increases continue to bolster toll road revenue

After significant revenue growth in 2023, most toll road operators are set to see another year with material revenue growth driven by inflation-linked toll increases. We expect revenue growth of 4%-6%.

2. Economic conditions and high toll fees will test traffic resilience

Given sluggish global economic prospects, we expect marginal commuter traffic growth. We also project freight traffic to remain stable or even decline for some toll roads.

3. Inflation and commodity prices will boost investment costs

High capital expenditures across regions will likely be driven by distinct factors such as inflation- and commodities-adjusted investments to finalize ongoing expansion; pressure to top up maturing concession portfolios in China, Europe, and Brazil; and merger and acquisition opportunities.

We expect revenues to rise across the board in Asia-Pacific at 5%-9% in 2024. Tariff increases may be a bigger driver of revenue than traffic growth. In China and South Korea, however, regulators may not agree to fully meet price increases sought by operators. Capital expenditures loom as the major financial consideration for toll roads that are expanding, particularly where those activities are largely debt-funded.

Australia: Given the inflation-linked toll increases for Australian toll roads (adjusted quarterly or annually), the higher inflation in the past 12-18 months will continue to feed into higher revenues in fiscal 2024 and fiscal 2025 (ending June 30). Traffic in Australia has already surpassed pre-COVID levels in most of the assets, although those connecting to airports or central business districts are still seeing some lag in traffic recovery. We anticipate limited opportunities for greenfield projects over the next few years.

China: Revenue continues to improve from the low base in 2022 in China, while volumes are by and large at or above pre-pandemic levels, driven primarily by small vehicles. However, the rebound in freight vehicle traffic is muted due to the sluggish economy. Volume remains the key revenue driver, although some newly opened roads may have the ability for discreet tariff adjustment. Toll revenue growth will likely be lower than traffic growth due to the higher mix of light vehicles versus freight vehicles. Concessions will be due to expire in the next few years, further driving investments for renewal.

South Korea: We expect toll roads' income to increase modestly, backed by steady traffic volume growth in South Korea that has already recovered to pre-pandemic levels. We estimate traffic volume to grow 2%-4% per year in the next three years, which is largely in line with South Korea's GDP growth.

We expect traffic growth in European operations of 1%-4%, coupled with toll fees increasing in line with inflation. We broadly expect light vehicles to outperform heavy vehicles in 2024, in line with the performance for 2023, reflecting that prospects for the European economy to remain close to stalling and that heavy traffic volumes are more exposed to economic downturn.

Within our rated portfolio, companies have managed to pass through inflation into toll tariffs, reinforcing operational margins and mitigating increased budgets on upcoming capex, affected by high inflation and financing costs. Our rated European road portfolio performed strongly in 2023, and we expect overall EBITDA to grow 7%-9% compared to 2022.

Finally, our European portfolio is heavily exposed to the dynamics of French toll roads, which are approaching the last 10 years of their concessions, so we expect them to gradually deleverage ahead of their maturities. This would improve credit metrics but wouldn't necessarily reflect a rise in overall creditworthiness. We expect European infrastructure companies, particularly those focused on brownfield operations, to continue monitoring acquisitions and auctions abroad given the limited pipeline in Europe through the concessional model.

In North America, our outlooks on public-private partnership (P3) toll roads are stable and positive, despite the uncertain economic conditions we expect in 2024. Given that P3 concession agreements typically allow inflation-linked tariff increases (sometime with a one-year lag), most toll roads saw material growth (in some cases, 10% and above) in 2023, and we anticipate another year of strong revenue growth in 2024 due to toll increases. As we anticipated, despite the high toll fee increases, most toll roads saw traffic growth in 2023 as commuters returned to work due to pent-up travel demand despite lower discretionary income. We expect continued modest growth in commuter traffic in 2024. For freight traffic, we expect growth to slow or stabilize from high growth seen during the pandemic.

We don't expect shifts in the credit quality of U.S. not-for-profit toll road operators, given the almost complete rebound in demand, supported by steady commercial vehicle traffic and toll rate increases. Toll roads have been among the most resilient transportation infrastructure asset classes in recent years, with no downgrades during the pandemic. Revenue growth will be accompanied by increased operations and maintenance expenses, as well as capital spending for capacity expansions and continued conversions to all-electronic toll collection against a backdrop of higher financing costs.

Although pent-up consumer travel demand following the pandemic might be subsiding, we continue to see stable to growing commercial vehicle traffic across the sector.

Latin American traffic volumes in most of countries rose with 3x-4x elasticity to GDP in 2023, driven by heavy vehicle traffic, in particular in Brazil and Mexico, where good exports were a key part of economic performance. We expect increased expansion capex from Brazilian entities that extended their maturing concession portfolios by participating in new concession auctions. We also expect maintenance investments earlier than expected, due to the degradation of pavement caused by increased heavy traffic.

We expect financing conditions to be tighter to fund these investments, given the higher interest rates across markets in Latin America countries. The negative impact of high inflation and weaker economic performance might hamper Chilean toll roads, as inflation-adjusted toll rates start to weigh on commuter traffic. Finally, we are monitoring the development of the early termination of the Rutas de Lima toll road in Peru, announced in early 2023.

Credit metrics and financial policy

Metrics should remain generally stable in the next one to two years as growing revenues offset capex in some markets.

Asia-Pacific: In Australia, capex should remain elevated for the next 12-18 months as projects that are under construction move toward completion. The situation is similar in China, where maturing concessions will likely be extended in exchange for both new road construction and expansion of existing toll roads. In South Korea, capex and debt remain elevated largely due to new expressway construction scheduled to be completed over 2024-2025.

Europe: The rated portfolio was cash flow negative in 2020, but by 2021 the overall debt level was already similar to that in 2019. As a result, our portfolio now benefits from stronger credit metrics.

North America: Most toll roads have seen material growth in their cash flows and debt service coverage ratios, driven by strong revenue performance this year. This helped absorb high interest rates for roads with refinancing risk. Some toll roads, like 407 International, continue to add leverage to offset the revenue growth, keeping creditworthiness in line with existing ratings.

U.S. not-for-profit toll roads have maintained debt coverage levels near historical levels as a result of transaction growth and toll increases accompanied by higher operations-and-maintenance expenses. Management teams continue to increase liquidity positions as a proactive approach to mitigating potential stresses, including rising construction costs and operating expenses. The rapid recovery in transactions and operating revenue allowed issuers to build cash reserves, because revenue exceeded budgeted amounts significantly in fiscal years 2021 and 2022. We expect increased capital project costs stemming from inflationary pressures will result in higher debt, but be supported by revenue growth from strong demand and toll rate increases.

Key risks or opportunities around the baseline

1. Affordability and regulatory risk in emerging markets

As is typically the case, regulatory issues will be specific to markets. In China, future investment will hinge on the development of the government's "Regulations on the Administration of Toll Road" policy, which will determine concession periods and investment returns. Toll road investment plans and schedules will be subject to the final determination of regulations. In South Korea, the government's tight control of toll price increases remains a key risk. Similarly, affordability issues caused riots against toll fee increases in Brazil and Chile, and that risk remains.

2. Slower-than-anticipated U.S. economic growth

Toll road operators are less affected by global conditions and external shocks than by domestic economic trends. An unforeseen recession could weaken disposable income, travel demand, commuter trends, and activity associated with transporting goods. However, our baseline forecast projects a shallower and more attenuated slowdown in the U.S. than we previously expected.

3. Working capital and high funding costs to perform investments

Construction costs and rising operations and maintenance expenses have pressured toll road operators. Overall debt levels have increased materially for many issuers we rate. Although issuers have generally raised toll rates and increased liquidity positions as a proactive approach to mitigate future potential stresses and rising costs, credit risks related to inflation are pressuring management teams. Furthermore, despite the high interest rates for borrowers, we expect toll operators will continue to finance projects with debt, given the meaningful revenue growth from continued demand in toll transactions and increases in toll rates that can support the additional costs.

Ratings Trends: Roads

Chart 15

Ratings distribution

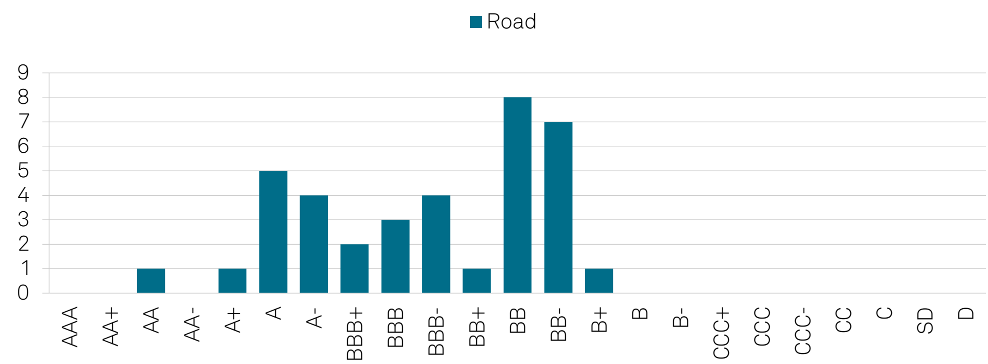


Chart 16

Ratings outlooks

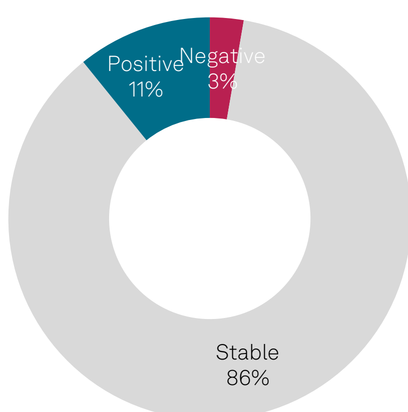
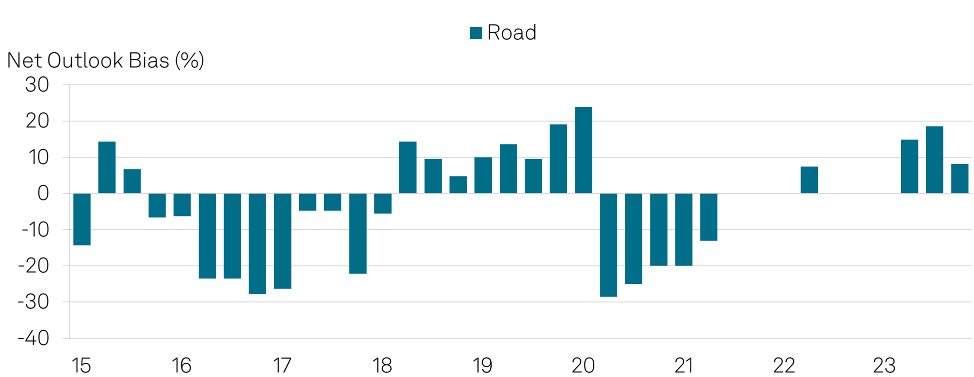


Chart 17

Ratings outlook net bias



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

Industry Credit Metrics: Roads

Chart 18

Debt / EBITDA (median, adjusted)

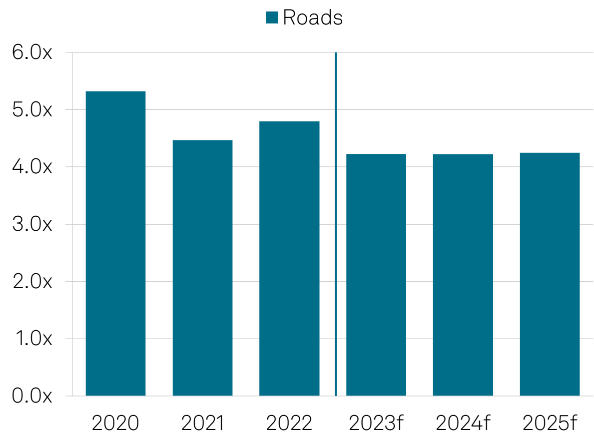


Chart 19

FFO / Debt (median, adjusted)

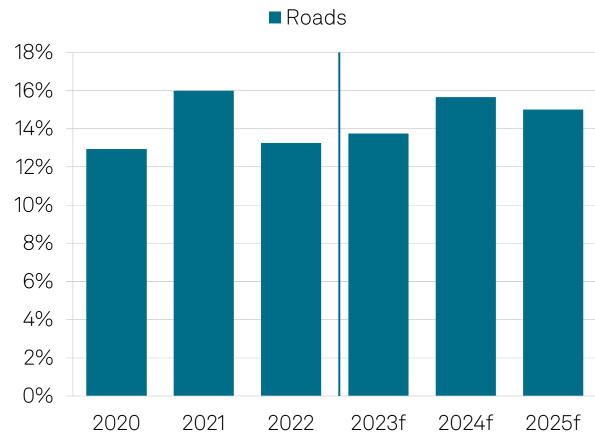


Chart 20

Cash flow and primary uses

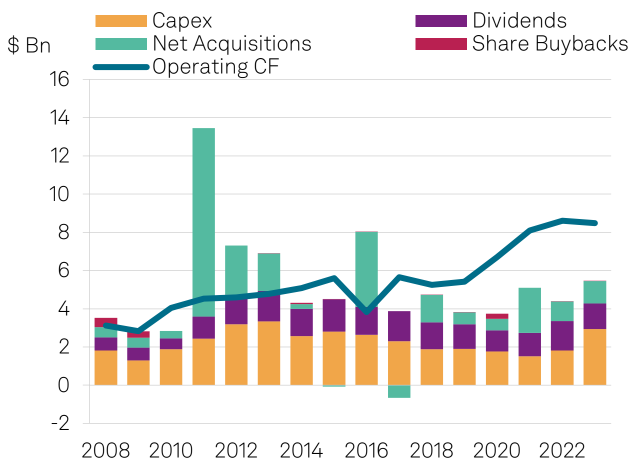
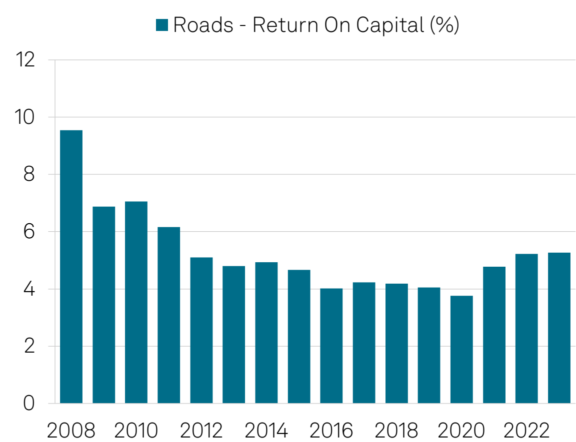


Chart 21

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historical exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO--Funds from operations. Most recent (2023) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: Railways And Mass Transit

Ratings trends and outlook

Even though over 80% of rated railway and mass transit operator ratings have a stable outlook, traffic volumes are still below 2019 levels. We also still have negative outlooks on two railway operators in Europe, mirroring their respective sovereign ratings. In the U.S., we continue to have a negative view of the sector because many large transit agencies face headwinds from persistent lower ridership and the expected void left by the spend-down of $71.7 billion in pandemic-related federal aid. Identifying a sustainable tax and revenue model to meet operating and long-term capital needs remains an ongoing topic of debate, setting up key decisions in the coming months that will pit service levels against available resources for 2024 and beyond.

Main assumptions about 2024 and beyond

1. Organic passenger growth

For passenger rail (including metro-style rail), we expect modest passenger growth in 2024 from a new baseline of volumes, considering some level of permanent passenger loss after the pandemic.

2. Higher reliance on public funding

We anticipate governments may not be willing to increase the cost of using public transportation for citizens despite higher costs and accelerating capex needs, which increases the reliance on public funding for these transit companies or public providers.

3. Advances in mobility transition

Rail's lower greenhouse gas emissions compared with other forms of transportation positions the sector well to benefit from the energy transition and European countries' efforts to lower dependence on fossil fuels, particularly in countries with energy mixes that don't heavily rely on fossil fuels.

Asia-Pacific: Most markets have recovered to 2019 levels and we forecast modest passenger growth in 2024. Some assets with the ability to generate additional revenues from consumers through shopping and tourism-related activity will be comparatively better positioned.

In Australia, we expect coal volumes to remain stable, assuming no significant weather events like those seen in 2022. Coal haulage remains a significant contributor to revenue and earnings, with diversification of revenues coming from intermodal (freight) and bulk haulage. Opportunities to convert road freight to rail may emerge. Competition in the rail business segment remains high and exposed to recontracting risk. Operating costs look set to remain high in 2024 and we anticipate significant capex in the next two years.

In China, operating conditions for metro businesses in the major cities will remain stable, underpinned by the resilience in domestic operations. Demand for travel and local government financial capacity remain the key drivers of network expansion.

The increasing connection between Hong Kong and mainland China will drive strong growth in cross-boundary operations. The connection will also drive lucrative duty-free and station commercial revenue growth. Hong Kong rail ridership has hit near pre-pandemic levels for some time, while cross-boundary traffic has even exceeded historical levels.

Passenger revenue in Japan in fiscal 2023 (ending March 31, 2024) will be 85%-90% of fiscal 2018 levels, rising to 90%-95% in fiscal 2024. Noncommuter income has been getting closer to pre-pandemic levels, driven by tourism demand, but commuter income has not, in part because many people are still working from home. Average EBITDA margins of the rated companies will approach pre-pandemic levels in the next two years because of recovering passenger demand, price hikes, cost cuts, and increased earnings from nonrailway operations.

We expect rail ridership levels in Singapore to continue to rebound, achieving full recovery of pre-pandemic levels by fiscal 2026 (ending March 31, 2026). This is one year earlier than our previous expectation of full recovery by fiscal 2027, because ridership levels surpassed 90% of pre-pandemic levels by mid-2023. Some of the revenue benefits of this rebound have been offset by higher costs. Ongoing higher inflation remains a key risk as rail operators continue to be challenged by higher energy prices, labor costs, and maintenance costs.

Europe: Our rated portfolio relates mostly to the national incumbents, owned by their respective governments, and so is heavily focused on providing public service operations (PSOs). The portfolio maintains stable operational performance, although we expect operating margins and EBITDA to slightly decline in 2023 and 2024, mostly because of high inflation.

This is not necessarily negative, because of the government-owned nature of our rated portfolio, although issuers may rely more on the public funding they receive directly from governments. We'll monitor how governments balance the need to support heavy capex needs in railway infrastructure with their other objectives and policy goals. For example, following the German Constitutional Court ruling in November 2023, part of the payments from the government's Climate and Transformation Fund to Deutsche Bahn (DB; Germany's national rail company) has been frozen. Although we think the German government continues to support DB, exact funding mechanisms and sources are yet to be determined.

The European Commission works to foster cross-border rail traffic, including the return of night trains after decades of decline, mainly due to competition with low-cost airlines. The release of the revised technical standards to improve rail interoperability across borders in September 2023 could be an important step to boost cross-border railway services. Throughout 2023, high-speed railway in Spain is now operating in competition following the entrance of two companies, Ouigo and Iryo, adding further competition to the high-speed rail market in Europe. The competition in long-distance railway is one of the main pillars of the fourth railway package of policies published by the EU in 2016.

In many European countries, the increased use of the railway network plays a key role in reaching climate transition goals and is in some cases backed with massive government funding for railway infrastructure development and improvement (e.g., in Germany). What's more, given the Russia-Ukraine conflict, fostering the development and use of rail is an effective way for European countries to lower their dependence on imported fossil fuels, although it generally depends on the country's power mix. We have seen a surge in expected investments around railway infrastructure and service to boost its use, service quality, and punctuality and to make up for historically accumulated underinvestment. Although the funding and execution of large rail infrastructure programs is a challenge, we think this could reinforce the importance of railway across Europe in the long term.

U.S.: Our view of the U.S. not-for-profit mass transit sector remains negative as many large agencies struggle to balance operating funds, given depressed passenger fare revenue and the fact that pandemic-related federal assistance runs out beginning in 2024. A few transit agencies have received a combination of temporary relief and longer-term tax support amid an ongoing policy debate at the state, regional, and local levels regarding how to support operating and capital requirements with sustainable tax and revenue models.

However, year-to-date rating actions have been positive for some U.S. mass transit operators that benefit from significant tax support and are relatively less reliant on fare revenues. Specifically, sales taxes have experienced strong growth in recent years that we expect will provide ongoing financial flexibility. Overall, we believe the credit quality of transit operators that historically rely on fare revenue will depend on their long-term ability to enhance existing recurring revenue sources or establish new recurring ones, and to adjust operating expenses and capital spending as needed to achieve a sustainable fiscal balance.

Mass transit's business model for moving suburban commuters in and out of the city center five days a week--and the revenues derived from that ridership base--may have ended permanently or at least for the foreseeable future. Across the U.S., data from all transit agencies through December 2023 show ridership has recovered to approximately 77% of pre-pandemic levels, but there are wide variances between regions and between modes of transit. Heavy commuter rail systems continue to experience weaker ridership due to remote working trends, while bus and subway ridership have generally performed better.

Transit agencies have a variety of options to close the operating fund gap, including seeking more state or regional funding, new dedicated revenues or other sources, and fare increases. Although cost reductions, service cuts, and shifting capital funds to operating funds are options, most transit operators are unlikely to pursue workforce reductions. While aligning service levels with demand patterns is essential, we see only marginal gains in efforts to stimulate ridership. In many instances, transit agencies are at the mercy of large downtown employers and their decisions regarding remote work options for their employees. We've observed that depressed ridership also has a knock-on effect for cities and the economies of city centers, particularly as it relates to the retail and commercial real estate sectors.

Realistically, to close forecast operating fund deficits, large U.S. transit agencies lacking significant tax support will need access to long-term, dedicated funding above what they currently receive to support anticipated service levels. Absent that or a dramatic change in the return-to-work movement, modifications in transit schedules, fare increases, and expense reductions are unlikely to compensate for the loss of daily commuters and the revenue they generated to support transit enterprises.

Credit metrics and financial policy

In Asia-Pacific, we expect funds from operations to debt for most rated entities to be stable because capex-to-revenue ratios have generally peaked. However, in Australia, capex will be significantly high because the two main rail players (Aurizon and Pacific National) plan to invest in developing intermodal terminals as well as on increasing their fleet size. Chinese metro capex is likely to diverge between regions, with investment continuing in more developed regions, particularly in tier-one cities with population inflows. In Hong Kong, we expect capex to pick up starting in late 2023.

Key risks or opportunities around the baseline

1. Pressure on margins

Operating costs, which are usually linked to inflation, look set to remain high in most countries in 2024. For instance, personnel expenses typically account for the largest proportion of total operating expenses (on average about 50%) for our rated rail European operators. Further increases in labor costs--which increased by 6.3% year-on-year in the third quarter of 2023--could test the resilience of rail companies' operating margins.

2. Large capex programs to test execution and funding in Japan

In Japan, larger investment in real estate development could strain credit strength while other nonrailway business expansion could heighten revenue volatility.

3. Subsidy and affordability risks amid continued inflation

Regulatory risk for tariff settings due to affordability issues is a factor in times of high inflation, since concession contracts tend to be adjusted by inflation. In addition, subsidies to tariffs will depend on each government's financial capacity to offset the impact of inflation on tariffs.

Additional ongoing financial support

In China, metro operations are highly dependent on local government operating subsidies. The credit quality of local governments could also drive investor sentiment due to metro operators' strong links with and financial reliance on these governments, influencing the ability of these entities to access the capital market.

In North America, some transit systems have received interim and longer-term financial support from lawmakers and regional stakeholders. However, for most transit agencies, identifying a sustainable tax and revenue model to meet operating and long-term capital needs remains an ongoing topic of debate, setting up key decisions in the coming months that will pit service levels against available resources for 2024 and beyond.

Ratings Trends: Railways And Mass Transit

Chart 22

Ratings distribution

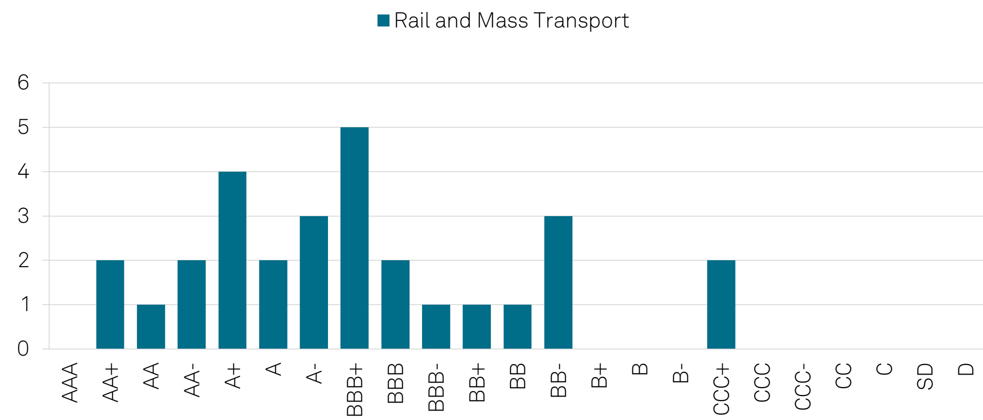


Chart 23

Ratings outlooks

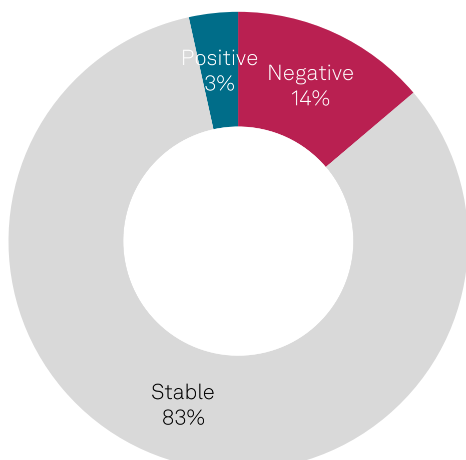
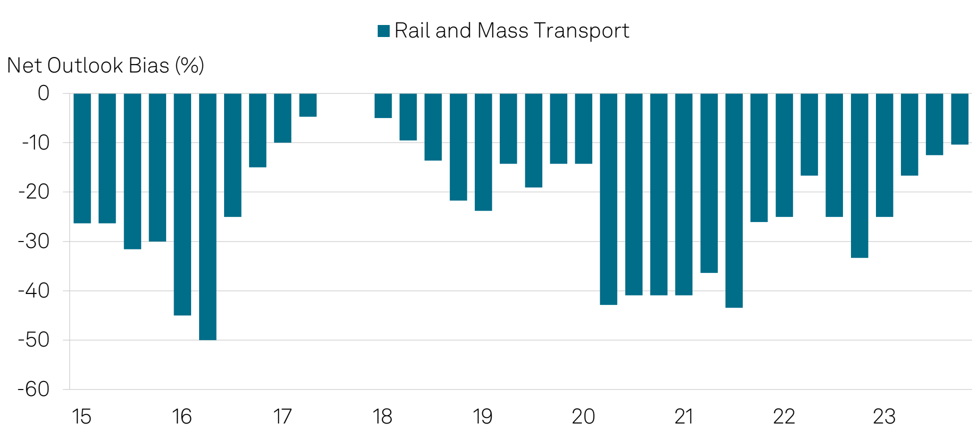


Chart 24

Ratings outlook net bias



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

Industry Credit Metrics: Railways And Mass Transit

Chart 25

Debt / EBITDA (median, adjusted)

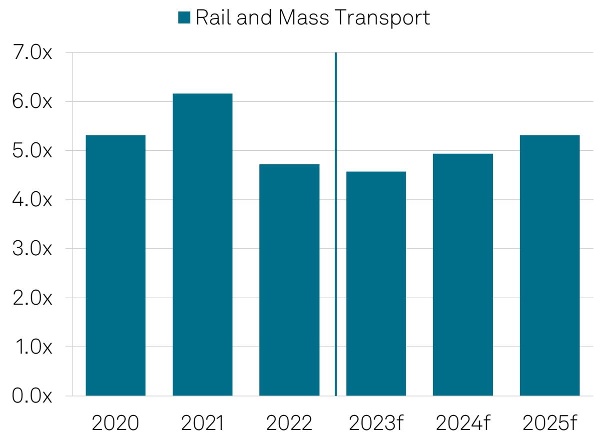


Chart 26

FFO / Debt (median, adjusted)

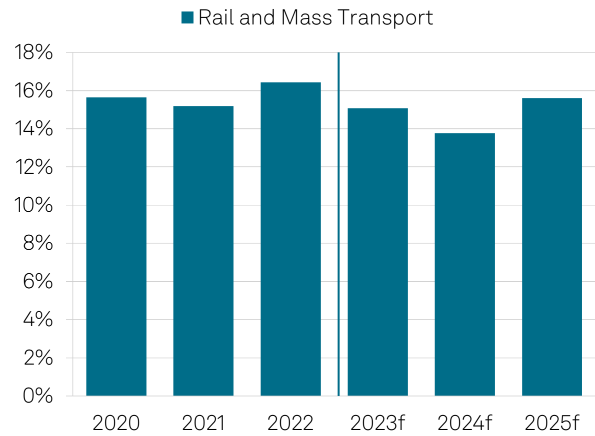


Chart 27

Cash flow and primary uses

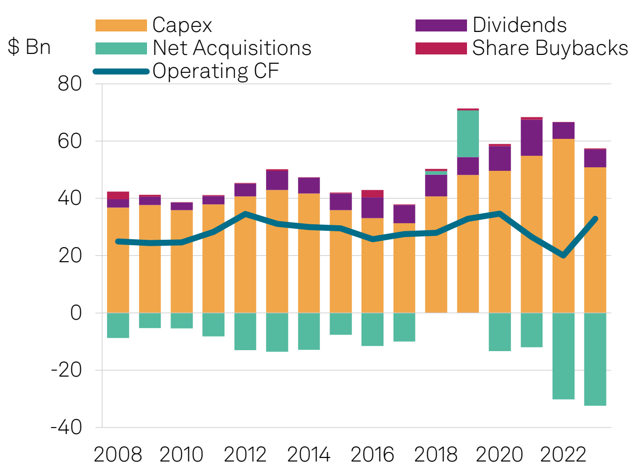
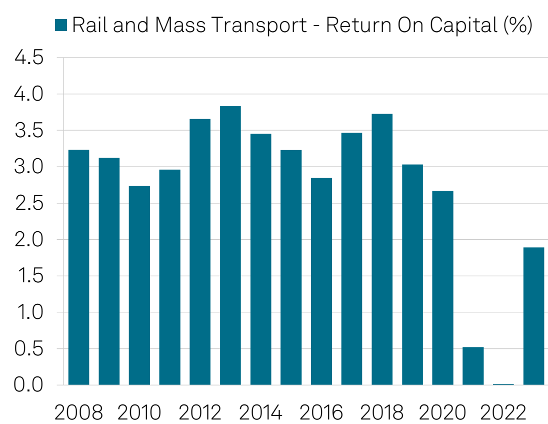


Chart 28

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.

Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historical exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO--Funds from operations. Most recent (2023) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

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