Foreword

From a macro-economic perspective, credit conditions for the global corporate sector remain benign. A synchronized global economic upswing is underway and likely, in terms of S&P Global Ratings’ base case, to continue into 2018. While U.S. interest rates are set to move higher still and elevated valuations across many asset classes are raising concerns about whether exceptionally low volatility can persist, it is also the case that interest rates are likely to remain at exceptionally low levels in most regions and reinforced by ongoing quantitative easing in the Eurozone and Japan.

Yet this is only part of the picture for corporate credit. Political clashes over tax and trade in the U.S. and Europe in 2018 are being closely watched and will have profound long-term implications for corporate business prospects. At the same time, business transformation is being driven by intense competition, rapid technological change and digital disruption, with environmental concerns also driving change in certain sectors.

Favorable macro conditions, close attention to costs and easy access to financing mean that credit metrics are comfortable for many sectors. Yet aggregate debt levels continue to rise, financial covenants are becoming less restrictive and significant M&A activity is expected in many sectors, as companies seek to bolster their competitive positions. This suggests that risk levels are rising, even if the broader operating and financial environment is expected to remain supportive.

To communicate our credit views on rated companies in this environment, we have recently published 17 S&P Global Ratings Industry Top Trends reports for corporate industries globally. This publication brings those reports together into a single volume and is the third annual collection in this format.

These reports outline S&P Global Ratings analysts’ key industry assumptions for 2018, as well as key risks and opportunities that may affect sector trends. They draw on the assessments of over 4,600 corporate entities rated by S&P Global Ratings 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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Key themes

Need to know

- Stronger economic growth and cheap financing are feeding into a marked improvement in operating trends and credit metrics, as reflected in favorable ratings trends and outlooks.
- Various forms of disruption (technology, regulation, policy and trade uncertainties) are offsetting cyclical improvement for many industries.
- Increased capex and an upturn M&A are common themes across many sectors.

The rising tide - top line expansion and margin improvement

A key theme apparent across most of the Industry Top Trends reports is the positive impact of a relatively benign macro environment on growth forecasts and credit metrics. The synchronized global economic upswing and relatively steady global commodity prices have led to a sharp improvement in revenue and EBITDA growth in 2017 (see charts 1 and 2). While the pace of growth is expected to moderate in 2018-2019, the aggregation of S&P Global Ratings analysts’ forecasts for rated entities suggests sales growth of 5% for both those years and slightly higher EBITDA growth, implying a slight improvement in EBITDA margins. Revenue growth is expected for all industries and EBITDA margin expansion for all but one (see chart 3).

Chart 1 – Global non-financial sales growth

[Bar chart showing sales growth for various years and sectors]

Chart 2 – Global non-financial EBITDA growth

[Bar chart showing EBITDA growth for various years and sectors]

If borne out, this will mark a positive inflection point in non-financial corporate operating performance away from the stagnant top line and declining profit margins that characterized the
past few years. Despite the improved cyclical position, S&P Global Ratings expects that central banks will continue with accommodative monetary policy for the next year at least, given an absence of inflationary pressures and a pace of growth that remains modest relative to previous cycles. While we expect the U.S. Federal Reserve to raise rates further in 2018, modest inflationary pressure and ongoing risks to growth suggest that the rate and frequency of changes will remain measured. As such, financing costs are likely to remain favorable, barring a substantial repricing of risk premia in financial markets.

**Corporate ratings net outlook bias improving globally**

Positive revenue and cash flow generation, cheap and generally accessible financing and relatively stable credit metrics in aggregate are reflected in the continuing improvement seen in ratings trends for non-financial corporates globally. We have seen five consecutive quarters of improvement in the global net outlook bias (see chart 4), and the synchronous nature of the global economic improvement means that this pattern is reflected in the trends seen across all major regions (see chart 5). Even Latin America, the most pessimistic region in terms of its negative outlook bias, has improved for the past three quarters.

**Disruption is creating an impact on relative ratings trends**

While cyclical conditions may be favorable – and are expected to remain so in 2018 – secular pressures are apparent across many industries, most notably those grappling with the risks and opportunities presented by increasingly ubiquitous digital technology. For example, e-commerce is disrupting almost all segments of global retail, presenting major challenges in terms of inventory and distribution, physical space requirements, online presence and pricing. It is striking to see how little the global economic upswing has benefited the outlook bias for the retail sector relative to another traditional cyclical sector, chemicals (see chart 6). And that is despite the chemical sector facing its own challenges in terms of global overcapacity.

Similar pressures are highlighted by S&P Global Ratings analysts in the media sector (where media consumption and advertising patterns are transforming dramatically), consumer products (changing tastes and preferences, retailer price pressure), telecoms (changing usage patterns, regulation, investment needs) and autos (electrification and autonomous driving).

Also discussed are the shifting balances of power apparent between manufacturers and suppliers, as highlighted in our reports on aerospace and defense and autos. Auto OEMs have faced more direct financial pressure from rising investment needs and emissions-related regulatory requirements than auto suppliers, as reflected in relative net outlook bias trends (see chart 7). In response to this pressure we expect to see more partnerships emerge in relation to the
development of new products. In aerospace, we also expect the OEM-supplier relationship to evolve as the former try to cut costs and increase control over aircraft development and production.

Chart 6 – Global retail & restaurants and chemicals net outlook bias

Chart 7 – Global auto OEMs and suppliers net outlook bias

Other risks persist: trade, tax and oversupply

Disruption is not the only threat highlighted in our industry reports. Overcapacity – mainly supply derived – remains a serious issue for a number of industries, notably chemicals, metals and mining, oil and gas and shipping. Likewise, the increasing scope of environmental regulation globally is adding further impetus to R&D and investment spending needs that the auto sector faces and remains a critical issue for utilities.

The change in emphasis in U.S. trade policy from pursuing multilateral treaties towards negotiating and renegotiating bilateral deals is creating uncertainty about the future of NAFTA, with possible ramifications for global supply chains, an issue highlighted in the auto, aerospace and defense and transportation reports. The U.K.’s impending exit from the EU – Brexit – is creating similar uncertainties, both for trade, future regulatory environments and supply chains. It is also creating uncertainty surrounding prospects for the commercial real estate outlook for London and similarly some potential uplift in some continental European cities.

And last, but far from least, the uncertainty around the final outcome of proposed changes to U.S. corporate taxation and healthcare policy is an issue flagged by many sectors. As an illustration of this, the repatriation of overseas earnings poses a potential credit risk to U.S. technology companies should it lead to more generous returns to shareholders than we currently expect from their financial policies.

Rising capex: benefitting some sectors but presenting risks for others

In the context of the disruptive pressures affecting many sectors, the resumption of positive corporate capex growth (see chart 8 and ‘Global Capex: Ready for takeoff’, July 31, 2017) can be seen as a mixed blessing. Both the capital goods and technology reports highlight the positive aspects of this upturn, with rising demand from core end-markets providing a favorable tailwind for revenues in those sectors. What is less positive is the confluence of capital expenditure in increasingly contested areas. Elements of the capex spending of retail (both food and non-food), technology companies and autos – which rank among the top five sectors in terms of industry capex growth in 2017 - are essentially in competition with one another, an example being Amazon’s move into fresh foods which has intensified the price competition already in play from discounters. In this sense, the upturn in capital spending can be seen as less a sign of confidence in the economic upswing and more a costly and potentially risky attempt to hold or gain market position. Positive returns on investment are unlikely to accrue to all of this spending.
M&A activity expected to pick up with potential financial risks

This defensive stance is also apparent in one of the other core themes of the reports, namely our expectation that mergers and acquisitions activity is likely to pick up in 2018. For example, a key driver of potential M&A in the consumer products sector is the need to shift portfolios into faster-growing categories and regions in the face of income constraints in developed markets and retailers adjusting their product mix and pricing to compete with online offerings.

Similarly, the telecoms report suggests a possibility of more M&A in the U.S. than other regions given the need for scale to protect profitability and hedge against heightened competition and technology shifts. While there is nothing novel about M&A activity driven by these motives, overall it adds to a picture of a corporate sector still wrestling with a low-growth and highly competitive operating environment rather than a textbook cyclical upswing.

Should the expectation for an upturn in M&A be borne out, this will be a significant change from the relatively muted levels of activity seen in 2017. Quarterly values of closed M&A transactions globally have been broadly declining since mid-2015 (see chart 9) and only a couple of industries – consumer staples and utilities – have seen total M&A for 2017 (up to November 16) exceed the year before (see chart 10).

From a ratings perspective, the crucial question will be what any deals presage in terms of financial policy and any associated business risk. The aggregate indebtedness of S&P Global-rated
nonfinancial corporates that are currently below investment grade has risen from 32% to 42% between 2004 and now, expressed in terms of total debt to total assets (unadjusted), suggested growing financial risk.

Yet debt servicing costs remain exceptionally low – and with little fundamental reason to move sharply higher in terms of S&P Global Ratings’ base case for policy rates and inflation – and have been improved by regular re-financings. Median debt to EBITDA ratios for high-yield sectors (see chart 11) show a mixed picture split roughly half and half between sectors that have seen this measure of leverage rise, and those that have seen it fall over the past three years. The biggest increases have come in business and consumer services, engineering & construction, technology and oil & gas. The M&A pick up anticipated in many of the Industry Top Trend reports is seen as one of the key potential risks to ratings in the year ahead.

Chart 11 – Median debt/EBITDA ratio for 2017 versus 2014 for global high-yield non-financial corporates

Source: S&P Global Ratings

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Overview

- **Ratings Outlook:** Rating trends across the global aerospace and defense industry have remained stable on increased defense spending in the U.S. and Europe and higher aircraft production rates, which have supported elevated demand for commercial aerospace suppliers. However, some suppliers’ credit profiles have become strained because of operational problems and required investments to meet the increased production.

- **Forecasts:** S&P Global Ratings expects that the credit ratios of global aerospace and defense companies will improve in 2018 on moderate revenue growth and higher margins, although this improvement will likely be constrained by the large U.S. defense contractors (which will return most of their cash to their shareholders) and the impact of certain debt-financed acquisitions.

- **Assumptions:** We expect that the volume of commercial aircraft orders will be flat-to-declining in 2018 but anticipate that production will increase modestly at Boeing and Airbus. In the U.S., we expect defense spending to rise moderately next year, though this increase could accelerate if Congress approves higher levels of spending. We also anticipate that defense spending in most European countries will grow somewhat during 2018.

- **Risks:** The largest risk facing the commercial aerospace industry is the ongoing shift in the relationship between aircraft manufacturers and their suppliers, which could negatively affect suppliers’ revenue and earnings. For U.S. defense contractors, political concerns and competing fiscal priorities that limit the growth of military spending are the key risks to further growth. In Europe, the key risks facing defense contractors include possible fallout from Brexit negotiations, issues with their program execution, and corruption probes.

- **Industry Trends:** The commercial aerospace market is softening somewhat but remains strong. Increased defense spending in both the U.S. and Europe should continue to support demand in those markets.
Ratings trends and outlook

Global Aerospace and Defense

Chart 12 – Ratings distribution

Chart 13 – Ratings distribution by region

Because we currently have stable outlooks on almost 80% of the aerospace and defense (A&D) companies that we rate, we do not expect that there will be many rating changes in this segment over the next 12 months. However, there is a negative bias among the companies that do not have a stable outlook, thus any rating actions will likely be negative. This negative bias has lessened since earlier in the year because we have downgraded some of the companies that we previously had negative outlooks on and revised our outlooks on others back to stable. The vast majority of our outlooks on North American A&D companies are stable and most of the non-stable outlooks are related to pending acquisitions. European-based A&D companies make up only a small portion of our global portfolio. The negative outlooks that we have on a few European A&D companies mainly reflect company-specific factors.

Industry forecasts

Global Aerospace and Defense

Chart 18 – Revenue growth (local currency)

Revenue growth should accelerate somewhat in 2018 and 2019 as the production rates of commercial aircraft increase and defense spending rises in the U.S. and Europe.

Chart 19 – EBITDA margin (adjusted)

EBITDA margins should improve slightly as aerospace suppliers improve their operating efficiency and their volumes increase. This improvement will be offset by added pressure on defense companies’ margins despite their higher sales.

Chart 20 – Debt to EBITDA (median, adjusted)

Leverage should decline as earnings increase, although this decline may be offset if larger U.S. firms choose to allocate more of their cash flow to shareholder rewards or acquisitions.

Chart 21 – Funds from operations to debt (median, adjusted)

Companies in this sector should also see their cash flow improve as their earnings increase.

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 historical exchange rates. Forecasts are converted at the last financial year-end spot rate.
Key assumptions

Commercial Aerospace

1. Aircraft orders will likely be flat to declining
   Since peaking at a record of over 3,300 in 2014, the number of large aircraft orders at Boeing and Airbus have declined steadily, which is a trend that we expect to continue over the next few years. The number of orders in 2017 will likely come in at less than the approximately 1,450 aircraft we expect the manufacturers to deliver this year and could even reach the lowest level since 2010. For 2018, we expect that the number of orders will likely remain flat compared with 2017 because most of the near-term demand has been met, the manufacturers’ large backlogs are leading to long wait times for popular aircraft, and there are few new models to drive increased sales. Widebody sales have been particularly weak, especially for the largest aircraft such as the Boeing 747 and Airbus A380, although these sales may pick up when the airlines begin to replace their older midsize widebodies, like the Boeing 777 and Airbus A330.

2. Rising revenue on increasing production
   Despite the lower overall level of aircraft sales, large backlogs (of seven to eight years in some cases) for popular models like the Boeing 737 and 787 and Airbus A320 and A350 are supporting increased production rates for those models. This should lead to increased revenue for most aircraft manufacturers and suppliers in 2018. However, this production growth may not help suppliers that have a large exposure to widebody aircraft, which are seeing production cuts, or other areas of the market that remain weak (like business jets, regional jets, and helicopters).

3. Margins and cash flow should improve
   The large number of new program launches and significant increases in production rates in recent years have increased the revenue of many firms in the commercial aerospace sector, though these same factors have also weakened some companies’ margins and cash flow. In addition, some suppliers have experienced operational problems or program delays that have negatively affected their performance. Now that the increases in their rate of production have slowed and there are fewer new programs being launched, most firms should see their margins and cash flow improve in 2018. However, efforts by the original equipment manufacturers (OEMs) to reduce their costs could limit the improvement in some of their suppliers’ margins.

Chart 22 – Large commercial aircraft orders

Chart 23 – Large commercial aircraft deliveries

Source: Manufacturers’ websites, S&P Global Ratings
## U.S. Defense

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<tr>
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<th>Increased revenue as defense spending rises</th>
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<td>1</td>
<td>We expect most U.S. defense contractors to see increased revenue in 2018 as U.S. defense budgets continue to increase and international sales remain strong. However, the pace of growth will vary by company depending on which programs they are on or what parts of the market they address. Government services contractors will likely see flat-to-modestly positive growth in 2018 because this market is only now beginning to recover from significant reductions in demand in recent years. If the U.S. defense budget increases by more than we currently expect, most contractors likely won't see the additional revenue until at least 2019 due to the lag between when money is appropriated by Congress and when it is actually spent by the military.</td>
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<th>Margins likely to moderate</th>
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<td>The U.S. government continues to look for the best technology at the most affordable price even though overall defense spending has increased. Therefore, we expect that the elevated pricing pressure in this industry will persist. Most companies have worked to rationalize their cost structures in order to bid more competitively on defense programs, though much of these savings are being passed on to their customers, which has limited any material improvement in their margins.</td>
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<th>High level of shareholder returns at large firms</th>
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<td>Most large U.S. defense contractors continue to generate solid cash flow and maintain sizable cash balances, which has led many of them to increase their level of share repurchases and dividends. We do not believe that this trend will lead to a general decline in credit quality for these companies unless their shareholder rewards exceed their cash flow— which would materially reduce their cash balances or increase their debt— or they increase their acquisition activity without reducing their share repurchases. The improving prospects for organic growth could reduce some of the pressure to maintain such a high level of shareholder returns, which should leave the companies with more cash to spend on internal investments or mergers and acquisitions (M&amp;A).</td>
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European Defense

1 European defense spending moving up, a little
Against a backdrop of heightened regional and global security threats and increased political pressure—especially from the Trump administration—we expect that European defense spending will increase slightly in the years ahead. The North Atlantic Treaty Organization (NATO) estimates that its members (excluding the U.S.) will increase their defense spending by 4% to about $300 billion in 2017. We have also seen renewed interest in defense cooperation in Europe, which could spur the creation of new defense and security programs. In addition, the conditions in the traditional export markets for European defense companies, such as the Middle East, are driving increased defense spending, which could further support demand. However, government budgets in certain key countries, such as the U.K., will remain constrained. And any increase in defense spending will take time to appear in contractors’ financial results because there is a time lag between when governments increase their defense budgets and when the money is actually spent by their militaries.

2 Margins to remain below those of U.S. peers
Defense companies based in Europe, the Middle East, and Africa (EMEA) continue to exhibit weaker margins than their U.S. peers because government contracts in Europe remain highly regulated and competitive and are constrained by fixed prices and budgetary pressures that limit spending levels on new programs, which we expect to continue. Cost reductions, efficiency gains, and the disposal of underperforming segments will be the main opportunities for EMEA-based companies in this industry to improve their margins.

3 Continued moderate financial policies
We do not expect there to be major changes in the financial policies of the main European defense players. We anticipate that these companies will remain focused on securing new orders while executing efficiently on their existing programs. Industry indicators suggest that conditions will support improved cash flow generation, though we do not expect there to be any major mergers or acquisitions in this segment (although there may be some midsize bolt-on deals to strengthen their market positions). Additionally, we anticipate that the level of shareholders returns will remain generally stable.
### Key risks and opportunities

#### Commercial Aerospace

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<th>Evolving relationship between OEMs and suppliers</th>
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<td>We expect that the relationship between aircraft manufacturers and their suppliers will evolve over the next few years as the OEMs try to reduce their costs and increase their control over aircraft development and production. Boeing has been particularly aggressive in attempting to reduce costs through its “partnering for success program” and has increased its presence in the lucrative aftermarket, brought the production of certain components back in-house, and is developing the capability to produce components that it hasn’t historically made, like avionics. This trend could lead to reduced demand and lower margins for aerospace suppliers, though we expect that this shift will likely take a long time to develop. The threat, however, has prompted some suppliers to increase their negotiating leverage by expanding the scope of their operations through acquisitions. The largest example of this response being United Technologies’ plan to acquire avionics maker Rockwell Collins, which itself just acquired aircraft interiors specialist B/E Aerospace. We expect this trend of consolidation to continue in 2018.</td>
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<th>Possible changes to international trade rules</th>
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<td>The commercial aerospace industry involves a complex global supply chain that could be disrupted by possible changes to trade agreements, especially in the U.S. and U.K. The Trump administration has proposed changes to the North American Free Trade Agreement (NAFTA), and has suggested pulling out of the agreement altogether, which could increase costs for the U.S. suppliers that moved their operations to Mexico to take advantage of the lower wage rates there. The U.K. is currently negotiating its exit from the European Union, which could eliminate its tariff-free access to the EU market. The country will also have to negotiate new trade agreements with non-EU countries, which could possibly make it a less attractive place for suppliers to locate their operations. If these negotiations have not been completed by the time the U.K. must officially leave the EU, trade between the U.K. and Europe could also be disrupted. Aircraft manufacturers have often used trade rules to try and stifle their competitors, such as the long-running World Trade Organization dispute over subsidies between Boeing and Airbus on large aircraft and between Bombardier and Embraer on regional jets. Most recently, Boeing won a preliminary 300% tariff on U.S. imports of Bombardier’s C-Series aircraft from the U.S. Commerce Department after it alleged that an order from Delta Air Lines was priced below cost. However, Bombardier may be able to avoid this tariff thanks to Airbus' recent investment in the C-Series and the company’s plans to move production to the U.S.</td>
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<td>Both Boeing and Airbus have huge order backlogs and the waiting lists for some popular models stretch out seven to eight years. These backlogs represent a large amount of potential earnings and cash flow for the OEMs and their suppliers if they are able to increase their production efficiently. However, some suppliers have struggled to increase their production fast enough to keep up with the OEMs. Most notably, deliveries of the Airbus A320neo and Bombardier C-Series have been slowed by issues with Pratt &amp; Whitney’s ramp-up of the production of its PW1000G family of engines. Research and development (R&amp;D) costs will also likely decline because almost all of the new aircraft in development will enter production over the next few years, boosting the OEMs’ profitability.</td>
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**U.S. Defense**

1. **Pace and size of defense budget increases**
   
   Although we expect U.S. defense spending to increase over the next few years, the pace and size of the increase is still uncertain due to competing political and fiscal concerns. President Trump’s $574 billion base defense budget proposal for fiscal-year 2018 calls for a 10% increase in spending from fiscal-year 2017 levels. In addition, some members of Congress have called for even higher levels of spending as there is added pressure on the government to increase military spending to offset previous cuts and address growing geopolitical instability (e.g., ISIS, North Korea, Russia, etc.). However, U.S. defense spending is still limited by sequestration and Congress faces competing fiscal priorities, like health care and tax reform, which could cause defense spending to increase at a slower pace than requested. Although we expect that Congress will either eliminate or temporarily waive sequestration to allow the government to increase the defense budget at a faster rate, nothing is certain in the current political environment.

2. **International sales**
   
   Sales to allies have offset the lower demand from the U.S. government for many domestic defense contractors in recent years. Many countries have been increasing their defense spending to address the resurgent threat posed by hostile states and international terrorism, a trend we expect to continue in 2018. The greatest increase in demand has been for missile defense systems, which countries use to defend themselves against missile attacks by Iran or North Korea. International sales typically carry higher margins than sales to the U.S. government, though they tend to be more difficult to predict and most countries have much smaller defense budgets than the U.S. Shifts in U.S. foreign policy under the Trump administration could be a mixed blessing for weapons exports. While the president has indicated that he would like allies to spend more on defense, they may not be inclined to buy weapons from U.S. defense companies.

3. **M&A**
   
   The pace of M&A in the U.S. defense sector has been increasing over the past few years and could accelerate further in 2018 as the visibility surrounding the government’s future spending improves. The recent announcement that Northrop Grumman plans to buy Orbital ATK could prompt other companies to pursue acquisitions that broaden their offerings to address high-priority areas of defense spending. In the government services space, there has been a significant amount of consolidation and intense price competition due to the lack of available work, which has favored companies with greater scale. We expect this trend to continue. Specifically, we anticipate that larger prime contractors will look to buy small- to mid-size companies to acquire new technologies or gain access to certain markets. However, we do not expect that any of the large prime contractors will attempt to merge with each other because the U.S. government has expressed concerns about the level of competition in its industrial base.

**Chart 24 – U.S. defense spending**

**Chart 25 – U.S. supplemental war funding**

*Source: U.S. Department of Defense, S&P Global Ratings*
European Defense

1. Brexit risks disrupting supply chains and trade flows
   The U.K. is Europe’s second-largest aerospace manufacturing nation (by turnover) after France and U.K.-based A&D companies provide a critical link in the high-value, high-tech global supply chain, either as prime contractors or suppliers. The U.K.’s departure from the European Union in March 2019 has the potential to create new trade barriers and disrupt supply chains and trade flows depending on the outcome of the negotiations. Specifically, U.K. defense contractors generated over £31 billion of revenue in 2016, of which over 90% came from exports.

2. Maintaining order backlogs and smooth project execution
   We expect European A&D companies to remain focused on winning new orders, to maintain their order books, and ensuring the smooth execution of their existing contracts, so that their production facilities remain fully utilized. Their backlogs provide a degree of revenue visibility over the next two to four years, depending on the business segment and lifetime of the underlying contracts, but additional costs can emerge if contracts are not won or renewed due to excess capacity.

3. Legacy issues of bribery and corruption
   Certain A&D companies in Europe have been the subject of ongoing legal investigations into cases of historic bribery and corruption. These cases are related to illegal payments that were made to suppliers, government officials, and intermediaries by the defense contractors. While we believe that such practices are no longer taking place, the risk from these legacy practices remains and could lead to fines and reputational damage, which could magnify any deficiencies in the companies’ management and governance.

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Related research
- Credit FAQ: Airbus’ Investment Adds Lift to Bombardier’s C-Series Aircraft, Turbulence to Narrow-Body Market, Oct. 20, 2017
- Credit FAQ: Behind M&A Activity, Economic Growth, And Other Key Issues Affecting Capital Goods, Aerospace and Defense, Oct. 16, 2017
- Credit FAQ: United Technologies’ Acquisition of Rockwell Collins Is Changing The Aerospace Industry Competitive Landscape, Sept. 18, 2017
- Few Surprises And Mostly Positive For Contractors In Fiscal-Year 2018 Defense Budget Proposal, May 25, 2017
- President Trump’s Call For Increased Military Spending Should Support U.S. Defense Contractors Credit Quality, March 16, 2017
Cash, debt, and returns

Global Aerospace and Defense

Chart 26 – Cash flow and primary uses

Chart 27 – Return on capital employed

Chart 28 – Cash and equivalents to total assets

Chart 29 – Total debt to total assets

Chart 30 – Fixed versus variable rate exposure

Chart 31 – Long-term debt term structure

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
Industry Top Trends 2018

Autos

Overview

- **Ratings Outlook**: Rating trends across the sector remain broadly stable; 72% of issuers have a stable outlook. This reflects globally steady sales and some degree of headroom in the ratings due to low adjusted debt, improving business mix, higher technology content, and cost reductions from continuous restructuring. Offsetting factors include ongoing pressure on pricing, high research and development (R&D) spending, high capital expenditure (capex), and the prospect of increased regulatory costs or fines.

- **Forecasts**: Steady credit metrics are expected in 2018, despite auto manufacturers increasing R&D spending and capex to comply with environmental regulation and to protect their competitive position vs peers in the supply of a wide range of electrification options. Slightly improving forecasts for suppliers are reflective of both the benefits of cost reduction measures over the last few years and the acceleration of electrification, which is likely to result in higher content per car in the next two to three years.

- **Assumptions**: We expect global auto sales to increase by about 2%-3% in 2018 and 1%-2% in 2019, consistent with our projections of GDP growth hovering at around 2% in Europe and the U.S., 5.5% in the Asia-Pacific region, and in the 2%-3% range in Latin America. Global light vehicle sales are expected to trend toward 96 million units in 2018 and 98 million units in 2019.

- **Risks**: Pressure on profitability from price competition, higher commodities costs, increasing R&D expenses, and higher residual risk at large original equipment manufacturers’ (OEMs) captive finance operations, which is linked to lower used car prices and the accelerated decline of diesel as a share of new car registrations. Geopolitical risks persist, and we see them as mainly linked to decisions on trade agreements (i.e., NAFTA and Brexit negotiations) that could in a worst-case scenario result in additional costs for the industry.

- **Industry Trends**: The electrification of powertrains is accelerating and is likely to be the most significant and potentially disruptive industry trend in coming years, and comes in response to widespread tightening of environmental regulation, in particular in China and Europe. Additional spending levels are already underway and captured in our base-case forecasts, but how this trend will impact our assessment on business risk, for example, will take time to emerge. We see autonomous driving as a more long-term disruptive trend associated with the commoditization of cars and changes in consumer preferences. Investments in autonomous driving are more of a risk for the sector as a whole, given the significant deployment of companies’ resources toward these technologies.
Ratings trends and outlook

Global Autos

The global rating outlook is largely stable for the global automotive sector. In the U.S., we see limited upside. We think ratings are approaching a ceiling for most U.S. carmakers and suppliers, with nearly 80% of those we rate having a stable outlook. Furthermore, nearly 75% of U.S.-rated issuers are at or above pre-recession rating levels. In Europe, we foresee the rating environment being broadly stable over the next two years, with only a few exceptions. We believe that, despite supportive market fundamentals, rating upside will be limited due to continued high R&D and capex spending to invest in new models and meet heightening environmental standards.

In Asia-Pacific, the credit quality of Japan’s automobile and auto components industries is likely to stay on a stable path for the next year or two, supported by steady revenue sources and companies’ sound financial health. We expect rating trends across the Latin American auto suppliers industry to remain mostly stable for 2018 and 2019, with just one issuer having prospects for a higher rating on potential improvement in leverage levels. Our stable outlook also reflects our expectation that issuers’ key credit metrics will remain commensurate with their rating category amid global vehicles growth slowdown and potential operating setback from NAFTA renegotiation or termination. The aforementioned is mainly underpinned by improved macroeconomic conditions, already-booked platforms, continued cost efficiency measures bolstered to improve profitability and cash flow generation, maintenance of leading market positions, and initiatives aimed to reduce leverage.
Industry forecasts

**Auto OEMs**

**Chart 38 – Revenue growth (local currency)**

**Chart 40 – EBITDA margin (adjusted)**

**Chart 42 – Debt / EBITDA (median, adjusted)**

**Chart 44 – FFO / Debt (median, adjusted)**

**Auto Suppliers**

**Chart 39 – Revenue growth (local currency)**

**Chart 41 – EBITDA margin (adjusted)**

**Chart 43 – Debt / EBITDA (median, adjusted)**

**Chart 45 – 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.
We believe global automotive demand is likely to remain stable, largely in line with our previous expectations. We see China’s outlook remaining stable to positive, the U.S. market showing some signs of softening, and European markets mostly continuing on a moderate growth trend. Visibility remains low in markets such as Brazil, Russia, and India because of likely volatility and macroeconomic uncertainty. We note that these markets account for less than 8% of global vehicle sales, while China alone represents one-third.

In the U.S., auto industry growth is falling behind our earlier expectations in 2017, with a sales decline of 2%-3%. In 2018 and 2019, we think light vehicle sales could weaken slightly from 2017 levels (relative to our prior expectations) but stay at a relative healthy total of 16.5 million-17 million units per year. For Ford and GM, we see limited likelihood for ratings rising again over the next 12-24 months given increasingly competitive conditions. We incorporate modest declines in margins in our forecast for 2018 and 2019 to account for higher commodity prices (mainly steel), large engineering expenses for autonomous and electrification-related technologies, increased regulatory costs, and pricing pressure in several key markets. Those factors will be partly offset by cost efficiencies. For Tesla, we expect lower initial gross margins of the Model 3 due to under-absorption of labor and overhead costs in 2017 and early 2018, with modest improvements later in 2018, and gross margins approaching 25% in 2019 through ongoing cost reductions and improved manufacturing efficiency. We expect PACCAR and Navistar’s EBITDA margins to be slightly up in 2018 due to ongoing cost-management efforts and increasing sales.

For U.S. auto parts suppliers, we believe credit quality has approached a peak, with signs of a modest deterioration in EBITDA margins for about one-third of our issuers (consistent with the normal cyclical variation inherent in the automotive business). For the majority of issuers, we expect steady low-single-digit revenue growth in 2018 as new business wins and higher-value content are offset by foreign currency headwinds and higher commodity prices. We expect EBITDA margins for most U.S. suppliers to be flat to slightly up, albeit with increased downside risks, as they focus on improving their manufacturing and engineering footprint and cutting operational costs.

In Europe, following better-than-expected performance in 2017 on improving economic conditions in the area, which we assume will consolidate, we expect demand for cars to remain steadily in the 2%-3% range over the next two years. Based on this, we expect single-digit growth in revenues for both OEMs and suppliers over the next two years. The rating environment for European car manufacturers should remain generally stable over the next two years. We believe that, despite supportive market fundamentals, rating upside will be limited due to continued high R&D and capex spending to invest in new models and meet heightening environmental standards. Meeting these standards could be even tougher if the decline of diesel’s market share accelerates, to the benefit of petrol. It remains to be seen whether automakers will be able to defend the profitability of their industrial operations while investing in electrification and digitalization—costs that can’t be postponed in light of mounting competitive pressure and stricter environmental regulations. However, these costs’ impact on ratings should be viewed on a case-by-case basis because many OEMs have strengthened efforts to reduce other costs.

We expect European car suppliers to reap benefits from ongoing cost reductions and commitment to higher efficiency. We see strong order books in response to the acceleration of electrification and, in some cases, the sharing of development costs with OEMs. In the longer term however, competition in a full electric/mobility environment will increase for auto suppliers.

In Asia–Pacific, overall market trends are broadly in line with our expectations. However, we now see higher risk in China’s market than we did at the beginning of 2017. In Japan, due to the prospect of a steady economy and low interest rates, we expect the recent steadiness in Japan’s new car sales (+8.1% through August 2017) to continue over the next one to two years. The Association of Southeast Asian Nations (ASEAN’s) six major countries—Indonesia, Thailand, Malaysia, the Philippines, Vietnam, and Singapore—posted steady auto sales growth of 6% during the first eight months of 2017. Considering stabilized commodity prices and a steady regional economy, we believe solid growth is likely to continue in ASEAN. Conversely, we see a slowdown in China. We expect auto volume growth in China over the next two to three years at a pace close to or
in line with GDP growth. Ongoing competitive pressure due to industry overcapacity and increasingly sophisticated consumer tastes will likely continue.

In Asia-Pacific, the credit quality of automobile and auto components issuers is likely to stay on a stable path for the next year or two, supported by steady revenue sources and many companies’ sound financial health. Higher sales incentives in North America will weigh on profitability, as intensifying competition in emerging markets and rising raw material prices continues. Nevertheless, we believe these companies are likely to maintain generally stable profitability underpinned by geographically-diversified business portfolios. For example, a slowdown in U.S. sales would be partly offset by favorable sales in Japan and ASEAN. Also contributing to steady profit margins is technological competitiveness in battery vehicles (EVs) and other types of environmentally-friendly cars to meet tighter environmental regulations, as well as autonomous driving technologies. Ongoing efforts to reduce costs have been major mitigating factors against foreign exchange rate fluctuations.

In Latin America, political uncertainties linger in Brazil, which could weigh on industry and consumer confidence, despite our expectations for recovering macroeconomic conditions. Brazilian demand is still weak but expected to improve by 2018, commensurate to its GDP growth. The sound global demand for commercial vehicles will partially mitigate the weak Brazilian market and will continue to support the industry in spite of U.S. market softness. We believe that the recovery of the Brazilian market will continue in 2018, mainly supported by commercial vehicles, the appreciation of the Brazilian real, and lower inflation. Latin American auto suppliers are highly dependent on the North American market—specifically Ford, FCA, and General Motors, which account for a significant portion of Latin American auto supplier revenues. A softer U.S. market could drag on Latin American auto suppliers. In our view, Brazilian auto suppliers’ revenues will continue to come mostly from its foreign operations and exports during 2018. We note that less than 20% of Brazilian auto suppliers’ revenues are generated domestically. Brazilian issuers have continuously implemented efficiency initiatives to reduce costs and hence improve profitability, which we expect to continue during 2018.
Key assumptions

**Auto OEMs**

1. **Steady economic environment**
   
   We assume a supportive economic environment for the global automotive sector, including a recovery in Latin America and Russia.

2. **Headwinds to EBITDA margins**
   
   We assume limited opportunity to improve profitability for most automakers because of increasing pressure from regulatory and environmental costs, commodity inflation, potential adverse consequences from trade agreements, and Brexit and potential litigation-linked costs.

3. **High capex and R&D**
   
   We assume capex and R&D costs to represent an increasing percentage of sales over the next years, which will limit financial flexibility prior to the next downturn.

**Steady economic environment**

Global macroeconomic trends appear supportive of steady auto sales for the coming year or two. We expect global GDP growth in 2017-2019 to accelerate to 3.6%-3.7% from 3.1% in 2016. Specifically:

- In the **U.S.**, we assume steady GDP growth year-on-year (real GDP growth in the 2.0%-2.3% range in 2018 and 2019), and rising housing starts and gasoline prices. Other supportive factors include still-satisfactory data on vehicle affordability, an upturn in homeownership among young adults, and single-family building permits being at a 10-year high. If these trends are sustained in 2018 and 2019, it could support steady demand for autos in the U.S.

- We believe the economic environment for car sales will remain favorable in **Europe**, where we estimate GDP growth at 1.9% in 2018 and 2019. We project unemployment will continue to decline to below 8% over the next two years from the double-digit peak reported during the recession, thus supporting consumer confidence. Other supporting factors include extremely accommodative financing conditions, which we expect will characterize the whole of 2018.

- In **Asia-Pacific**, we see real GDP growth hovering at approximately 5.5%-5.6% in 2018 and 2019, driven by GDP growth in China and India, two key markets for the auto industry.

- In **Latin America**, economic recovery is underway and we estimate annual growth of real GDP in the 2%-3% range over 2018 and 2019.

**Headwinds to EBITDA margins**

We assume automakers will compete in an environment characterized by commodity inflation and increased regulatory and environmental costs. For some global OEMs, potentially higher litigation risk could add to cost pressure, not necessarily from fines, but more from the need to repair any alleged wrongdoing with specific reference to upgrades of emission-linked software/hardware.

Soft performance in some key markets is seen in combination with the risk of increased pricing pressure. In the U.S., we assume this trend will intensify over the next 12-18 months, which could hurt new-vehicle margins given the correlation between new car and used car prices after several years of competitive pricing.

Our forecast does not reflect the potential impact of trade agreement revisions (NAFTA) or increased tariffs (related to Brexit). NAFTA is under renegotiation talks between Canada, the U.S., and Mexico. The risk that the agreement is terminated remains. Global OEMs with plants in Mexico could be affected, which would trigger substantial revisions to supply chains. Similarly, trade-constraining agreements linked to Brexit could lead to the displacement of production outside of the U.K.
Despite the fact that most OEMs announced draconian cost reduction measures, which could support EBITDA margins in 2018 and 2019, the capacity of these initiatives to offset what we see as a general cost increase for the industry linked to environmental challenges, geopolitical risks, and disruptive trends could lose steam and result in margin pressure.

**High capex and R&D**

We assume an increasing share of R&D and capex as a percentage of sales in 2018 and 2019 for global OEMs. This trend is linked to OEMs’ investments in new models, the electrification of powertrains, and clean diesel to meet heightening environmental standards. We believe this will generally constrain the financial flexibility of global OEMs, although the majority of car manufacturers enjoy some headroom to absorb downside risks, as many feature zero or low S&P Global Ratings’ adjusted debt levels (excluding captive finance operations), and aim to cover capex costs with operating cash flows. We expect some OEMs to try to manage increasing costs through capital alliances or business alliances with other companies.

**Auto Suppliers**

<table>
<thead>
<tr>
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<th><strong>Acceleration of electrification is supportive in the medium term</strong></th>
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<tbody>
<tr>
<td>1</td>
<td>As OEMs are committed to providing the market with a wider range of engine electrification options across their product offering, we believe auto suppliers could benefit from new business.</td>
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<td>2</td>
<td><strong>Steady EBITDA margins</strong></td>
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<tr>
<td></td>
<td>We believe stronger order books and partial cost sharing with OEMs will support car suppliers’ margins despite the impact of higher commodity cost and foreign exchange headwinds. However, margins for car suppliers exposed to lower growing markets may have already peaked.</td>
</tr>
<tr>
<td>3</td>
<td><strong>M&amp;A partnerships and corporate restructurings</strong></td>
</tr>
<tr>
<td></td>
<td>We expect suppliers to consider strategic reviews of their existing business models to take advantage of new market opportunities while managing the costs linked to these opportunities.</td>
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</tbody>
</table>

**Acceleration of electrification is supportive in the short term**

While some OEMs may still opt to manufacture electrification equipment themselves, we expect suppliers to start playing a much bigger role in this. For suppliers, new electrified powertrains represent a business opportunity.

A key focus will be on suppliers that innovate and produce value-added components to assist carmakers in meeting new carbon dioxide emission and fuel economy standards. For example, products such as turbochargers or direct fuel injection, both of which improve internal combustion engine (ICE) efficiency. Components such as turbochargers and power electronics solutions will experience increased demand as vehicle electrification accelerates. Other suppliers that could benefit include those that manufacture and design products that provide the critical electrical and electronic backbone that supports increased vehicle electrification, reduced emissions, and higher fuel economy through weight savings.

Electrification technologies, such as advanced propulsion systems and drivelines, could therefore result in more content per vehicle for suppliers, at least until fully electric vehicles become mainstream. There could be increased outsourcing of standard auto components, such as metal components and assemblies, because automakers have to focus capital investments on autonomous vehicle and electrification technologies. Seating suppliers could also benefit from increased penetration due to demand for lighter-weight seats to improve battery range.

Overall, trends toward electrification could have a neutral to slightly positive impact on suppliers’ credit quality over the next three to five years as increased engineering and R&D-related spending mostly offsets increased revenue.
Steady EBITDA margins

We see strong order books in response to the acceleration of electrification and, in some cases, the sharing of development costs with OEMs. At the same time, we believe suppliers continue to reap benefits from ongoing cost discipline. We expect new business wins and higher value content will be partly offset by foreign currency headwinds and higher commodity prices. We expect EBITDA margins for most U.S. suppliers to flatten out as they focus on improving their manufacturing and engineering footprint and cut operational costs. European car suppliers will reap benefits from ongoing cost reductions and commitment to higher efficiency. We expect suppliers in Asia-Pacific to maintain stable profitability underpinned by geographically-diverse business portfolios. We believe that the softness of the North American market is a factor that could drag on Latin American auto suppliers given their concentration on this market (both geographically and by customer), although some auto suppliers in the region will partly mitigate this risk through diversification in Europe.

M&A, partnerships, and corporate restructuring for auto suppliers

International cooperation between OEMs and suppliers is becoming more common. In one instance, a new company called HERE, which provides mapping data and related services, is owned by a consortium of German automotive companies, including Audi, BMW, and Mercedes. Other examples include the cooperation between leading car companies Audi, Daimler, Tesla, Toyota, and Volvo with auto suppliers like Bosch, ZF Friedrichshafen, Autoliv, and Nvidia to develop artificial intelligence technology for the European New Car Assessment Program (NCAP) safety certification for the mass deployment of self-driving vehicles. We expect this trend to continue over the next few years.

Recent actions by large suppliers are noteworthy. Delphi’s announced spin-off of its powertrain business underscores the need to focus its resources on advancing active safety, connectivity, and electrification amid increasing competition from large industry players and cash-flush Silicon Valley firms. Autoliv’s recently announced strategic review to consider spinning off its electronics business is another signal that indicates the importance of agile innovation as global suppliers compete for tens of billions of dollars in orders from automakers on the cusp of a massive transition to electric and self-driving vehicles.

In our view, auto suppliers will need to be more proactive in offering new products to OEMs instead of waiting to get a new order, which is why we expect to see more partnerships emerge in developing new products. A recent example is the strategic partnership for developing cutting-edge interior and safety technologies for autonomous vehicles between ZF Friedrichshafen and France-based Faurecia, both leading global systems suppliers for cars and trucks. Another example is the agreement between German auto-supplier Continental and Chinese car-making start-up Nio to work together in the fields of EVs and autonomous vehicles.
### Key risks and opportunities

#### Auto OEMs

<table>
<thead>
<tr>
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<th>Risk Description</th>
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<tbody>
<tr>
<td>1</td>
<td><strong>Tightening environmental constraints</strong>&lt;br&gt;Complying with short term environmental regulation is already a challenge for most OEMs and new EU emission targets for 2025-30 confirm the tightening trend.</td>
</tr>
<tr>
<td>2</td>
<td><strong>Risk of overinvestment and duplication of technologies</strong>&lt;br&gt;The attempt to seek a first mover advantages could lead OEMs to overinvest and duplicate technologies for which there is not yet clear evidence of superior competitiveness.</td>
</tr>
<tr>
<td>3</td>
<td><strong>Asset deterioration and lower profitability of captive finance operations</strong>&lt;br&gt;A less accommodative policy is expected to hurt the profitability of captive finance operations, and for OEMs with a material share of leased assets, we see a risk of asset deterioration linked to the decline of diesel.</td>
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#### Tightening environmental constraints

Compliance with 2019–2020 environmental constraints sits high on the agenda of global OEMs and represents, in our view, the bulk of increased R&D costs. Pressure may vary depending on macro regions. Europe and China--where environmental constraints could be particularly stringent--are driving the change and supporting the acceleration of powertrain’s electrification. OEMs have had a good track record in reducing emissions year after year, but the increasing consumer perception of diesel as a threat to public health may turn the diesel option into a below-average investment versus hybrid petrol vehicles, which could make it challenging for automakers to hit their targets (average 95g/km by 2021 in Europe). The uncertainty of environmental regulation beyond midterm targets paves the way for full electric mobility. China is a frontrunner in the competition, having announced a quota of new EVs imposed on new car sales in 2019. EVs are still expensive to produce on high battery cost and low production volumes. A successful mass introduction of EVs is contingent upon the provision of generous public incentives, increased supply of batteries, and the build-up of efficient infrastructure, all issues linked to different countries’ energy and industrial policies. This explains the large percentage of electric vehicles in new car sales in Norway and China versus low percentages in countries like Italy and the U.S. The powertrain electrification is likely to be the single most important mega-trend in the next decade and OEMs cannot defer investments in electrification with the risk of undermining their future competitive position, but the profitability of these investments is not fully transparent.

#### Overinvestment in technologies

We recognize the potential for electrification, autonomous vehicles, and new mobility services such as ridesharing to shake up the auto industry landscape, even with many questions about risks related to regulations, safety, technology, and insurance. We believe these issues will have a mixed impact on the credit quality of both carmakers and auto suppliers.

Autonomous driving is likely to be less disruptive for the industry at this time, in our view, as it not only depends on supply-driven innovation, but also regulatory developments. As such, it could impact large markets like the U.S. and China first, but be delayed in Europe, where reaching a consensus among different governments could prove more challenging. Given that investment in autonomous driving doesn’t currently enjoy high visibility on commercial returns, players might see it as less of a priority at this stage.

We see investments in autonomous driving as more of a risk for the sector as a whole, given the significant deployment of companies’ resources toward similar technologies. Ultimately, a narrow set of factors will determine what technologies make it to market, determined mainly by insurers,
regulators, and consumers. This is unfamiliar territory for many carmakers, and they are competing with large, cash-rich, powerful technology-focused companies such as Google and Apple, and large electronics makers such as Samsung, alongside auto industry disruptors such as Tesla. In our view, through ongoing collaborative partnerships, automakers and suppliers will work increasingly together to share long-term investments with incremental design and engineering-related synergies.

If a carmaker’s autonomous vehicles are more likely to be ready for large-scale commercial deployment without human drivers sooner than expected, it could lead to an improved business risk profile assessment because it would create a sustainable competitive advantage. The rapid deployment of self-driving fleets could help first movers establish significant barriers to entry, particularly in major metropolitan areas, where penetration of autonomous ridesharing over vehicle ownership is likely to be higher. However, a risk factor is that autonomous driving in cities will reduce the importance of branding and lead to a more commoditized experience for passengers who are no longer drivers.

Lower profitability of captive finance operations and risk of asset deterioration

The normalization of monetary policy in advanced economies has entered a new phase, with the U.S. Federal Reserve aiming to shrink its balance sheet and the European Central Bank to taper asset purchases. Rising borrowing costs might reduce margins for auto captive finance operations, which heavily rely on capital markets.

We note that a potential decline in the value of diesel cars could hit residual values, thus leading to losses at large auto manufacturers' captive finance operations that have material leasing businesses, in particular in the premium segment, where the share of diesel is highest. The risk is higher where the decline of diesel is more visible, namely in Europe.

Auto Suppliers

1. Reliance on new product development
   Suppliers will need to proactively invest in the development of new products, as a substantial share of combustion engine-linked traditional business will eventually subside.

2. Acquisition of new technologies
   The ongoing drive toward improving technology will put suppliers in front of the ‘make or buy’ dilemma.

3. Increasing competitive pressure with the transition to electric mobility
   We will see only few large suppliers in the market in the long term.

Execution risk on new product delivery

Execution on product delivery is the main risk we observe for auto suppliers as large OEMs get ready for significant product launches in 2018, 2019, and beyond. OEMs are racing to extend electrification options to their entire fleet of vehicles and competition is high among car manufacturers trying to be first to provide the largest variety of engine types. Operational efficiency and focus on product quality are thus paramount for car suppliers over the next few years. The consequences of product failure can be fatal, as observed in the air bag recall by Takata that preceded the company’s default on $270 million in debt before summer 2017.

Acquisition of new technologies

In our view, auto suppliers will need to be more proactive in offering new products to OEMs instead of waiting to get a new order, which is why we expect to see more partnerships emerge for developing new products. We expect that the pressure to acquire new technologies will remain high.
for car suppliers. Cost sustainability remains the major challenge that we expect car suppliers to continue to tackle with partnerships and acquisitions. A recent example is the strategic partnership for development of cutting-edge interior and safety technologies for autonomous vehicles between ZF Friedrichshafen and France-based Faurecia, both leading global systems suppliers for cars and trucks. Another example is the agreement between German auto-supplier Continental and Chinese carmaking start-up Nio to work together in the fields of EVs and autonomous vehicles.

**Increasing competitive pressure with the transition to electric mobility**

In the longer term, competition in a full electric mobility environment will increase for auto suppliers. Beyond 2030, when electrification technologies catch up to meet the power, load, and duty requirements of larger vehicles, and fully electric vehicles become more mainstream, there will be significant downside to suppliers' business risk profiles because the majority of the traditional auto supplier segments linked to the ICE powertrain will become obsolete. The complexity of a fully electric vehicle and the number of parts is much less than combustion fueled cars. In the longer term, possibly beyond 2035, these trends will likely create an extremely narrow set of mega-suppliers with enhanced diversity, scale, and profitability. This trend accelerates the need for corporate restructuring and revision of the business models, which we already see are underway.

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**Related research**

- Global Auto Industry 2018: At a Crossroad, Oct 10 2017
- S&P Global Expects U.S. Auto Sales To Decline Modestly To 16.8 Million-16.9 Million Units in 2018 and 2019, Oct 5, 2017
- Japan Corporate Credit Spotlight: Automobiles And Components, Oct 4, 2017
- No Smooth Ride For German Carmakers After Federal Election, Sept.25, 2017
- Credit FAQ: Could Allegations Of Collusion And Declining Diesel Sales Stall European Automakers?, Aug 7, 2017
Cash, debt and returns

Global Autos

Chart 46 – Cash flow and primary uses

Chart 47 – Return on capital employed

Chart 48 – Cash and equivalents / Total assets

Chart 49 – Total debt / Total assets

Chart 50 – Fixed versus variable rate exposure

Chart 51 – Long term debt term structure

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
Overview

- **Ratings Outlook:** Rating trends across the industry remain mostly stable, with an overall neutral bias. Latin America is the exception for some ratings, mostly due to sovereign risk influence, which showed a negative trend during 2017. Asia Pacific ratings trends improved during 2017, and currently show a marginally positive outlook bias. Positive momentum in the U.S. and the recovering construction industry in continental Europe support a stable rating trend in these regions.

- **Forecasts:** Credit ratios are likely to improve modestly in 2018, reflecting improving operating leverage and moderately positive price movement. We believe that a recent increase in commodity costs should be absorbed through pricing and cost efficiency, thus limiting any significant negative impact on margins.

- **Assumptions:** We assume supportive macroeconomic fundamentals in North America, with margin modestly improving across the board. In continental Europe, we believe the industry recovery will gain pace, but we are more cautious regarding the U.K. We also assume that some regions in Africa and the Middle-East may suffer because of political risk. In LatAm, we foresee sluggish sales growth, a slight improvement in EBITDA margins, and gradual deleveraging. In APAC, we assume mild demand recovery and price stabilization; we expect that curtailed investments will support further debt reduction.

- **Risks:** Overcapacity in emerging markets and relaxed financial discipline in developed markets are the main sector risks. Still relatively low utilization rates in LatAm and some APAC regions are negatively affecting operating margins. Positively, in some APAC markets, such as Indonesia, the utilization rate should now stabilize after a significant decline in the past few years. In U.S. and Europe, Middle East, and Africa (EMEA), we see a risk of relaxation of financial discipline which could result in share repurchases or increased dividends. We also see risks related to accelerated interest rate increases in the U.S., soft economic conditions in LatAm, and raw material cost volatility. International players may also suffer from currency volatility, in both the developed and emerging markets. In APAC, liquidity and refinancing risk remain key risks for smaller players, while capital spending and operating efficiency remain vital for larger players.

- **Industry Trends:** We forecast continued market consolidation, particularly in the cement industry, and in the U.S., small, regional manufacturers and distributors. We also observe that companies have trimmed investments in those regions with overcapacity, which should result in stabilization of capacity utilization rates in the next few years. In Europe, most companies are exploiting currently favorable debt market conditions to refinance their capital structures at lower interest rates. In most healthy regions, namely the U.S. and Europe, we believe that companies will use cash flow to undertake growth opportunities or to return more funds to shareholders.
Ratings trends and outlook

Global Building Materials

Chart 52 – Ratings distribution

There are a high number of ratings in the ‘B’ category due to the large number of smaller highly leveraged issuers owned by financial sponsors.

Chart 53 – Ratings distribution by region

North America and, to some extent Western Europe, have the largest number of ‘B’ category ratings due to the prevalence of financial sponsors and private equity investment in the regions.

Chart 54 – Ratings outlooks

Overall, ratings are predominantly stable, because the sector is in the recovery phase in both Europe and North America. Rating upside is limited, notwithstanding positive sector fundamentals in those regions, due to highly leveraged issuers owned by private equity.

Chart 55 – Ratings outlooks by region

We see a prevalence of negative outlooks in LatAm, reflecting still-soft macroeconomic conditions and overcapacity. In Western Europe, negative outlooks are mainly driven by increased debt as result of refinancing.

Chart 56 – Ratings Outlook Net Bias

Outlook bias worsened slightly in 2017 compared to 2016, mainly reflecting still-soft conditions in LatAm and increased leveraged structures in Western Europe, which more than offset improved conditions in APAC.

Chart 57 – Ratings Net Outlook Bias By Region

Industry forecasts

Global Building Materials

Chart 58 – Revenue growth (local currency)

We expect mid-single-digit growth in most regions.

Chart 59 – EBITDA margin (adjusted)

Overall modestly improving margins reflect increased operating leverage that offsets some inflation cost.

Chart 60 – Debt/EBITDA (median, adjusted)

Increased EBITDA and capital expenditure optimization drive the improvement in leverage. For investment-grade companies, we expect debt repayment to be less than 2017, and instead we believe companies may undertake acquisitions or increase shareholder remuneration. For financial sponsor-owned companies, we expect little change or potentially some increase in leverage, because these companies should continue seeking out acquisitions or eventually pay dividends.

Chart 61 – 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.
# Key assumptions

## North America

<table>
<thead>
<tr>
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<th>Still healthy macroeconomic fundamentals</th>
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<tbody>
<tr>
<td>1</td>
<td>In the U.S., for 2018, we expect 2.3% real GDP growth, 4.1% unemployment, and 1.3 million housing starts. We further expect mid-to-high single-digit growth in repair and remodeling activity, sub 5% growth in nonresidential construction, and infrastructure spending to be steady to slightly elevated due to stronger state budgets. These modestly positive fundamentals portend another year of improved sales and earnings for building materials companies, but with less sales and earnings growth than experienced in 2016 and 2017 as the long slow recovery in housing enters its eighth year.</td>
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<tr>
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<th>Healthy credit measures likely to plateau in 2018</th>
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<tbody>
<tr>
<td>2</td>
<td>Our forecasts suggest that in 2018 the North American construction sector will continue to follow a rather modest recovery path as housing starts tick up another 100,000, states continue to catch up on deferred improvements on roads and bridges, and consumers spend more to remodel and update their homes. Still, given the improvement in credit metrics that has already taken place in the sector, we see little prospect that companies will use excess cash flow to reduce debt. Nearly all of our investment-grade and 'BB' rated issuers have already lowered debt leverage below original targets. Rather, companies are using their excess cash flow to invest internally in operations to improve efficiencies and looking for acquisitions, but these are few in number given inflated multiples. They might spend more on share repurchases, but we have seen very little of this activity given high equity valuations and a record Dow. In the lower speculative-grade space ('B' category), private equity has remained very active in buying small companies as the sector continues to consolidate, but multiples are getting very high. Still, leverage levels for these companies are less than they were at the last housing peak in 2007.</td>
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<th>Steady margins given modest cost inflation and good pricing</th>
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<tr>
<td>3</td>
<td>The tailwinds from lower commodity costs ended in 2016 and companies have faced modest labor and raw material cost increases in 2017, particularly in wood, metals, resins, and glass. We expect this trend will continue in 2018, but between continued cost efficiencies (as companies invest in automation) and the ability to pass on price increases, the sector, for the most part, has been able to more than offset the higher costs. Most companies still have some excess capacity to take on more demand as long as the growth is modest as expected.</td>
</tr>
</tbody>
</table>
**EMEA**

1. **Recovery continues in most continental European countries**
   Most European markets continue to gradually recover, with Italy and France now starting to exhibit a positive upturn and supporting our overall growth assumptions for the region. This should translate into higher GDP and in turn an improved rate of construction compared with 2016. We expect the Eurozone to grow by 2.2% in 2017 and 1.8% in 2018, and construction output to increase by about 2%-3%, on average, in the region. As volumes improve and prices stay at least stable, if not slightly positive, we expect a gradually improved performance for many of our issuers through 2018.

2. **Foreign exchange volatility may continue to affect financial results**
   In contrast to this gradual positive growth, many of our issuers may continue to experience foreign exchange headwinds, as they did through 2016, when many smaller currencies devalued against major currencies, resulting in a negative impact when repatriating earnings to euros. In 2017, the expectation was that this trend would gently reverse, but political uncertainty continues to cast doubt on this reversal through 2018. This volatility has also started to affect rates between major currencies, with Brexit negotiations and wider political uncertainty contagion having spread to affect the British pound versus the U.S. dollar and the euro.

3. **Any exposure to USA/North America buoys results**
   Any of our issuers with material exposure to the U.S. are experiencing good growth rates now, often pulling up overall (global) financial results. Heavier products like cement and aggregates are particularly attractive areas of the U.S. market to be in right now, and some of our issuers have made acquisitions to increase their exposure to this market. We have not factored in any significant impact from any possible tax reform because it seems too far off, but any cut in the corporate tax rate would likely be slightly credit positive for our issuers with U.S. operations.
Latin America

1. Slow volume growth expectation
Our 2018 forecasts suggest that LatAm building materials companies will still post modest volume growth due to our expectation of soft economic activity and the still-uncertain political landscape in the largest markets of the region. In terms of volume sales, Mexico is probably the market with the most significant downside risk due to sluggish volume growth that is affected by low to declining public spending in infrastructure projects and low investments in nonresidential projects. However, housing should continue to some extent compensate for the overall trend. In most LatAm countries, we remain cautiously prudent regarding housing demand because volatility in the international market could pressure inflation and interests rates. Companies with geographic diversification, particularly with a presence in the U.S, should continue to post healthy top line growth.

2. Prices to stabilize and profitability to sustain
We expect overcapacity to constrain significant additional price hikes in most LatAm countries throughout 2018. That being said, cement producers in the region have been posting higher operating margins than those of global peers, mainly because of their competitive cost structures and pricing power. For 2018, we expect low-single-digit-to-flat price increases and EBITDA margins to trend toward the 20%-22% range, on average, supported by ongoing cost-control initiatives amid the risk of lower demand, as well as by the issuers' ability to overcome inflation costs by passing them through to end consumers.

3. Deleveraging trend across the region
Following a five-year period of important capital investments and merger and acquisition (M&A) activities that drove leverage above 3x, we expect most industry players to scale back cash allocation for capital expenditure (capex) purposes and to focus on debt reduction instead. We believe that companies will continue to optimize their costs structure, with the aim to increase cash flow generation and to protect liquidity positions. In Brazil, however, companies are still struggling to generate free cash flows and to reduce very large debt positions.

Asia-Pacific

1. Stabilizing economy driving demand growth
Since we expect stabilizing growth for most Asian countries, the sector's credit conditions will continue to improve on the back of economic growth and construction activities. Infrastructure investment will continue to propel the growth, together with modest growth in the property industry. China's infrastructure investment growth mainly fuels a turnaround story for Chinese companies. In Japan, infrastructure needs and a modest recovery in the property market are favorable for building materials producers while Korea's property slowdown caps companies' growth. Improving home construction and repair needs underpin stable prospects for Australian companies.

2. Resilient prices support operating cash flow
In most of APAC, we see a stabilizing price trend due to a recovery in demand. We expect overcapacity to constrain pricing upside in some regions, like China. We did not see a large capacity retirement in the past few years; however, self-disciplined production control between regional players helped maintain prices.

3. Deleveraging trend to continue in general
We expect companies to restrain their capital spending over the next two years, and we do not expect aggressive M&As in the region. Most of the companies are deleveraging while improving their profitability amid the sector recovery.
Key risks and opportunities

North America

1. Uncertainty over tax code changes

   Given the lack of progress in advancing any of the Trump administration’s original initiatives on immigration, trade agreements, or taxes, it is uncertain at this time if the current push on tax reform can be approved. However, until a firm plan can be hammered out and agreed upon, there is much uncertainty on what tax reform will ultimately look like. Still, the loss of the tax deductibility of home mortgage interest and state income taxes on the part of individuals (which is being talked about) even if offset by a reduction in overall tax rates, could have a dampening effect on home buyers and those who use home equity loans to fund major repairs and remodeling, particularly in high income, high tax states like New York and California.

2. Higher interest rates

   While the Federal Reserve has certainly taken a slow and measured approach toward increasing interest rates, our economists do project it to raise interest rates three times in 2018, by 25 basis points each time, to a target Fed Funds rate of 1.75% to 2%. We do not expect that this would derail home buying momentum or increase the cost of borrowing for home improvements to the point that construction activity slows. However, should inflation pick up in 2018, causing the Fed to raise rates more quickly and in higher increments, we think consumers and homebuyers would likely pull back from their current spending patterns on homes and large ticket remodeling activity, possibly choking off the construction recovery.

3. Acquisition multiples and the return to high leverage

   Going into 2017, we expected companies to spend more of their improved cash flow on acquisition activity and expansion. While acquisition activity has picked up slightly and there have been some deals in the space (Stanley Black & Decker Inc.’s acquisitions of Newell Tools and Craftsman and Martin Marietta Materials Inc.’s pending purchase of Bluegrass Materials Co.), large acquisitions have been few and far between because investment grade and ‘BB’ rated issuers have remained very disciplined, passing on the current high multiples in the space.

   For the ‘B’ rated names in the space, most of which are owned by private equity, acquisitions have been more plentiful as financial sponsors roll up the smaller companies in the sector. But with recent purchase multiples of 10x or more, we have seen financial sponsors contribute more equity to those transactions to keep financing and leverage at manageable levels. However, should cash pile up on the balance sheets of the better-rated names, pressure from shareholders may mount to put that cash to work, perhaps resulting in more willingness to pay high prices and incur more leverage in order to grow through acquisition. Likewise, on the lower speculative-grade side, as competition among highly liquid private equity firms for quality acquisitions intensifies, even higher purchase multiples and leverage may be in the offing.
EMEA

1 Relaxed financial discipline
Virtually all of our speculative-grade building materials issuers now have fairly aggressive, covenant-lite debt structures in place, and we have noticed leverage levels gradually rising across this section of the portfolio, particularly for some private equity-owned issuers. This increased leverage has sometimes resulted in a weakening of credit metrics and lower rating level. Building materials issuers have in the past exhibited a rapid EBITDA decline when the market has taken a downturn, meaning that high leverage leaves less room for building materials issuers to maneuver when under stress. At the same time, we noted that some building materials players in the investment-grade category have increased shareholder remuneration through higher dividends and share buybacks, which resulted into lower rating headroom.

2 Brexit and political volatility
Political uncertainty continues to be a major theme for our issuers and is partly responsible for driving the foreign exchange volatility that has been affecting their financial results. In particular, the uncertainty being created by Brexit and political volatility (in countries where some of our issuers have material exposure, such as Algeria, Egypt, and Turkey) may drive further foreign exchange volatility through 2018. We believe that while most of our issuers with exposure to the U.K. will not face cross border servicing/logistics issues, local demand will likely weaken as consumer sentiment falls. This could result in pressure on some of our issuers with a high concentration to the U.K. construction sector, namely HSS Hire Group PLC and Travis Perkins PLC.

3 Many issuers have debt that is priced at historic low interest rates
During 2017, almost all of our EMEA building materials issuers refinanced either part or all of their debt, at historically low interest rates. In our opinion, rates can and will only rise in the future and these issuers could face a higher interest cost when they next look to tap the markets. It also slightly raises the refinancing risk four to five years out because most of the structures put in place through 2017 mature in 2022 or 2023.
### Latin America

#### Political uncertainty

In 2018, various general elections will take place in LatAm, including Colombia (May 2018), Mexico (July 2018), and Brazil (October 2018). In many cases, we believe that these elections will bring volatility to the market and could delay investor's and issuer's investment strategies, and to some extent, economic growth, as well as refinancing activities. Moreover, the lack of clarity with respect to U.S. policies remains and will still weigh on investments decisions, particularly in Mexico.

#### Sluggish economic recovery

In our view, domestic demand will continue to drive economic growth in most countries in the region. Nonetheless, public investment is either low or falling in most countries, given fiscal challenges and delays from corruption scandals. Private investment will remain sluggish in most cases, as investors wait for more clarity in the political arena as elections approach. In Brazil, we expect a gradual recovery, with GDP growth to reach about 2% in 2018 compared with our estimate of 0.5% for 2017, driven by an improvement in exports and household spending as long as labor market dynamics stabilize and inflation decreases, which will support a recovery in private consumption. In Mexico, we expect GDP growth to remain relatively flat at 2.3% in 2018 compared with our 2.2% estimate of growth for 2017. We anticipate still-weak public infrastructure spending and private investors to hold off on investments due to the uncertainty around the political landscape and NAFTA. In Peru, we expect GDP growth of 3.5% compared with our 2.6% estimate for 2017, with the economy recovering from the impact of the heavy floods that took place in the first quarter of 2017, as well as from a series of corruption scandals in the construction sector.

#### Overcapacity likely to remain high

Most of the LatAm building materials companies that we rate have a dominant market position and well established distribution network, as well as state of the art production plants, which in our view allow them to sustain their profitability measures. However, we expect high overcapacity in the market due to likely low utilization rates caused by slow economic activity, which could pose some operating efficiencies risk. We estimate that utilization rates in Brazil will remain at about 50%-60% in 2018, well below the 75% before the country’s economic downturn. Mexico is the second-largest market in the region, with about 40 million tons in cement sales and 61 million tons of installed capacity, while Peru’s cement market has an installed capacity of about 15 million tons and volume sales of about 10 million tons.
Asia-Pacific

1. **Overcapacity**
   Continued overcapacity remains a short-term risk for the building materials sector, particularly in China, in our view. We do not expect new capacity expansion for most companies, but industry consolidation could dampen profitability and amplify liquidity risks for small to midsize players.

2. **Demand growth**
   Macro conditions in APAC, particularly in China, are key to the sector outlook and profitability. Any slowdown in economic growth, especially driven by infrastructure and property, could lead to slower demand growth for building materials. In turn, this could affect selling prices and profitability.

3. **Liquidity and refinancing risk**
   Liquidity and refinancing risk remain key risks for smaller players while capital spending and operating efficiency remain vital for larger players. For instance, small Chinese cement companies may continue to face high refinancing and liquidity risk because banks are reluctant to lend under the government’s de-capacity reinforcement. We expect large companies to focus on improving operating efficiency, particularly those that just completed acquisitions over the past two years.

Industry developments

**EMEA: Market consolidation remains a key theme...**

We expect that market consolidation in the EMEA building materials sector, particularly the fragmented and competitive cement market, will continue to gather pace through 2018. International heavy materials producers have been ramping up their pursuit of acquisitions in attractive overseas markets, mainly in the U.S., where demand, volumes, and prices are robust.

The European cement market is consolidating further since the heavyweight merger of Holcim Ltd. and Lafarge S.A. in 2015, and the acquisition of Italcementi SpA by HeidelbergCement AG in 2016. Some small and distressed cement producers are being acquired by larger groups, especially in more-fragmented markets such as Italy. We see large players’ willingness to reduce local overcapacity, optimize their distribution network, and put in place conditions to reduce the price pressure that compressed margins in the past decade. Similar consolidation is taking place in other niche and specialty areas. Any of our issuers with material exposure to the U.S. are experiencing good growth rates now, often pulling up overall (global) financial results. Heavier products like cement and aggregates are particularly attractive areas of the U.S. market to be in right now, and some of our issuers have made acquisitions to increase their exposure to this market by acquiring the assets that merging companies disposed of to comply with competition authorities or by exploiting some opportunities in the regional U.S. market. This is the case of CRH plc, which acquired most of the assets that LafargeHolcim Ltd. disposed of and is now looking to potentially acquire several cement producers, including Kansas–based Ash Grove Cement Co. and Florida–based Suwannee American Cement LLC. Some issuers are targeting small bolt-on acquisitions in emerging markets, particularly in LatAm, because opportunities may arise to acquire recently built, technologically advanced plants at much lower than usual multiples because weak local market conditions have distressed their owners.

We expect that future acquisitions are likely to involve asset divestments or asset swaps aimed at achieving streamlined and optimized country positions, supporting deleverage processes, or financing more-generous shareholder remuneration.
...while digitalization gains weight in the sector as driver of competitive advantage

In our view, digitalization is emerging as a key theme, particularly for large players, to improve operating efficiency and ultimately strengthen their competitive advantages over smaller and less sophisticated companies. In particular, digitalization of business processes and the value chain is proving to better serve local markets, also through web-based sales platforms. Large building materials distributors have invested modestly in internet platforms, and so far withstood competition from potential new entrants, such as large retail distributor Amazon, fairly well due to the value they can add for customers. In our view, digitalization will play an increasing part in companies’ strategy in next few years and therefore a larger portion of their overall capital spending, but we expect the investment to remain fairly modest compared with other industries such as automotive or capital goods.

At the same time, digitalization may increase the risk of losing customer access through digital disruption or cyber-attacks. In June 2017, Compagnie de Saint-Gobain experienced a cyber-attack that affected the majority of its systems in Western Europe. Saint-Gobain estimates the impact of the attack was a €220 million sales reduction and a €65 million operating income reduction during the first half of 2017, equivalent to 1.1% of organic sales growth and 4.4% of operating income. The company also estimates that the full-year 2017 impact would be up to €250 million on sales and €80 million on operating income. We believe that digital disruption, or cyber-attacks, is becoming a key risk that companies need to manage, particularly distributors, and we expect companies to allocate increasing funds to manage it.

North America: Capital allocation: internal investment first, acquisitions second

With healthier balance sheets, low debt servicing requirements (due to long dated debt maturities and low interest rates), and good cash flow, the North American building materials sector, particularly in the investment-grade and ‘BB’ rated spaces, is looking to deploy cash flow to improve earnings and to expand its business. We have seen a renewed focus on investing in internal operations through more automation and technology to streamline costs and improve margins. For ‘BB’ and higher-rated names in the space, we have seen moderately increased capital expenditures, often described as “growth capex” geared toward greater efficiencies and, in some cases, increased capacity for product lines where demand is exceeding supply. For these higher-rated names in the space, internal investment is the first option for deploying excess cash flow and capital. Acquisitions are also high on the list, but most issuers tell us that most opportunities are simply overpriced. So most companies are remaining prudent and are not willing to aggressively boost leverage to fund expensive acquisitions. Even in the speculative-grade space where private equity has been very actively acquiring companies, we have seen greater use of equity in financing structures in the more recent 10x multiple acquisitions so that opening debt leverage is still manageable. We expect private equity to continue to pursue acquisitions, particularly targeting smaller companies ($500 million of sales or less). However, with multiples already high, more equity investment may be needed in transactions to make financing them feasible.

Latin America: Upcoming general elections, slow economic recovery, and still large overcapacity weigh on industry fundamentals

As discussed above, 2018 will be marked by various general elections in LatAm, including Colombia (May 2018), Mexico (July 2018), and Brazil (October 2018). In many cases, we believe that elections could delay investor’s and issuer’s investments and economic growth, to some extent, as well as refinancing activities. As a result, the main risk for the region remains related to sluggish economic growth prospects and still-low government spending in public infrastructure projects. The potential risk for higher inflation and interest rates will likely continue to weigh on household disposable income and ultimately on housing starts, which all together will limit volume growth to the mid-single-digit area. Overcapacity could also constrain additional price increases in the region.
Asia Pacific: Sector to remain stable on resilient demand

We see an improvement and stabilizing trend in 2018 because nearly all of the companies have a stable outlook. In our view, downstream demand for building materials in APAC will continue to grow steadily over the next 12 months, thanks to infrastructure projects and property market growth, particularly in China. We anticipate that key risks include slower-than-expected economic growth causing weaker demand, overcapacity, and liquidity and refinancing risk, especially for small players.

More specifically, for China’s building materials sector, we expect production volume to remain resilient in 2018. Infrastructure recovery and property industry growth will stimulate demand growth. We believe the increase in approvals for infrastructure projects led by the government and the government’s “One Belt, One Road” initiative will remain an impetus for demand in the coming quarters. Supply curtailment remains a long-term benefit for supply-demand equilibrium and price recovery. However, small players may stay under financial pressure and struggle in the industry consolidation. Large companies, on the other hand, are leveraging economic scale to cut costs and looking to form alliances on pricing to survive competition. We expect liquidity for most companies in APAC to remain adequate. Companies with aggressive capital spending or a heavy reliance on short-term financing may face near-term liquidity risk.

Financial policy

EMEA: Increasing risk of relaxed financial discipline

Our issuers are currently experiencing and benefitting from gradually improving operating conditions (good volumes and pricing), the realization of synergies as result of past M&A, ongoing tight capex discipline, and significantly reduced interest expense. This all translates into stronger free operating cash flows, which would suggest a reduction of financial leverage across the sector. However, our credit metrics indicate that large companies’ financial deleveraging is proceeding at a rather slow pace, which does not provide significant headroom to ratings. This is because many of our rated issuers are increasing their shareholder remuneration through higher dividends or share buybacks. For example, starting in 2017, LafargeHolcim began pursuing a more-generous dividend distribution and a share buy-back program; in our opinion, this is translating into slower decreasing leverage than we initially anticipated, which has reduced rating headroom. The currently improving operating environment in continental Europe and the U.S. should continue to reload companies’ yearly free cash flow in the next few years. However, if any unexpected downturn is not immediately followed by an adjustment of companies’ financial discipline, we believe that pressure on ratings may mount.

In the speculative-grade world, particularly in the ‘B’ category, a large number of companies have recently taken advantage of benign debt market conditions to fund acquisitions or refinance their capital structure at historically low rates. In most cases, this translated into more leveraged structures, usually covenant lite. As result, in a few instances we lowered our ratings or revised our outlook to negative.

North America: Modest share repurchases—for now!

With stock market values at record highs, what we have not seen is a return to large share repurchases. As indicated above, better-rated names are focused on internal investment first and acquisitions second (if available); normally, share repurchases would be third. But at current stock prices, it is not efficient for most companies to repurchase shares. Without opportunities to deploy cash, for the time being, among the ‘BB’ and higher-rated names, we would expect to see some cash accumulate on balance sheets, resulting in lower net debt leverage. However, we do not expect companies to use cash to actually repay debt given the long maturities and low interest rates that are locked in.

However, companies can only allow so much cash to accumulate before pressure will come from shareholders. We have already seen some minor increases in dividend payout rates. But given the
cyclicality inherent in the sector, companies don’t want to boost dividends too high because they would be loath to cut a dividend in a downturn. Therefore, if this slow recovery continues to result in improved cash balances with limited investment opportunities, we think some issuers may make additional pension contributions and perhaps, although less likely, consider a special dividend. What we do not see is any inclination, now or in the future, for our publicly rated building materials issuers to use debt to fund shareholder distributions or repurchases. Therefore, among these higher-rated and public names we expect financial policy to remain prudent, with leverage maintained at or close to current levels. Among the lower-rated, private equity-owned names, however, debt-financed dividends always remain a possibility, particularly if the company reduces debt leverage below 4x and there are no near-term acquisition or IPO opportunities.

**Latin America: We expect players to keep a prudent financial policy**

We expect LatAm issuers to generally maintain their prudent and disciplined financial policy throughout 2018, particularly in the context of the upcoming elections and sluggish economic recovery. We expect issuers to keep focusing on profitability and cash generation and to gradually deleverage their capital structures. We continue to expect that debt repayments will be performed through excess cash flows and noncore assets disposal. We are not expecting important expansion capex programs nor large M&A activities. Last, but not least, we foresee most issuers to maintain comfortable liquidity positions with no aggressive dividend payments and very limited share buy-back activities.

**APAC: A general deleveraging trend**

We expect a general deleveraging trend across the building materials and forest products sectors because stable market conditions across Asia will keep a lid on expansion plans for most companies. For some players in the sector with aggressive acquisition appetites, capital management remains under control but rating headroom has decreased. Disciplined financial policies and capital spending curtailment support our base case and stable outlook for the building materials sector.

*Under S&P Global Ratings’ policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.*
Cash, debt and returns

Global Building Materials

Chart 62 – Cash flow and primary uses

Chart 63 – Return on capital employed

Chart 64 – Cash and equivalents/Total assets

Chart 65 – Total debt/Total assets

Chart 66 – Fixed versus variable rate exposure

Chart 67 – Long term debt term structure

Source: S&P Global Market Intelligence, S&P Global Ratings calculations.
Overview

- **Ratings Outlook:** The stabilization of commodity prices in 2017 and continuous positive trends across several other important end markets for global capital goods companies, such as automotive, construction, have eased the ratings pressure within the capital goods sector. Currently, 74% of ratings on capital goods companies carry a stable outlook, versus 70% at the end of 2016. Currently 19% of ratings in the global capital goods sector carry a negative outlook, of which the majority are in North America. We expect the negative bias to ease over the next 12 months driven by widening ratio headroom, caused by improved sector operating and financial performance.

- **Forecasts:** We expect that positive performance in the majority of end markets will lead to higher capital expenditure (capex), particularly on new equipment, which will help buoy companies’ revenues, as well as their profits. On aggregate, we expect a modest improvement in credit metrics, with funds from operations (FFO) to debt increasing to 36.4% and debt to EBITDA remaining at 2x on average over the next 12 months, with sector ratings pressure easing further. However, ratings remain under pressure for companies that concentrate on certain industries or segments, for example, oil and gas, where we do not expect a fast recovery, despite recent price increases.

- **Assumptions:** On aggregate, we expect the capital goods sector to benefit from global economic growth of 3.5% in 2018. We expect improved macroeconomic prospects in the U.S. and the Eurozone (excluding the U.K.), and decelerating growth in China, as the Chinese government focuses on policies to curb credit growth. We expect the sustained growth to turn into modestly increasing capital spending across all major industry sectors over the next two years, with a positive impact on overall sector revenues, which we expect to grow by an average of 4%. We assume that most industry participants will be able to sustain or improve their operating margins based on industry-wide cost-reduction measures over the past few years. We further expect financing conditions to remain supportive of both strategic and financial sponsor-driven mergers and acquisitions (M&A) in the capital goods sector in the short-to-medium term.

- **Risks/Opportunities:** Accommodative monetary policy is likely to further incentivize more aggressive financing structures, particularly among speculative-grade issuers. In the medium term, we expect monetary policy tightening to increase the cost of debt, which could weaken credit metrics within the highly capital-intensive sector. In the speculative-grade category, and particularly for highly leveraged transactions, we foresee a significant increase in refinancing risk materializing in 2021, with debt maturity volumes mounting. As well as companies concentrated on commodities, we also foresee the margins of the suppliers to the largest industry players coming under pressure, despite the positive sector outlook. We expect original equipment manufacturers (OEMs) to continue to outsource lower-value items to their suppliers, and expand, or in some cases insource, higher-value items and more critical parts of their operations. In the medium term, the digitalization of manufacturing, or “Industry 4.0”, in our view poses both a transformational risk and an opportunity for the whole sector.
The capital goods sector turned a corner in 2017, with an increase in broad-based demand for equipment and services across the most important end markets, and 74% of the rated companies on a stable outlook. The share of negative outlooks has steadily declined since the third quarter of 2016, but a clear negative bias persists in the distribution. This is mainly due to the sector’s weighted aggregate leverage, which, reached its highest point at the end of 2016 and continues to limit the credit ratio headroom for the current ratings levels.

Notable rating actions during 2017 include:
- The upgrades of CNH Industrial N.V. and KUKA AG;
- The downgrades of Toshiba Corp. and The Weir Group PLC;
- The placements of General Electric Co. on CreditWatch negative and of Thyssenkrupp AG on CreditWatch positive; and
- The outlook revisions on Caterpillar Inc. to stable from negative, and on Hitachi Ltd., and KION Group to positive from stable.
Industry forecasts

Global Capital Goods

For the capital goods sector globally, we expect revenues and operating profit to grow by around 4% and 7%, respectively, in 2018, aiding the improvement of credit metrics from 2017 levels. We further expect a mild recovery of commodity prices (except iron ore and oil and gas), as well as a moderately supportive macroeconomic environment, to favorably influence demand and revenues.

We expect EBITDA margins to continue to grow by low single digits over the next two years, as a result of expected topline growth and the cost-cutting measures that most of the largest industry players have implemented. We forecast that our key credit metrics—S&P Global Ratings-adjusted FFO to debt and adjusted debt to EBITDA—will modestly strengthen, with adjusted FFO to debt increasing to 39.5% in 2019 from 34% in 2016, and adjusted debt to EBITDA improving to 1.9x in 2019 from 2.2x in 2016. However, this strengthening will depend on whether companies take advantage of the low interest rates to undertake debt-financed M&A.
Key assumptions

Capital Goods

1. Global growth is accelerating, but not without risks
   Global economic growth has picked up this year, after a dip in 2016 and weaker growth in the Americas. We expect the global economy to grow at around 3.5% in 2017 and 2018 from 3.1% in 2016. Key expectations for 2018 include: the normalization and unwinding of the Federal Reserve’s (Fed’s) balance sheet, with three rate hikes of 25 basis points (bps) each; improved macroeconomic prospects in the Eurozone (excluding the U.K.); decelerating growth in China; and further recovery in Latin America following the emergence of Argentina and Brazil from multiyear recessions. Despite accelerating global growth, geopolitical risks, such as escalating tensions surrounding North Korea or the risk of a disruptive U.K. departure from the EU (Brexit) could cast doubt on future capex and investment decisions and ultimately sector credit metrics.

2. Sustained demand recovery
   Market conditions for capital goods issuers started to improve in the second half of 2016, with the recovery of commodities benefitting some of the sector’s main end markets. We expect improving performance in metals and mining (except iron ore), and steady growth from non-commodities-related end markets, to support the recovery in overall demand in the sector.

3. Global capex: a return to investment
   Global corporate capex growth has turned positive after four years of decline. We estimate global capex growth of 5.5% in 2017. The recovery is broad-based, with growth expected in all regions and nearly all sectors. Sustained growth in capex should support the positive development of the credit metrics of the majority of capital goods sector companies. In addition to the positive revenue impact, we expect margins to hold up well, based on the restructuring and cost-cutting measures that companies have undertaken in the past few years, which have reduced the aggregate controllable cost base.

Key risks and opportunities

Capital Goods

1. Operating efficiency, automation and OEM outsourcing
   End markets continue to stabilize and capital goods issuers shift their focus to growth initiatives from the cost-reduction programs that they implemented to cope with declining demand over the past few years. We believe that the multiyear restructuring and cost-reduction programs are now largely complete, and we anticipate that issuers will focus capex on boosting their competitive advantage by investing in new or improved products and technologies (as opposed to pure capacity expansion).

2. Financing conditions and refinancing risk
   The global speculative-grade default rate decreased to 2.8% as of Aug. 31, 2017. We don’t expect a significant increase in the future default rate. Accommodative monetary policy in the U.S. and Europe has allowed capital goods companies and corporate entities in general to borrow at very low interest rates, leading to an increase in debt issuance. A number of capital goods companies, particularly speculative-grade entities, have extended debt maturities to 2021-2022, increasing refinancing risk if interest rates rise significantly.

3. Increasing M&A and divestitures
   We expect the pace of M&A and divestitures to increase further in 2018. We expect that some large capital goods companies could accelerate M&A in the next year to expand overseas, enhance core business, look for synergy opportunities, and speed up technology gains. Additionally, we expect high leveraged buyout (LBO)-related M&A activity to persist, boosted by supportive financial conditions and overall sector growth prospects.
Industry developments

1) Macro-economy: Global growth is accelerating, but not without risks

We forecast continued strengthening of the U.S. economy, with real GDP at 2.1% this year and 2.3% in 2018. There is a broad-based recovery in end markets, despite a few pockets of weakness, which should provide a relatively stable operating platform for U.S.-based capital goods companies in 2018. The pro-business stance of the Trump administration appears to be buoying confidence in the sector. While there was initial optimism for an infrastructure-spending bill, one has yet to appear, although this has not hampered industry prospects. The recent hurricanes have weighed on the U.S. economic rebound this year, although they could spur revenue growth in the medium term as rebuilding gets underway.

U.S. monetary policy remains accommodative for highly leveraged entities, although we expect three rate hikes of 25 bps each in 2018. We think most issuers can absorb a moderate pace of interest rate hikes, given limited refinancing needs through 2018, but a sharper rate of increases could pressure liquidity or covenant compliance for weaker issuers. Under the moderate interest rate hike scenario, we expect steady access to capital markets to support potential M&A and LBO activity in the sector, especially in the U.S.

European capital goods companies face better economic prospects going into 2018, as political uncertainty has to some extent abated since the German and French elections. However, a disruptive Brexit could prove challenging to companies with concentration in the U.K. We expect Euro area growth of 2.2% in 2017 and 1.8% in 2018, with growth substantially lower in the U.K. at 1.4% for 2017 and 0.9% in 2018. Financing conditions will remain favorable, allowing M&A to protect margins.

China will remain a key growth market for rated capital goods and aerospace issuers. We expect Chinese real GDP growth of 6.8% in this year, slowing to 6.5% in 2018, although remaining well above that of the U.S. and Europe. Importantly, we expect that infrastructure spending will still exceed GDP growth, as this is a key growth driver in China. Infrastructure investment grew by a robust 20% during the first three quarters of 2017. Manufacturing sentiment has improved slightly, aided by domestic and external demand. The official manufacturing Purchasing Managers Index rose by 30 bps to about 52 bps in August 2017, indicating continued expansion. However, growth driven by expansion of credit remains a key risk. Government policies to curb credit growth could result in meaningfully slower economic growth, dragging on demand for a broad base of capital goods products and airplanes.

In Latin America, we expect slow economic recovery in 2018, with GDP growth of 2.1% against our 1.0% estimate for 2017 for the region. For the capital goods sector, we anticipate that market conditions will gradually improve, benefitting from the sector’s main end-market dynamics. Large infrastructure projects, particularly in Peru, should support top-line growth, although public infrastructure spending will remain low or decline in the region’s other countries, such as Mexico. The main risks for the industry relate to international market volatility, which could affect commodity prices and mining production output, and the upcoming general elections in most of Latin America’s largest countries, which could delay fixed investments and large infrastructure project spending.

2) Key end markets: Sustained growth in demand is likely in 2018

Market conditions for capital goods issuers started to improve in the second half of 2016, with the recovery of commodity prices benefitting the sector’s main commodity-driven end markets (excluding oil and gas), namely, mining and utilities. We expect steady growth from non-commodities-related end markets to support the recovery in demand in the sector.

Since oil prices collapsed from 2014, oil majors have made relatively few final investment decisions on major new projects. We believe oil prices will likely remain under pressure in 2018, despite the agreement between the Organization of the Petroleum Exporting Countries and Russia in May 2017 to maintain their oil production cuts for a further nine months. We believe the industry is not ready
to commit to a new capex super-cycle, as oil majors are focused on rebalancing their costs and are now signaling breakeven oil prices of $50-$55 a barrel. For capex to restart materially, higher prices on a sustainable basis would be necessary.

In the mining sector, commodity prices have continued to increase, contributing to rising free cash flows, although we continue to see companies earmark these for shareholder remuneration rather than sizable investment projects. There are only a handful of major greenfield projects globally, and guidance about upcoming capex suggests it is typically only at a maintenance-to-low level (see “Strong Cash Flows: the Latest Surprise For Big Miners,” published on March 13, 2017).

In the utilities sector, trends can vary substantially among different regions. In Europe, for example, recovered power prices are not yet providing long-term signals for investment in new conventional generation capacity. However, we believe that energy efficiency in mature markets, and the expansion of renewable generation capacity and gas and power infrastructure in emerging markets, could provide some support to the capital goods sector in the medium term. Strong competition in bids for new renewable capacity globally suggest that the future profitability of this subsector will depend materially on the performance of equipment, instead of on subsidies, leading to pressure on revenues and continuous investment in research and development (R&D) for equipment manufacturers.

Despite signs of plateauing light vehicle sales in the U.S., in our view global demand for autos remains steady, growing 2-3% in 2018 and 1-2% in 2019. In the auto sector, we expect capex and R&D expenses to increase as a percentage of sales over the next two years. While we know that the bulk of the additional spending will be on engine electrification in the next two years, auto manufacturers need to get ready to compete in a different environment where connectivity and data collection and processing will designate winners and losers in the industry. We therefore believe that the contribution of the auto sector will support capital goods players with ambitions in big data and artificial intelligence.

The construction sector is showing robust performance, even in mature markets like Europe, after dwindling growth for many years, especially in Spain and Germany, followed by a recovering trend in France and Italy. Construction is upbeat in North America, although concerns over a real estate bubble start are increasing in China.

While virtually all end markets for capital goods have recovered from historic lows, some key industries will maintain a relatively cautious stance on investments. Capital goods players that were heavily reliant on large contracts in the previous super-cycle could be worse off than their more diversified peers.

3) Global capex: A return to investment

In North America, we expect overall capex growth of 3%-4% in 2017, driven mainly by increases in the energy and information technology (IT) sectors. Declines in the materials sector of 10% and in the industrial sector of 7%, will drag on regional capex. In energy-related end markets, there has been a marked recovery in upstream business, while the midstream end market remains subdued.

In Europe, we estimate capex growth of around 10-11% for 2017, with the strongest growth in the consumer goods, IT, and telecoms sectors. Many European corporates have delayed spending decisions and now find themselves with strong cash balances. Notably, we estimate that industrial companies in Europe will increase capex by around 15% in 2017. Over the longer term, the move to 5G connectivity in Europe should increase telecoms-related capex.

Despite clear positives within the European market, event risk remains. Brexit could substantially reduce capex in the U.K. and could increase revenue volatility for European companies with large exposures to the U.K. Conversely, U.K. capital goods companies exporting to the EU could face pricing pressure if a March 2019 transition deal is not secured or if the EU and U.K. governments resort to World Trade Organization tariffs.

In Asia Pacific (excluding Japan), we expect overall capex growth of around 3% in 2017, driven mainly by increases in technology hardware and in the IT and consumer goods sectors. We expect a
decline in capex in telecoms of more than 15% and in health care of more than 5%-6%. Conversely, we expect strong growth in these sectors in Japan, with year-on-year growth of around 10%, driven by the technology, IT, auto, and machinery industries.

Chart 78 – Global sector capital expenditure growth by sector in 2017 (estimate)

Current consensus and guidance-based estimates for 2018 and 2019 are less positive, suggesting a stalling of growth. However, our analysis suggests that there is a general tendency for analysts to undershoot with their early estimates of second and third year capex. For this reason, we expect that 2017’s upswing will gather momentum, absent an unexpected deterioration in global economic growth, which is not S&P Global Ratings’ base case. We expect increasing volume growth related to capex, although pricing pressure could, in certain sectors, lead to a net negative pricing mix, as we have seen in metals and mining.

Despite a primary focus on capex growth, a number of rated capital goods companies rely increasingly on operating expenditure (opex) to maintain revenues, whereby they are willing to succumb to pricing pressure on original equipment sales in return for long-term maintenance contracts. This development has reduced the cyclicality of cash flow volatility, improving the underlying credit profiles of rated entities.

4) Operating efficiency, automation, and OEM outsourcing

As end markets continue to stabilize, we expect capital goods issuers to shift their focus to growth initiatives from the cost-reduction programs that they implemented to cope with declining demand over the past few years. We believe that the multiyear restructuring and cost-reduction programs are now largely complete, and we anticipate that issuers will focus on boosting their competitive advantage by investing in new or improved products and technologies (as opposed to pure capacity expansion). We believe that the sector has preserved sufficient manufacturing capacity to support volume growth over the next couple of years, which should support margin expansion in the medium term.

We have seen capital goods issuers largely maintain their R&D spending through the past economic downturn, and believe that investments in technology and automation will remain a theme in the sector. Industry 4.0, or the digitalization of manufacturing processes, remains one of the greatest structural opportunities and challenges for capital goods companies in 2018 and beyond. We see substantial scope for manufacturers to enhance productivity through digitalized processes, especially for early adopters. Over the next few years, we expect Industry 4.0-related spending on R&D and new assets to increase, and we see scope for some consolidation and M&A as companies expand their digital capabilities beyond their core competencies. On a global level, we see a long-term potential for "on-shoring"--companies locating their production closer to end markets, often
The movement toward a more efficient digitalized production process is further accelerating this development.

The competitive landscape in end markets continues to evolve, particularly the relationship between manufacturers and their suppliers. In a recent example of such evolution, OEMs have begun to vertically integrate into systems and components manufacturing, taking production in-house for some products in order to reduce costs and maintain more control over the development and production process. This development poses a risk to suppliers as it could remove part of their current revenue streams. Additionally, the margins of the component suppliers to large sub-sector OEMs are under pressure in certain capital good subsectors, as the OEMs use their purchasing power to boost margins.

5) Financing conditions and refinancing risk

With the Fed's current monetary policy, we expect financing conditions to tighten, although at this point we would not consider the next six-to-nine months to constitute a true "rising rate" environment, even if the 10-year yield surpasses 2.5% again, as it did earlier this year. We expect pressure on speculative-grade U.S. capital goods firms to increase over the next five years, given the large dollar amount of speculative- and investment-grade debt maturities in 2020-2021 and the prospect of significantly higher borrowing costs, resulting in a decline in interest coverage metrics. We expect some issuers to be under pressure to refinance their debt over the next 12-24 months due to generally high debt leverage and negligible free operating cash flow.

In Europe, financing conditions remain supportive. Simulative central bank measures have seemed to contribute to the region’s issuance in 2016 and its relative strength so far in 2017. However, should European central banks raise interest rates in line with the Fed, the pace of issuance could slow. However, we do not expect either higher interest rates or any subsequent drop in issuance until 2018. European corporates have generally shied away from leverage, although we have seen an increase in leverage among speculative-grade issuers. Toward the end of 2017, we have seen increasingly aggressive financing structures in LBOs in the capital goods sector, with net debt to EBITDA exceeding 7x in some cases.

In Europe, yields on new corporate issuance have fallen to historical lows in 2017, benefiting from the European Central Bank’s recently enacted bond-buying program and investors’ search for yield amid even lower yields on the region’s sovereign bonds. Speculative-grade borrowing costs are particularly low, with the average yield to maturity on new ‘B’ rated issues down to 6.8% from an already low 7% at the same time last year. Once again, there is potential for refinancing risk among speculative-grade capital good companies, although this is unlikely to materialize until 2020-2021.

Emerging Asia’s overall financing conditions continued to improve in 2017. Investment-grade debt is concentrated in Japan, with the majority maturing in 2019, while speculative-grade debt is largely based in China, with the largest total maturity in 2022. A large proportion of corporate debt in the region is U.S. dollar-denominated; should the dollar begin to strengthen, we could see greater refunding risk for capital goods companies.

With favorable lending conditions, a number of rated speculative-grade corporates, including those in the capital goods sector, have extended their debt maturities to 2021 (see chart 13). We expect that both Eurozone and U.S. interest rates will rise in this time horizon, thereby increasing the cost of debt. We see the highest risk among our “B” category issuers, with a large number of highly leveraged financial sponsor transactions. The current debt structures entail mainly bullet maturities, enabling low ongoing debt service costs of cash interest payments only. Rising interest rates are likely to affect high-yield issuers’ debt coverage ratios and expose these companies to significantly increasing risks when maturities start from 2020.
6) Increasing M&A and divestiture activity is driving financial policy

For capital goods, we expect the pace of M&A and divestitures to increase in 2018 from already elevated levels in 2017. We expect that some large capital goods companies could accelerate M&A in 2018 to expand overseas, enhance core business, look for synergy opportunities, and speed up technology gains. Cross-border transactions have also been on the rise, with global companies looking to expand their international footprint as growth prospects in their home markets are relatively limited. Some notable recent transactions include:

- United Technologies Corp.’s proposed acquisition of Rockwell Collins Inc.;
- Komatsu Ltd.’s acquisition of Joy Global Inc.;
- Deere & Co.’s proposed acquisition of Wirtgen Group;
- Parker Hannifin PLC’s acquisition of CLARCOR Inc.;
- Siemens AG’s mergers of rail activities with Alstom S.A. and of wind power activities with Gamesa S.A., and acquisition of Mentor Graphics Corp. for $4.4 billion;
- ABB Ltd.’s acquisitions of GE Industrial Solutions for $2.6 billion and of Bernecker + Rainer Industrie-Elektronik GmbH for an undisclosed sum; and
- Schneider Electric S.E.’s acquisition of ASCO Power Technologies and merger of software activities with Aveva Group PLC.

We also believe that the pace of divestitures or spinoffs could increase as companies continue to focus on their core competencies, enhance their business portfolios, and improve profitability through the divestiture of weaker-performing business segments or spinoff of business units with growth potential to create shareholder value. Notable transactions include Honeywell’s announced spinoff of its home and global distribution businesses ($4.5 billion of annual revenues) and transportation systems ($3 billion). Pentair also announced that it plans to separate its electrical business from its water business to form two independently traded companies in a tax-free spinoff. Consequently, we expect that potential tax reforms in the U.S., including the ability to repatriate cash at a lower tax rate, could spur M&A activity to enhance returns. In view of improving industry fundamentals and continuing low interest rates, we think that overall sector financial policies could become more aggressive as issuers consider transactions to grow revenue, gain scale, or enhance their portfolios. As such, we expect capital allocations (chart 19) to shift towards increased capex and acquisitions spend.
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Related research

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- Japan Corporate Credit Spotlight: Capital Goods and Heavy Industry; Electric Utility and Gas, Oct. 4, 2017
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- Global Capex: Ready For Takeoff, July 31, 2017
- Credit Trends: Global Refinancing Study—$10.69 Trillion In Rated Corporate Debt Is Scheduled To Mature Globally Through Year-End 2022, July 26, 2017
Cash, debt and returns

Global Capital Goods

Chart 81 – Cash flow and primary uses

Chart 82 – Return on capital employed

Chart 83 – Cash and equivalents / total assets

Chart 84 – Total debt / total assets

Chart 85 – Fixed versus variable rate exposure

Chart 86 – Long-term debt term structure

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
Industry Top Trends 2018

Chemicals

Overview

- **Ratings Outlook:** The outlook for ratings in the sector is largely stable. Stable and positive rating outlooks in 2017 are a higher proportion of total outlooks, compared with 2016. S&P Global Ratings anticipates an increase in 2018 EBITDA and a slight strengthening of credit metrics on average. These positive credit factors offset what we consider credit risks including pricing or demand weaknesses in certain subsectors, mergers and acquisitions (M&A), and a growth in commodity chemical capacity. Some commodity chemical producers’ margins might be under stress, given the increase in capacity for some commodity chemicals. Specialty chemical producers tend to be more insulated than commodity producers from capacity increase-related margin pressures.

- **Forecasts:** We believe EBITDA margins will largely stabilize in 2018 following several years of improving margins. The flattening of margins is somewhat attributable to the increase in commodity chemical capacity. However, we forecast an increase in total revenue in 2018, which, when combined with flatter margins, generates increased total EBITDA. This higher EBITDA contributes to our expectation for slightly stronger credit metrics, including an improvement in the median funds from operations (FFO) to total debt ratio in 2018. We project this improvement will occur across all major regions.

- **Assumptions:** Key forecast assumptions include positive GDP growth in key regions including Latin America, North America, Europe, and Asia-Pacific (APAC). We expect GDP growth to support demand arising from key end markets including, industrial, automotive, and housing markets. Another key assumption is for relatively stable oil and natural gas prices, which should support general stability for raw material prices.

- **Risks:** Despite our outlook for generally stable credit quality, we believe the sector faces key risks that could potentially have a negative impact on credit quality. These include risks arising from the sector’s ongoing M&A trend, and the potential negative impact on credit metrics from funding them with debt. Weakness in subsectors such as fertilizers remain a risk. The subsector has a higher proportion of negative outlooks than any other subsector within the chemicals sector.

- **Industry Trends:** Cost-competitive petrochemical capacity additions in the U.S. and ongoing M&A are important industry credit trends. The potential shutdown of less cost competitive capacity is a key unknown variable in determining the impact on total supply from the increase in U.S.-based capacity. Some of the sector’s transformational M&A have the potential to influence not only credit quality of the companies involved, but also the competitive landscape, and therefore the credit quality of other companies not directly participating in these deals.
Ratings trends and outlook

Global Chemicals

The sector’s net rating outlook bias has progressed globally since the beginning of 2017, reflecting an increasing proportion of stable and positive outlooks relative to negative outlooks.

A large majority of chemical companies’ rating outlooks (80%) are stable. Although negative outlooks are the second largest category, they only slightly outnumber positive outlooks. The number of stable outlooks is higher than at a corresponding time last year. The distribution of rating outlooks is fairly similar across APAC, North America, and Europe. In APAC in particular, the trend of balance sheet improvement has contributed to more than 90% of ratings with stable outlooks and much less downward rating momentum than 12 months ago when nearly 20% of companies in the region had negative outlooks. Latin America remains an exception, with about 40% of ratings having a negative outlook.

Some subsectors have a greater proportion of negative outlooks than others. For example, ratings on six out of 14 publicly rated fertilizer producers have negative outlooks. Credit weakness in this sector is related to prevailing weak pricing conditions globally.

Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending September 30, 2017
The large proportion of stable outlooks in part reflects S&P Global Ratings forecasts of steady, marginal, strengthening of credit metrics in 2018. Average EBITDA margins across the sector have generally been on an upward trend since 2014 (with some exceptions), coinciding with reduced hydrocarbon prices, especially naphtha, which halved between 2014 and 2016 benefitting chemical producers largely in regions outside of North America and the Middle East that use naphtha as a raw material. North American and the Middle East producers that use natural gas rather than naphtha remain at the top in terms of cost-competitive locations for commodity chemical production. Product spreads—especially across the polymer chain—sharply improved, allowing producers to post near top-of-the-cycle profitability.

Industry forecasts

Global Chemicals

Steady margins, combined with an increase in revenues, have translated into modestly stronger cash flow adequacy ratios, with the sector’s median debt-to-EBITDA ratio improving since the beginning of 2017. We project a steady improvement in FFO to total debt ratios through 2018, most notably in North America and Europe. Aggregated credit metrics projections in Asia are showing mostly stable cash flow adequacy ratios going into 2018 as debt reduction has mostly taken place in 2016 and 2017. We are also seeing signs in the region that companies are taking advantage of a solid operating environment to resume capital spending. Though we anticipate that EBITDA margins will remain mostly flat in 2018 relative to 2017, we expect revenue to grow, resulting in higher earnings and consequently in a slight strengthening of credit ratios in 2018 relative to 2017.

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 historical exchange rates. Forecasts are converted at the last financial year-end spot rate.
Industry developments

Large new North American capacity in olefins such as ethylene and propylene, and in downstream products such as polyethylene are an important development in the industry. The growth in capacity is a response to the emergence of low-cost shale gas as an input material in this region. We expect capacity growth could put some pressure on product prices in North America and also globally. One result for the capacity growth will likely be the increase of U.S. exports to Europe and mostly Asia (primarily China) as a way to channel oversupply in the Americas. We note that although the export of cheaper ethane-based feedstock could hurt Asian producers, it could also potentially benefit Asian intermediate and downstream product customers because they’ll have access to cheaper raw material.

M&A remains an important development in the sector across the globe. The sector has witnessed several transatlantic M&A proposals, with potential acquirers from Europe interested in North American companies and vice versa. In Latin America, notable M&A include the pending acquisition of Petrobras’ PTA and PET assets by Alpek in Brazil, which is still waiting for approval from authorities and still under negotiation.

Key assumptions

**Chemicals**

1. **Steady demand growth**
   We expect that economic growth rates will support gradually increasing demand for the chemicals industry. Our base case assumes that through 2019, U.S. GDP growth will be between 2% and 2.3%, and Eurozone GDP will be between 1.6% and 2.2%. We are forecasting China’s GDP growth, which is the largest chemicals market globally, of between 6.4% and 6.8% through 2019. Additionally, we would expect key end markets for chemicals demand, such as automobiles and housing, to continue to witness strength in 2018. Despite this, we would expect certain sectors, such as fertilizers, to continue to be hindered in 2018 by supply additions, particularly in potash and phosphates, which should lead to ongoing challenging operating conditions.

2. **Relatively stable oil prices**
   While oil prices are well below what they were several years ago, we expect they’ll be higher than in 2016 and remain relatively stable, averaging $50 per barrel in 2017 and 2018. Oil continues to remain a key input for the global chemicals industry, and product prices are typically based on the marginal producer, which primarily uses more expensive oil-derived feedstocks. Our forecast assumes that Henry Hub natural gas prices will remain at $3/MMBtu over the next few years. The oil to natural gas price ratio has narrowed from over 20x in 2014 to about 15x expected at the end of 2017, although this is still high by historical standards. We expect this ratio to continue to benefit North American producers, which use natural-gas-based feedstocks.
Key risks and opportunities

Chemicals

1. Large-scale, debt financed acquisitions
   While both the number and volume of chemicals M&A has fallen in 2017 compared with 2016, we anticipate M&A to remain an important credit factor for the global chemical industry as companies try to look for growth through acquisitions fueled by the availability of cheap financing and a prevailing trend for chemical industry consolidation. Several North American, European, and Asian chemical companies are participating in large M&A transactions. As a result, there’s an increased likelihood of mounting debt leverage to finance these transactions or a general increase in integration and transaction risk. Some M&A deals could result in companies divesting existing assets or businesses for regulatory reasons, which also creates some uncertainty or opportunities, depending on the situation.

2. Supply-demand imbalances
   We believe that after a run of improving EBITDA margins over the past several years, starting in 2018, profitability could level off on average, and decline for some petrochemicals producers in North America and Europe. We believe that North American capacity additions, predominantly in the ethylene chain-based petrochemicals segment, which relies on the availability of competitive low-cost shale gas feedstock, could offset the beneficial impact of potential tailwinds such as strong economic growth. Along with increased exports in Europe, this could result in a more unfavorable supply-demand balance in North America. In 2018 and due to some delayed projects in 2019, we expect the majority of capacity that is currently under construction to hit the market, which could put some pressure on global operating rates and profit margins.

3. Continued weakness in the fertilizer sector
   We believe the downturn in the fertilizer sector, which has hampered earnings since 2016 to continue through 2018, and possibly even beyond. Price declines, mainly in 2016 for potash and phosphates, and a more long-drawn decline for nitrogen beginning 2014 are key reasons for earning declines in the sector. The lower prices are mainly related to an ongoing capacity buildup in all three fertilizer types that has pushed supply over demand. For all fertilizer types, we anticipate that supply will exceed demand over the next two years at the very least. This pressure on credit quality has resulted in some negative rating actions in the sector in 2018 and 2017 and nearly half of our ratings continue to carry a negative outlook, indicating that we’ll see downward rating pressure to prevail at least through 2018.

Under S&P Global Ratings’ policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.
Cash, debt and returns

Chemicals

Chart 97 – Cash flow and primary uses

Chart 98 – Return on capital employed

Chart 99 – Cash and equivalents / total assets

Chart 100 – Total debt / total assets

Chart 101 – Fixed versus variable rate exposure

Chart 102 – Long term debt term structure

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
Industry Top Trends 2018
Consumer Products

Overview

- **Ratings:** Ratings trends should continue to be modestly negative in 2018. We expect rating actions to result from mergers and acquisitions (M&A) activity and financial policy decisions given the low growth environment. We have stable outlooks on the majority of the rated companies, reflecting the generally good cash flow capabilities of the companies and the nondiscretionary nature of many of the products.

- **Forecast:** Organic sales growth in the low-single digits driven by price/mix, innovation and emerging markets. Margins expand slightly because of M&A synergies, companies’ cost reduction programs, and managing pricing and promotions. Credit metrics strengthen slightly because of companies’ cost cutting and some debt repayment.

- **Assumptions:** Global GDP growth of 3.7% in 2018. Consumers spend cautiously and shop value. Spending habits continue to shift to healthier food and experiences. Medical and energy expenses increase, taking a larger share of the consumers’ wallet. Environment remains highly promotional.

- **Risks:** We see M&A as the biggest risk to the ratings given companies’ needs to shift portfolios into faster growth categories and regions. Traditional grocers are reconfiguring their stores to effectively compete against online retailers; this could result in less space for shelf-stable products and increases in private label. Companies with exposure to slow or declining category growth are most at risk for incurring pricing pressure from retailers. Consumers shift purchases to e-commerce more rapidly, geopolitical risks, and changes in trade policies are also risks.

- **Industry Trends:** Consumers continue to spend cautiously and focus on value. Companies will protect/grow market share by investing in their brands, product innovation, repositioning portfolios, e-commerce channel. Barriers to entry are declining because of digital media, and small brands and private label are poised to gain share as retailers use them as to differentiate themselves. Companies will continue to focus on driving out costs and using the savings to invest in their businesses.
The majority of our ratings are speculative-grade and we do not expect upward rating migration in categories with stronger investment-grade ratings given continued investment, M&A, slow growth, and financial policy shifts in light of real and potential activists.

W. Europe and Asia-Pacific currently have the most stable outlook. Latin America’s rating trend is negative but is showing improvement, and North America’s continues to be slightly negative.

Consumer durables ratings outlook is volatile because it is vulnerable to economic cycles. The agri & commodity foods sector is also volatile because it is vulnerable to commodity cycles. Branded nondurable ratings bias continues to be slightly negative despite the nondiscretionary nature of many of its products because of changing consumer tastes and M&A.

The sector has had a negative bias reflecting strategic and financial policy choices and underperformance because of changing consumer tastes and preferences. Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending Sept. 30, 2017.
We expect slow revenue growth for the sector overall. In North America, we anticipate revenue growth to be below GDP. In Western Europe, revenue growth will be moderately positive. In Asia-Pacific, we expect more stable revenue growth. In Latin America, growth partly reflects recovering economies and high inflation.

We anticipate margins will expand modestly for the industry overall and also by region. Western Europe and North America margins show the most improvement, reflecting synergies from acquisitions. Latin America is expected to improve because of the improving economies.

We think the sector will deleverage slightly over the next two years, with continuing lower leverage trends in all regions. It is unlikely that aggregate deleveraging will be sufficient to trigger widespread upgrades. We think some growth in EBITDA, rather than significant reduction in debt, will account for most of the deleveraging. Any lower leverage in the speculative-grade segment would signal potential dividend recapitalizations or sale on sponsor-owned companies.

We assume aggregate cash flow to debt as measured by funds from operations (FFO)/debt bottomed out in 2016 for developed regions but we do not expect any large improvements; the exception being Latin America, mainly due to expected deleveraging. Lower interest rates in Brazil will also driving higher FFO.

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.
### Key assumptions

#### U.S.

#### 1. The macro environment is unlikely to lift sales growth

S&P Global economists see little in the offing that will spur GDP growth to 3%-4%. We forecast that the U.S. economy will expand 2.1% this year and 2.3% the next, with growth remaining around 2% annually through 2020. Fiscal policy is expected to add some support for growth in 2018. Baked into our conservative assumption is $500 billion worth of Federal income tax cuts, spanning the next 10 years, equally divided between corporations and individuals. Declining unemployment should support consumer confidence and sales. We forecast the unemployment rate will fall to 4% on average in 2018, from 4.4% in August 2017. Paychecks should continue to climb gradually over the next year, encouraging consumer spending and supporting economic activity. We see wage gains reaching just 2.6% year over year by December and slowly climbing to a modest 3.1% year-over-year next year. However, this is much lower than the 4% we would expect at this stage of the business cycle when the unemployment rate has been running slightly below our natural rate estimate. Moreover, we expect consumers to save more next year, which will cut into spending. In addition, rising medical and energy costs are weighing on the consumer’s capacity to spend on consumer products. This combined with changing consumer tastes and preferences, pressure from retailers for price concessions, and small brands and private label taking share, should lead to branded consumer products companies’ organic sales growth being below U.S. economic growth.

#### 2. Amazon and other retailers gain negotiating leverage

Although our forecast calls for margins to expand slightly, primarily because of the sector’s focus on lowering its cost structure and synergies from M&A, there are risks to our forecast. The biggest risk to margins right now is retailers gaining negotiating power over the large branded consumer products companies. With Amazon and hard discounters poised to erode the traditional grocer channel, grocers are investing more heavily into their business. This includes increasing SKUs of their private label brands, reconfiguring stores to include “click-and-collect” services, and prepared foods reducing the space for shelf-stable products. This is reducing branded products companies’ negotiating power with grocers, putting pressure on the branded goods manufactures to support the retailers either through price concessions, providing in-store displays, increasing advertising to drive traffic to stores, or changing packaging to enable retailers to lower labor cost. Amazon has also indicated that it plans to increase its breath of private label. This could spur more consolidation in the consumer products sector as companies try to preserve negotiating power by getting bigger. Other pressures include companies investing more in innovation and e-commerce. For example, consumer branded companies will have to invest in packaging and logistics if they want to gain space on Amazon as it has specific box sizes and more distribution points than traditional grocers do. Rising labor, pulp, and resin freight and shipping costs may also crimp margins.

#### 3. Credit metrics strengthen but won’t trigger upgrades

We forecast credit metrics will strengthen over the next 12 months because of increases in EBITDA, modest debt repayment, and less robust acquisition activity in 2016 and 2017. Although the sector remains acquisitive, M&A activity slowed in 2016 and 2017 compared with 2015 as valuations for targets were high because of the strength of the stock market. In 2017, we believe private equity companies slowed the turnover of their portfolios because they expect valuations will improve next year if the Trump administration is able to achieve tax reform. We do not have a positive bias for the sector as the packaged goods sector is under pressure, as consumers have shifted their purchases away from shelf-stable products to fresher products and eating away from home. We also saw increased pressure in the household products sector because retailers reduced inventory. The only sectors where we are seeing positive momentum in are beverages and meat processors. However, we do not believe the positive trends will result in many upgrades. We expect M&A activity to pick up given the industry’s low growth and consolidation in the retail sector resulting in leverage increasing. In addition, we believe share repurchases as a percent of free operating cash, which has been below pre-recession levels, could rise if the U.S. government reduces taxes on the repatriation of the large amounts of overseas cash U.S.-based multinational have on their balance sheets. This could cause leverage in the sector to remain at current levels, although we have not factored it into our forecast.
Europe

Geopolitical Risks and slowing GDP across the eurozone

Macroeconomic prospects in the eurozone (excluding U.K.) have improved as political uncertainty has eased. The French and German elections have delivered in line with expectations and against Euroscepticism, but Eurosceptic parties and political fragmentation are still on the rise. Eurozone growth is becoming increasingly inclusive and increasingly supported by investment and construction with economic recovery mid-cycle.

The Brexit vote has cast a shadow with regards to the U.K. Confidence in the U.K economy is slipping. Growth in Britain is expected to slow from 1.4% expected for 2017 to 0.9% expected for 2018, while growth in the eurozone is expected to remain at 1.8% in 2018 versus 2.2% expected for 2017. Even though election results were not against expectations, the overall uncertainty did result in slowdown across Europe, especially now that details of the U.K. divorce haven’t been agreed upon, which results in looming pressure across the sector.

Capital expenditure and overhead costs are being tightly managed across the consumer-facing industries. Even though confidence indicators in the U.K. and across Europe seem to show resilience, some capex slowdown expectations are already creeping across Europe, the Middle East, and Africa (EMEA) consumer companies. Refugee and terror-related risks are expected across various geographies in the eurozone and the U.K., and will undermine global growth. Still, despite volatility, we don’t expect the U.K. or Europe to enter into a recession as fundamental credit conditions remain marginally subdued. As a result, our outlook on the consumer sector for EMEA remains stable to negative for 2018 as a whole, with some softening both on top line as well as on EBITDA margins. In some situations, especially for branded nondurables, we see modest margin improvement (between 50-100 bps), fundamentally driven by large transformational acquisitions.

Inflationary pressures

2017 proved to be a year of change from deflationary environment to increasing inflationary pressures. These inflationary pressures have been more pronounced in the U.K., where inflation is expected to reach to about 2.6% by the end of 2017 and remain at similar levels for 2018. Contrary to U.K., across the EU the CPI is expected to remain at about 1.6% for 2018.

Inflationary pressure combined with real wage growth slower than originally expected and unemployment remaining at 4.8% for the U.K. and 8.5% for the eurozone creates an environment with real income static resulting in a squeeze on disposable income. This pressures the end consumer, who is moving towards value-added items and is more alert and focused on nondiscretionary spending.

The eurozone is proving economically resilient, and we foresee most countries reducing their output gaps in the coming three years. The biggest economic uncertainty is linked to the euro exchange rate and monetary policy developments on both sides of the Atlantic.

Companies in the U.K. operate in a more competitive environment and some also face foreign exchange pressures due to sterling depreciation resulting in higher input costs and marginal dilution in EBITDA margins and some top line slowdown.

M&A activities remain on the horizon; albeit with financial discipline

We believe financing conditions in Europe remain relaxed and the European Central Bank (ECB) is not expected to change the 0% main refinancing rate until inflation rises to 2% by 2019 at least. As a result, in the past two years we have seen large transformational M&A activities across the consumer sector in Europe. Due to this, we expect double-digit top-line growth in 2017, including the impact of acquisitions for both consumer durables and branded nondurables, while agribusiness and commodity foods is estimated to grow by mid-single digits with only small to midsize acquisitions. Organic growth is estimated to be in the range for 2%-4% over the next three years for the consumer sector as a whole in Western Europe.

We believe any future M&A would largely be disciplined as we now are seeing companies focusing on bringing synergy benefits and absorbing the large M&As completed. We expect the companies to focus more on deleveraging but a slower pace. However, M&As remain a fundamental event risk. In the high-yield space, we have seen opportunistic refinancing and dividend recaps in some cases as we expect to see more front-loading before Brexit happens in 2019.
Latin America

1. Political and trade risks could undermine economic recovery
   We expect a continued gradual economic recovery in Latin America for 2018, but still at a slow pace. This trend is supported by sustained domestic demand in most countries, controlled inflation levels, favorable commodity prices and increasing external capital flows. Nevertheless, several countries in the region continue to face challenges, including potential volatility derived from the upcoming heavy election cycle, uncertainties around the NAFTA renegotiation for Mexico, and political risk pressures. On a general basis, despite tough competition and foreign currency volatility, relatively stable disposable income and purchasing power at the household level should continue to support private consumption, benefiting consumer product companies within the region, maintaining a moderate although consistent volume of sales and revenue growth. The majority of ratings have a stable outlook, although sovereign rating caps or refinancing pressures for ‘B’ rated companies could weigh on ratings in 2018.

2. Margin stability despite subdued growth
   In light of political uncertainties and subdued growth, we expect industry participants within the region to continue focusing on protecting their profitability and strengthening their credit metrics through cost and capex reductions, operating efficiencies, and product innovation, being able to pass-through cost increases, mainly derived from foreign currency volatility. Package food producers and protein players should further benefit from stable low grain prices amid an expected sizable crop and declining cattle prices, particularly in South America. In addition, lower sugar prices may benefit the cost structure for bottlers, but also reduce revenues and cash flow generation of sugarcane processors from 2018 on as future prices show a declining trend. This should be partly offset by the good momentum for the ethanol. Well-funded players in the ethanol and sugar (E&S) sector are still enjoying good pricing environment due to hedged position and amid favorable weather conditions, which should help deleveraging in 2018. Specifically, in Mexico, potential changes in NAFTA could lead to additional tariffs on imported raw materials from the U.S., pushing companies to seek alternatives to somewhat mitigate margin pressures.

3. Intense M&A activity with financial discipline
   M&A dynamism should remain in the region, although we believe in most cases companies will continue seeking accretive opportunities, mainly to expand geographic presence abroad and increase economies of scale while maintaining financial discipline, without compromising their leverage metrics and overall financial performance. Moreover, we have seen issuers within the sector taking advantage of positive capital flows to Latin America supported by investors’ appetite for yield, allowing them to fund these transactions, and/or refinance liabilities, improving their capital structure by extending their debt maturity profiles and reducing interest expenses. Given the aforementioned, we expect overall financial flexibility to remain solid, with limited refinancing risk throughout 2018. In Brazil we have seen a few M&As in the E&S sector, but only on distressed companies selling assets, and some opportunistic movements within the protein sector (Minerva’s acquisition of JBS beef assets in South America and the announcement of the Mexican company, Lala, acquiring Vigor). However, large acquisitions seem not to be on the radar in the following months.
### Asia-Pacific

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<thead>
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<th>Organic growth moderates and varies across regions and sectors</th>
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<tr>
<td>1</td>
<td>Regional GDP growth and rising middle class will continue to moderately lift domestic consumption. We expect sector revenue growth to vary from low (Japan) to mid-single digits (most countries in the Association of South-East Asian Nations [ASEAN] and China) for the next 12 months. We also expect to see varying growth prospects for individual consumer product segments, especially in China. We expect growth in innovative and higher-end food and beverage products, sportswear, and health care-related sectors to continue to outpace GDP growth, given a lower penetration rate, higher average selling prices (ASP), and consumers' increasing health awareness. Consumer sentiment is also recovering especially in China, with consumers splurging on high-value cars and luxury brands, and gross gaming revenue growing in Macau.</td>
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<th>Intense competition persists</th>
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<td>2</td>
<td>We expect intense competition to persist and to constrain profit margins particularly for sectors with weaker growth prospect and higher fragmentation. Downward margin pressure could occur due to higher advertising and promotional expenses in light of moderating growth and higher input costs. Nevertheless, we believe profit trends may vary for individual companies over the next 12 months. Companies focused on product upgrades or cost streamlining may moderately improve margins.</td>
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<th>Debt-funded M&amp;A remains an event risk</th>
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<td>3</td>
<td>We expect the M&amp;A market in China to remain active, driven by continued market consolidation. This is particularly so for companies competing in the highly fragmented market or looking to gain control over high-quality raw material sources or better brands. The Chinese government’s recent tightening of capital outflows and control on government-related entities' (GREs’) debt leverage somewhat temper the risk. Japanese consumer products companies may also be interested in acquiring small overseas targets given subdued domestic demand. We believe financial discipline and capability to smoothly integrate acquired companies will differentiate credit quality of rated companies over the next 12 months.</td>
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Canada

1. **Stabilizing economy, yet low consumer confidence**
   Our economists forecast economic activity will improve in Canada given stabilized commodity prices and the energy sector's recovery. As a result, the Bank of Canada increased the benchmark rate by 0.5% in 2017. Despite economic momentum, consumer confidence remains low because risks of higher interest rates and an overvalued real estate market loom. The heavily debt-burdened Canadian population, coupled with a possible housing correction in Toronto and Vancouver, could lead to eroded consumer wealth and confidence. In addition, concerns about further interest rate hikes have left many Canadians anxious about their historically high consumer debt levels. On average, we expect ratings to remain stable. However, as the Canadian consumer product portfolio is primarily in the single 'B' category, they remain vulnerable to capital market shifts. Earnings pressure from rising wages combined with high leverage from a period of heavy M&A activity could lead to a liquidity crunch for certain issuers if interest rates continue to increase.

2. **Rising labor costs and NAFTA changes could impact profitability**
   Because most Canadian consumer product companies are heavily exposed to the U.S., changes in NAFTA regulations could pose a significant threat to profitability. Higher U.S. taxes on Canadian goods, coupled with inflationary pressures from rising minimum wages, will lead to EBITDA margin deterioration and weaker cash flows. Smaller consumer product companies, which do not have the scale to meaningfully cut or pass-through costs, will especially feel the pain. In our opinion, these companies will face issues in raising prices because most of their Canadian retailer customers will also be dealing with similar inflationary pressures.

3. **Foreign exchange pressures could impact demand**
   The significant appreciation of the Canadian dollar is also expected to taper growth for most Canadian consumer products companies with international exposure. The Canadian dollar’s approximately 10% appreciation since the beginning of the year will raise the cost of Canadian exports. Given that most Canadian consumer products companies are heavily indexed to the U.S., a stronger Canadian dollar is likely to hurt the top line and constrain growth.
Key risks and opportunities

Packaged Foods

1. Adapting to changes in consumer tastes and preferences
   We forecast minimal organic revenue growth during the next 12 months, likely flat to down (in the low-single digits) for packaged food manufacturers. As a result, we view having the ability to rapidly adapt to changes in consumer tastes and preferences—e.g., current consumer demands for healthy, natural, or on-trend products such as protein or no sugar—as a competitive edge. We believe the majority of the large, packaged food companies are vulnerable to this trend and all have some brands that are out of favor in their portfolios. Companies that are more snacking focused such as Hershey and Mondelez are faring better than more center-of-the-store focused companies such as Kellogg and Campbell. Millennials are shopping in different channels and are generally less brand-loyal than their parents, so we do not forecast packaged food revenue trends improving any time soon. Successful innovations and renovations are key to differentiation and competing in faster growing categories are key. We expect the trend of big food companies buying new, on-trend brands to continue. We still expect faster growing demand from emerging markets because we expect consumers in those markets to remain loyal to mainstream brands, but also offer the potential for future trade-up supported by growing incomes and catch-up in consumer preferences for premium and healthier products.

2. Active M&A and portfolio shifts continue
   Companies continue to focus on optimizing their brand portfolios and buy brands in faster growing categories to spur growth. We expect more asset sales and potential larger M&A. Favorable tax rate changes in the U.S. could also spur more deals. However, uncertainty about renegotiations of the NAFTA agreement remains a concern for the Canadian and Latin American industry. Potential tariff barriers that reduce regional trade could limit growth for producers and manufacturers that are heavily exposed to the U.S. Kraft Heinz again could be on the hunt for another large asset. In Europe, Unilever and Nestlé could be potential consolidators after both announced a review in their strategies that includes potential releveraging, which we believe could be achieved through share repurchases or acquisitions. However, we do not expect these companies to go for large assets, but for more selective targets that will drive long-term growth (such as health driven, functional foods). Companies with some room in their balance sheet to make acquisitions relative to their ratings include Campbell, Conagra, Hershey, and Kraft Heinz.

3. Changing retail landscape
   Many packaged food companies have focused on cost reduction and improving margins due to shareholder pressures. We expect cost-cutting programs to continue but believe margin expansion may slow as companies face changing retailer demands with the rapid change in the retail landscape. Although in the U.S and globally, e-commerce represents less than low-single digits for most food retailers, we believe the food, drug, and mass retail channels face increasing competition from online players. With the Amazon and Whole Foods merger, we believe the pressure will rise for packaged food manufacturers to increase online sales, especially if Amazon is successful at scaling its grocery presence and passing on lower prices to consumers. We believe packaged food manufacturers will also face increased competition from private label and small local brands. Walmart, most food manufacturers’ largest customer, is also focusing on increasing its e-commerce presence in food. Currently, there is no clear leader in e-commerce among the large food companies. Therefore, we think winners could emerge if they can adapt to both retail giants and participate in all channels the consumer demands. Slow adapters may find themselves left behind.
Beverages

**Price/mix and innovation is driving top-line growth**

Profit growth is not all about cost cutting as premium pricing, innovation in the right categories, and managing price and mix can grow the top line. Unlike the broader packaged food sector, the beverage sector has better growth opportunities, albeit not widespread, and therefore will rely less on cost cutting for profit growth.

Nonalcoholic beverages continue to benefit from good demand in energy products, flavored offerings, and natural teas. Beer companies can still generate good organic growth in craft and premium import offerings; while strong demand for high-quality brown spirits is fueling above-average growth in that category. Investing in marketing and innovation in premium-priced categories while managing pricing and promotions in slow growing or even declining categories can yield low- to mid-single-digit sales growth.

Moreover, emerging market economic growth may be rebounding, which could add another tailwind to the sector’s growth profile as global brands would further penetrate these faster growing markets.

Tapping into these top-line trends while executing on ongoing cost-cutting programs can lead to meaningful EBITDA growth and help companies reduce leverage and improve their credit profiles. By contrast, companies with less exposure to the sector’s favorable trends could see ratings pressure.

**Sugar taxes may be fizzing away**

Concerns over the impact of taxes on sugary beverage sales may be waning, particularly in the U.S., where early results appear disappointing following last year’s flurry of local government tax initiatives implemented across the country in part to raise revenue and plug budget gaps. Cook County, home to Chicago, may be facing an uphill battle now that it has to overcome a court challenge to impose its sweetened beverage tax. Other harsh realities appear to be settling in too, such as revenue collections coming in below projections in large markets like Philadelphia, while manufactures like PepsiCo have responded by closing distribution centers leading to unemployment.

Still, many governments are moving forward with such taxes, including in the U.K. where the tax is set to take effect in 2018. Therefore, sugar taxes continue to be a developing risk factor that could curb future growth; but for now the likelihood of this threat gaining enough steam to be a game changer for ratings appears remote.

**Less flexibility for M&A given bloated balance sheets**

Several rated beverage companies have significantly increased financial leverage following a slew of debt-financed M&A transactions. The list includes Anheuser-Busch Inbev, Molson Coors, Dr Pepper Snapple Group, and to a lesser degree Heineken, Diageo and Coca-Cola Femsa. The lack of financial flexibility for many companies in the sector limits their ability to make more large acquisitions without jeopardizing the ratings.

Yet M&A remains an important growth driver, as it is often the main avenue for companies to shift their portfolios into faster growing categories and geographies. For example, Heineken added Kirin brands, boosting its Brazilian market share and competitive position. The Dutch brewer also bought the remaining 50% of U.S. craft beer brand Lagunitas, surfing on the craft craze in North American beer market. Dr Pepper Snapple levered up to buy flavored still beverage manufacturer Bai LLC. And with little impact to its leverage profile, Diageo recently bought Casamigos Tequila; both the Patron and Casamigos acquisitions strengthened the acquirers’ positions in the fast-growing U.S. tequila category.

In short, several balance sheets remain stretched and ratings would be pressured for these companies if they embark on more M&A prior to paying down debt and shoring up their balance sheets.
**Agribusiness And Commodities Foods**

1. **There's no sugar-coating it; margins remain pressured**
   Another good 2017 U.S. grain harvest on the backs of a large South American harvest earlier in the year will likely mean another tough 2018 with too much supply for grain traders and processors. What's more, higher on-farm storage capacity (particularly in the U.S.), and waning demand out of China for commodities like corn will lead to less predictable sales volume and further pressure margins in already difficult market conditions.

   The margin challenges are not only limited to the grain and oilseed markets. With the EU ending sugar quotas in 2017, European sugar producers have ramped up production and global sugar stocks are mounting. Therefore, global sugar prices should remain depressed through 2018, which will hurt profitability and free cash flow for many producers, despite the benefits of economies of scale as plants run near full capacity.

   A slowly consolidating Brazilian sugar market, where bankruptcies have shaken out some but not enough of the weaker players, means the pace of consolidation will provide little relief for excess production and tight margins. In addition, the Brazilian government’s policies to promote local ethanol demand may divert some cane production away from sugar to ethanol, but only modestly.

2. **A consolidation wave may wash out expansion into ingredients**
   Agribusiness companies are poised to benefit from the changing packaged foods industry landscape, where consumers are seeking simpler and healthier ingredient in their diets. Most companies have the scale, longstanding relationships with food manufacturers, and R&D capabilities to leverage their existing capabilities and expand into the higher margin value-added ingredient businesses for new products; and they have been doing just that.

   Examples include ADM's acquisition of WILD Flavors in 2015, and in August of this year, Bunge announcing the acquisition of specialty palm ingredients provider Loders Croklaan to diversify its soybean-concentrated portfolio.

   But these incremental gains may not be enough to offset companies’ grain origination and processing struggles, which may need to be right-sized via M&A. Glencore PLC, which is looking to build its still patchy regional presence in agribusiness, is currently in a standstill agreement regarding any possible courtship with Bunge until 2018. Other industry players (like Louis Dreyfus) are looking to divest underperforming assets. With several balance sheets currently underleveraged, we may see M&A accelerate, pressuring ratings.

3. **Meat outlook is still healthy, but the JBS fallout is a risk**
   The U.S. meat sector continues to benefit from low feed costs, plenty of livestock, and high plant capacity utilization. The world continues to be awash with grains, which will keep feed costs low in 2018. Furthermore, production capacity is aligned with demand as key companies like Cargill (that shuttered plants in the prior downturn) are now filling their plants near capacity. Moreover, the industry can rely on the added buffer of export markets that are ready to consume any excess domestic production. These conditions can provide upside to ratings.

   The outlook out of Brazil, another key meat producer globally, would be similar were it not for the cloud of uncertainty hanging over beef giant JBS, whose owners are currently in jail on insider trading allegations and could face additional charges regarding government corruption investigations. This has generated uncertainty over production volumes and cattle prices in that region, and while JBS has not shed any of its core assets, the industry is alert to this possibility and may look to take share.
Household Products

1. Evolving consumer purchasing patterns
   Consumers are increasingly willing to buy branded products sold by more local brands and, to a lesser extent, private labels. E-commerce with direct-to-consumers models (like Dollar Shave) provide emerging brands with the virtual shelf space to grab a share of the consumers' wallet. In this channel, we believe brand differentiation remains a challenge for homecare products compared to personal care or consumer health products. This is because brand trust is a more important consideration for consumers. With digital marketing developing fast, manufacturers have to adapt their message and manage brand perception to very different audiences. Moreover, retailers are increasingly marketing quality private label products to shore up their bottom lines. Most branded household personal care (HPC) issuers are vulnerable to these trends.
   
   These factors will force many HPC competitors to step up innovation, lower prices, make acquisitions of on-trend niche or local brands in emerging markets, or potentially enter/expand private label offerings. These evolving trends will likely result in flat organic sales and moderate margin pressure for most HPC issuers. Combined with large scale M&A risk, the direction of ratings is balanced toward the downside.

2. Reloading the restructuring arsenal
   Large restructuring initiatives started several years ago have or will be coming to an end soon. Supply chains and capex programs are already quite lean among the large producers. We see potential large scale M&A likely to come mostly between branded competitors, with some more active product portfolio rotation. We believe most investment-grade HPC issuers would be willing to give up at least one notch for the right large acquisition as long as they maintain 'BBB' ratings and access to commercial paper markets.
   
   Absent large M&A, we expect ongoing productivity programs to continue, which tend to focus on wringing price concessions from suppliers (often for more business), cutting overhead costs in mature markets, improving equipment efficiency, lowering product cost through engineering optimization, and improving logistics.

3. Shifting discretionary dollars
   In mature markets, we expect increased emphasis on supporting retailers at the expense of large advertising expenditures or any expansion capex in core categories of HPC. This means lowering prices to large retailers (including online) in North America and Europe to maintain market share.
   
   However, HPC companies are increasingly employing advanced data analytics to pinpoint what products to discount, when to do it, and how to deliver the saving (coupons, free samples, two-for-one, etc.). Price-premium is likely to remain stronger in certain categories (natural, health, male grooming, luxury creams) that can also be sold in specialized channels.
### Tobacco Manufacturers

#### Managing secular volume decline through robust pricing model

We expect continued decline in underlying demand for tobacco products globally, and smoking prevalence in North America and Western Europe to contract significantly because of changing cultural practices and the regulatory frameworks. Although global industry volumes are declining, we see an optimal price mix and innovative package formats as key to sustainable earnings growth. We expect the big four tobacco companies to try to increase the revenue contribution from developed markets, which often have lower price elasticity and more stable foreign exchange rates, as seen with the most recent Reynolds takeover by BAT. We believe producers with greater exposure to developing markets will have to drive cost efficiency by possibly rationalizing brand and product portfolios, to mitigate any volatility in reported earnings.

We expect industry pricing to remain robust, in line with the past five years, with any increase in excise taxes being absorbed by price increases, often above inflation levels. Exceptions may occur in markets with disruptive tax hikes and/or tighter regulation, which are both impacting volumes and ability for manufacturers to apply multiple price increases at the same time. This was the case in Russia, the Philippines, Indonesia, but also in Australia. We believe cigarettes will continue to account for over 90% of the tobacco market value, with smokeless tobacco (including chewing tobacco) continuing to decline and some positive momentum in the cigar segment, particularly in the U.S. However, we also expect the vapor segment and heat–not–burn technology to continue growing: the pace and ultimate market share captured will be determined by regulation across markets. Continued focus on operating efficiency and strategic merchandising should help preserve the reported profitability metrics of tobacco producers and support future deleveraging and cash flow generation in line with our forecasts.

#### Regulatory headwinds unlikely to ease

The evolving regulatory environment, in particular in the U.S. and EU, may be the largest driver of a structural shift in the industry and may accelerate the growth of noncombustible products, such as e-cigarettes and heat-not-burn products.

The FDA is seeking to regulate and lower the level of nicotine in combustible cigarettes, acknowledging the continuum of risk. While this concept is not new, an ultimate regulatory action could have significant consequences for tobacco players operating in the U.S., including U.K.–based BAT (via 100%-owned Reynolds American Inc.) along with the U.S. leader Altria. However, we expect the FDA will face hurdles to enactment and industry participants might legally challenge this implementation. The risk of compensation smoking, of a rise in illicit markets, and of switching to smoking alternatives (for which no clear evidence exists that they are less damaging than combustible cigarettes) are the major hurdles in our view. The timeframe for implementation of FDA proposals (should it occur) could be between five to 15 years, and that’s primarily due to the sweeping nature of the proposal.

The July FDA announcement also introduced a key proposal to extend applications for noncombustible and newly regulated products (to 2021 and 2022, respectively) signaling a first positive stance on these alternative tobacco products.

In Europe, regulation is tightening with the new European Tobacco Product Directive fully implemented since May 2017, introducing bans on small packs and on menthol cigarettes from May 2020. Additional regulatory developments for mature tobacco markets include a move to plain packaging--already implemented in Australia, the U.K., and France. We would view the impact as more negative if it were implemented in a number of emerging markets where brand is playing an important role. We note that there are proposals at an advanced stage in Brazil, Thailand, and South Africa to apply plain packaging.
Further industry consolidation driven by NGP capability

Further industry consolidation is less likely following last year’s takeover of Reynolds by BAT. However, we note that there is clear divergence in strategy around next-generation products (NGP). While combustible cigarettes still represent the only source of profit and cash flows for the first half of 2017, NGP could be a step-change in business model of manufacturers in the medium-term. For Philip Morris (PMI), the first entry player in heat-not-burn technology, this franchise could represent a non-negligible part of its volumes and sales growth by the end of 2018, and we expect it to break even by the end of the year.

Consolidation might be spurred by desire to offset this lack of capability internally. We believe the FDA proposal decreases the likelihood that PMI may attempt to acquire Altria, bearing in mind the substantial valuation of Altria ($140 billion in enterprise value) and hefty investments of PMI in developing its heat-not-burn franchise; on the other hand, we cannot rule out the likelihood of Altria making a bid on PMI as a way to boost its exposure to NGPs and to markets outside the U.S.

We also note that there is a diverging financial policy among the largest players, which may put leverage metrics under pressure in the coming years. BAT has no headroom under the current rating and needs to deleverage. PMI is tied up with its investments in its IQOS franchise and has no headroom under the current rating, with a negative outlook still pending. Imperial Brands is currently focused on decreasing its leverage following the acquisition of Lorillard’s assets in 2015 and as such is adhering to a strict dividend policy and focusing on efficiency improvements. We don’t expect any large debt-funded acquisitions in the near term given its leverage targets and commitment to the current rating level. We don’t expect Altria to deviate from its current financial policy in the near term, particularly given the lack of visibility into the economics of the IQOS licensing arrangement with PMI, and the potential impact on the combustibles market. The company has meaningful headroom under the current rating, so despite longer term uncertainties, we expect shareholder payments will remain consistent.
Luxury Goods

1. **Rebound of Chinese demand**

   In 2017, luxury companies are reporting improving results supported by different factors. In our view the most relevant one is the rebound of demand in China. This has started in the last months of 2016, it has gained momentum in 2017 and we expect it to continue in 2018. The Chinese population represents the largest group of luxury buyers in the world but in the last years a significant part of their purchases were concluded outside China. The recent pick-up in domestic sales is supported by the increasing middle class income and it should translate into lower volatility with respect to the past. The apparel, leather goods, jewellery and upper-end spirit sectors are benefitting from this positive trend. We notice that the mix is less rich than what it used to be before the anti-corruption campaign started in 2013, but it seems to be more sustainable and it has room for improvements in the medium term.

2. **Potential volatility**

   Notwithstanding the reduction of potential volatility in confidence and consumptions coming from political events (i.e., elections in large economies), there is still the possibility that in the next 12 months specific factors could trigger a worsening scenario. Among these situations we include Brexit and other independence aspirations in Europe, tensions in Asia due to North Korea, or the still uncertain recovery in Brazil and Argentina. These factors can have significant impact on the decision to buy luxury items and on the places or channels used to do so. We believe the touristic flows can help to mitigate the potential negative effect in specific countries but not all the luxury players have an extensive geographic coverage and can fully capture touristic movements. Large luxury players are better placed because they tend to have a more expansive presence worldwide. The ones having lower geographical diversity are expected to suffer more from potential sudden falls in demand in specific areas.

3. **Changing Preferences**

   Among the existing or potential luxury customers there is an increasing trend to switch from items to experiences. With the increasing importance of millennials, the possession of a luxury good is becoming less relevant while the possibility to have a unique luxury experience is gaining momentum. This opens opportunities for new players and creates threats to the traditional ones that do not diversify their offer. Among the luxury experiences, travel, sports, wellness, and food are the most popular, and the digital channel is a key success factor to get information and make a purchase. In the traditional luxury space, digital sales are typically below 6% of the total sales because the shop still represents a relevant part of the purchasing experience, but the use of digital is very important to define preferences.
Apparel Manufacturers

1. **Focusing on fast fashion trends and fastest growing sportswear**
   
   Apparel manufacturers will continue to face challenges due to an increasingly competitive environment in the apparel industry, soft mall and store traffic, and general sluggish spending on apparel products. Sports-inspired apparel will outpace all other categories in the apparel space, as customers choose healthy lifestyles and wear sportswear not only for workouts but also to various functions and events. China will remain a key growth driver for sportswear, securing its position as the second largest sportswear market after the U.S. and becoming an increasingly important market for major sportswear brands. In addition, fast fashion is changing the industry into a demand-driven one, and apparel companies must be proactive rather than reactive in order to stay relevant. Enhancing the efficiency of supply chains and shortening product lead time will be central focus for the companies.

2. **Channel rationalization will continue; margins relatively stable**
   
   Choosing a right distribution strategy is increasingly challenging in the apparel sector. Companies will seek a balance between consumer expectations that products are available instantly and anywhere, while maintaining brand image and integrity.

   We expect companies will continue to rationalize channels of distributions by selectively choosing wholesale partners and/or focusing on distributing products through owned stores in order to remain agile and flexible. Also, as internet retailing is growing and consumers are increasingly willing to make digital purchases, apparel companies will continue to invest in e-commerce capabilities. Margins should remain relatively stable for most companies because of improving supply chain efficiency, focus on cost controls, and lean inventory position that should support full price sell-through.

3. **Acquisitions and emerging markets will drive growth**
   
   With limited growth potential in the mature and saturated U.S., apparel companies will seek to make acquisitions and shift focus to emerging markets as these offer the greatest growth opportunities. Acquisition is also on the table for apparel companies in Asia-Pacific, especially China, to increase brand or product diversity. Sizable acquisitions could hurt the companies’ credit quality; however, many of the large apparel companies built some cushion in their balance sheets to make small, bolt-on acquisitions without risk to ratings. For example, both Carter’s and Levi Strauss have debt leverage of about 2x and a downside trigger set at leverage of about 3x, and both have room to make small bolt-on acquisitions without a downgrade. On the contrary, Hanesbrands and G-III continue to integrate their recent acquisitions and any new large acquisition could weaken the credit profiles for these issuers, which could take a toll on ratings, absent meaningful synergies or commitment to reduce debt leverage. PVH also continues to indicate its appetite for acquisitions in order to broaden its presence and improve digital capabilities. Any significant acquisition that results in debt leverage sustained above 3x could also result in a negative rating action for PVH.
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Related research

- Consumer Products Companies Look For Growth In A World Where Customers Are Becoming More Fickle, Apr. 17, 2017
- U.S. Packaged Food Companies Look To Extend Their Shelf Life As Market Evolves, Aug. 2, 2017
- Brexit means leaner margins for UK Food manufacturers, Apr. 17 2017
- Can Mexican Consumer Products And Retail Sectors Withstand Downside Risks In Consumption?, Aug. 9, 2017
- Japan Corporate Credit Spotlight: Consumer Products; Retail; Advertising; Health Care, Oct. 4, 2017
- Disruption Risks Lie Ahead For Greater China's Consumer Products, Gaming, Retail, And Telecom Companies, Apr. 20, 2017
- Credit FAQ: The FDA's Plan To Take Aim At Combustible Cigarettes Could Hurt Large Tobacco Companies If Regulations Follow, Aug. 9, 2017
- A Shifting Foundation: Smaller Players Are Making Established Cosmetics Brands Blush, Jan. 11, 2017
- FAQ: How Recent Business Deals Are Changing The Eyewear Industry, Feb. 8, 2017
Cash, debt, and returns

Global Consumer Products

Chart 115 – Cash flow and primary uses

Chart 116 – Return on capital employed

Chart 117 – Cash and equivalents / total assets

Chart 118 – Total debt / total assets

Chart 119 – Fixed versus variable rate exposure

Chart 120 – Long term debt term structure

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
Industry Top Trends 2018: Health Care

Overview

- **Ratings outlook slightly negative:** Although 78% of our outlooks are stable, there is a significant negative bias to our non-stable outlooks, even following a year where rating downgrades outnumbered upgrades by an almost 5:1 margin, including downgrades on high-profile companies such as Teva Pharmaceutical Industries Ltd., Abbott Laboratories, and Community Health Systems Inc. Our outlook bias primarily reflects operating weakness among low-rated service providers and generic pharma companies, as well as some companies with stretched balance sheets following mergers and acquisitions (M&A). We see pharma and health care equipment industry fundamentals as healthy, with big pharma having capacity for moderate-sized acquisitions.

- **2018 forecasts call for stable growth and flat margins, but pockets of weakness exist:** On a consolidated basis, we expect the health care companies we rate to grow revenues about 4%-5% in 2018, which includes the impact of M&A. While operating trends for health care equipment and big pharma companies remain very stable, health care service companies face slowing organic growth next year given likely soft patient volume, and we expect generic drug manufacturers to face another year of significant price deflation. Margins are broadly stable across the portfolio, with some deterioration among service providers (especially hospitals), as well as generic and some specialty pharma companies.

- **Regulatory risk is lower following failed attempts to repeal the ACA:** We expect governments in developed countries and private payors in the U.S. to continue exerting pressure on health care spending. While we see a repeal of the Affordable Care Act (ACA) in the U.S. as unlikely following several failed attempts, we expect some declines in insurance coverage levels as a result of Trump administration policies, and that scrutiny of pricing will limit companies’ ability to raise prices on older drugs.

- **Slowing health care utilization and shifts in financial policies are key risks:** For more highly leveraged companies, especially providers, we’re focused on the risk that patient growth slows more than expected, given very stretched sector credit metrics. We also see risks that investment-grade companies will temporarily shift toward more aggressive financial policies if we see meaningful U.S. tax reform, give cash overseas for many companies and our policy of netting some cash in leverage calculations. While we don’t factor in this level of “event risk” into outlooks, at least two of our prominent investment-grade rating actions of 2017 (our downgrade of Abbott and our negative CreditWatch listing on Becton Dickinson & Co.) were a consequence of sudden shifts in financial policy.

- **Payors remain in the driver’s seat:** Powerful commercial payors continue to exert pressure on providers through plan design (including narrow networks as well as the use of co-pays and deductibles to encourage use of lower-cost providers). Meanwhile, payors and pharma purchasing groups are using competition to push down prices on older, substitutable drugs. Across the board, health care companies will need to effectively innovate to preserve their competitive positioning and profitability.
Ratings trends and outlook

Global Health Care

Chart 121 – Ratings distribution

The corporate health care sector ratings distribution is skewed toward the 'B' category, reflecting the presence of many small, private equity owned companies, especially in the health care services subsector. Our investment grade rating distribution continues to drift lower, with continued shift from the 'A' category to 'BBB' category.

Chart 122 – Ratings distribution by subsector

Though ratings are predominantly stable, the net negative outlook bias primarily reflects operating pressures (including weak volumes for service providers and pricing challenges for generic and specialty pharma companies), with less impact to ratings from debt-financed M&A activity.

Chart 123 – Ratings outlooks

The weakest ratio of negative to positive outlooks in the health services sector primarily reflects operational challenges in this sector, as payors seek to restrain health care utilization growth.

Chart 124 – Ratings outlooks by subsector

Our net negative bias, which intensified in 2016, persists in 2017, reflecting operating challenges and, to a lesser extent, stretched balance sheets following recent M&A in pharma and equipment.

Chart 125 – Ratings outlook net bias

Our net negative bias remains strongest for health care service providers, and recent improvement to the trend reflects, in part, several downgrades among companies that were previously on negative outlook. The bias remains modestly negative on pharma and equipment companies.

Industry forecasts

Health Care

Chart 127 – Revenue growth (local currency)

Industry revenue growth slowed somewhat in 2017, reflecting lower levels of M&A in pharma and services and some Big Pharma patent expirations. We expect about 4% industry growth in 2018—slightly higher in services and devices (reflecting low-single-digit organic growth and the impact of M&A) and slightly lower for pharma, given our expectations for Big Pharma patent losses in 2018 and pricing pressure for generic and some specialty players.

Chart 128 – EBITDA margin (adjusted)

We expect broadly stable EBITDA margins in 2018 across all three subsectors. We expect pockets of margin deterioration among hospital operators (who face a challenging volume environment) and among generic and specialty pharma companies, who face pricing challenges.

Chart 129 – Debt/EBITDA (median, adjusted)

Chart 130 – FFO/debt (median, adjusted)

Pharmaceutical industry forecast

We expect global pharmaceutical sales to grow in the low-single-digit range, about 3%, slower than recent years due to patent expirations and a continued negative pricing environment for generic and some specialty products. We expect public scrutiny around pharma pricing to continue into 2018, and think that this pressure will result in another year of more moderate price increases. Patent expirations abound in 2018, and several large companies, including Merck & Co. Inc., Novartis AG, Eli Lilly & Co., and Valeant Pharmaceuticals International Inc., face headwinds from drugs going off-patent.

We expect the generic pharma industry to remain challenged in 2018, as high-single-digit price declines on older generics will not be offset by new product launches. This sector has already
experienced downgrades in 2017 after we lowered ratings on Teva Pharmaceuticals (BBB-/Negative/--) and Endo International PLC (B/Stable/--) by one notch each, reflecting operating weakness tied to generic price deflation. Following our Teva downgrade, we revised our rating outlook to negative just month later following weak third-quarter operating results. Very difficult conditions in generic end markets are also driving consolidation in this space, with Amneal Pharmaceuticals LLC and Impax Laboratories Inc. recently announcing their intent to merge, creating the fifth-largest global generic manufacturer.

With the notable exception of the generic players, we expect margins to be flat in 2018, and for credit metrics to remain stable. While M&A has slowed somewhat (likely reflecting uncertainty around prospects for U.S. tax reform), we think that the industry trend toward slower organic growth (especially among big pharma companies), decreasing profitability, higher volatility of revenues, increasing development and marketing costs, and longer and uncertain returns on investments will force increased M&A to drive revenue growth. Still, most large players in pharma have healthy balance sheets and debt capacity within their existing ratings profiles, supporting our expectation for ratings stability. This is despite our acknowledgement that our ratings do not reflect the risk of transformational M&A, and the fact that more than a few large companies have been willing to sacrifice ratings over the past few years to fund game-changing acquisitions.

**Health care services forecast**

For health care service companies, we expect low-single-digit organic growth in 2018, with significant variation across subsectors. We expect hospitals to see very low single-digit organic growth (consisting of near-zero volume growth and low-single-digit blended reimbursement rate increases), while companies providing outsourced services to hospitals and outpatient providers should grow slightly faster. We expect industry participants to see modestly higher bad debt expense in 2018 (reflecting slightly lower insurance coverage levels and the increasing prevalence of high-deductible health plans, given difficulty in collecting amounts owed by consumers). Given a strengthening U.S. economy, we could see incremental upward pressure on wages, which, combined with lower growth, would lead to further margin pressure for facilities-based providers (especially hospitals). We see leverage as broadly stable, with some potential for large issuers like Tenet Healthcare Corp., Community Health Systems, and Quorum Health Corp. to reduce leverage through asset sales.

In Europe we expect reimbursement to for-profit health care service providers to remain under pressure as governments continue to curb expenses. We therefore expect continuing pressure on profitability, especially for hospitals, nursing home operators, and social care services as fixed costs such as wages continue to increase and further cost savings will be harder and harder to generate.

We expect M&A activity to remain high but transactions to stay mostly small as the industry continues to consolidate. Given private equity interest in rolling up smaller providers (especially those with asset-light business models, like staffing providers and some physician practices), we expect a continued high level of first-time issuers in this sector in 2018. In Europe, we expect to see more acquisitions in the sector, especially in the labs and hospital services areas as these markets remain fragmented.

**Health care equipment forecast**

For equipment companies we see mid-single-digit top-line growth, with mid-single-digit revenue growth supported by favorable demographic trends, increasing penetration in emerging markets, and steady technological innovation stemming from regulatory requirements and extensive intellectual property. This incorporates our view that companies will face low-single-digit pricing headwinds stemming from margin pressure at hospital customers, a continued shift from volume to value, and initiatives to accelerate the pace of regulatory approvals, which incrementally increases competition. We expect incremental deleveraging in 2018 among larger rated players in the sector, as several companies that participated in large-scale M&A over the past few years reduce debt to meet their stated financial policy targets.
We expect health care equipment M&A to moderate in 2018 following three years of large-scale consolidation. Given that many of the larger industry players are currently digesting large acquisitions and working to restore leverage to historical levels, we think acquisition activity will be largely limited to tuck-ins in 2018, with minimal impact to credit metrics.

**Key assumptions**

**Health Care**

1. **2018 should see greater stability on the U.S. regulatory front**
   Following several failed attempts at "repeal and replace," we think it’s unlikely that the ACA will be repealed in the U.S. Although pharma pricing remains front-page news, we see federal drug pricing legislation in the U.S. as unlikely in 2018.

2. **Payors remain focused on cost containment**
   Despite the presence of many large players, even the largest health care companies we rate, including behemoths like drug maker Pfizer Inc. or hospital operator HCA Healthcare Inc., have very small market share, especially when compared to a very consolidated group of payors (including governments and very large U.S. commercial insurance companies). With payors focused on limiting growth in health care spending, we expect further pressure on U.S. patient volumes and on global pharmaceutical pricing.

3. **Industry consolidation continues, but we see limited ratings risk**
   While we expect the health care industry to continue to consolidate, we think this consolidation poses limited risk to ratings in the near term, as we think many industry participants will likely be on the sidelines for large-scale transactions pending the outcome of corporate tax reform proposals in the U.S.

**2018 should be a year of greater stability on the U.S. regulatory front**

While we think it’s unlikely that the ACA will be repealed in the U.S., we believe that federal health care policies are likely to be a small incremental credit negative for health care providers because we expect the administration to prioritize cost containment over coverage expansion. We expect U.S. insurance coverage levels to be incrementally lower in 2018 versus 2017 as fewer individuals sign up for ACA exchange plans given marketplace uncertainty and lower advertising, and we see further risk to provider bad debt levels as a result. With the notable exception of labs, which face sizable cuts, the preliminary 2018 Medicare rates are mostly benign for providers. While we believe that any efforts to weaken Medicaid coverage are unlikely to affect providers in 2018, we see risks that a longer-term shift from Medicaid as an entitlement to block grants could exert further pressure on service company revenues and margins.

Meanwhile, we expect pharmaceutical pricing pressure to continue, even without regulatory intervention. This is because we expect public scrutiny around pharma pricing to continue into 2018, and think that this pressure will result in another year of more moderate price increases. In addition, with opioid addiction an ongoing public health crisis, we see some product liability risk to companies that manufacture or distribute these drugs, though we do not expect the exposure to lead to rating changes.

We see health care equipment companies as facing only limited exposure to regulatory risk. Notwithstanding the recent Trump administration move to curtail recent bundled payment initiatives for hip and knee replacements, we think the shift toward value-based payments is likely to continue over time, which could affect equipment company margins. In addition, following several years of high product liability expense for several large companies, we expect this exposure to wane in 2018, though we acknowledge product liability to be an ever-present risk for equipment manufacturers.
Payors remain focused on cost containment

While health care equipment providers have often cited persistent low-single-digit annual price deflation, health care providers and branded pharma companies have long enjoyed mid-single-digit (or higher) annual price increases from commercial payors. While we expect provider reimbursement rates from government and commercial payors to grow at a low-single-digit rate in 2018, payors are becoming more aggressive in using plan design (including co-pays, deductibles, and narrow networks) to direct patients to lower-cost settings. This trend is a substantial headwind for hospital operators, who face growing competition from ambulatory surgery centers, outpatient imaging, urgent care facilities, and freestanding emergency rooms. With the notable exception of labs, which face sizable cuts, the preliminary 2018 Medicare rates are mostly benign for providers.

Generic drug price deflation stole the headlines in 2017, and we expect the pain to continue into 2018. We expect mid- to high-single-digit pricing deflation on older generics in 2018 as payors (including pharmacy benefit managers) continue to push down prices on drugs in competitive categories through the use of preferred positioning on formulary tiers (and in some cases, formulary exclusion) to drive greater discounts. However, innovative, highly effective drugs will be able to continue to command premium pricing.

Industry consolidation continues, but we see limited ratings risk

For health care service providers, 2017 was a year of consolidation among smaller providers (reflected, in part, in the large number of first-time debt issuers we rated this year). We expect this trend to continue in 2018, as smaller players seek to gain scale to effectively negotiate with very large, concentrated payors (both government and commercial). We don’t expect M&A to have a meaningful impact on credit quality across the subsector because we think more leverage-neutral transactions are likely given that leverage in this space is already high. Notably, we’ve also seen a few large hospital companies selling assets to refocus their portfolios, with Tenet Healthcare, Community Health Systems, and Quorum Health likely to remain net sellers and HCA Healthcare Inc. a net buyer. In Europe, we see rapid consolidation in the laboratory industry, primarily in response to ongoing reimbursement cuts. The majority of these transactions are predominantly debt funded, which could put current ratings under pressure.

Following several blockbuster deals in 2014 and 2015, M&A activity in the pharma sector has been relatively muted with only a few notable transactions with a price tag over $25 billion, including Shire PLC’s takeover of Baxalta in 2016, Johnson & Johnson’s takeover of Actelion in 2017, and Abbott Laboratories’ purchase of St. Jude Medical in 2017. While Shire was previously unrated and J&J had sufficient debt capacity at its rating, Abbott’s buying spree prompted a four-notch downgrade, to ‘BBB’, from ‘A+’. That said, with many European companies in the middle of strategic portfolio reviews and U.S.-based companies most likely waiting to see the results of potential tax reform promised by the Trump administration, we think the M&A focus will be on tuck in acquisitions, for now. At the same time, some pharma companies are rationalizing their portfolios: Pfizer Inc. and Merck KGaA are considering selling their consumer health care segments, and Sanofi announced that it could sell its generics division, with European pharma companies GlaxoSmithKline, Bayer, and Sanofi (who have expressed interest in this space) among the possible suitors.

Health care equipment companies are coming off of a period of large-scale consolidation, and we think large companies will likely focus on tuck-in acquisitions and reducing leverage in 2018.
Key risks and opportunities

Health care

1. **U.S. tax reform: good news in the long term, but short-term risks**

   While U.S.-based health care companies stand to benefit from potential corporate tax reform in the U.S. over the long term, given the potential for lower rates and higher free cash flow over time, we see some risk that some large companies with historically conservative balance sheets and large cash balances may view the ability to repatriate cash at attractive rates as an opportunity to finance large one-time share repurchases, or spur very large-scale M&A not currently incorporated into our ratings or outlooks.

2. **Value-based pricing poses risks and opportunities over time**

   We expect health care industry pricing dynamics to slowly transition pricing models to value-based models where pricing is determined by quality and outcomes from a fee-for-service approach. For industry participants that can demonstrate superior performance (in the form of safer medical devices, better drug treatment outcomes, or higher quality care), this shift poses opportunities, but there will be winners and losers over time.

3. **The regulatory “wild card” remains in play**

   While our base-case expectation is that we see no major impact from U.S. health care legislation in 2018, we cannot discount the risk that further attempts to dismantle the ACA, convert Medicaid to block grants, or regulate drug pricing at the federal level are possible.

**U.S. tax reform: good news in the long term, but short-term risks**

While U.S.-based health care companies would benefit over the longer term from tax reform that reduced corporate tax rates and allowed for lower-cost repatriation of overseas cash, we think any policy change could lead to short-term financial policy shifts for some companies that might be tempted to use repatriated cash for large share repurchases. Because we net a portion of many companies’ cash against debt in our leverage calculations, we’d view a decrease in these cash balances as a credit negative.

We also think that more clarity on future tax policy could spur an increase in very large-scale M&A, especially in the pharma sector, where large deal flow has slowed somewhat over the past few years. We view this risk as slightly less pronounced for health care equipment companies given the recent wave of large-scale consolidation, and see limited ratings risk to health care service providers, most of which are U.S.-centric (with little to no overseas cash) and generate substantially lower federal income tax bills relative to higher-rated pharma and health care equipment peers.

**Value-based pricing poses risks and opportunities over time**

While the shift to value-based pricing is a slow moving trend, the industry continues to move toward new pricing models that reward quality and outcome over quantity of treatment. Notwithstanding the recent Trump administration move to curtail recent bundled payment initiatives around hip and knee replacements, we think the shift toward value-based payments is likely to continue over time, and note that recent studies have shown that about 40% of large employers are now incorporating value-based initiatives into health care plan design. This poses both risks and opportunities for health care companies because those that can show the highest quality outcomes at competitive costs may be able to take market share at the expense of competitors.

In pharma, the launch of new classes of very promising oncology treatments with expected very high price tags and very targeted patient populations is driving a shift toward new value-based pricing models, where payors receive refunds or rebates if a drug doesn’t perform as expected in a
particular patient. This approach is not novel, as value-based pricing models have already been used for some diabetes treatments and for expensive PCSK9 inhibitor cholesterol drugs.

The regulatory “wild card” remains in play

Though our forecasts currently don’t contemplate any major changes in U.S. health care or drug pricing legislation, we think the current U.S. administration will remain focused on cost containment at the expense of insurance coverage levels, and we see some risk of further attempts to restructure the federal-state Medicaid program, including trying to convert the program from an open-ended entitlement to a block grant program, which would likely result in both lower reimbursement to providers and fewer individuals covered (and higher bad debt expense to providers, especially hospitals).

While we still think U.S. federal drug pricing legislation is unlikely, we believe there is a risk that pricing pressures will intensify, most likely as a result of the industry reacting to greater public scrutiny. While we think U.S. federal drug pricing legislation is unlikely in 2018, several states have passed or are considering bills that could negatively affect pharma pricing or profitability, including a pending California bill that would limit the ability of manufacturers to offer coupons or rebates on drugs for which a cheaper generic is available and a Nevada law passed in June that requires greater disclosure around pricing and pharma and pharmacy benefit manager (PBM) profits from diabetes drugs.

Key takeaway: Innovation is key in a changing landscape

Across health care subsectors, the industry is consolidating as companies react to increasingly aggressive attempts by payors (both government and private) to control health care spending growth. In addition, we’re seeing competitive threats emerge from new corners, including payors buying providers (UnitedHealthcare, through its Optum subsidiary), as well as e-commerce giant Amazon considering an entry into the pharma space, possibly competing with pharma supply chain participants, including distributors and PBMs. While we think the short-term risk is low given high regulatory barriers to entry, we see Amazon as posing a competitive threat to all pharmaceutical industry participants—including pharma companies, PBMs, distributors, and pharmacies—given the potential to dramatically improve price transparency.

For pharma companies, the ability to innovate remains key to success. Many pharma players face patent cliffs on their best-selling drugs, including Merck (Invanz, Vytorin), Novartis (Gleevec), Bristol–Myers Squibb Co. (Reyataz), Roche Holding AG (Herceptin), Sanofi (Lantus), Eli Lilly (Strattera), and Glaxo SmithKline PLC (Advair). At the same time, payors (including PBMs) are becoming increasingly aggressive in holding down spending on expensive “me too” drugs, using tools like higher co-pays and even formulary exclusion to limit spending on pricy drugs that don’t offer better outcomes. As usual, oncology remains at the forefront of innovation, with upcoming immunotherapies that have been heralded as the most important developments in cancer treatment in generations. While the space has seen a few big failures, Merck’s Keytruda has achieved great clinical success and we expect more oncology blockbusters to emerge in the near future.

For service providers, legacy operators will need to rethink how they deliver services to compete with new business models offering consumers access to care at convenient and less expensive sites of care. Many large hospital operators have shifted in this direction, but with leverage across the sector very high, it will be difficult for many to invest in building out their care networks. In the meantime, we expect health care companies to face persistent competition from new business models.
Related Research

- **Recent Performance In The U.S. Health Care Sector Is Increasingly Volatile, Sept. 21, 2017**
- **Pricing Pressure Continues To Weigh On Generic Drug Makers, Sept. 5, 2017**
- **Making The Rounds: Health Care Service Providers Have the Summertime Blues, Aug. 31, 2017**
- **The S&P Pharma Dose Newsletter: The Pharma Industry Outlook Is Revised To Stable From Negative As M&A Momentum Slows, April 7, 2017**
- **Despite A Three-Year Downgrade Streak for Investment-Grade Medical Device Companies, The Industry Outlook Remains Stable, Feb. 10, 2017**

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Cash, debt, and returns

Global Health Care

Chart 131 – Cash flow and primary uses

Chart 132 – Return on capital employed

Sources: S&P Global Market Intelligence, S&P Global Ratings calculations.
Industry Top Trends 2018
Homebuilders and Developers

Overview

- **Forecasts:** Globally, we expect improving demand, supporting some sales growth. In the U.S., we anticipate stable demand and a tight supply of new homes, supported by S&P Global Ratings' economic forecast for 1.3 million U.S. housing starts. Within APAC, property developers' credit metrics are diverging. In China, we expect the high cost of land to constrain margins. Sales growth also faces the risk of slowdown. We expect stable credit metrics for Indonesian developers with satisfactory sales and manageable debt maturities. A robust backlog, growing revenues, and healthy planned deliveries should sustain European homebuilders' credit ratios in 2018.

- **Assumptions:** In the U.S., we assume fundamental demand for new homes will continue to improve, with housing supply remaining low. As a result, we assume home prices appreciate further, closings grow about 6%-8%, and EBITDA rises. In China, we forecast property sales to fall 5% in 2018, mainly driven by volume decline. Average sales price (ASP) is likely to maintain as a whole, although some cities with stronger policy restrictions may experience mild slides in prices. We expect prices and volume to increase by up to 5% in Hong Kong, with stable prices with some volume growth in Indonesia. In Europe ex UK, low lending rates, gradually accelerating economic growth, and government incentives should continue to fuel the housing market upturn. In LatAm, we anticipate solid top-line growth, with a gradual improvement in profitability measures and cash flow generation, while homebuilders maintain prudent financial policies.

- **Risks:** In the U.S., we expect gross margin compression due to labor shortages and higher materials and land costs. Despite declining gross margins, debt levels now exceed their 2006 peak. As homebuilders chase volumes by targeting first-time home buyers, higher mortgage rates on this segment of the market could eventually affect credit quality. For Chinese developers, the key risk is significant credit tightening and refinancing needs. We expect the impact of Brexit on the U.K. housing market overall to be manageable and likely concentrated on prime residential properties in central London. Should household incomes sharply dip and property prices decline, the banking sector may seek to cut its exposure to the development sector. In Mexico, the downside risks for 2018 are related to further volatility related to the upcoming general elections that could undermine housing demand in the second half of the year. In Brazil, political uncertainty and economic recovery are the main risks for the next 12 months.

- **Industry Trends:** A cluster of natural disasters caused us to lower our expectations for 2017 orders and closings for exposed homebuilders. However, we could see some tailwinds entering 2018 as these homebuilders expect a boost in demand. In China, consolidation continues to gather momentum as larger players gain market share through acquisitions. In LatAm, we foresee a slow economic recovery in 2018, but controlled inflation, lower interest rates, and job creation should support better housing fundamentals and growth prospects.
Ratings trends and outlook

Global Homebuilders and Developers

Chart 137 – Ratings distribution

Chart 138 – Ratings distribution by region

Chart 139 – Ratings outlooks

Chart 140 – Ratings outlooks by region

Note that this regional split does not include CEEMEA ratings.

Chart 141 – Ratings outlook net bias

Chart 142 – Ratings net outlook bias by region


U.S.

Our outlook for the U.S. homebuilding sector is stable with a positive bias, with support from a continued favorable but uneven national housing recovery. We believe that positive rating actions could outnumber negative actions, given that about 12% of our rated universe has a positive outlook. Generally speaking, we incorporate solid top-line growth in 2018 into most of our ratings and stable outlooks on homebuilders, due to higher home deliveries and average selling prices.

EMEA

Improving economic conditions across Europe, including falling unemployment and rising consumer confidence in the face of moderate inflation, should continue to support robust revenue growth for developers in 2018. We expect house price appreciation to range between 1% for the
weaker continental market (Italy) and 6%-7% for stronger countries (Ireland and Germany). Only for the U.K., where we rate the second-largest homebuilder, Taylor Wimpey PLC, and smaller players like Miller Homers and Keepmoat, do we foresee a 1% drop in average house price in 2018. Throughout the Brexit process, we expect the shortage of housing and government’s measures will provide a buffer for ASPs nationally; declines are likely to be concentrated on the London prime residential segment, for properties exceeding £1 million. Prospects for developers in Russia and the Gulf Cooperation Council (GCC) are generally stable but remain dependent on the future state of those economies, partly driven by the oil and gas price environment and currency movements.

APAC

Our net outlook for the sector is moderately tilted negative. That said, the net outlook bias has become less negative than 12 months ago, as we see an improving credit profile for a number of Chinese developers. The relatively good contracted sales growth as well as the margin recovery driven by home price appreciation are strengthening Chinese developers’ credit metrics. We expect their credit profiles to continue to improve moderately over the next 12 months. Yet, the sustainability of such improvement is still uncertain as profitability will potentially deteriorate due to the high cost of land. In addition, contracted sales growth also faces the risk of a slowdown given the high base in 2017, as well as home purchase and mortgage policies tightening. Rated Chinese developers that have stepped up land acquisitions but have fewer inexpensive means to do so will potentially see a larger decrease in profitability, cash flows, and financial leverage.

Hong Kong developers have achieved good property sales with solid price increases, driven by strong demand and ample liquidity in the market. As a result, their leverage profile has generally improved with limited investment opportunities, while robust recurring rental incomes also support the ratings, especially as retail rentals show signs of stabilization. However, we expect Hong Kong developers’ leverage to increase over the next 12 months, as the city’s new administration allows more farm land conversion. The Chinese government is restricting companies’ property investments outside the mainland, reducing competition for Hong Kong developers. That said, we do not expect any substantial deterioration as Hong Kong developers have a track record of prudent new investment and financial management.

For Indonesian developers, we expect stable credit metrics in 2018. Most property developers met about 60%-70% of their budgeted sales targets by September 2017, within S&P Global Ratings’ expectations. We note that several developers augmented core property sales with land sales to generate cash. Consumer sentiment has picked up, with an improvement in presale momentum especially in the third quarter of 2017. We expect demand to improve in 2018, and this will translate into stable credit conditions for developers in the next 24 months. Construction costs are under control, the currency environment is stable, and most Indonesian property developers have pushed out their debt maturities beyond 2020.

Latin America

The ratings outlook remains mixed, with a negative bias--about 50% of the ratings have negative outlooks. All the negative outlooks are concentrated in Brazil, reflecting the risk that improvements in housing demand and cash flow generation could be slower than we expect. This could continue to pressure issuers’ credit metrics and the ratings on those companies. In Mexico, our ratings are broadly stable, reflecting our view that housing industry fundamentals will remain solid despite short-term macroeconomic downside risks. Yet, some ratings have positive outlooks, reflecting a possible one-notch rating uplift if these entities maintain their solid operating and financial performances.
Our homebuilding outlook for 2018 calls for continued stable demand and a tight supply of new homes, which is supported by S&P Global Ratings’ economic forecast for 1.3 million U.S. housing starts and our opinion that many fundamental demand drivers for new homes will continue to trend positively. Within APAC, we expect developers’ leverage profile to continue to diverge, although overall leverage should improve moderately in 2018 on average, driven by Chinese developers’ better sales and margin recovery due to relatively widespread home-price growth in the country. The sustainability of such improvement beyond 1-2 years is still questionable for Chinese developers. Land cost has risen substantially, and we expect sales growth to slow over the next 12 months. In LatAm, we expect Brazilian homebuilders to show gradual recovery in top-line and cash flow generation amid our expectation of slow economic recovery in the country. In Mexico, we expect industry players to sustain their growth strategies, while maintaining broadly stable profitability measures, relatively low leverage, and healthy liquidity positions.
Key assumptions

Overview

Our assumptions for homebuilders and developers diverge globally based on supply-and-demand conditions. In the U.S., S&P Global Ratings economists project about 8% growth in total U.S. housing starts in 2018. We expect new home sales for U.S. homebuilders we rate to maintain positive growth of about 8%, with home deliveries increasing at about the same rate.

In APAC, we expect slower sales. We forecast that property sales in China will decline 0%-5% in 2018, driven by volume decline. That is predominantly due to the high base in 2017, continuous policy tightening, and sustainability of good sales in lower-tier cities. Despite the general recovery in 2017, those cities present lesser fundamentals with population outflow and weaker economic development. In Hong Kong, unless interest rates increase more than we expect, we foresee property prices and sales volume will both increase by 0%-5%, supported by strong demand, while the rise in supply will hit the market gradually.

In Indonesia, we expect property sales to remain stable with some volume growth, about 15%-20% year-over-year, but the market is still recovering from peak sales in 2013-2014. Selling prices will remain flat as in the previous two years. Some developers have modified their product mix to launch smaller, lower-priced, and more affordable properties targeted at first-time homebuyers. Coupled with the slew of rate cuts by the central bank, mortgage rates are at an all-time low in Indonesia. Though profit margins may be lower, developers are hoping to offset this with higher sales volumes.

In LatAm, S&P Global Ratings economists project a slow economic recovery, which should generally support a better business environment for the housing industry. In general, we anticipate LatAm homebuilders’ sales to grow by low-double-digit percentages, resulting from a combination of improvements in units sold, especially in Brazil, and a better average price environment. Some market players, particularly in Mexico, transition their product mix toward the middle-income and residential segments. We also expect improving cash flow generation in Brazil and that Mexican companies will maintain their focus on cash flow generation and low-leverage metrics.
<table>
<thead>
<tr>
<th>U.S. Homebuilders/Developers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1</strong> Homebuilding demand continues to trend positively</td>
</tr>
<tr>
<td>S&amp;P Global Ratings economists project 1.3 million U.S. housing starts in 2018, about 15% less than the long-term average of 1.5 million. We expect several factors to remain positive heading into 2018: job growth of about 1.3%, wage growth of about 3.1%, increasing household formations, low interest rates, low existing-home inventory, and high confidence from consumers and builders. We believe these positive demand drivers support our assumptions for higher top-line growth as we assume new sales grow by about 8% in 2018.</td>
</tr>
<tr>
<td><strong>2</strong> Rate of home price increases slow</td>
</tr>
<tr>
<td>In 2009-2017, new home prices appreciated by about 25% (inflation adjusted), according to data from the S&amp;P/Case-Shiller Home Price Index. We believe this is due to inventory decline, from a peak of 10 months supply to five months supply, according to the U.S. Census Bureau. As recent housing demand has strengthened, we expect the supply/demand imbalance to remain heading into 2018. Consequently, we expect ASP to continue to increase. But as some builders increase their exposure to entry-level products, which typically have a lower price than other products, and further diversify their product mix, we expect ASP growth rates to decelerate for our rated homebuilders.</td>
</tr>
<tr>
<td><strong>3</strong> EBITDA growth with stable profitability</td>
</tr>
<tr>
<td>Profitability among rated builders is stagnant entering 2018, reflecting a contrast between weaker gross margins and better operating leverage. We expect adjusted gross homebuilding margins (which exclude capitalized interest from cost of sales) to continue to contract for most builders for the year. The primary factor for tighter margins, we believe, continues to be higher land prices, while labor costs and those associated with land development delays also affect the bottom line for many. While we expect gross margins to contract, we also expect builders to seek volume gains to better offset overhead costs and drive operating leverage. With the roughly break-even impact of gross margins and operating leverage, home delivery growth of 6%-8% and higher ASP should help overall EBITDA grow for most builders.</td>
</tr>
</tbody>
</table>
**European Homebuilders/Developers**

### Strong housing market in Germany

For developers, we forecast a robust housing market in Germany. After a record increase in German metropolitan areas in 2016 (9.6% according to Hypoport statistics), we foresee nominal house prices rising a sustained 7% in 2017 and 6% in 2018, and no sign of a housing bubble developing. Rising demand is supported by strong fundamentals: natural increase in households related to urbanization and demographic changes, high migration, structural shortage of housing supply, and robust economic indicators. House prices in Germany remain comparable with those in other European countries and affordable when put against real income level or rental yields. Although property construction output should surge to 300,000 units in 2017, it will unlikely fill the gap that has widened in recent years partly as a result of demanding regulation on land procurement and energy savings.

Listed real estate holding companies, such as Deutsche Wohnen or LEG Immobilien AG, could start their own residential construction activities to support organic growth. Following Germany’s general election on Sept. 24, 2017, tighter rent regulation appears unlikely; regulatory focus should primarily be on implementing construction-supportive measures.

### Relative slowdown in the U.K.

The structural undersupply of housing and government programs such as help-to-buy (HTB) continue to support demand for new homes, in particular in the mid-range and affordable housing segments—for which these schemes may account for one-third of overall demand. The HTB program is due to end in 2021, but extension should be assessed as part of the 2018 budget discussions before year-end. Nationwide, we foresee a moderate 1% drop in average house price in 2018. U.K. homebuilders could be affected by the Brexit fallout if demand for new homes falls more as purchase decisions are delayed and house prices decline on the back of market uncertainties.

### Recovery under way in France

Market conditions in the rest of continental Europe, especially in France, are recovering. We expect the trend to continue as long as positive macro-economic trends combine with sustained penetration of highly affordable mortgage loans. French developers should experience growing demand as the underlying economy continues to improve and political uncertainty has evaporated following the May-June 2017 round of elections. Growth in project starts and building permits turned clearly positive since mid-2017, and we expect those trends—backed by high backlog and reservations—to support French homebuilders and developers’ revenues at least throughout calendar 2018. We take into account the fact that the new French government is considering measures to slow price increases in the residential market; personal allowance for low-income tenants may be cut further, and the fiscal environment for buy-to-lets is being tightened. Still, structural features attached to the French VEFA system ensure high prefunding and should support French developers’ credit quality in 2018.
### Asia-Pacific Homebuilders/Developers

<table>
<thead>
<tr>
<th>1</th>
<th><strong>Good margin recovery, though the long-term trend is uncertain</strong></th>
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<tbody>
<tr>
<td></td>
<td>A number of Chinese developers’ profitability has recovered. We expect that this trend will likely continue in the next 12 months, as the recognized profit should reflect the relatively widespread home price increases that extended to some lower-tier cities lately. However, the sustainability of the prevailing profit margin beyond 1-2 years is still uncertain in our view, as land prices have increased even more. There is a risk that Chinese developers’ margin will be eroded by high land cost in 2-3 years, especially for those that acquire land aggressively but with less inexpensive means—mergers and acquisitions (M&amp;A), old town resettlement, etc.</td>
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<tr>
<th>2</th>
<th><strong>Rising funding cost and property sales slowdown in China</strong></th>
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<tr>
<td></td>
<td>Onshore funding cost in China is increasing, for regular bank loans and other alternative funding channels such as trust loans, asset management plans, etc. The cost increase magnitude for the latter is even larger, as some Chinese developers started to rely on this funding source more with the Chinese regulator slowing approval of bond issuance from developers. In addition, given the high base in 2017, home purchase and mortgage policies tightening, and the sustainability issue of good sales in lower-tier cities, Chinese developers potentially face the challenge of slowing sales over the next 12 months. We expect national property sales to be 0%-5% lower, driven by volume decline.</td>
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<tr>
<th>3</th>
<th><strong>Higher leverage for Hong Kong developers; Indonesia stable</strong></th>
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<tr>
<td></td>
<td>With the new administration in Hong Kong allowing more farm land conversion and the Chinese government restricting property investments outside the mainland, we expect that Hong Kong developers should accelerate land acquisitions. While that will likely result in higher leverage, we do not expect substantial deterioration as Hong Kong developers have a track record of prudent new investment and financial management. For Indonesia, we expect stable property sales with some volume growth. While profit margin may be lower, that could be offset by higher volume. Most of them have also pushed out debt maturities beyond 2020. These would support their stable credit metrics.</td>
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### Latin American Homebuilders/Developers

<table>
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<tr>
<th>1</th>
<th><strong>Brazilian players to continue improving cash flow generation</strong></th>
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<tr>
<td></td>
<td>We expect Brazilian homebuilders to gradually increase cash flows following the economic recovery, with lower interest rates and declining unemployment in 2018. Also, we expect lower cancelations and better working capital management, as transfers of receivables to banks are getting quicker. Moreover, after a period of holding back, companies have resumed launches in 2017 and should continue to increase since land banks are at adequate levels. But this would translate into higher working capital needs for construction than in past years.</td>
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<th>2</th>
<th><strong>Mexican homebuilders to post healthy results overall</strong></th>
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<tbody>
<tr>
<td></td>
<td>Our 2018 forecast suggests that Mexican homebuilders will report healthy results through the year, driven by our expectation of relatively flat GDP growth (2.3% vs. our 2.1% estimate for 2017), stabilization in interest rates, and lower inflation rates. Mexico’s housing industry fundamentals remain positive, primarily supported by demographics, job creation in the formal sector, and the availability of mortgage financing from commercial banks and public financial institutions. Overall, we anticipate Mexican homebuilders to post mid-single-digit percentage unit growth with low-teens percentage price increases. Market players continue to improve their product mix toward middle income and residential segments. As a result, we anticipate these companies will post low-double-digit percentage sales growth, stable EBITDA margins of about 15% on average, positive cash generation, and still low leverage metrics with debt to EBITDA below 2x on average.</td>
</tr>
</tbody>
</table>
Key risks and opportunities

Overview

In the U.S., the primary risks to our baseline forecast for homebuilders are similar to those from last year. A tight labor market and rising material costs, combined with delays in land development, led to increased cycle times and hurt builders’ profitability. This could cause builders to miss our forecasts and deteriorate credit quality. Despite these risks, our outlook generally calls for stable demand for new home construction, which should limit the downside for most U.S. homebuilders.

In APAC, more-severe-than-expected credit tightening remains the key risk for Chinese developers. This will dampen mortgage availability and pricing for homebuyers as well as developers’ funding conditions and their cash collection. Another key risk is the surging refinancing needs from 2018 onward, especially as regulators have slowed debt issuance approvals for Chinese developers. For Hong Kong, faster-than-expected interest rate increases could lead to weaker-than-expected sales, prices, and credit metrics. For Indonesia, key risks will be a marked economic slowdown that hampers buyer sentiment. An unexpected depreciation of the Indonesian rupiah (IDR) against the U.S. dollar (USD) will also hamper issuers' ability to service their debt.

In LatAm, key risks remain related to a possible slower-than-expected macroeconomic recovery that could delay housing demand and the upcoming general elections in Mexico and Brazil. Political uncertainties could bring volatility in the credit markets and put pressure on financing conditions for homebuyers. Brazilian and Mexican homebuilders have smooth debt maturity profiles in 2018.

U.S. Homebuilders/Developers

<table>
<thead>
<tr>
<th>Gross margin compression</th>
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<tbody>
<tr>
<td>We see limited prospects for an upside surprise to our base-case earnings forecast, as higher costs for labor, materials, and land mute stronger top-line growth. We expect continued gross margin compression throughout 2018 due to labor constraints, higher material costs (specifically concrete and lumber), and a higher cost basis for land as many builders have now worked through low cost inventory that was purchased coming out of the downturn.</td>
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<tr>
<th>Higher mortgage rates and declining affordability</th>
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<tbody>
<tr>
<td>Mortgage rates are still historically low. We believe we could see upward pressure as the Federal Reserve increases the target for the federal funds rate, which S&amp;P Global Ratings economists expect at least three times in 2018, and reduces the size of its balance sheet. We believe higher mortgage rates will have more of an impact on homebuyers for whom affordability is an issue. As rates rise, the amount required for the monthly payment increases and constrains affordability for those on the margin of deciding to buy their first home or to continue renting. As homebuilders more recently have focused on the entry-level buyer, an uptick in mortgage rates could reduce deliveries and eventually affect credit quality.</td>
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<table>
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<tr>
<th>Higher debt</th>
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<tr>
<td>Most credit ratings are still lower than they were before the housing crisis, but not because we view industry risk any differently. Homebuilders have as much debt and higher leverage than they did at the peak in 2006. Debt exceeds that peak compared to an earnings base and equity value that remain more than 30% lower. Debt to EBITDA has settled at almost double what it was before the downturn. Leading issuers Lennar Corp., PulteGroup Inc., and Toll Brothers Inc. increased fully adjusted debt to EBITDA (adjusted debt includes our pension, operating lease, and surplus cash adjustment) to a combined 3.3x at mid-year 2017 from 1.5x in 2006, consistent with the transition to speculative-grade from investment-grade ratings.</td>
</tr>
</tbody>
</table>
European Homebuilders/Developers

1. **Brexit**
   
   U.K. developers may be affected by stagnating valuations in certain areas like London as the implications of the Brexit process become clearer, especially for the financial industry. We believe that Brexit will give financial-services firms already under pressure to contain costs more reason to consider reducing their office space in London. We expect the pressure to be most acute for offices in the City of London or high-end residential properties, market segments that cooled off in 2017. As a result, we expect some slowdown in the development of commercial properties. We view Brexit as a medium-term risk, though, with full effects to unfold over several years, rather than being fully visible in 2018.

2. **Political tensions in Spain**
   
   The political tensions surrounding Catalonia’s call for independence have had limited impact on development activities. That will likely affect the region’s office real estate market the most. Residential, logistics, or retail segments influenced by consumer spending more than corporate sentiment should prove more resilient.

3. **Indirect commodity price dependency in Russia and the GCC**
   
   Prospects for developers in Russia and the GCC will continue to depend on the state of those economies, partly driven by the oil and gas price environment and currency movements (see industry developments below).

Asia-Pacific Homebuilders/Developers

1. **Further severe credit tightening and refinancing risk in China**
   
   Property sales in China have held up well despite the rollout of various tightening measures. While credit has become tighter, it is less so than in previous tightening cycles. A more severe credit tightening will further affect mortgage availability and pricing for homebuyers, developers’ funding conditions, cash collection from sales, and ultimately property sales. In addition, Chinese developers’ refinancing needs will surge from 2018 onward. Chinese regulators have slowed approving debt issuance applications, which may affect developers’ refinancing plans.

2. **Accelerated consolidation for larger Chinese developers**
   
   Consolidation is a major trend for Chinese developers, as smaller developers gradually exit the market due to their inferior competitiveness and disadvantage in funding. If the market slows over the next 12 months, there is a chance for larger developers to grab more market share. In this situation, consolidation may speed up as more small developers run into various difficulties.

3. **Higher-than-expected interest rate hike in Hong Kong**
   
   While the Hong Kong property market faces a number of ongoing risks, including rising supply and continued poor housing price-to-income affordability, the sharp increase in interest rates could have a huge impact. Although we see solid demand, multiple and significant interest-rate increases could dampen market sentiment and erode mortgage affordability. It still looks okay due to currently low interest rates, and subsequently undermine house prices.
Latin American Homebuilders/Developers

Market uncertainties could impair financing conditions in Brazil

As Brazil’s federal government continues to face fiscal challenges, public funding availability for the Minha Casa Minha Vida program could be lower. If banks remain strict on credit for homebuyers, it could lead to lower-than-expected sales and an extended period of high sales cancelations. Besides, given that 2018 is a presidential election year, credit and capital markets will most likely be volatile, which could worsen refinancing conditions for homebuilders.

Mexican macroeconomic conditions could show downside risks

We believe that the July 2018 general election in Mexico will bring volatility in the market, particularly on currency exchange rates and to some extent on economic growth and financing activities. These conditions could bring further hikes in inflation and interest rates, with potential impact on consumer confidence and disposable income, and consequently housing demand. Moreover, further Mexican peso depreciation against the U.S. dollar could have a direct upswing effect on building materials costs, which could pressure homebuilders’ operating margins and cash flows, despite their ability to partially pass these cost increases through to homebuyers.

Industry developments

Increase in U.S. natural disasters

Recently, natural disasters clustered in North America--Hurricane Harvey in Houston, Hurricane Irma in Florida, and California wildfires. Flood damage to homebuilder inventories in Houston was not as substantial as initially expected. Homebuilders we rate reported that damage to their communities was limited to a few model homes, with street flooding in some communities. Initial reports suggest that new home sales and closings may be lower than in the same period last year but should have no material impact on performance heading into 2018. As of the writing of this report, it was still too early to quantify the impact of the California wildfires on homebuilders. Based on historical data, the National Association of Homebuilders believes there won’t be a massive surge in homebuilding in affected areas but that it will take place slowly over a number of years. That said, estimates vary, but tens of thousands of homes were destroyed, which will boost demand from our previous expectations and provide a tailwind for exposed builders over the next 12-24 months. We believe that labor availability and land development substantially hinders normalizing Houston and Florida homebuilder operations and returning to steady volumes, while higher materials costs and lower overhead absorption will constrain margin improvements.

Russia

In terms of pricing, recovery of the Russian housing market remains constrained by weak personal income growth. Structural demand for housing in Russia remains sustained, though, and this should support the market in 2018. Due to the real price declines of housing properties over 2015-2016 and lowered mortgage rates, affordability measures in Russia are much more robust. The Russian government’s decision to end its mortgage-subsidy program after December 2016 has not dampened housing demand.

Gulf Cooperation Council

2018 is expected to remain as challenging as 2017 for the GCC real estate sector. Markets and sentiment remain sluggish as GDP growth rates have slowed, partly as a result of direct or indirect dependency on oil prices. While the economies are adjusting to oil at or around $55 per barrel, we expect governments to cut or postpone expenditure to manage tight fiscal budgets. The six GCC countries will, for instance, roll out a 5% value-added tax in 2018. While population growth is fundamentally supportive for residential real estate, the segment in Dubai has come under
pressure. We expect rents and house prices to fall further in 2018, with many developers still delivering large projects to increase housing supply.

Israel

We expect the Israeli housing market to continue cooling, which could be reflected in a slower pace of growth in housing prices and low level of transactions in the market. Market demand is adversely affected by the fact that many first-time buyers are not active in the free market but waiting to participate in the government Mechir Lamishtaken program for subsidized housing. Increased taxes on investors also put pressure on demand. On the supply side, there are early signs of a decline in building starts. This trend may again put upward pressure on housing prices in the next two years. We expect erosion in profitability of developers participating in Mechir Lamishtaken, although marketing risk under the program is substantially lower.

LatAm

In Brazil, we foresee the housing industry benefiting from a slow economic recovery in 2018, including GDP growth of 2% against our 0.5% estimate for 2017, coupled with lower interest rates and declining unemployment rates. These conditions should support a better environment for industry growth prospects. However, the key risk in Brazil is related to financing availability under market uncertainties and the general election in October 2018. The latter could affect housing demand.

In Mexico, we expect the housing industry trend to remain solid with relatively flat GDP growth, normalized inflation rates to about 3.5%, and the interest rate environment to slightly recover. The industry trend will remain driven by the large housing deficit, demographic dynamics, mortgage loan availability, and our expectation for increasing job creation in the formal sector of the population. Nonetheless, we remain cautiously prudent ahead of the general election in July 2018, which could induce downside risk on macroeconomic conditions and to some extent on housing demand.

Financial policy

In the U.S., shareholder returns have been a contributing factor in rising leverage for homebuilders. Dividends on our rated homebuilders troughed at about $100 million in 2013 before increasing back up to $360 million in 2016. We expect this to increase in 2017 and again in 2018. Share buybacks in 2017 will likely top their peak of $1.6 billion in 2006, as with Pulte’s commitment of $1 billion of repurchases for 2017; we expect repurchases to exceed $2 billion.

We expect U.S. M&A activity to continue after a few such transactions in 2017. In October, Lennar announced it will merge with CalAtlantic Group to create the largest North American homebuilder, and D.R. Horton completed its merger with land developer Forestar Group Inc. While we do not take a uniform view on M&A and assess each situation individually, the impact on a company’s financial risk profile depends on how the transaction is financed and our forecast of its pro forma credit metrics. We would likely view a heavily debt-financed acquisition less favorably. On the other hand, a transaction that enhances a builder’s geographic diversity and strengthens its share in local markets could bode well for its business risk profile. We also take transaction size and integration risk into account when considering the ratings impact, which is also situational.

In Europe, debt reduction for homebuilders is moderate because of their limited free cash flows, but increased revenues from project deliveries should sustain credit ratios in 2018. We also note that most developers keep interest hedging high and have taken advantage of recently favorable market conditions to extend their debt maturity profiles. Debt for large rated U.K. homebuilders remains low, which provides some buffer in the Brexit uncertainty.

In APAC, most Chinese developers are still expanding due to the good market conditions of the past 1-2 years, which spurred more companies to chase growth. Some developers also feel the peer pressure of maintaining scale growth to avoid losing their ranking in the national property sales league. While a lot of them still acquire land in open auction or tender, there is an increasing trend
of M&A activity as developers generally see that as a cheaper way to acquire land or projects. As a result, only a limited number of Chinese developers target a reduction in financial leverage.

Most Brazilian issuers already issued debt this year or refinanced in advance of their 2018 debt maturities due to potential market volatility, taking advantage of lower interest rates. Companies also continue to focus on improving cash flow generation by selling finished inventories, which reached peak levels in some cases, but have also resumed launching new units. With stronger cash flow generation, we expect stable to decreasing leverage, while companies maintain a prudent approach to land bank acquisition.

We expect Mexican homebuilders to sustain their prudent financial policies with low leverage and healthy liquidity positions supported by solid cash holdings, comfortable short- to medium-term debt amortizations, and significant undrawn committed credit lines available. We foresee that companies might accelerate land purchases from their 2017 pace to sustain growth strategies while focusing on profitability and cash flow generation. As to dividend distributions, we believe that market players should maintain relatively stable dividend payout ratios, which have not affected their cash flow generation nor debt levels. Finally, we have seen some industry players performing liability management before Mexico’s 2018 general election, which should continue to support their liquidity positions and overall financial flexibility.

Under S&P Global Ratings’ policies, only a rating committee can determine a credit rating action (including a credit rating change, affirmation or withdrawal, rating outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of rating committee action and should not be interpreted as a change to, or affirmation of, a credit rating or rating outlook.
Cash, debt, and returns

Global Homebuilders and Developers

Chart 147 – Cash flow and primary uses

Chart 148 – Return on capital employed

Chart 149 – Cash and equivalents/total assets

Chart 150 – Total debt/total assets

Chart 151 – Fixed vs. variable-rate exposure

Chart 152 – Long-term debt term structure

Sources: S&P Global Market Intelligence, S&P Global Ratings calculations
Industry Top Trends 2018
Hotels, Gaming, and Leisure

Overview

– **Ratings Outlook:** Discretionary spending in the global leisure industry will likely improve modestly in 2018—the base-case ratings outlook for the sector remains stable, with nearly 80% of ratings outlooks on issuers currently stable.

– **Forecasts:** The base-case forecast for modestly improving leverage in 2018 reflects modest revenue and EBITDA growth, but for many issuers, the forecast does not include opportunistic acquisitions and other unexpected leveraging events.

– **Assumptions:** We expect particular strength in the global cruise industry, another year of revenue growth in Las Vegas and Macau, flat revenue per available room (RevPAR) in U.S. lodging, surprising resilience in European RevPAR, and good growth in the theme park sector.

– **Risks:** Mergers and acquisitions (M&A) and development opportunities could lead to incremental leverage in the gaming sector. The U.K. government’s recently announced plan to limit betting amounts could hurt retail operators that get a majority of cash flow from gaming machines. We address long-term risks from nontraditional hospitality options, and security risks to European travel trends. Adverse weather and security risks are ever present in the global cruise market, and yield management in the China cruise market will remain challenging over the near term.

– **Industry Trends:** Real estate and other business separations may drive M&A in the gaming and lodging sectors in 2018, as discrete assets become available and if they fit well with other asset portfolios. Lodging M&A may focus on moderately sized acquisitions or single assets, but timeshare combinations could be transformational. Few new gaming license opportunities and modest anticipated organic revenue growth could also motivate M&A in U.S. gaming. Further regulation could also encourage M&A in European gaming. We expect issuers that generate positive free cash flow to repurchase shares in the absence of M&A opportunities. We expect high levels of capital expenditures in the cruise segment, although shipyard capacity is limited for years to come, which should moderate the pace of fleet expansions.
The vast majority of ratings are non-investment grade, reflecting high levels of competition and fragmentation in this discretionary and cyclical sector, combined with high leverage in many cases.

Discretionary spending in the global leisure industry will likely improve modestly in 2017—the base-case ratings outlook for the sector remains stable, with 77% of ratings outlooks on issuers currently stable.

Rating stability is present across all sub sectors.

Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending September 30, 2017
Industry forecasts

Global Hotels, Gaming and Leisure

Chart 159 – Revenue growth (local currency)

We expect sustained strength in the cruise sector due to rising net revenue yields and good capacity absorption.

Chart 160 – EBITDA margin (adjusted)

Minimal margin improvement over the forecast period is due to slowing revenue in many sectors and markets, and rising labor and other costs.

Chart 161 – Debt / EBITDA (median, adjusted)

The base case forecast for modestly improving leverage in 2018 reflects modest revenue growth, but for many issuers, the forecast does not include opportunistic acquisitions and other unexpected leveraging events, which will almost certainly flatten this downward curve in future periods.

Chart 162 – 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.
### Key assumptions

#### Gaming

<table>
<thead>
<tr>
<th>1</th>
<th>Will Las Vegas’s winning streak continue in 2018?</th>
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<tbody>
<tr>
<td>We expect 2018 to be another year of growth in Las Vegas, particularly on the nongaming side, as visitors continue to view Las Vegas as a broader entertainment destination. Despite our forecast for low-single-digit RevPAR growth across most U.S. lodging markets, we believe Las Vegas could be poised for another year of low- to mid-single-digit RevPAR growth. Las Vegas continues to experience high levels of visitation, as well as good convention business. Strong demand coupled with no meaningful change in the supply of hotel rooms prior to 2020 should allow operators to increase rates next year, while maintaining high occupancy. We believe the tragic mass shooting in Las Vegas could have a modest short-term impact, but as long as it remains an isolated event, we don’t expect any meaningful negative impact on tourism or convention business in the city. On the gaming revenue side, we’re forecasting low-single-digit growth, in line with consumer spending.</td>
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<tr>
<th>2</th>
<th>Volatile VIP growth has an outsize influence on Macau’s recovery</th>
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<td>We expect good economic growth in China, the opening and ramp-up of new casinos, and ongoing infrastructure improvements to support continued growth in Macau gross gaming revenues (GGR) through 2018. We are forecasting relatively steady growth in the mass market segment and a material deceleration of growth in the VIP segment. Our base case assumes mass market GGR will grow in the 5% to 10% range, and that VIP GGR growth will be less than 15% next year. This should support total Macau GGR growing in the 6% to 12% range in 2018. The VIP segment has been the main driver behind the stronger-than-expected recovery in 2017 GGR, growing nearly 30% through Sept. 30, 2017, but we don’t expect this high level of growth to continue. (We base our VIP estimates on reported figures from the Gaming Inspection and Coordination Bureau of Macau, which differs from casino operators’ reported figures—which we believe could overstate VIP gaming revenue growth and understate mass-market growth based on operators’ reclassification of tables.) The VIP segment is highly volatile, in part because it is highly susceptible to policy changes in mainland China, which makes forecasting this segment difficult. We believe that if the Chinese government were to further curb capital outflows, renew its crackdown on corruption, or tighten regulations for junket operators, growth in the VIP gaming segment could materially weaken over the next 12 months. While we expect casinos’ EBITDA margins to expand slightly, driven by better operating leverage as newly opened properties ramp up operations and cost-saving initiatives, profitability improvements continue to be diluted by faster growth in the VIP segment, which has much lower margins than the mass-market segment.</td>
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<th>3</th>
<th>Online growth will mitigate potential volatility in European gaming markets</th>
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<tr>
<td>We anticipate slow and steady growth for the European gaming market in most countries, with GGR growing by the low-single digits during the year despite heavy regulations. The online segment continues to be the industry’s main source of growth, and we expect operators with strong brand and product propositions to continue achieving double-digit revenue increases in this segment in 2018. Retail-based betting is stable, although we observe some deterioration in several markets (mainly U.K. and Germany). Increased regulation and taxation would weigh on gaming companies and could pressure earnings and overall profitability. We expect consolidation from M&amp;A and bolt-on acquisitions to continue, following several large mergers in the industry over the past couple of years. We expect mergers to be primarily debt financed; hence, industry leverage could increase this year. Nevertheless, as cash flow generation of these companies is strong, we anticipate that leverage would be reduced over time absent any regulation or unanticipated shocks.</td>
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Hotels

1. **U.S. RevPAR grows 1% to 3%**
   
   U.S. RevPAR growth has held steady at just under 3% through the first nine months of 2017 after slowing significantly to a growth rate of 3.2% in 2016. Record-high occupancy levels are proving to be resilient despite supply growth climbing to about 2%, since demand continues to grow in line with GDP. We predict that demand will continue to grow around 2% in 2018 and supply growth will match demand growth. As a result, we expect 2018 occupancy to be flat or very modestly positive. Even if occupancy does grow slightly, we predict another year of slow RevPAR growth between 1% and 3%, nearly all due to average daily rate (ADR) growth that has been tepid despite high occupancy levels. We believe key risk factors to our RevPAR forecast include an unexpected jolt to the economy, or further declines in inbound international travel due to either U.S. dollar strength or the negative perception of Trump Administration security policies. Although our 2018 forecast predicts growth for the industry overall, we expect to continue to see a meaningful divergence in RevPAR performance between certain markets and chain scales. Companies with concentrations in markets and chain scales with particularly high supply growth will likely experience lower occupancy, resulting in weaker RevPAR growth.

2. **M&A could take more than its usual share of investment spending**
   
   We typically include a placeholder assumption for most lodging companies to incorporate dividends, share repurchases, acquisitions, and other types of investment spending in our base case forecasts. The placeholder assumption is often sized in line with leverage policy goals if we believe issuers are committed to them. The recent trend toward real estate and other business separations may drive M&A in the lodging sector in 2018, as discrete assets become available and if they fit well with other lodging portfolios, and provided the capital markets remain receptive to financing acquisitions. Lodging M&A activity may ultimately be mostly moderately sized acquisitions or single assets, but aggregate M&A spending may also take up more than its usual share of investment spending in 2018. Timeshare combinations, if they occur, could be transformational. (See expanded timeshare industry M&A comment in Industry Developments below.)

3. **Solid recovery in European RevPAR boosted by supportive economic trends**
   
   We expect European RevPAR growth between 6% and 7% in 2017 (in euros) compared with modest growth of around 2% in 2016. We expect European RevPAR to moderate to the low- to mid-single-digit area in 2018. Strong performance in southern Europe drove 2017 RevPAR growth so far during the year, as tourism redirected from regions more affected by terrorist events in western Europe. Terrorist attacks, which impaired RevPAR in Paris and Brussels in 2016, pose a risk that is always present in the industry but the effects of which are temporary. We expect solid low-teens RevPAR growth to persist in Spain and Portugal in 2017 as holidaymakers continue to shy away from other rival tourist destinations outside Europe (North Africa, Turkey, and Middle East) in response to the persistence of geopolitical tensions in those areas. However, this buoyant growth is expected to ease somewhat in 2018 as European travel slowly redirects to competing regions.

   Despite a turbulent year marked by terrorist events, we expect the U.K. to post low-single-digit RevPAR growth in 2018 as the weaker pound continues to offset the negative impact that the terror events had on the number of visitors. Finally, pent up demand and the abatement of geopolitical risk could cause RevPAR to grow in the low- to mid-single digits in western Europe in 2018. However, our forecast is contingent on the nonrecurrence of such events.
Cruise

**Net revenue yields grow**

We expect constant currency net yields to improve in the low-single-digit percent area through 2018 reflecting continued good anticipated consumer demand for cruises and well received new ship builds that command pricing premiums. Net yield growth will also be supported by modest industry capacity growth of around 5.5% (according to data provided by Cruise Line International Association (CLIA) and company information), and a favorable economic environment that should drive pricing discipline across large cruise operators.

We believe the impact of recent hurricanes in the southern U.S. and Caribbean (Harvey, Irma, and Maria) will have a minimal negative impact on 2018 net revenue yields since the hurricanes occurred during a seasonally low booking period for the Caribbean, and many ports of call in the Caribbean remained fully operational, or are expected to be operational in the near term. Although we believe operators offered modest discounts or promotions in the weeks following the storms in order to encourage bookings, we view this pricing behavior as temporary and believe the favorable economic climate will support a return to more disciplined pricing.

**Capacity expands**

We estimate 2018 capacity will grow around 5.5% based on data provided by CLIA and company filings. We believe this level of capacity growth can be absorbed since we believe a favorable economic environment and a tendency to vacation will continue to drive improved demand, particularly from North American and European sourced passengers.

We believe operators will continue to invest in developing the Chinese cruise market over the long run. However, we do not believe there will be capacity growth in the market in 2018. Although 2018 capacity will reflect a full year of operation of the Norwegian Joy (which began sailing in mid-2017), removals of ships from the market (for instance, Royal plans to remove its Mariner ship from the market for dry docking) will diminish capacity. Operators' deployment strategies and itineraries vary year by year, which can result in shifts in capacity in specific regions, as operators look to deploy capacity to the highest yielding destinations and itineraries.

**Lower fuel costs from hedging strategies could aid margin improvement for some**

We believe fairly stable fuel costs in 2018, for operators with hedging strategies, along with rising net yields, will help offset expected modest increases in net cruise costs, driven primarily by inflation. Our expectation with respect to fuel costs incorporates operators' fuel hedging strategies, and our economists' forecast for about a 6% increase in oil prices in 2018.

Of the major operators, both Royal Caribbean Cruises Ltd. and NCL Corp. Ltd. have fuel-hedging strategies that we believe will benefit EBITDA margin in 2018, given our forecast for rising net yields. As of Sept. 30, 2017, Royal had 56% of its projected fuel purchases hedged for 2018, at a cost per metric ton that is about 15% lower than 2017 levels. For NCL, as of Sept. 30, 2017 the company hedged around 65% of its total projected fuel consumption for 2018, a portion of which is at lower cost than 2017.

For the U.S.-based cruise operators, a weaker dollar may result in improved reported yields as foreign currency revenue is translated into higher dollar value, but the impact of this revenue improvement could be dampened by increased expenditures in dollar terms for operating costs and ship deliveries.
Key risks and opportunities

Gaming

Operators continue to eye investment in Japan, but new resorts are unlikely before 2023

Gaming operators continue to focus on the possibility of securing a license to develop an integrated casino resort in the future, should Japan pass the necessary implementation bill to establish the regulatory framework for integrated casino resorts, which could occur sometime in 2018. We expect the process for securing a license in Japan will be very competitive, given the potential size of the market and strong prospects for this new gaming destination. Most of our rated casino operators in Macau and a number of operators with limited to no existing international presence have already expressed a strong interest in pursuing a gaming license in Japan.

However, how much operators are ultimately willing to invest will depend heavily on the ultimate regulatory framework, which will set gaming tax rates, the number of licenses, and possibly the location of those licenses, size of required minimum investment, and any entrance restrictions. These factors could weigh on the return potential of a project, given high corporate tax rates in Japan and the high cost of land in many areas.

Once the regulatory framework is established, we expect there to be a competitive process for securing a license, and construction of these types of resorts typically takes several years. As a result, we believe it’s unlikely any meaningful capital spending in Japan would occur before 2020 or that an integrated casino resort would open before 2023. That said, given the size of potential investments that operators have outlined previously, we expect the winners of these licenses would incur higher debt and weaker credit measures than we’re currently forecasting in our base case.

Will M&A Heat Up As Gaming Operators And REITs Pursue Growth?

We believe M&A activity will remain a key component of both gaming operators’ and gaming REITs’ strategies in 2018, particularly as there are few new gaming license opportunities and modest anticipated organic revenue growth. We expect few, if any, new gaming opportunities in the U.S. over the next one to two years. As a result, gaming operators will continue to focus on acquiring single assets or small portfolios to drive growth and improve economies of scale. We also believe operators are looking to M&A as a way to increase diversity or strengthen their market position or competitive advantages in an existing market.

Additionally, with the spin-off of Caesars Entertainment Operating Co.’s real estate assets into a new REIT (VICI Properties Inc.), there are now three gaming REITs (including Gaming & Leisure Properties Inc. and MGM Growth Properties LLC) in the sector that need to pursue M&A transactions in order to achieve any meaningful growth, given a largely fixed rent structure.

While we believe there is still a relatively healthy level of capital available, the competition for M&A deals could drive multiples higher. The extent to which M&A transactions affect ratings will depend on the mix of debt and equity financing companies use to capitalize acquisitions, as well as how the acquired assets improve business positions. We also believe that it’s likely we will see existing gaming operating companies continue to partner with the gaming REITs to diversify operations.
U.K and German land-based operators could suffer from coming regulation

The U.K. government announced the findings of its triennial review of gaming machines stakes and prizes on Oct. 31, 2017, after a very long waiting period. Four potential options were recommended for the maximum stake amount: £50, £30, £20, and £2 (all of which would be a reduction from the current £100). The government has given market participants 12 weeks to comment on the proposals, which will be finalized on Jan. 23, 2018. Since the result of the review is unclear, the effect it will have on U.K.-based operators is still unknown. Nevertheless, if the severe £2 scenario materializes, we believe this would have a strong negative effect on the U.K. gaming industry, particularly on retail-based operators that earn a majority of cash flow from gaming machines. This scenario could lead to downgrades for retail-based U.K. companies, as we would likely lower our future earnings and cash flow forecasts. Once the government finalizes its findings, we expect to review and publish our view on the potential effect on rated companies. We also note that any changes would probably not come into force before early 2019.

In Germany, the interim phase of the German Interstate Treaty ended on July 1, 2017, enabling full enforcement of supply restrictions. Consequently, we believe that up to half the gaming machines in the country are at risk of closure by various state authorities. For the time being, most local communities are delaying decisions as to which particular gaming arcades must go, and we expect most arcade operators will appeal decisions at various court levels or apply for hardship compensation if this is made available.

While we expect minimal impact on earnings from gaming operations in 2017, we foresee more pronounced effects in 2018 and 2019. While some state authorities could be more favorable to the gaming companies, others could take a more strict approach. In our view, the reduction in machines will be partly offset by the increased anticipated utilization of the remaining gaming machines, but overall earnings could fall significantly. We also understand that the German sports-betting market is currently not within scope of supply restrictions. However, this segment still lacks an EU-compliant regulatory framework, which means the authorities are not able to award official licenses and leaves operators exposed to regulatory risks over the medium term.
Hotels

Long-term risk from nontraditional lodging options
Compared to traditional lodging options, we believe alternative accommodations such as Airbnb appeal to a more adventurous consumer, one who is willing to forgo the consistency and amenities of a hotel in exchange for a lower price and a potentially more immersive local experience. We also believe the product appeals to small groups of travelers, for whom booking a block of hotel rooms might be prohibitively expensive. As a result, it is our view that Airbnb and other alternative accommodations providers are expanding the travel market by providing options for people who would not otherwise travel as frequently. We have observed recent research suggesting that Airbnb supply growth has had a limited impact on RevPAR growth for traditional lodging companies so far, and we suspect minimal incremental impact to RevPAR in 2018. However, we see potential long-term risk to the traditional hotel industry if Airbnb is successful in its efforts to create more standardized and consistent offerings, especially those that appeal to business travelers. If employers increasingly accept Airbnb as a realistic option for business travel, this would have a negative impact on RevPAR at traditional hotels. Additionally, because of the lower average price point and highly elastic supply dynamics, we believe Airbnb may have a bigger impact on RevPAR during economic downturns compared with periods of economic growth. People may be more willing to rent out rooms in their homes in order to replace lost income during periods of increasing unemployment. The potential increase in overall lodging supply in some markets could negatively affect traditional lodging occupancy, especially if demand is falling simultaneously.

Lack of leverage commitments affect U.S. “cross-over” credits
There are six U.S. lodging and timeshare issuers rated ‘BB+'. For each, leverage is currently low compared to downgrade thresholds, but ratings upside is limited by possible future policy choices that could increase leverage. We believe near-term M&A is a distinct possibility in the U.S. timeshare industry, and Marriott Vacations Worldwide, Hilton Grand Vacations, and ILG Inc. are not committing to sustain low leverage because they may participate and use leverage to complete transactions. Host Hotels also has similarly low leverage compared to our downgrade threshold, but we believe it would be a more active acquirer of hotels if the opportunity becomes available. Both Choice Hotels and Hilton Worldwide have similar low capital intensive business models with favorable cash flow characteristics and leverage well below our downgrade threshold, but neither will commit to a policy that would keep leverage under our 4x upgrade threshold. We believe their reason is to keep flexibility for potential acquisitions and possibly to return capital to shareholders at some point. This is a rational option for many issuers, but is not without risks to creditors. To raise ratings on any one of these issuers, we would need to be confident that any future leverage policy commitment is based on a plausible and sustainable strategic and financial rationale.

Security and political risks for European travel
In the absence of further security risks and supported by our view of European GDP growth of 2.0%-2.3%, we expect demand for European travel to remain sound in 2018 and to benefit all participants in the travel chain, including tour operators, online travel agents, and hoteliers. However, performance in the European travel sector will remain contingent on perceived security risks and geopolitical volatility. We expect that hoteliers present in regions that suffered the negative impact of the year’s terrorist attacks in France and Belgium will recover and post sound positive RevPAR growth. The detrimental impact of these events will slowly fade away and tourists will regain confidence. Southern European countries will continue to outperform other European regions, although political volatility could affect the region. For instance, escalation of tension between the Spanish central government and the autonomous region of Catalonia has already translated into a decline in hotel reservations, the relocation of some corporate headquarters out of the Catalan region, and some social unrest. However, and given our assumption that Catalonia will remain part of Spain, we don’t expect an immediate material impact on Spanish business travel especially given that part of the hotel cancellations may go to other Spanish regions and companies are relocating to other Spanish cities. In any case, rated hotel groups are not significantly exposed to Catalonia.
Cruise

Cruise companies likely to weather the recent storms, but event risk is always a factor

For 2018 bookings, adverse weather has become the headline event risk. Although recent hurricanes occurred during a seasonally low booking period, and the majority of Caribbean ports of call remained operational, we believe operators offered modest discounts in the weeks following the events in order to stoke demand. We view this pricing behavior as temporary, however, and believe the favorable economic climate will support disciplined pricing over the next few quarters. Cruise operators also benefit from their ability to modify itineraries and change ports of call in response to adverse events.

Further, although we believe adverse geopolitical or terrorist events continue to be a risk factor, we believe the magnitude of the negative impact may be abating as evidenced by strong booking trends over the past few months. That being said, geopolitical and terrorist events can have an outsized impact for cruise operators in the luxury, expedition, and river segments. These operators, which represent a small part of the overall industry, generally cater to retirees, who tend to have more flexibility with respect to vacation schedules and therefore can more easily postpone or cancel vacations if they have safety concerns. This drives exposure to both lower occupancy and net revenue yield pressure following events.

High capital expenditures can cause volatility in credit measures

High capital expenditures are an ever-present risk factor for cruise operators since operators continuously commit to building expensive new ships to stay competitive and must commit to ship orders as many as five years in advance to secure shipyard capacity. These large advance commitments expose operators to meaningful swings in credit measures because if ship deliveries occur during periods of weak operating performance, operating cash flow may be insufficient to fund ship costs and operators will typically increase their borrowing to fund any remaining costs.

We believe, however, that operators will take a measured approach with respect to new builds over the next few years since shipyard capacity is limited—there are only about four major shipyards globally. Given operators’ new build programs, and data from CLIA, which estimates there are 71 ships on order (including both ocean and river ships) between 2018 and 2026, we expect the major shipyards will be at full operating capacity for the next few years. We believe this, along with the long lead times to build ships, will preclude operators from unexpectedly or meaningfully increasing their new build related capital expenditure levels over the near term.
China’s developing cruise market might not be smooth sailing over the next few years

Outbound travelers from China are still a relatively new demographic that cruise operators are marketing to, and the region still reflects only a small portion (less than 5%) of the industry’s capacity. We believe the market is robust in terms of population breadth and depth, and we expect operators will continue to invest in the market over the long run–as evidenced by investments in ships dedicated to Chinese customers including NCL Corp.’s Norwegian Joy and Carnival’s Majestic Princess. Nevertheless, we believe challenges persist in establishing cruising as a viable vacation alternative and we believe the market may be choppy at least for the next few years.

We believe that yield management in the Chinese market will remain challenging in the near term due to a variety of issues: Chinese travel patterns, travel restrictions, and the sales and distribution channel in China. Unlike North American or European travelers who tend to travel for a week or more at a time, Chinese travelers tend to take shorter trips--five days or less--which limits the itineraries cruise operators can offer, and therefore limits sales opportunities. Travel restrictions, such as the recent restriction on travel to South Korea, have had a negative impact on pricing in part due to having to rebook passengers on alternate itineraries. Travel restrictions also reduce the variety of itineraries that cruise lines can offer. Further, operators currently sell cruises largely through the travel agent network in China, which limits operators’ ability to manage pricing and messaging to customers. We believe that in the near term, these challenges may drive operators to focus on more traditional cruise markets to extract greater yield. Over the long run, however, the Chinese market remains a significant opportunity for operators, particularly if economic growth persists.
Industry developments

Macau concession renewal process unknown and could pressure operators’ credit measures

We view the 2020 and 2022 concession expirations as a credit limitation for the operators in that market, although our base case does not assume that any existing concessionaires or sub-concessionaires lose their gaming licenses during the rebidding process. While the gaming license rebidding process is unknown at this time, we expect concession renewals could require some form of economic consideration from operators. This could include a potential upfront payment for license renewal, required additional capital investments, or a change in the tax regime. In our view, a higher tax rate is the least likely outcome because Macau’s gaming tax rate is on the high end compared to other markets. Increasing the tax rate would reduce cash flow available for investment and marketing spending and possibly hurt market participants’ ability to compete as effectively against operators in competing gaming jurisdictions, particularly as gaming expands across the region. The concessions/sub-concessions of SJM Holdings Ltd. and MGM Resorts International will expire in March 2020, while those of Wynn Resorts Ltd., Melco Crown (Macau) Ltd., and Las Vegas Sands Corp. will expire in June 2022. We think it’s possible that the government could extend the 2020 concession expiration to 2022 in order to complete a comprehensive license rebidding process for all operators concurrently. In the event Japan moves forward with gaming and any of the Macau concessionaires are selected for licenses there, large capital investments in Japan could complicate their ability to build in sufficient financial flexibility ahead of the Macau license rebidding process, particularly since we don’t believe meaningful capital spending in Japan is likely before 2020. As a result, ratings upside is probably limited at least over the next few years for gaming companies with a significant Macau presence until we can estimate incremental leverage, if any.

Seasonality remains a risk factor for theme park operators, while security risks continue to rise

We expect theme park operators to continue growing the business by opening new parks or expanding existing ones through adding new attractions over the coming years. We observe a large pipeline for new theme parks, particularly outside the U.S., which will add supply to meet rising demand for new parks in several locations, including the Middle East, Korea, China, and even a new Legoland park planned for completion in 2019 in Goshen, New York. As this is a capital-intensive business model, we expect operators to invest free cash flow to expand; hence, we expect to see a modest increase in leverage for some over the medium term.

Many regional theme park operators typically have their parks located in areas that are not open all year round, predominantly due to cold weather during part of the year. This reduces the operating calendar to a shorter season, and creates a high risk of adverse weather conditions over a short time frame. In past years, we have seen several theme park operators suffer from earnings volatility due to bad weather conditions, and we believe this is an ongoing risk factor.

Safety issues and growing security threats also create event risks with high potential impact. Safety events that involved severe injuries or death have had an immense impact on the specific park where they have occurred, but usually have not resulted in a threat to industry attendance. Recent terror attacks also had a big impact on the leisure industry, and we observed a negative effect on the theme park sector in Europe, as the number of visitors in affected locations decreased. We continue to see security issues as a significant risk in the future, due to the high impact they could have on the entire industry.

Latin American lodging poised for RevPAR growth

The lodging industry in Latin America is experiencing a positive demand cycle causing a sustained period of stable occupancy and RevPar growth. In the broader leisure segment, Cancun and Los Cabos remain popular destinations given their strategic locations, favorable weather throughout
the year, and rapid urban development. Most Latin American destinations are highly competitive compared to those in the U.S and Europe, due to the depreciation of many currencies in the region, while dollar referenced rates at Latin American destinations provide companies with revenue in a strong currency and a cost structure in local currency, which benefits profitability. The business travel segment remains highly fragmented and provides consolidation opportunities for large hotel companies and hotel REITS. Hotel chains often perceive competitive advantages from operating under a larger scale. As REIT-like structures (also known as FIBRAS in Mexico and Fundos de Investimento Imobiliario in Brazil) gain traction, we believe hotel owner and operators will adopt a more asset-light structure, which could boost growth and increase industry transactions.

On Aug. 22, 2017, the U.S. State Department issued a warning to U.S. citizens about the risks of traveling to certain parts of Mexico, including Cancun and Los Cabos, due to activities of criminal organizations in these areas. We do not anticipate occupancy and ADR will be materially affected in popular travel destinations in Mexico and believe any potential negative implications would be temporary. Room inventory management in both destinations is often supported by strong time-share operations and loyalty programs that incentivize recurrent travel and provide occupancy visibility well in advance. Based on current expansions in the pipeline, we believe the U.S. State Department warning will not reduce capital investments in destinations such as Cancun and Los Cabos, and we expect these destinations will continue to experience a positive trend in foreign tourism supporting room expansions. However, we will continue to monitor the effect of security measures implemented by the Mexican government in these areas to address the situation, and the potential implications to the lodging industry in Mexico in case further warnings arise.

Increasing regulations and acquisitions could pose obstacles for Canadian casino operators

In 2018, we expect the increasing regulatory scrutiny by the British Columbia government, especially on high-limit players, could lead to reduced level of gameplay. These account for a substantial portion of gross gaming revenues and have higher margins, which could pressure BC casinos. However, we expect this to be partially offset by casino operators diversifying away from BC through the acquisition Ontario Gaming Bundles. Although the initial acquisition cost is low, future capital investment to refurbish and develop the gaming sites is significant, leading to lower levels of free operating cash flow. Notwithstanding this, we expect earnings to grow, which underpins stable credit metrics for the Canadian casino operators.

M&A could affect credit risk in U.S. timeshares

The period of relative calm that we expected for the timeshare industry in 2017 was short lived. Just months after Hilton Worldwide completed its spin-off of Hilton Grand Vacations (HGV), activists began pressuring ILG to consider a merger with Marriott Vacations Worldwide (MVW), MVW acknowledged that it has an appetite for acquisitions, and Wyndham decided to pursue a spin-off of its lodging management and franchise business, after which only its timeshare ownership and timeshare exchange businesses will remain. We believe the ratings impact of any potential transactions will depend mostly on how much debt is used to finance them, but will also depend on how transformative the acquisitions (or separations) are and whether we reassess our view of business risk as a result. Notwithstanding the potential leveraging impact of M&A, we expect timeshare ratings overall to be stable in 2018 because of good anticipated sales execution by most operators and a supportive level of expected consumer spending growth. However, as large operators like Wyndham and MVW continue to shift focus to acquiring new customers, we expect ongoing margin compression due to elevated sales and marketing costs.

Under S&P Global Ratings’ policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.
Cash, debt and returns

Global Hotels, Gaming and Leisure

Chart 163 – Cash flow and primary uses

Chart 164 – Return on capital employed

Chart 165 – Cash and equivalents / Total assets

Chart 166 – Total debt / Total assets

Chart 167 – Fixed versus variable rate exposure

Chart 168 – Long term debt term structure

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
Industry Top Trends 2018
Media and Entertainment

Overview

- **Ratings Outlook:** Rating trends across the global media and entertainment industry remain broadly stable but negatively biased due to ongoing secular shifts in media consumption and advertising spending. Media companies in the print and publishing, radio, and television sectors face the greatest credit pressures. Overall, we believe diversified media companies with global footprints are more favorably positioned to face these secular trends than niche companies with concentrated operations in a few regions.

- **Forecasts:** Advertising spending is highly correlated to overall economic growth and consumer spending. In 2018, we expect mid-single-digit percentage growth in global ad spending, fueled by continued hypergrowth in mobile ad spending. Traditional media ad spending will either slow down or decline, while growth in TV ad spending will vary by market, driven by cyclical events such as sports and elections. We also expect healthy TV ad spending growth in the U.S. and key European markets such as the U.K., Germany, and France due to cyclical events, particularly the Winter Olympics and FIFA World Cup. In Brazil, the FIFA World Cup, coupled with economic recovery, should also boost TV ad revenues in 2018.

- **Assumptions:** We forecast U.S. GDP growth of 2.3% and consumer spending growth of 2.3% in 2018, driven by modest job and wage gains; and eurozone GDP growth of 1.8% in 2018, with significant regional disparities. As Brexit negotiations continue, we expect the gradual economic slowdown to result in overall U.K. GDP growth of 0.9% in 2018, down from the expected 1.4% for 2017.

- **Risks:** The key risks to our industry outlook include global economic uncertainty or shocks hurting consumer confidence and ad spending, increased entertainment options leading to accelerated television audience fragmentation, and continued shift in ad spending to digital media from traditional media.

- **Industry Trends:** In the U.S. and Europe, we expect the secular shifts in viewing consumption and ad spending to digital media at the expense of traditional print-based media to continue in 2018 and beyond. Digital ad spending will remain strong in 2018, driven by mobile advertising, while traditional sectors such as print, radio, and, increasingly, television, will see ongoing audience and ad revenue declines. We also expect further industry consolidation, especially in the U.S., as media, telecom, and technology companies reposition themselves to address these secular trends.
Ratings trends and outlook

Global Media and Entertainment

Chart 169 – Ratings distribution by subsector

Chart 170 – Ratings distribution by region

Chart 171 – Ratings outlooks by subsector

Chart 172 – Ratings outlooks by region

Chart 173 – Ratings net outlook bias by subsector

Chart 174 – Ratings net outlook bias by region

Chart 175 – Ratings outlooks

Chart 176 – Ratings net outlook bias

Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending September 30, 2017
Industry forecasts

Global Media and Entertainment

Chart 177 – Revenue growth (local currency)

Chart 178 – EBITDA margin (adjusted)

Chart 179 – Debt / EBITDA (median, adjusted)

Chart 180 – 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.
### Key assumptions

#### Television

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<th>The bifurcation of U.S. media will continue</th>
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<td>For the past few years, U.S. media companies have been evolving into two categories: those that are successfully changing with the shifting dynamics in the television ecosystem, and those that aren’t and are thus facing more challenges. We expect these trends to continue.</td>
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<td>There has been an uptick in video subscriber losses in traditional large-bundle pay-TV subscribers over the past year. And although some of these customers are shifting to over-the-top (OTT) virtual “skinny” cable bundles (such as DirecTV Now and Sling), the total number of consumers subscribing to some form of video bundle (cable, telco, satellite, or virtual) is still declining. As a result, we believe media companies with broadcast networks, major sports programming (NFL, NBA, MLB, etc.), and compelling original content are better positioned to secure their networks among the plethora of skinny bundle offerings that have been launched in the past two years. We expect broadcasters that secure carriage in these virtual bundles will report better affiliate revenue growth and lower subscriber losses than those that don’t.</td>
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<th>Content is still king, but how it’s delivered matters</th>
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<td>Compelling content is key to media companies’ success, but content delivery is increasingly becoming important as consumers demand more flexibility and choice. Historically, media companies allowed third parties, primarily pay-TV providers and, more recently, streaming video on demand (SVOD) services such as Netflix, Amazon, and Hulu, to control the distribution of their content. However, pay-TV and SVOD providers have both used the data provided from delivering content to create their own original content and deepen their relationships with their subscribers. For instance, in Europe, Sky PLC has announced plans to increase investments in its original programming production by 25% in 2018, which will help broaden its content offering and add more local content in Italy and Germany to attract new subscribers.</td>
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<td>Some media companies have responded by shifting tactics and creating their own direct-to-consumer (DTC) delivery systems to establish direct relationships with consumers. For example, CBS launched a successful DTC service (CBS All Access) in 2014 that now has over 2 million subscribers, and The Walt Disney Co. has announced it will have a DTC offering for ESPN in 2018 and another for its Disney brands (Disney, Pixar, Marvel, and Star Wars) in 2019. We view Disney’s proposed OTT streaming service as a significant move. Although other media companies have launched similar services on a much smaller scale, Disney is unique in both the depth and breadth of its intellectual property. We believe the company’s twin launches could pressure other U.S. media companies to follow suit, which would likely accelerate the fragmentation of audience viewing, putting even more pressure on the traditional video bundle. We also believe Disney’s propositions will further exacerbate the growing divide between media companies that have strong intellectual property and a deep library of content—and are therefore positioned to survive in this changing landscape—and those that don’t.</td>
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We haven’t reached peak TV yet

Despite the increasing threat of unsustainable growth and oversupply, media companies are producing even more original scripted programming each year. According to FX Networks Research, 455 scripted original TV series were produced in the U.S. in 2016, and we expect production will easily eclipse this number in 2017 as SVOD providers such as Netflix, Amazon, and Hulu continue to make significant investments in original content. Netflix expects to spend over $6 billion in content costs in 2017, up from $4.9 billion in 2016, and we expect this to rise to about $7.5 billion in 2018. We also expect increased spending from Amazon, Hulu, and new entrants such as Apple. And while this will lead to more scripted original TV series, it won’t necessarily result in more success for the companies because the added content will compete for attention from consumers who are already bombarded with a plethora of entertainment choices.

Many of the newer market entrants appear comfortable with sacrificing short-term profitability to acquire compelling content that they believe will help drive long-term subscriber growth. However, this strategy will likely pressure established media companies’ operating margins, requiring them to show considerable discipline in their programming budgets to avoid margin degradation. We also believe that while most media companies will continue to invest in their own content production, those with weaker balance sheets will need other means such as co-production partnerships and joint ventures to gain access to either intellectual property or financing to produce the content.

Consumers will continue to demand increased flexibility and personalization

Pay-TV operators’ strategy of offering a limited number of bundles (especially in terms of price points) worked well in the past when watching TV through a pay-TV bundle was the only option. But we believe this one-size-fits-all offer no longer works for everyone. As audiences fragment to alternate entertainment options, consumers are demanding the ability to watch TV everywhere, anytime, and on any device, and new pay-TV competitors are entering the market with heavily discounted offerings.

For these reasons, we believe Sky will continue its strategy in Europe of offering skinny video packages, build-your-own-bundle options, and one-off access to its channels through daily passes. In France, Canal+ has both simplified and increased the flexibility of its video bundles, allowing consumers to build their own bundles by adding or upgrading from a cheaper basic bundle. Similarly to Sky’s offerings such as daily or monthly passes, Canal+’s OTT offerings come with a no-commitment (“cord never”) commitment.

Local Media (Radio and Outdoor)

Core radio ad revenues will continue to decline

We expect radio broadcasters’ share of audience attention and advertising dollars will continue to decline at a low-single-digit percentage rate for the foreseeable future due to audience fragmentation and broadcasters losing market share to digital media. As ad rates decline, radio broadcasters will find it challenging to maintain stable top-line growth via digital media or other revenue streams. Still, we forecast traditional radio’s share of audience attention will decline only slightly in 2018 as audience consume more digital radio and other media alternatives. We also expect the radio industry’s operating margins will decline modestly due to stable or slightly lower top-line growth, offset by inflationary cost increases.

U.S. outdoor ad revenue growth will likely exceed GDP growth

U.S. outdoor advertising will maintain its share of advertising in 2018. We believe the growth in digital advertising and the minimal disruption from digital advertising will lead to higher ad rates, increased occupancy levels, and, ultimately, some topline growth. We expect outdoor advertising revenue will grow in line with or slightly faster than U.S. GDP, and industry operating margins will remain robust and relatively stable.
### Internet/Online

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<thead>
<tr>
<th>1</th>
<th>One-to-one marketing moves closer to reality</th>
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<td>&quot;Mobile first&quot; will remain a key business strategy in 2018 as one-to-one personalized marketing moves closer to reality. With their always-on, uniquely identifiable, and personal nature, mobile devices provide the ideal environment for one-to-one marketing. We estimate mobile will account for about 70% of all digital media consumption and just over 50% of the estimated $220 billion global digital ad spending in 2018. Moreover, mobile platform's importance will continue to increase as smartphone penetration grows to the projected third of the global population in 2019, companies increasingly compete for customer moments, and personalization engines that identify the optimum experience for an individual begin to mature. We believe large platform companies, such as Google and Facebook, will continue to benefit from the rapid adoption of the mobile platform and capture most of the incremental mobile ad spending in 2018. However, new innovations in mobile computing, the internet of things, and predictive analytics could create disruptions as new platforms emerge over the next two years.</td>
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<th>2</th>
<th>Context is the new data battleground</th>
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<td>Context will be a key competitive strategy for online business and data-driven enterprises in 2018. Context marketing brings meaning to data and underpins companies' desire to develop deep customer engagement and loyalty. It has the potential to improve business and product investment returns and to broaden performance advantages or competitive moats. From a credit perspective, ad monetization rates, particularly particular mobile ad monetization, will improve as advertising becomes more locally focused and relevant. In addition, marketing technology spending will increase meaningfully as a percentage of total marketing budget as companies invest in enterprise customer data management and analytics capabilities.</td>
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<th>3</th>
<th>Digital video as a tool to connect with consumers across platforms</th>
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<td>We expect digital video growth to outpace traditional TV growth in 2018, accounting for 20% of total viewing hours (over 1.45 hours) per day. Digital video monetization will increase across subscription and digital advertising as new social media video ad platforms improve programmatic revenue, shorter ad pre-rolls improve customer engagement, and better designed and targeted ad-units improve mid-roll advertising performance. Additionally, the OTT ecosystem, which is in a constant state of evolution, will continue to grow as companies introduce new bundle packages. We expect consumer choices to expand and audience fragmentation to increase in 2018 as deep-pocket new entrants such as Apple and Facebook invest billions in original content. We also expect traditional media companies will continue to lose advertising market share to digital video. Still, despite strong viewing trends, digital video advertising is just a small portion of overall TV advertising and will likely remain so over the next two to three years.</td>
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Ad Agencies

Digital growth is accelerating, but one size doesn't fit all
Digital advertising will continue to drive growth for ad agencies as technology disrupts and creates new ways for brands to connect with consumers. In particular, programmatic advertising and targeted digital marketing will grow as advertisers target narrower audiences with personalized messages aimed at the most receptive potential consumers.

Programmatic advertising enables advertisers to buy digital ad space automatically and better target their audience using data from consumers’ internet consumption habits, giving them behavioral insights on existing and potential consumers. It can be done in-house, and it’s sometimes the preferred route for advertisers that want to have full transparency on their ad spending. However, given the technology and expertise programmatic advertising requires, it is typically outsourced to ad agencies. Still, advertisers also need to address the mass market in order to build brand awareness among all potential customers, not just those who are likely to buy their products. Hence, we believe ad agencies will need to offer more personalized advertising packages to advertisers as well as complementary targeted and mass market ad campaigns, depending on the brands.

Competition is getting tougher…
Ad agencies operate in a tough environment, marked by stiff competition, technological disruptions, and shifting audience preferences. We expect activist investors, zero-based budgeting techniques, and slow top-line growth will continue to pressure companies’ marketing expenses over the next two years, leading to lower ad spending and more competition to renew or win advertising contracts. Some ad agencies may respond to the competitive pressures by extending payment terms to their clients to renew or win contracts, which, we believe will negatively affect working capital. Still, we don’t expect any significant impact on the companies’ operating margins and cash flow generation in 2018 because most of the big ad agencies have responded to these challenges by utilizing their resources more effectively, particularly their creative talents.

… and broader
The competitive landscape has broadened for ad agencies, with IT and consulting firms entering the industry. Earlier this year, ad agency Publicis Groupe partnered with consulting and technology company Capgemini on a contract with McDonald’s in August, and consulting and technology firm Accenture acquired Australian creative agency The Monkeys in May. Although not yet significant, this merging of tech and consulting illustrates how companies’ digital transition and transformation have become an important part of their marketing strategy and budget allocation. We believe this trend will accelerate.
## Key risks and opportunities

### Television

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<th>Is content being devalued?</th>
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<td>Although aggregate spending on original content have been increasing due to fierce competition from new players, consumers' perceived value of that content may be declining. Virtual skinny bundle offerings are priced significantly lower than the traditional pay-TV bundles they are capturing market share from, and the myriad of SVOD offerings are generally priced even lower, at below $10. Additionally, wireless companies such as AT&amp;T Inc. and T-Mobile U.S. Inc. have started using content as a tool to attract and keep customers. AT&amp;T is currently offering HBO for free for life to certain new wireless subscribers and pricing its DirecTV NOW offering at $10 per month—well below its cost of content; and T-Mobile is giving Netflix service for free to its wireless subscribers. Even though the media companies are still paid full price for their content (and are not losing any revenue), to the extent consumers get accustomed to not paying for media content or to getting it at a sizable discount, the value of that content may degrade over time.</td>
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<th>2</th>
<th>Media companies are developing direct relationships with consumers</th>
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<td>As the global television ecosystem continues to evolve, traditional media companies have started taking more direct roles in building relationships with consumers. Successful media companies are more effective at insulating themselves from negative secular trends such as cord-cutting, while getting valuable consumer data that can help with digital advertising and other monetization opportunities. To successfully build a direct relationship with customers, we would expect media companies to take one of three paths: partnering with platforms that already have DTC operational capabilities, such as customer case and billing; investing in building their own platforms; or acquiring key technology, such as Disney did with its recently announced acquisition of a controlling stake in Major League Baseball’s leading BAMTech platform.</td>
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<th>3</th>
<th>Further M&amp;A is likely</th>
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<td>The U.S. television industry saw three significant media mergers and acquisitions (M&amp;A) announced in the past 12 months: AT&amp;T’s proposed acquisition of Time Warner Inc., Twenty-First Century Fox’s proposed acquisition of Sky, and Discovery’s proposed acquisition of Scripps. Although we are skeptical of the merits of vertical integration, such as those proposed by AT&amp;T and Fox, we believe more could occur in 2018 as technology companies consider their strategic options. We also expect more horizontal transactions (such as the Discovery and Scripps transaction) in 2018 as media companies with less ability to navigate the evolving television landscape partner up to increase audience and programming scale to make them more relevant within the television ecosystem.</td>
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Local Media (Radio, Television, and Outdoor)

1. **Large M&A unlikely in 2018**
   
   We don’t see much prospect for additional radio M&A over the next 12 months beyond the proposed merger of CBS Radio Inc. and Entercom Communications Corp. Few companies have the balance sheet capacity to undertake a sizeable acquisition. However, if media ownership rules loosen under the Trump administration, there could be a resurgence of acquisitions and swaps of local television stations. We believe TV station swaps could be a credit positive for TV station operators if leverage remains similar to current levels, given the potential margin expansion that TV station duopolies (more than one TV station in a particular market) would provide TV station operators.

2. **The GDP impact**
   
   With local media revenue highly correlated to GDP and the health of local markets, a recession would cause corresponding revenue declines for local media companies and magnify declines in EBITDA and operating margins. For instance, although television broadcasters and outdoor media advertisers have recovered the revenues lost during the 2008–2009 recession, the radio industry, which saw revenue decline 25%, has yet to recover.

3. **Radio broadcasters’ financial woes pose significant credit risks**
   
   With two of the largest U.S. radio broadcasters, iHeart Media Inc. and Cumulus Media Inc., facing financial duress and are seeking to restructure their debt obligations, increased volatility could cause larger-than-expected decline in radio advertising rates and revenues in 2018. We expect low–single-digit percentage revenue declines or worse, which would likely result in several downgrades and us reexamining whether radio broadcasters' leverage levels are sustainable.
Internet/Online

1 Unaddressed ad fraud and fake news could undermine the media industry
Fake news, extremist sites, and ad fraud dominate headlines globally in 2017, making transparency and trust key development needs in 2018. Ad fraud, which includes nonhuman traffic, ads that have no chance of being seen, and ads that intentionally misrepresent, account for an estimated $16.4 billion of wasted global ad spending in 2017, according to WPP. However, because ad fraud is lucrative with minimal risk of punishment, we expect the problem to persist in 2018. Fake news, a centuries old propaganda practice of deliberate misinformation and a common newspaper practice in the late 18th century, has resurged in recent years, undermining consumers’ trust of the media. Both ad fraud and fake news are insidious problems with no easy solution, and they have the potential to weaken or even damage media companies and brands.
Trust will become increasingly important as more companies seek to create compliance and ethics frameworks, accreditation, and risk assessments to address ad fraud and fake news. As a first step, we expect media companies to implement third-party ad measurement solutions to establish trust in their ad delivery capabilities and for search engines to prioritize well-established or branded publishers. Additionally, new technologies such as blockchain could provide a systematic approach to establishing trust. However, practical applications might have to wait until well past 2018. We expect compliance and security costs to increase in 2018 as companies invest in people and technology to strengthen systems and prevent abuse. However, we don’t expect a lack of trust to hinder digital advertising or the digital economy in 2018.

2 Regulation fears increase as jurisdictions pursue uncertain and divergent paths
Online and information services companies, such as Apple, Amazon, Google, and Facebook, face many regulations globally, including ever-evolving consumer and data protection, content limitations, privacy, network security, encryption, and payments laws. The regulations’ scope and application vary by country, based on each country’s public interest policy goals or desire to encourage growth or competition.
These companies also operate with uncertainty as to how some existing regulations will apply as media, tech, and telecom businesses increasingly converge, or how a change in government regimes or new interpretations of laws could lead to retrospective changes (such as the EU’s claim that Apple owes $15 billion of back taxes). The EU’s recently adopted General Data Protection Regulation (GDPR) is one such change, and it expands the regulation of personal data processing throughout the region and significantly increases penalties for noncompliance. Complying with such regulations is costly for companies, requiring changes in their business practices and restricting aspects of their business operations. From a credit perspective, it is impossible to predict exactly how the global regulatory environment will evolve or the impact the changes will have on the media industry. But given the media industry’s importance to local economies and its ability to shape public perception, we can surmise with some certainty that industry regulation will increase in coming years and costs will increase as companies implement new business controls and practices.
The widening skills gap could impede growth

The internet and information services industries depend on attracting and retaining highly skilled workers with science, technology, engineering, and mathematics (STEM) skills. According to ManpowerGroup, about 40% of employers across the globe are facing acute talent shortages, and The Bureau of Labor and Statistics estimates that the U.S. will need approximately 1 million more STEM professionals over the next decade.

The industries currently face a shortage of computer science, data science, cyber security, and innovation and product development professionals. We believe companies that adopt human capital strategies to acquire these skills will have performance and competitive advantage. To address this shortage, we expect companies will increasingly use outsourced and offshore talent, retain high-talent women and older workers, and expand workforce flexibility to use independent consultants and freelance work. We also believe employee turnover and the pressure to hire technology talent in a timely manner will result in employee cost inflation and, in some cases, impact small and midsize companies’ ability to innovate and scale their business platforms and technology infrastructure. In 2018, we expect these factors will have only a minimal impact on business performance.

Industry developments

Audience fragmentation and shifting ad dollars

The U.S. television industry is facing two key risks, audience fragmentation and shifting advertising dollars. TV audience ratings continue to decline as consumers take advantage of a growing selection of entertainment choices, and traditional media continues to lose ad revenues to digital and mobile platforms as advertisers seek better returns for their advertising budgets. We believe TV networks that broadcast premier sports programs and events will better withstand these pressures over the next four years.

Unlike other TV genres, such as scripted programming, sports are overwhelmingly watched live and audiences generally watch the commercials, making it the best way for advertisers to reach large national audiences globally. Key sports events such as the World Series, the Super Bowl, the Olympics, and FIFA World Cup can be found exclusively on broadcast television because only over-the-air television currently offers broad national audiences, high-quality TV production capabilities, and a dependable viewing platform. For these reasons, among others, audience ratings for key sporting events such as the Olympics, the FIFA World Cup, and the Super Bowl, are less susceptible to declines. As a result, sports programming is critical to the U.S. television industry: It is the glue that holds together pay-TV video bundles and the key anchor that underpins our credit view of the industry.

In continental Europe, these trends are present but less pronounced because television is primarily free and funded by TV advertising. Free TV content is typically local (local language, local actors, and adapted to local audience) and of high quality, and ad break intensity tends to be lower than in the U.S. because EU regulation caps television advertising at 12 minutes per hour (versus 17 minutes in the U.S.). As a result, pay-TV penetration is typically lower. In Germany, for example, pay-TV penetration is estimated at 21% (versus more than 75% for the U.S.), with monthly spending per pay-TV subscriber below $30 (versus close to $100 in the U.S.). In addition, pressure from OTT providers remain moderate because free-to-air TV is protected due to windowing. In France, for example, the SVOD movie window comes after both pay-TV and free-to-air television, on average 36 months after the theatrical release. Whereas in the U.S. the first release window is typically 90 days after theatrical release, and both premium pay TV networks and SVOD providers (Netflix in the case of Disney) get the same window. The conditions are similar in several Latin American countries, with pay-TV accounting for less than 30% of households in Brazil, for example.
Global media companies expand OTT platform experiments

As the pressure on the traditional video bundle increases, media companies in Europe and the U.S. have embraced virtual OTT bundles. Five new virtual multichannel video programming distributor (MVPD) options have launched in the U.S. in the past year, bringing the total to seven (CenturyLink Stream, DIRECTV Now, FuboTV, Hulu Live TV, Sony PlayStation View, Sling TV, and YouTube TV). We expect additional virtual MVPD services to launch over the next year. This and the growing number of DTC, SVOD, and OTT services, such as CBS All Access, HBO Now, and the soon to be released ESPN SVOD service, have resulted in a myriad of OTT options for consumers.

It’s still too early to determine whether virtual MVPD bundles will counter the video subscriber losses traditional pay TV operators are experiencing or encourage more consumers to move outside the traditional television ecosystem. We view the current selection of OTT virtual bundles as incomplete and unlikely to fully satisfy consumers. Virtual bundles all lack a full slate of broadcast stations and exclude many cable networks. Even Hulu’s virtual Live TV bundle, which showed great promise due to its ownership by Comcast’s NBCUniversal Media LLC, Time Warner, Fox, and Disney, is fully loaded with the partners’ owned networks but lack most non-owned networks such as those offered by Discovery Communications Inc., Viacom Inc., and AMC Networks Inc.

Traditional media loses revenues as ad spending shifts to digital

We expect overall ad spending in the U.S. to increase about 4% in 2018 due to the Winter Olympics and, to a lesser degree, the midterm elections. Excluding those two events, core ad spending (local and national) will likely increase by only 2.6%—modestly ahead of our U.S. GDP forecast of 2.3%. In 2018, we expect digital advertising to grow at a mid-teens percentage rate as it takes market share from traditional media, with only the digital, outdoor media, and TV sectors showing solid growth, while other media sectors (newspapers, magazines, and radio) experience continued advertising declines. In the television segment, we believe cable networks will face the largest declines and local TV advertising will be the least affected. Still, we believe TV ad spending will remain resilient despite some investor concerns that television will soon join print media as a declining industry. As long as brand building remains a key component of advertisers’ marketing strategy, which requires reaching broad audiences instead of targeting demographics, demand will continue for TV ad spots. Television—especially live (including sports and news) and special events—remains the best media for reaching the broadest audiences, even though we expect audience ratings will continue to decline.

In Western Europe, we expect ad spending growth will remain stable at around 3.5% in 2018, with some disparities among the counties, including uncertainty in Spain due to the political unrest in Cataluña. After a slow down in 2017, U.K. ad spending will likely outpace that of Western Europe in 2018. Meanwhile, at the other end of the spectrum, Italy and France will likely post very modest growth, with the latter improving from 2017 levels due to a better economic outlook. Overall, we expect strong growth in digital ad spending, particularly mobile, video, and programmatic in 2018. We also believe the digital disruption will continue in Europe but with significant differences among the various European markets. For example, digital media spending will likely overtake TV spending in Germany, while TV will remain the dominant media type in Italy, with TV ad spending twice as large as digital.
Financial policy

Vertical integration and subsector consolidation will likely increase M&A

We expect an uptick in M&A in the media and entertainment industry, and between the media, telecom, and technology sectors, during the next few years. The industry saw several major transactions during past 12 months, including two vertical integration deals (AT&T’s proposed acquisition of Time Warner, and Fox’s proposed acquisition of Sky) marrying content creation and video distribution. The others were horizontal mergers (Discovery’s proposed acquisition of Scripps, and Sinclair’s proposed acquisition of Tribune).

We are skeptical on the merits of vertical integration because the potential synergies may be more difficult to achieve in vertical integrations, and the clash of corporate cultures could disrupt the acquired company. Although some media, telecom, and technology companies may feel strategic pressure to emulate the integrated platforms of AT&T and Time Warner, Fox and Sky, and Comcast and NBC Universal and opt for vertical mergers, we believe more are likely to participate in horizontal mergers, especially among the U.S. TV station operators as FCC ownership rules relax. For cable network operators, we don’t believe added scale (having more cable networks) is the long-term solution to the secular pressures affecting television, and consolidation only makes sense in conjunction with reducing the number of second-tier cable networks.

In Europe, however, we don’t expect any transformational M&A. Instead, we believe media companies will focus on smaller bolt-on acquisitions to bolster their existing operations and improve their geographic footprint, and fund these acquisitions with generated cash flows. We also expect TV broadcasters and pay-TV operators will focus on deals that extend their digital offering and content production. Overall, we believe the absence of large M&A will have a neutral to positive impact on leverage for European media companies in 2018.

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Related research

- Research Update: Time Inc. Ratings Lowered To 'B' Amid Efforts To Reposition The Company; Outlook Stable (Sept. 19, 2017)
- Weakening Ad Markets Expose Growing Divide Among Media Companies (Sept. 5, 2017)
- Complexity And Partisanship Dominate The Media, Telecom, And Cable Industries’ Regulatory Agenda (June 30, 2017)
- Credit FAQ: What Are The Key Factors Supporting U.S. Newspaper Publisher Ratings? (May 23, 2017)
- U.S. Local TV Broadcasters Outlook: The FCC’s Reinstated UHF Discount Could Spur Mergers And Acquisitions In 2017 (May 11, 2017)
- Research Update: The Walt Disney Co. Upgraded To ‘A+’ From ‘A’ Following Peer Review; Outlook Stable (May 3, 2017)
- Research Update: Discovery Communications Inc. Outlook Revised To Negative From Stable On Scripps Acquisition; ‘BBB-/A-3’ Rating Affirmed (July 31, 2017)
- Research Update: Discovery Communications Inc. Outlook Revised To Negative From Stable On Scripps Acquisition; ‘BBB-/A-3’ Rating Affirmed (July 31, 2017)
Cash, debt and returns

Global Media and Entertainment

Chart 181 – Cash flow and primary uses

Chart 182 – Return on capital employed

Chart 183 – Cash and equivalents / Total assets

Chart 184 – Total debt / Total assets

Chart 185 – Fixed versus variable rate exposure

Chart 186 – New debt issuance or maturity schedule

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
Industry Top Trends 2018
Metals and Mining

Overview

- Ratings Outlook: The outlook for upstream producers has generally improved, with a modestly positive rating bias for 2018. We expect the focus on financial prudence—particularly among the largest globally diversified miners—to persist into 2018 amid what our base case assumes to be a (continuing) generally supportive price environment. For global downstream producers, we expect relatively flat conditions on average, albeit with regional variation. Any upgrades are now likely reflect financial policy implementation and future resilience to downturns as much as prevailing strong metrics.

- Forecasts: Our base assumptions result in credit measures gradually strengthening in 2018 for upstream and downstream producers. Modestly lower net debt is the driving force behind the improvement, given our relatively flat price and output expectations for next year. Given the cyclical and unpredictable nature of the industries, we also assess the potential rating impact of deviations from our base case projections.

- Assumptions: Generally supportive prices for most metals and mining commodities over the next two years reflect our views of relatively balanced global supply/demand conditions. We also expect the debt reduction cycle to continue as issuers improve resilience to future industry downturns, with judicious use of discretionary cash flow for investments and shareholder friendly initiatives, at least in 2018. Although we do not foresee a significant increase in capital expenditures for now, and we expect issuers to remain focused on maximizing profitability, the industry has a poor track record of capital discipline through cycles.

- Risks and Opportunities: China remains the primary force behind the fundamentals of the metals and mining industry. Slowing demand remains a key risk that could disrupt what we expect will be relatively balanced conditions for most metals and mining commodity markets. However, ongoing supply-side reforms could also lead to stronger than expected market fundamentals for certain commodities. Overall, we expect prices will remain volatile, with fluctuations likely related to developments in China, and potentially due to other governmental policies and geopolitical risks.

- Industry Trends: The prevailing mood of balance sheet conservatism is expected to persist into 2018 for the majority of upstream and downstream producers. However, we believe shareholder remuneration will start to increase—in some cases as a function of financial policy frameworks—and could emerge as a future risk to financial profiles. That said, prudent financial policy implementation should support ratings, that is, provided that balance sheets have headroom for the next downturn and shareholder returns are funded by cash generation.
The outlook for ratings on metals and mining issuers have become decidedly more positive. As of third quarter 2017, the outlook net bias has significantly improved: 15% of issuers have positive outlooks compared to 8% at year-end-2016. In addition, the share of negative outlooks within the sector has declined from about one-third of all ratings to 15% over the same period. All regions have witnessed positive ratings and outlook momentum. However, the trend is most notable in APAC (at year-end-2016, about 50% of APAC ratings had negative outlooks or were on CreditWatch Negative), buoyed up by stronger than expected demand for commodities and steel. Moreover, we have seen an upward shift in ratings from the lowest categories; companies rated ‘CCC+’ and lower now account for less than 15% of total ratings, versus close to 25% at end-2016.
Industry forecasts

Global Metals and Mining

Chart 193 – Revenue growth (local currency)

We expect relatively subdued revenue growth in 2018 and 2019 – well below significant levels expected this year. Our estimates are driven primarily by average metals and mining commodity prices that we assume will generally stabilize near to the average year-to-date 2017 levels. While revenues are likely to remain volatile and predominantly linked to spot price fluctuations, we do not foresee a return to a period of sharply lower prices and revenue as witnessed in 2015 and 2016. Our price assumptions are mainly underpinned by relatively balanced global supply/demand fundamentals, both in the upstream and downstream segments.

Chart 194 – Capex growth (adjusted)

We believe the rebound in capital expenditures in 2017 will be short-lived. For upstream producers, higher spending this year generally reflects reinvestment in assets and higher discretionary spending on growth projects, following significant past spending retrenchment amid sharply weakened industry conditions. However, we believe producers are exhibiting capital restraint – at least for now – given the uncertainty of future commodity prices. For downstream producers, limited facility expansion amid a relatively balanced market contributes to the tepid capital expenditure (capex) outlook in 2018 and 2019.

Chart 195 – Debt / EBITDA (median, adjusted)

We expect the declining trend in adjusted debt to EBITDA (and improvement in funds from operations [FFO] to debt) to continue at a modest and steady pace. Downstream producers are expected to remain more leveraged than upstream producers, but the gap is narrowing through 2019. We view modestly lower net debt as the key driver of the improvement, given our relatively stable price and output expectations over this period. At this point, we do not expect significant debt-financed acquisitions or shareholder-friendly initiatives that would materially weaken balance sheets.

Chart 196 – 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.
Upstream

The outlook for upstream producers has generally improved, with a modestly positive rating bias for 2018. Most issuers have high operating leverage in the stronger price environment, and this has contributed to material improvement in earnings and free cash flow generation through this year. The corresponding focus on debt repayment—particularly among the largest globally diversified miners—is expected to persist into 2018 amidst what we expect a favorable albeit generally stable price environment. Balance sheet conservatism is a bit of a departure from previous high points in the commodity cycle characterized largely by significant debt-financed acquisitions, capital investments, and shareholder friendly initiatives. As such, we believe the persistence of lower gross debt levels and flexible shareholder returns should reduce the comparative volatility of credit measures during the next industry downturn. However, in our view, this is heavily predicated on whether or not producers remain financially disciplined. This is a key aspect and one that we are assessing on an ongoing basis.

We expect steady global demand for metals and mining commodities—led by China—will be generally well matched to supply and support prices near contemporary levels over the next two years. Our subdued estimates for capital expenditures (capex) within the upstream segment—basically flat from materially higher levels in 2017—indicate a measured approach to future investments in productive capacity. In certain cases (copper, for example), we expect a looming supply deficit as new production is unable to keep pace with steady demand predominantly from the Asia-Pacific (APAC) region and the U.S. Given the relatively recent trough in copper prices (2016) and the years required to develop new mines, we expect to see higher prices into 2019. Until recently, most producers have not been sufficiently incentivized to invest in new capacity, given high price volatility and uncertainty. Hence, we acknowledge that potential for capex to rebound to above our expectations, which could be influenced by higher than assumed commodity prices. Alternatively, we expect a heightened supply response in iron ore, coking coal, and zinc markets (outside of China); the ramp-up of new mines (iron ore) and the potential emergence of previously idled capacity (notably in zinc) are likely drivers of gradually lower prices for these commodities over the next two years.

Three of the largest U.S. coal companies that account for over 40% of domestic production, will conclude restructuring efforts through the beginning of 2017. The close to 20% production decline last year included selling and closing less profitable assets, which boosted margins. This, along with the stronger balance sheets post-restructuring, positioned these companies to take advantage of increased seaborne coal demand, spurred on by both policies in China to reduce supply and weather events in Australia. The resurgence of coking coal exports has also prompted the rise of smaller producers that are organized to sustain its high levels of price volatility. Nevertheless, we expect the spike in prices and demand in 2017 to be an anomaly. We forecast that the industry will return to a pace of flat or moderate contraction starting in 2018. Producers will stay cautious and less likely to react to price increases; despite the elevated levels of cash generation this year, there has been limited appetite to invest in growth. Instead, management teams are opting for investor friendly actions such as dividends and share buy backs as well as debt prepayments. While there may be limited and sporadic opportunities for growth in the sector, we continue to believe that well positioned industry participants can be profitable. Financial policies are conservative and focused on surviving down cycles. While regulatory and policy developments have received a lot of recent attention, we continue to believe that market factors—including the costs of substitutes—as well as international demand will be key variables in the sector. Our rating assessments by and large recognize the improved financial risk profiles, but also take into account the sensitivities companies might have to the volatile price environment.
Downstream

The outlook for the credit profile of U.S., European, and APAC downstream companies – notably steel and aluminium producers and processors – is generally stable. Industry consolidation, capacity rationalization in China and lower import levels (mainly in the U.S. and Europe) are trends that we expect will persist over the near-term and preserve relatively favorable supply conditions. Combined with steady, albeit modest, demand growth from most end markets, we expect average prices to remain close to prevailing levels. However, price volatility is expected to persist and especially affect primary producers exposed to spot price and input cost fluctuations.

In Brazil, there is a comparatively positive view for downstream producers. Very weak macroeconomic conditions reduced flat and long steel demand by around 30% to 50% for the past two to three years, which resulted in consecutive negative rating actions for the companies that are highly concentrated in the country. Producers were able to increase exports to maintain low idle capacity, but also resulted in the shutting down of plants and margin compressions. In our view, the outlook has improved for 2018, with very gradual volume increases and significant price adjustments notably related to lower steel imports (foreign exchange-related).

China remains the critical propeller of global steel and aluminium markets conditions, and we expect this influence to continue at least through next year. China is expected to continue to account for roughly 50% of global steel production, or about 800 million tons annually. We expect rising crude steel production in Asia will contribute to global supply, making a modestly higher contribution than apparent steel demand and somewhat limiting upward price momentum. Meanwhile, production in the U.S. and Europe continues to grow as well amid relatively healthy demand and we expect this to continue (albeit less than in Asia) over the next 12 months. Moreover, steel-related trade case filings in both regions have lessened the impact of imports, though they remain elevated relative to historical trends. That said, worldwide steel capacity utilization remains relatively low—at approximately 73.5% as of September 2017 but has steadily increased and remains a risk to market stability, particularly in the event of weaker than expected demand (notably from China).

We expect certain steel producers to face a degree of margin pressure but the outlook for 2018 is generally stable even after a generally strong 2017. Raw material prices for integrated producers – namely iron ore and coking coal – remain high and have been significantly volatile. We expect this volatility to persist, but do not view current prices as sustainable based predominantly on our expectation of gradual capacity expansion, mainly in iron ore. Hence, gradually lower input costs should provide some relief, although this will heavily depend on how closely they track steel prices. We expect electric arc furnace (EAF) steel producers to remain comparatively less sensitive to input cost volatility given highly variable cost structures, but remain exposed to high scrap prices.

For aluminum, we assume a continuing favorable price environment based on balanced market fundamentals. In our view, demand should remain healthy and increase in the low-to-mid single digit area over the next 12 to 24 months, with well-matched supply. The Chinese government appears to be focused on implementing capacity curtailments to combat pollution; initial reports suggest that cuts are now occurring. In addition, we believe there is potential that favorable trade actions arising from the World Trade Organization investigation of illegal subsidies in China and U.S. trade filings (i.e. Section 232) could lend further pricing support. Our aluminum price assumption of US$1,900 per metric ton for 2018 and 2019 incorporates recent price trends and our aforementioned view of relatively balanced supply/demand conditions globally. We believe prices sustained near this level (which is below contemporary levels) should support relatively stable to modestly improving profitability. However, the impact of sharply rising aluminum prices lessens the associated positive margin impact for downstream issuers and, in most cases, meaningful improvement in credit ratios.
## Key assumptions

### Metals and Mining

<table>
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<th><strong>Generally supportive prices</strong></th>
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<tr>
<td>1</td>
<td>Relatively balanced market conditions for most metals and mining commodities should support prices near average year-to-date 2017 levels over the next two years, but we expect short-term volatility to persist.</td>
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<th><strong>Balance sheet improvement</strong></th>
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<td>2</td>
<td>Debt reduction cycle to continue as issuers improve capacity to manage future industry downturns, with judicious use of discretionary cash flow for investments and shareholder friendly initiatives.</td>
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<th><strong>Profitable output</strong></th>
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<tr>
<td>3</td>
<td>Miners expected to focus on cost base improvement to maximize profitability of output rather than maximizing production and revenue.</td>
</tr>
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</table>

### Metals and mining commodity prices

S&P expects average prices for most of the metals and mining commodities we track to remain broadly flat in 2018 and 2019. Prices in the majority of instances have sharply increased through 2017 and prompted multiple upward revisions to our assumptions this year – notably for base metals. Short-to-medium term supply constraints were a key contributor to the rally, but we believe it has largely run its course. In general, we assume average prices will stabilize near strong year-to-date average levels, but we acknowledge the likelihood that future volatility will persist. Our base case assumptions are heavily predicated on relatively balanced expectations for supply/demand fundamentals; in particular, steady global demand growth and a lack of significant capacity expansion. Our most recent price assumptions for the metals and mining commodities we track were published in August 2017 (see “S&P Global Ratings Raises Several Metal Price Assumptions” – Aug. 29, 2017 on Ratings Direct).

### Balance sheet improvement

We continue to expect the majority of issuers to remain focused on balance sheet strength. Many of the large globally diversified mining companies have pledged to further reduce debt, which is a theme witnessed across much of the industry. In our view, the move to lower gross and net debt reflects the relatively recent period of stress that faced most issuers in the latest cycle downturn that, in many instances, was exacerbated by leverage. In aggregate, downstream companies are likely to remain more leveraged than their upstream counterparts, although many are also paying down debt to improve financial resilience. However, in the U.S., we continue to view refinancing and liquidity concerns as the most influential near-term factors on credit quality. Large maturity walls of approximately $6 billion and $10 billion in 2019 and 2021, respectively, could limit the ratings upside at least through next year.

### Profitable output

Production within the upstream and downstream sectors is estimated to remain relatively stable in 2018. The prevailing consensus among miners – namely the larger-scale producers - is a focus on cost base improvement rather than increasing less profitable production for the sake of revenue growth. We expect widespread efficiency initiatives will continue because input and labor cost inflation will likely remain key (though modest) annual challenges for earnings and cash flow. Of late, certain issuers are embarking on a digitization as well as automation of mining operations as another means of enhancing productivity, though such innovation projects are in their early stages. Moreover, the highly cyclical nature of market conditions has increased the need for producers to continue to reduce all-in sustaining costs as protection against future sustained price declines.
Key risks and opportunities

Metals and Mining

1. China

China’s stronger than expected demand and the supply side reform aimed at reducing capacity has pushed up commodity prices, including coal, steel, and aluminum through 2017. China’s GDP growth remained strong in the first three quarters of the year, averaging 6.9% and exceeding market expectations. We forecast growth of 6.8%, 6.5%, and 6.4% in 2017-2019. Investments in infrastructure and property were key drivers of the robust demand for commodities over this period. For example, after cutting 65 million tons per annum (mtpa) of steel capacity and 290 mtpa of coal capacity in 2016 (both exceeding our expectations), the Chinese government has targeted additional cuts of 50 mtpa of steel capacity and 150 mtpa of coal capacity in 2017. We continue to view moderating Chinese economic growth in 2018 as a key risk to metal and mining industry fundamentals, which could prove to be disruptive to what we expect will be generally stable conditions. However, stringent government policies aimed at reducing production (particularly on a permanent basis) could mitigate the impact of a potential slowing in demand or add fuel to already strong market conditions.

2. Price volatility

Average prices for metals and mining commodities have continued to increase though 2017 and are well above most recent trough levels. However, we have also witnessed unprecedented volatility in certain commodities over this period. Contemporary prices for most of the metals and mining commodities we track remain below previous peak levels reached about five years ago – but are getting close. For the most part, we assume a relatively stable price environment in 2018 and 2019. However, we acknowledge the many factors that could lead to a substantial departure from our assumptions – both positively and negatively. Given that prices are the key rating driver for most issuers, this could have a material impact on issuer credit profiles and our outlook for the metals and mining sector.

3. Government policy and geopolitical risks

Government policy and geopolitical risks could have a meaningful effect on commodity markets. Resource nationalism and labor unrest remain key risk factors in developing markets, notably in African and Latin American countries. Numerous strikes in the South African gold industry and adverse regulatory and legal actions in Tanzania and South Africa are among several recent examples. In addition, the impact of government-mandated export restrictions in certain countries, the impact of supply reform in China, and developments related to the North American Free Trade Agreement (NAFTA) and Brexit could also lead to market volatility.
Financial policy

We continue to witness a continued focus on balance sheet improvement across much of the metals and mining industry. Importantly, this lower leverage represents a reduction of net debt and not just higher operating cash flows. The strong price environment this year has boosted cash generation and financial flexibility but not led to sharply higher shareholder-friendly initiatives or aggressive acquisitions - as in past cycles. Discretionary cash flow is strongly positive in 2017, with relatively flat or only modestly increased absolute levels of capex, dividends, and share buybacks. In addition, assets sales, which are used in part to strengthen balance sheets, have far outpaced acquisitions. Among the largest global mining companies, including Anglo American, BHP Billiton, Glencore, Rio Tinto and Vale, all have meaningfully reduced gross debt with cash over the past year. Also notable is that some of these issuers have articulated more prudent financial policy frameworks, including absolute debt constraints and shareholder distributions based on generated cash flow.

In our view, across metals and mining, the prevailing mood of balance sheet conservatism is expected to persist into 2018. However, we believe shareholder remuneration will start to increase—in some cases as a function of financial policy frameworks—and could emerge as a future risk to financial profiles. Higher shareholder distributions have been funded in part with asset sale proceeds, thereby limiting the impact on credit measures through 2017. That said, returns on capital remain low and new high-return projects are generally scarce. As such, companies may feel the pressure to reward shareholders with higher dividends and/or share buybacks, or substantially increase capex for internal growth objectives that can reduce financial flexibility (particularly during the eventual price downturn). We note that there is typically a lead time for material capital projects, which means much higher near-term investments are unlikely, but might result in future committed investments in a weaker price environment.

Large or transformative acquisitions are not expected in 2018. Most assets available for sale have cash cost profiles in the third or fourth quartiles within the industry cost curve, whilst cost-competitive assets remain scarce. Moreover, at this point, we believe most producers view prospective acquisitions as too expensive relative to brownfield expansion projects. While we have witnessed an increase in the acquisition of development-stage assets, most are of smaller scale and financed with equity rather than cash or debt.

From a rating perspective, we assume that miners will continue to build rating headroom into 2018, with the majority of ratings being well placed. However, in our view, continued execution of debt repayment and financial framework implementation could lead to positive actions where rating headroom and resilience could accommodate future industry downturns. This has contributed to the modestly positive sector bias. That said, the potential volatility of metals and mining commodity prices and the quality of each company’s portfolio of assets will remain key considerations.

Under S&P Global Ratings’ policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.

Related research

- S&P Global Ratings Raises Several Metal Price Assumptions – Aug. 29, 2017
Cash, debt and returns

Global Metals and Mining

Chart 197 – Cash flow and primary uses

Source: S&P Global Market Intelligence, S&P Global Ratings calculations

Chart 198 – Return on capital employed

Chart 199 – Cash and equivalents/Total assets

Chart 200 – Total debt/Total assets

Chart 201 – Fixed versus variable rate exposure

Chart 202 – Long-term debt term structure

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
Industry Top Trends 2018

Oil and Gas

Overview

- **Ratings Outlook:** After a tumultuous period where there were a significant number of downgrades, the S&P Global Ratings' outlook for the sector is broadly stable. The ratings outlook largely reflects our generally range-bound outlook for hydrocarbon prices.

- **Forecasts:** Given the outlook for hydrocarbon prices, we don't expect significant increases in credit ratios for the sector. Cash generation will generally trend upward, with capital expenditures (capex) remaining moderate. Decisions about shareholder returns—and any acquisitions and disposals—are likely to be as important for debt levels.

- **Assumptions:** Our hydrocarbon price assumptions for oil and natural gas are broadly flat, mirroring the futures curves. We expect global capex to increase nominally with the U.S. demonstrating more substantial increases as steep decline curves warrant high investment. Though improved, we don't expect oilfield services (OFS) to improve much further due to the flat rig count, given the outlook for hydrocarbon prices. We believe the offshore deepwater market has bottomed and won't experience a rebound anytime soon because oil prices remain far below breakeven to justify a greenfield project and there's still too much rig supply in the market.

- **Risks:** Hydrocarbon price risk remains the number one risk in the sector. The outlook for the credit ratings reflects a flat oil and natural gas prices of $50 per barrel and $3 cubic feet, respectively. A great deal of uncertainty remains as to how long OPEC production cuts continue. Moreover, the sector has a significant amount of debt maturing over the next couple of years and any **meaningful** drop in prices will lead to defaults and bankruptcies. Acquisition activity upstream is also increasing. To date this has been more opportunistic than the more defensive OFS and engineering merger deals.

- **Industry Trends:** The 2018 outlook for many of the industries in the sector is one of general stability and largely reflects the range-bound price environment for hydrocarbon prices. Many companies have reduced debt through asset sales or equity offerings and the industry appears to be in good standing with the capital markets. The upstream segment will be hard pressed to see more incremental benefits from efforts to drive further costs and productivity from the system. For longer-term planning and investment, the energy transition, including the rate of adoption of electric vehicles, remains on the agenda. The impacts on strategy vary significantly by company.
Ratings trends and outlook

Global Oil and Gas

Clearly, the number of downgrades has stabilized owing largely to generally stable hydrocarbon prices and effort by oil and gas companies to reduce costs, improve productivity, and de-lever the balance sheet where appropriate. The rating spectrum is still highly weighted toward high yield because most issuers are in the U.S. and we rated them during the four-year period prior to the November 2014 OPEC meeting. The OFS industry has the preponderance of negative outlooks. Despite the improvement we’ve seen in the sector and the overall price increases they’ve initiated, the price increases and volumes are insufficient to garner adequate rates of return and healthy credit ratios. Thus, these companies will remain under pressure for possibly further negative rating actions unless there’s additional improvement in hydrocarbon prices. Moreover, the OFS subsector includes the offshore contract drillers, almost all of which have negative outlooks, reflecting the uncertainty of when the offshore deep water industry will recover. The O&G industry’s liquidity remains healthy because debt markets are robust, with attractive rates and covenant-light deals being the norm. The banking environment and borrowing bases are stable and we don’t expect any declines in borrowing bases during upcoming redeterminations.
Credit ratios for the sector largely improved along with the rebound in the oil prices and the significant decrease in industry costs and productivity gains garnered by producers. Some companies, particularly the larger investment-grade companies, have sold assets to reduce debt or they’ve issued equity to transact deleveraging asset acquisitions. OFS margins will remain mostly flat because OFS companies are limited in their ability to increase prices more and we don’t expect exploration and production (E&P) companies’ costs to improve. Moreover, we believe there’s limited opportunity for additional productivity and efficiency gains. The slight improvement in credit metrics for 2018 will stem from slightly higher production levels due to ramp ups in capex.
Key assumptions

**Exploration and Production**

1. **Oil prices**
   
   Our base case price deck for West Texas Intermediate (WTI) and Brent is broadly flat at $50 per barrel (bbl) for the remainder of 2017 and 2018, and $55/bbl for 2019 and beyond. Oil prices, for the past year have been trading range-bound between $45/bbl and $55/bbl and are being supported through 1.8 million bbl/d of production cuts from OPEC and several other nations. The OPEC cuts, which were implemented to address oversupply in the market and reduce record high inventory levels, are up for renewal in March 2018. We believe the cuts will either be extended or slowly unwound as inventory levels haven’t yet reached targets and the elimination of those production cuts would likely lead to a rapid and significant decline in oil prices. Moreover, we believe the Saudis, who are likely to proceed with an IPO of Saudi Aramco, will have incentive to maintain production to keep oil at prices that will support the IPO.

2. **Natural gas prices**
   
   Our natural gas price deck is stable at $3.00 per Btu over the next three years. Our premise hasn’t changed from last year. We believe that there is ample natural gas supply in the U.S., particularly from the Northeast where the prolific and low-cost Marcellus and Utica shale plays will continue to supply much of the growth in natural gas demand. The slow rise in long-term natural gas demand is primarily driven by coal-fired utilities switching to natural gas, increased liquid natural gas (LNG) use, and exports to Mexico. Northeast regional differentials continue to remain below the Henry Hub price but we believe they will narrow given the significant amount of takeout capacity being built in the region over the next several years. A lot of associated gas comes from extensive oil drilling occurring in the Permian Basin.

3. **Capital expenditures**
   
   We believe global capex will still be substantially below levels needed to sustain production. We haven’t yet compiled our forecast for next year’s capex but third-party industry forecasts are anticipating a 4% increase in 2018 down from 8% this year. North America spending continues to lead the pack and is anticipated to grow 31% this year. We expect onshore spending in the U.S. to increase 15% next year reflecting mostly stable price deck of $50-$55 per barrel. International spending again is expected to grow in the low-single digits in 2018. The one area that will likely see a decline in spending is the offshore sector because oil prices will remain below levels needed for sanctioning deepwater greenfield projects. We expect offshore spending to drop approximately 10%-15% in 2018—on the heels of an expected decline in 2017 of about 20%.
## Oilfield Services

### Rig count
The global rig count (not including the U.S.), which has been dwindling, now stands at approximately 931 as of the date of this report and is close to the cycle low of 921. The rig count decline has been concentrated in Mexico, Venezuela, Indonesia, and Thailand. Mexico and Venezuela continue to face declining production and Venezuela remains in financial distress.

After bottoming to a low of 316 in May of 2016 from a high of 1,609 in October 2014, the oil rig count in the U.S. has had a nice rally and increased 133% as of the date of this report, driven primarily from the rebound in oil prices. The region in the U.S. that has had the most significant growth has been the Permian Basin where the count has grown by over 300% to just over 400 rigs. The U.S. natural gas rig count has remained relatively flat over the past year and with the $3 natural gas price expected to remain relatively flat for 2018, we don’t believe there will be a significant increase in the overall count.

### Margins
OFS companies’ margins, while improved in 2017, will remain weak for issuers in 2018. Despite an increase in overall prices for OFS of about 10%-15% in 2017, we don’t expect significant increases in prices in 2018 without a corresponding increase in rig count. OFS companies enjoyed 10%-15% increases in drilling costs but more than 25% in completion services, particularly pressure pumping. We expect frac sand prices to decline as more capacity is added in 2018 and the existing shortage of pressure-pumping equipment in the Permian will be alleviated as more capacity is added.

### Spending
The ability of OFS to increase prices will be dictated ultimately by rig counts. While spending will be higher for the E&P industry, much of it will be to sustain production with some growth spending as well. Drillers have become very efficient, which has in some respects reduced the need for some OFS activity. As noted, we don’t expect significant increases in spending globally outside the U.S. OFS companies in the U.S. should reap a nominal benefit from a 30% expected increase in spending.
Refining

Gasoline and distillate demand
Emerging economies will likely continue to spur global gasoline demand and demand growth, as well as for other oil products, while demand from the Organization for Economic Cooperation and Development (OECD) members drops further. The U.S. Energy Information Administration (EIA) forecasts U.S. gasoline demand to increase about 1% in 2018. Our demand forecasts are generally in line with the EIA in this respect. Industrial activity and economic growth is likely to support healthy demand for diesel. In the U.S., we expect diesel and other distillate demand to remain robust in 2018, driven by stronger expected economic growth, increased exports, greater oil and natural gas drilling activity, and an assumption of normal temperatures. Our forecast for distillate demand growth is about 2% in 2018.

Increasing crude oil production
We see global oil supply and demand growth being broadly matched in 2018, assuming OPEC production constraints remain. U.S. growth is a key factor, with the EIA predicting 2018 crude oil production to reach an average of 9.9 million bbl/d, which is 0.6 million bbl/d higher than 2017 and would surpass the previous record of 9.6 million bbl/d set in 1970. EIA forecasts that most of the U.S. crude oil production growth will come from both the Permian region in Texas and the Gulf of Mexico. We believe this will mean narrower crude differentials between WTI and Brent that will average $2-$3 per barrel, or the cost of transportation. This will likely mean more moderate profitability for U.S. refineries, as crack margins and differentials return to their pre-Harvey levels.

Refining margins
We’re assuming regional 2018 crack margins to be generally in line with 2017. We expect average utilization for most OECD and non-OECD refining capacity to be in the low- to mid-90% area, remaining at the upper-end of the five-year average. Higher U.S. gasoline production and inventory levels in 2017 contributed to refinery margin compression. Despite an increase in gasoline production and high inventory levels, rising U.S. exports provided some support for gasoline margins, which we expect to continue into 2018. Healthy demand continues to support diesel margins.
## Contract Drilling

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<tr>
<th>1</th>
<th><strong>Rig supply and demand</strong></th>
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<tr>
<td>Both the global jack-up and the floater markets remain in a state of oversupply. We expect this to continue until late 2019 at least. This reflects the collapse in demand, especially in deepwater drilling, since late 2013, but also the ongoing supply of about 150 newly constructed rigs—ordered in 2014 before market conditions grew radically stronger. This imbalance exists despite nearly an estimated 100 floaters being retired (scrapped) or cold stacked (moored in need of reactivation) by 2018. Many older vessels in need of periodic surveys are being retired. Fewer jack-ups have been scrapped as they can be cheaper to cold stack (around $1,000 per day compared with up to $40,000 per day for drill ships). We note some recovery in demand for jack-ups for example in South East Asia and the North Sea, though not in the Gulf of Mexico. Shallow-water activity in the Middle East, India, and China has only been mildly disrupted.</td>
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<th>2</th>
<th><strong>Utilization rates</strong></th>
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<tr>
<td>Utilization rates remain low at about 55% across jack-ups and floaters. We generally assume that vessels coming off contract won’t find employment. We estimate utilization for floaters is unlikely to improve substantially until late 2019 at the earliest.</td>
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<th>3</th>
<th><strong>Day rates and costs</strong></th>
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<tr>
<td>We don’t see stronger dayrates until utilization has picked up—usually 85% is the threshold when rates begin rising. In general, we understand contract extensions and short-term contracts are being signed at close to break-even levels. Keeping rigs ready for work involves paying the majority of costs—without revenues—and is therefore uneconomic for all but the most attractive vessels with well-funded owners.</td>
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Midstream

Commodity prices
We believe commodity prices for both crude oil and natural gas will be relatively flat for 2018. Our base case price assumption for WTI and Brent crude is unchanged at $50/bbl for 2018, improving to $55/bbl for 2019 and beyond. Our price assumption for natural gas is unchanged at $3 per million Btu over the next few years. We are forecasting that natural gas liquid (NGL) prices to average about 60 cents per barrel in 2018. Under these price assumptions, we don’t expect commodity prices to substantially impact midstream companies’ credit profiles because most already have largely fee-based contract profiles. However, we think the flat-price environment could cause a slowdown in organic growth projects, especially if upstream companies slow down their production spending.

Cost of capital
We expect capital costs to be pressured in early 2018. We expect midstream companies structured as master limited partnerships (MLPs) to continue simplifying their corporate structures by eliminating incentive distribution rights (IDRs) in an effort to improve their capital costs and bring down equity yields. We forecast an increase in distribution-coverage ratios and a reduction in distribution-growth rates to the mid- to low-single digits as companies shift their focus to financing a greater portion of their capital projects with retained operating cash flow. Unless equity prices improve or equity yields decline meaningfully, we expect a significant increase in hybrid equity issuances and for companies to pursue joint-venture opportunities when possible to reduce financing requirements.

Volumes
With commodity prices roughly flat from 2017 levels, we believe location is the most important factor for gathering and processing companies’ volume growth expectations in 2018. In our view, companies with strong acreage positions in the Permian basin should see the largest growth in 2018 due to its low break-even drilling costs and double-digit returns even with $50/bbl crude prices. Outside of the Permian, we forecast volumetric growth in the Marcellus and Utica as construction of infrastructure projects conclude and become fully operational. Once Rover Pipeline is fully operational, which we expect to occur in the first half of 2018, it will improve natural gas takeaway capacity in the Northeast. We also forecast volumes to improve in the South Central Oklahoma Oil Province (SCOOP) and Sooner Trend Anadarko Basin Canadian and Kingfisher Counties (STACK) basins. Stronger NGL prices will likely result in an increase in processing and fractionation volumes across the U.S.
Key risks and opportunities

**Exploration and Production**

1. **Hydrocarbon prices and productivity/efficiency gains**
   Much of the direction of oil prices will hinge on what OPEC does with the current production cuts that are set to expire at the end of March 2018. At the very least, the cuts have put a floor on pricing. However, in the event that the cuts aren’t extended or at least unwound slowly, we’ll most likely see oil prices rapidly decline. Our ratings are relatively stable and would remain so long as oil prices are at least in the mid-$40 price range or higher. Natural gas continues to take market share from coal and with any increase in demand being met by the Marcellus and Utica basins, companies with exposure to these regions could see ratings improve.

   The productivity gains and cost reductions that have occurred in U.S. shale have been well documented. However, additional productivity gains from longer laterals, cluster spacing, and adding more proppant are limited. The tier I wells many companies drilled when prices were low present greater risk and uncertainty. Although not expected for the next few years, we believe that shale production will begin to decline at some point as the inventory of tier I wells begins to deplete and shale continues to contend with rapid decline curves. E&P companies will in such a scenario, see increasing costs, reduced productivity, and declining production.

2. **Mergers and acquisitions**
   After deal activity accelerated in late 2016 and the first half of 2017, we expect activity levels to nominally increase in 2018. The market remains in a state of cautious optimism. The expectation of stable oil prices will aid in eliminating some of the uncertainties and the wide bid/asks typically exhibited in a volatile market. Large integrated oil producers could seek more shale acquisitions as they move from longer to shorter cycle projects and to replace very high production levels. For the smaller companies, purchases of contiguous assets will remain the norm. Asset valuations, especially for acreage in the Permian are very high and with interest rates and equity valuations remaining low, we believe that debt-financed acquisitions will account for the majority of deals completed in 2018, which could lead to lower ratings. The private equity segment remains active in the sector.

3. **Capital market access**
   The oil and gas industry faces a significant amount of debt maturities over the next couple of years. This is due to many companies issuing or refinancing debt during the high oil prices of 2012-2014. However, while interest rates are low and the high yield spreads are near the low levels they were in September 2014, any significant declines in oil prices, would result in a severe amount of companies unable to refinance their debt and would lead to another wave of bankruptcies. Equity investors are also becoming less patient with companies that continually outspend cash flow to grow and utilize debt to fund the difference. They are placing a premium on issuers that can grow within cash flow. We expect borrowing bases, which are the life blood for many high yield companies, to remain stable. However, a distressed pricing environment coupled with the impact of reduced drilling budgets, liquidity could be strained.
Oilfield Services

Hydrocarbon Prices
We believe the primary risk to OFS companies lies with OPEC and whether they’ll continue with the production cuts in March. At current hydrocarbon expectations, the rig count is unlikely to change much. A sustained oil price environment below $40 would lead to a rapid decline in rig count and hence a resulting decline in prices for OFS goods and services. This would lead to another round of bankruptcies and likely consolidation in the industry.

Limited Price Improvements
The level of price increases garnered in 2017 by the OFS companies was insufficient to cover internal rates of return for many. Further price increases will be needed to achieve some stability. Approximately two-thirds of the companies we rate in this sector are in the single 'B' and below category and approximately two-thirds have negative outlooks as they continue to report insufficient returns and produce aggressive credit metrics.

Refining

Regulations
Environmental and other regulation remains a key risk area. The implementation of changes to accommodate the IMO sulfur cap to be enforced in 2020 is one example of recent regulations. We view the U.S.’ renewable Identification credits (also known as RINs) an ongoing burden on refineries' profitability because the full cost is not always passed through to the consumer at the pump. The industry had high hopes of moving the point of obligation under the Renewable Fuels Standard (RFS) to the fuels blenders under the Trump Administration, but the initiative seems to have faltered. The status quo will cost many refineries such as PBF Energy Inc., CVR Refining L.P., and Valero Energy Corp. collectively over $1 billion.

Refining margins steady
In general, we assume average refining margins and profitability will be broadly similar to 2017, which we view as slightly below mid-cycle margins in the U.S. owing to an oversupply of crude oil feedstocks and demand that might not keep up with refined product supply. For the U.S., product exports should continue to provide relief in this regard, but we believe it will keep a ceiling on consistently better margins. While crude differentials could widen from time to time during periods of unexpected outages (i.e., Hurricane Harvey), we think crude differentials will likely narrow and not provide much upside for U.S. refiners during 2018 overall.

Higher leverage
Given the potential volatility of EBITDA, we are sensitive to structural increases in gross and net debt. For some, stronger profitability in 2017 has been somewhat offset by higher share buybacks and lower average cash balances. This has eroded the large cushion in credit ratios some refiners built up from 2011-2015. Larger diversified refiners with a full backlog of midstream or retail assets will fare much better than their smaller less-diversified peers. U.S. refiners that have growing midstream MLPs have some options and flexibility to monetize assets, but could increase consolidated debt as the midstream business becomes a large part of total EBITDA. The refining operations will benefit from its ownership in their midstream subsidiaries and the distributions received, which could help moderate the effects of volatile refining margins.
## Contract Drilling

<table>
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<th><strong>Stronger oil price recovery</strong></th>
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<tr>
<td>1</td>
<td>A realization or widespread expectation of sustained higher oil prices than our base case or current consensus assumes would make more offshore projects economic. A consequent ramp up in offshore and particularly deepwater exploration and development activity would increase rig demand and likely accelerate a recovery for drillers as the market tightened. Given the present and enduring excess rig supply, even stronger oil prices would have a significant lag before stimulating the drilling market. A price recovery could however delay the scrapping of older rigs, thereby maintaining the rig market imbalance and delaying a recovery in utilization and day rates.</td>
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| 2 | **Faster rate of rig scrapping** |
|   | Across all segments of the offshore rig market, current supply and nearly finished rigs in yards mean more scrapping of older and less economic rigs is almost certain to be a precursor for any rig market rebalancing. More rapid retirement and scrapping across fleets could address market oversupply and improve utilization sooner. We note that bankruptcies of drilling companies haven’t resulted in their rigs automatically leaving the market. Indeed, under Chapter 11 proceedings, some modern, high-specification vessels now carry lower overheads. |

| 3 | **Mergers and acquisitions** |
|   | There has been some corporate mergers and acquisitions (M&A), but also a number of asset transactions as companies either acquire rigs at below the cost of construction or improve their fleet with high-specification, modern rigs. |
Midstream

Cost of capital

The high cost of equity capital is likely to continue to pressure the balance sheets of many midstream companies. Most companies have outlined their dividend policy for 2018 and we expect distribution growth to be in the 5%-7% range. Many companies have simplified their corporate structures--either by eliminating burdensome IDRs or collapsing their structure to become a corporation rather than an MLP--to resolve issues related to capital costs, while at the same time positioning themselves for sustainable long-term growth.

Companies with double-digit equity yields that lack a credible growth strategy might have to reconsider their distribution policy and, in some cases, continue the trend of resetting (cutting) their distribution. In some instances, this might even mean cutting the distribution more than once or eliminating it all together. Relative to some of their more mature peers, newly formed high-growth MLPs such as Valero Energy Partners L.P. and Delek Logistics Partners L.P. are likely to stand out amongst peers in the sector as they benefit from an inventory of assets at their parent companies that are likely to be dropped into their MLPs to facilitate growth.

Capital expenditures

Under a flat commodity price environment, the backlog of capital spending projects has declined as midstream companies are instead focusing on improving the utilization of their assets while at the same time reducing operating costs. We forecast capital spending to be about 5%-10% higher in 2018, particularly for more diversified investment-grade companies. Capital spending projects will focus on low-cost basins such as the Permian, SCOOP/STACK, Utica, and Marcellus for which we anticipate volumetric growth year over year.

In terms of M&A, we believe the bid-ask spread remains wide, with acquisition multiples elevated. We don’t envision any significant M&As in 2018 unless equity costs improve. However, we do expect additional joint-venture opportunities for large, long-lead time projects as companies focus on improving their balance sheet and sharing the risk, such as the Gulf Coast Express Pipeline Project, which includes Kinder Morgan Inc., DCP Midstream L.P., and Targa Resources Corp. combining separate pipeline projects into one.

High leverage

We forecast investment-grade midstream companies to target adjusted debt/EBITDA of about 4x-4.5x. We believe management teams will undertake greater financial discipline by financing a larger percentage of capital spending with internally generated cash flows. Under an environment of lower distribution growth, more companies are using excess cash flow to reduce debt. This is forecast to reduce equity needs to some extent with the remainder largely coming from hybrid equity and at-the-market equity offerings. We expect companies to refinance debt opportunistically, which includes issuing hybrid equity to term out borrowings outstanding on their revolving credit facility.

Under S&P Global Ratings’ policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.
Cash, debt and returns

Global Oil and Gas

Chart 213 – Cash flow and primary uses

- Capex
- Net Acquisitions
- Dividends
- Share Buybacks
- Operating CF

Chart 214 – Return on capital employed

Global Oil & Gas - Return On Capital (%)

Chart 215 – Cash and equivalents / Total assets

Global Oil & Gas - Cash & Equivalents/Total Assets (%)

Chart 216 – Total debt / Total assets

Global Oil & Gas - Total Debt / Total Assets (%)

Chart 217 – Fixed versus variable rate exposure

Variable Rate Debt (% of Identifiable Total)
Fixed Rate Debt (% of Identifiable Total)

Chart 218 – Long term debt term structure

LT Debt Due 1 Yr
LT Debt Due 2 Yr
LT Debt Due 3 Yr
LT Debt Due 4 Yr
LT Debt Due 5 Yr
Nominal Due in 1 Yr

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
Overview

- **Ratings Outlook:** We expect the credit quality of global REITs and real estate operating companies to remain largely stable. In the U.S., upgrades continued to outpace downgrades, but the pace of upgrades has slowed due to the decelerating rent growth. In EMEA, the outlook for operating companies is generally stable following several upgrades. Throughout 2017, we consistently maintained an issuer-specific negative outlook bias in Asia-Pacific (APAC), reflecting debt-funded acquisitions and difficult operating conditions in some markets. In LatAm, while ratings are broadly stable, we have a negative bias for Brazil due to sovereign risk.

- **Forecasts:** Overall, we expect steady economic growth and positive demographic and employment trends to support real estate demand in most markets, while supply conditions remain fairly benign across most property types. In the U.S., operating fundamentals are slowing, and we expect rent growth to decelerate with occupancy fairly stable. For REITs and operating companies in EMEA, we expect overall positive rent growth as a result of sustained economic recovery. Most REIT managers in APAC are expected to maintain moderately conservative financial risk metrics. This creates a large rating buffer to withstand debt-funded growth and economic shocks. In LatAm, defensive portfolios imply solid operating and financial metrics.

- **Assumptions:** We expect steady economic growth to support U.S. real estate demand despite interest rate increases. Low-interest rates have raised valuations and in our view reached frothy levels in some markets. Higher rates and decelerating rent growth could pressure real estate values and we’re seeing widening capitalization rates, particularly in the retail sector. We expect rental revenues in EMEA to grow by low-single-digit percentages due to inflation indexation clauses. We also see potential for more M&A and market consolidation. In APAC, we assume stable occupancy and, for the most part, lease rental income increases where they are contracted. Retail is facing digital disruption challenges, and we are cautious about assumed releasing rates as tenants reassess their space requirements. Our assumptions for LatAm are for robust occupancy and renewal rates. We also anticipate selective M&A and prudent financial policies across the region.

- **Risks:** The potential for interest-rate hikes remains a key risk given the capital intensity of the sector, with higher funding costs and associated market volatility having the potential to restrict access to capital and curtail developments. More generally, the current U.S. real estate cycle is relatively mature and this creating sentiment that a correction is on the horizon. We do not expect a steep drop in prices, but rather modest price pressure reflecting low growth in many areas. NAFTA renegotiation and Brexit pose significant risks. The latter will weigh on commercial property in London, but may prove beneficial for continental cities such as Frankfurt. E-commerce is creating both risk and opportunities for property portfolios as the retail landscape changes dramatically.
The credit outlook for global real estate companies is largely stable. In the U.S., only 5% of our ratings have positive outlooks following two years of positive bias when upgrades dominated our rating actions. Sectors such as industrials, health care, and multifamily REITs improved credit quality the most. The sector outlook for European REITS is now broadly stable following several upgrades in 2017, reflecting growing portfolios’ scale and leaner balance sheet. Main upgrades this year were those on Annington Homes, Goodman European Partnership, NEPI Rockcastle, Prologis European Properties Fund, and Inmobiliaria Colonial. Among European REITs, two companies—France-based office company Gecina and Sweden-based residential holding company Akelius—have positive outlooks. S&P Global Ratings published 12 new ratings on EMEA REITs in 2017.

The outlook bias for rated APAC REITs is somewhat negative, reflecting stretched credit metrics due to debt-funded acquisitions or difficult operating conditions in some markets. This negative bias is a consistent theme in 2017 but tends to be issuer-specific, and the rated portfolio largely remains on stable footing. Also, given the largely investment-grade portfolio of APAC REITs (with a
notional average rating of ‘A-‘), we expect that potential rating migration will be modest. The sector outlook on LatAm real estate companies remains broadly stable, particularly in Mexico, although certain risks persist, mostly related to uncertainties surrounding the NAFTA renegotiation and macroeconomic downside risks. In Brazil, a negative outlook bias is due to sovereign risk influences because some real estate companies are already at the maximum number of notches above the sovereign rating.

### Industry forecasts

#### Real Estate

**Chart 225 – Debt to capital (adjusted)**

**Chart 226 – EBITDA interest coverage (adjusted)**

**Chart 227 – Debt to EBITDA (median, adjusted)**

**Chart 228 – FFO to debt (median, adjusted)**

Overall, we expect steady economic growth and positive demographic and employment trends to support real estate demand in most markets, while supply conditions remain fairly benign across most property types. In the U.S., operating fundamentals are slowing, and we expect rent growth to decelerate with occupancy remaining fairly stable. We expect net operating income (NOI) growth to decelerate to about 2.5%-3% in 2018, compared to 3%-3.5% in 2017. For REITs and real estate operating companies in EMEA, we expect overall positive rent growth as a result of sustained recovery in the European economy. Still favorable funding conditions and sustained investor appetite for the sector should support credit metrics, while occupancy remains robust. Most REIT managers in APAC are expected to maintain moderately conservative financial risk metrics, in line with the large proportion of stable outlooks. Their financial stance will create a large rating buffer to withstand debt-funded growth and economic shocks. In LatAm, we expect real estate companies to post solid operating and financial indicators due to their defensive portfolios.
Key assumptions

**U.S. REITs**

<table>
<thead>
<tr>
<th>1</th>
<th>Slowing operating fundamentals</th>
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<tr>
<td>Fundamentals in the U.S. commercial real estate (CRE) market continue to soften, with decelerating rent growth and occupancy relatively stable. We expect NOI growth to slow to about 2.5% to 3%, in 2018, compared to 3%-3.5% growth in 2017. Prospects in the industrial sector remain healthy due to e-commerce demand. Conversely, prospects for the retail sector remain dim due to increasing competitive pressure from rising e-commerce sales driving rationalization of brick-and-mortar stores. Fundamentals in the multifamily sector are stable, though supply increase in the next 6-12 months in markets such as San Francisco and New York. In the office sector, high-barrier-to-entry markets continue to outperform lower-barrier markets. Despite a recent slowdown from increased supply among tech-related tenants is driving demand, and most should achieve higher rent from new leases and maintain healthy occupancy rates. We expect rent growth in the retail sector to remain under pressure, with flat to negative growth for mall REITs while grocery-anchor strip centers should remain fairly stable. Mall REITs have been pressured by accelerated store closings and retailer bankruptcies, with department stores and apparel-focused specialty retailers the hardest hit. We think the pressures from rising tenant vacancy could result in increased capital expenditures (capex) and may also pressure rent growth as REITs struggle to keep occupancy rates up.</td>
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<th>2</th>
<th>Steady economic growth and measured interest rate hikes</th>
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<td>Despite slowing rent growth, we think the underlying macroeconomic landscape will continue to support relatively stable cash flow into 2018. This and healthy access to debt given the still low interest rate environment should help sustain credit quality for most real estate borrowers. U.S. REITs have been active in the capital markets, with total issuance (debt, preferred, and equity capital) up about 20% from the comparable period in 2016, with refinancing and acquisitions being main drivers for issuance increase. We expect a continued path of interest rate normalization in 2018. We believe current leverage and robust liquidity would allow our rated REIT universe to withstand moderate interest rate increases.</td>
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<th>3</th>
<th>Moderate increase in M&amp;A activity</th>
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<tr>
<td>The pace of M&amp;A activity picked up in recent quarters as issuers sought to increase scale and enhance portfolio quality. Notable transactions include Digital Realty Trust Inc.'s (BBB/Positive/--) $7.6 billion acquisition of DuPont Fabros Technology Inc. strengthening its dominant position in data centers. Regency Centers Corp.'s acquisition of Equity One made it the largest strip center REIT by market capitalization. Health care REITs engaged in a flurry of activity, with Healthcare Trust of America Inc. (BBB/Stable/--) acquiring Duke Realty Corp.'s (BBB+/Stable/--) medical office building (MOB) portfolio for approximately $2.3 billion, and Sabra Health Care REIT Inc. (BB+/Stable/--) merging with Care Capital Properties Inc. (not rated) to combine two skilled-nursing-focused REITs. We think there is potential for M&amp;A activity to moderately increase in 2018. U.S. REITs were active in selling assets the past two years and could look for growth opportunities to enhance the asset portfolios scale and quality. Most REITs have improved balance sheets with lower leverage, and some are building sizable cash positions. We expect most property acquisitions to be modest rather than large scale.</td>
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European REITS

1. **Revenues up and increasing portfolios**
   Widespread indexation of rents on various inflation measures and improving macroeconomic trends suggests that like-for-like revenue growth for Europe-based REITS, especially those operating in the office segment, will increase in the low-single-digit percentages in 2018. We also foresee rising revenues from portfolios’ additions, partly as a result of M&A but also through direct investments and high ongoing development activities (renovations, extensions, and greenfield or pre-let projects).

   In Germany, demand for commercial properties remains strong with positive effects on occupancy rates, and we expect mid-single-digit percentage like-for-like rental growth for office and other commercial real estate players in 2018. In the U.K., commercial valuations may come under greater pressure because of Brexit (see below).

2. **Improved earnings**
   Our expectation for EMEA REITs is for low-single-digit percentage NOI growth in 2018. We see two main trends that should support operating performance this year:
   - The market for continental office lessors will benefit from a better GDP growth momentum with rent level improving and occupancy staying robust. CRE markets in France and Italy are in recovery mode. It was also the case until mid-year in Spain and the eruption of political tensions between Catalonia and the central government.
   - German residential property players will continue to flourish amid strong demand and favorable funding conditions.

3. **Robust coverage ratios, sustained M&A activity**
   Following another year of very active refinancing activity, our base-case scenario for REITS in Europe foresees stable or moderately improving interest coverage ratios in 2018. Leverage metrics will naturally depend on execution of pipeline, but most REITs harbor a disciplined investment policy and should benefit from positive portfolio revaluation gains at year-end 2017.

   Ample liquidity provisions and increased headroom under most REITs’ leverage covenants should favor high acquisitions continuing in 2018. M&A transactions will depend on availability of targets per asset class and evolutions of share prices (vs. net asset value, NAV) throughout the year. In France for instance, Gecina is in the process of taking over Eurosic for €3.3 billion, and Icade is purchasing ANF Immobilier’s €0.5 billion portfolio.

   We also see a trend of REITs expanding prudently into development (for example, in the German or Swedish residential segments) as portfolios for sale become scarce or too expensive.
Asia-Pacific REITs

### Stable occupancy levels and increases in lease rental income

Our focus is on gateway cities, where rated REITs generally own solid portfolios of attractive real estate. As a consequence, we are assuming stable occupancy levels and, for the most part, lease rental income increases where they are contracted. However, the retail sector is facing digital disruption challenges, and we are cautious about the assumed releasing rates that will be negotiated as retail tenants reassess their space requirements. We also expect asset-enhancement and replacement initiatives will begin to generate incremental cash flow and support credit metrics.

### Modest increase in interest rates

A modest increase in interest rates is assumed as banks pass on higher funding costs. We are mindful of the floating interest rate exposure that the sector adopts and the trend has been to fix a greater portion of their debt book and take advantage of low interest rates. The sector’s liquidity position is either strong or adequate, reflecting REITs’ prudent treasury management. Generally, REIT managers continue to adopt treasury management policies, seeking to diversify their funding mix and extend the debt tenor.

### Managers will maintain moderately conservative metrics

We believe that the rated sector benefits from considerable size, scale, and diversity, but is focused on local markets. As the rated sector holds solid market positions in their respective cities, most APAC REIT managers are likely to maintain moderately conservative financial risk metrics, in line with the large proportion of stable outlooks. Given the frothy asset prices across these markets, their financial stance creates a large rating buffer to withstand debt-funded growth and economic shocks.

Latin American Real Estate

### Brazilian real estate operators to show continuing strong cash flow generation

We expect companies to continue to present robust cash flow generation in 2018, as occupancy rates keep their improving trend after some negative impact from Brazil’s weak economic conditions over the past two years. The majority of the rated companies operate in the resilient high-income malls segment and in high-quality offices at premium locations, which are much less affected by economic volatility. We also expect lower basic interest rates to improve the companies’ EBITDA interest coverage and cash flow generation, combined with a decreasing leverage trend.

### Mexican real estate companies to post solid operating and financial indicators

Our 2018 forecast for the Mexican real estate sector show that despite uncertainties surrounding the NAFTA renegotiations, we expect the entities we rate across the sector to continue to post robust operating and financial indicators supported by their high quality assets, prime locations, and the favorable supply/demand dynamics in Mexico. For the next 12 months, we expect occupancy rates in all sectors (industrial, retail, and office) to sustain, renewal rates to remain robust and rents to keep increasing in line with inflation rates. In our view, Mexican real estate companies will continue to focus on leasing activities and on expansion projects (under build-to-suit contracts), and in some cases on selective and accretive M&A transactions, focused on high value properties, mainly financed through cash generation and equity follow-on, while maintaining a moderate use of debt. Given this, we foresee a slight improvement in credit metrics.
Key risks and opportunities

Overview
The potential for steep interest-rate hikes remain a key risk in the real estate sector. Given its capital intensity, higher funding costs or capital-market volatility could dampen access to capital, limiting investment and development opportunities. Higher interest could also pressure property valuation, which we think reached frothy levels in some gateway markets in the U.S., APAC, and EMEA, particularly in London and the Netherlands. Overall, still solid operating fundamentals and expectations of steady cash flow are expected to support asset value.

As we get later into the current real estate cycle in the U.S., there is broad sentiment that a correction could be on the horizon. While we do not expect a steep drop in real estate prices, we think that modest price pressure could continue in 2018 given slowing fundamentals in light of a low economic growth landscape.

The rise of e-commerce is driving robust demand for industrial properties, while pushing retailers to rationalize their store footprints. More store closures due to bankruptcies could further pressure retail real estate companies. Still, rated retail REITs and real estate operators in the U.S., APAC, and Brazil have weathered the increased retail distress--mostly department stores and apparel retailers with high leverage--mainly because of tenant base diversity and high portfolio quality. Many have re-leased vacant space and achieved higher rent in most cases. In EMEA, the steady development of online retail and a gradual shift from hypermarkets to convenience stores have negatively affected the performance of those retail REITS less focused on city-center locations, a trend that we expect to continue in 2018.

In EMEA, the process of the U.K. leaving the European Union (Brexit) in coming years will weigh on valuations of commercial properties in London, but may prove beneficial for some continental cities such as Frankfurt, Germany.

In Brazil, there is a risk of delays in asset-occupancy improvement mainly in the office segment, whereas in Mexico key risks are linked to political and macroeconomic downside risks, and to the uncertainties related to the North American Free Trade Agreement (NAFTA) renegotiations.
1. **Capital-market volatility and steep interest rate hikes**

   Capital-market volatility, such as a steep equity market correction or sudden spike in interest rates, could hurt CRE valuations. Higher rates can reduce property values and compress yields on investments. The potential for steep interest rate hikes remains a key risk in the real estate sector. Given the sector’s capital intensity, higher funding costs or capital market volatility could dampen access to capital, limiting investment and development opportunities. Higher interest could also pressure property valuation, which we think has reached frothy levels in some U.S. gateway markets.

2. **Increased supply in certain sectors**

   Supply growth in multifamily properties, particularly in markets such as New York, San Francisco, and Houston, has caused NOI growth for multifamily REITs to decelerate. Still, rising construction costs and a tight bank lending environment could slow the pace of development, and we think there is a good chance that new supply will peak in 2017 or 2018. We are also monitoring the industrial-sector supply growth given significant development activity. While speculative development has increased, particularly in California’s Inland Empire, Dallas, and Atlanta, supply tends to be more constrained in high-barrier markets. Development costs, including rising land, entitlement, and construction costs, could suggest a more measured supply increase than in the last economic downturn. We continue to project positive absorption and sustained high occupancy levels for the rest of 2017, though the pace of NOI growth will slow down.

3. **Rise of e-commerce reshaping industrial and retail real estate**

   The rise of e-commerce is driving robust demand for industrial properties, pushing retailers to rationalize their store footprints. More store closures due to bankruptcies or tenant distress could further pressure retail real estate companies. Still, rated retail REITs in the U.S. have weathered the increased distress in retail—mostly department stores and apparel retailers with high leverage—mainly because of the tenant base diversity and high portfolio quality. Many have re-leased vacant space and achieved higher rent. Demand for industrial properties is strong as retailers, including Amazon.com, quickly build out their distribution network to enable fast delivery of merchandise to customers. Rent growth for industrial properties is outperforming other property sectors. Retailers’ e-commerce growth and supply chain investments resulted in persistently strong demand for the industrial space and pushed occupancy rates to historic highs. Moreover, tenant retention for industrial REITs within our coverage universe remains robust at around 80%. As a result, REITs continue to aggressively push up rental rates.
European REITS

1 Higher interest rate
Across Europe, recent increases in property valuations are partly driven by low interest rates. A change in monetary policy and more expensive funding conditions would likely depress valuations unless rents rise with only a limited time lag. To affect valuations, a rise in interest rates would need to be substantial (more than 50 basis points) and market conditions in the rental market would need to stagnate.

Current valuations incorporate substantial risk premium, reflecting asset characteristics and issuers’ credit standing. This should act as a buffer against sudden adverse movements in portfolio values in 2018. Most companies have taken full advantage of historically favorable funding conditions to extend their average debt maturity profile and fix (or hedge) a large majority of their stock of debt, commonly above 80%. We believe that the generally low interest environment will prevail near-term in the eurozone so that companies can continue to refinance under favorable conditions at least throughout the first-half of 2018.

2 Brexit and political tensions in Spain
U.K. commercial real estate companies may be affected by stagnating valuations in certain areas like London as the implications of the Brexit process, especially for the financial industry, become clearer. We believe that Brexit will give those financial services firms already under pressure to contain costs more reason to consider reducing their office space in London. We expect the pressure to be most acute for landlords with a large number of offices in the City of London or high-end residential properties, markets that cooled in 2017. Even if a cheaper sterling has helped to attract new investors to the U.K., the process of leaving the European Union has brought the long-run trend of commercial real estate assets appreciation in London to a stop. For the London office market, we see valuations falling by as much as 10% over a two-year period starting in 2018.

Other regions and asset classes in the U.K.--retail, industrial, hotels, mixed use, and specialty--should be more resilient. Conversely, some markets like Frankfurt or Dublin, or to a lesser degree Paris, may benefit from the separation process. We expect Brexit’s full effects to unfold over several years, rather than being fully visible within 2018.

In Spain, the political tension surrounding Catalonia’s call for independence has had limited impact on real estate rental activities. Persistence of political tensions would likely have the most impact on the region’s office real estate market.
Changes in retail
Retail property owners in 2018 will continue to face three main challenges:

- The steady development of online retail, which is positive for demand of industrial assets like warehouses or storage depots but not so for retail space. The line between e-commerce and physical stores is blurring; offering multichannel shopping options is becoming a critical factor for distributors and therefore for their landlords.

- Fears for individual security, such as those related to terrorism threats. At times, this can affect physical footfall and retailers’ sales, at least temporarily and for specific locations. Unfortunately, no European country can be seen as immune against this risk any more.

- Tougher competition between shopping centers, with prime international retailers becoming more selective in choosing store locations. We see a clear trend among retailers to reduce the number of shops and to concentrate on the best quality assets.

We expect the flight to quality to continue among large European shopping center owners, especially in highly competitive retail segments like fashion. The gradual shift from hypermarkets to convenience stores has supported the operational performance of those retail REITs focused on city-center locations, a trend that we expect to continue in 2018. Difference in anchorage—shopping centers in Europe are commonly anchored around a food supermarket and not a department store like in the U.S.—partly accounts for their greater resilience.

Asia-Pacific REITs

1 Sharp rise in interest rates
Debt capital remains available and is competitively priced for core real estate. The sector is getting a tailwind from the low cost of debt and has the continued support of debt providers in rolling over maturing debt. A sharp rise in interest rates could adversely affect REITs that have large floating-rate debt exposures.

2 Hunt for yield
The lower base interest rates and hunt for yield are lifting asset prices across the four markets, distorting rated REITs’ gearing ratios. The exuberance in asset prices is at odds with the payback and coverage credit metric measures given subdued markets. We are mindful of the sector’s risk appetite for lumpy debt-funded growth. REITs’ adherence to articulated financial policies remains key to maintaining rating stability.

3 Changing capital flows
Capital flows throughout the region are robust and have principally supported the region’s growing asset values. However, recent capital controls imposed by China’s regulatory authorities, anecdotally, have reduced the number of competing bidders for high-quality real estate. While this is not immediately affecting asset prices, as there remains healthy capital flows from other Asian market participants, it is allowing local incumbents to purchase assets and bolster their investment portfolios.
**Latin American Real Estate**

1. **Prudent and selective M&A opportunities**
   In both Brazil and Mexico, we anticipate real estate companies to continue to pursue selective and accretive M&A transactions, to be funded through recent and upcoming equity follow-on and to a lower extent through incremental debt, reflecting their prudent strategies. In our view, real estate companies still have opportunities to acquire properties at reasonable valuations across the retail, office, and industrial sectors in both Brazil and Mexico. Overall, we are not expecting a significant impact on credit metrics in the region.

2. **Risk of delays in occupancy improvement in Brazil**
   Despite the observed resilience of rated real estate companies, office operations had some negative effects in the past two years over occupancy rates, since tenants in this segment suffered more from economic volatility. We expect gradual improvement in 2018, following the economic recovery. But if occupancy rates don’t improve as expected, profitability and cash flow generation could be impaired, as prolonged discounts would be necessary to attract new tenants.

3. **Political and macroeconomic downside risks in Mexico**
   Although we do not expect significant risks in the next few quarters in the Mexican real estate sector, political and macroeconomic downside risks remain. In our view, the upcoming general election (July 2018) and uncertainties surrounding the NAFTA renegotiation could create further market volatility. The latter will likely maintain low fixed investment, which could delay growth opportunities for most Mexican real estate companies. Nonetheless, we anticipate defensive leasing activities across sectors will continue through 2018. We will monitor consumer confidence and corporate activities, because even if it is not our base case scenario, a prolonged macroeconomic deterioration scenario could affect retail and office space activities. We will also monitor leasing activities in the industrial sector after we have more clarity regarding the NAFTA renegotiation and its potential impact on tenants’ activities, overall portfolio occupancy and renewal rates, and rent pricing.
Industry developments (other regions)

Gulf Cooperation Council

We expect 2018 to be as challenging as 2017 for the real estate sector. Markets and sentiment remain sluggish as GDP growth rates slowed down partly as a result of direct or indirect dependency on oil prices. While the economies are adjusting to oil at or around $55 per barrel, we expect governments to cut or postpone expenditure to manage tight fiscal budgets. The six Gulf Cooperation Council (GCC) countries are about to roll out a 5% value-added tax in 2018. Over the next five years, tourism should remain an important source of market growth spurred by Dubai’s Expo 2020 and Qatar hosting soccer’s World Cup tournament in 2022. We expect market polarization to remain pronounced in the office segment amid some oversupply, while rents should be stable for prime office locations. A weaker dollar, pound, and yuan have affected tourist arrivals and spending, a key driver for the United Arab Emirates and more so for Dubai. In 2018, we expect to see lower average daily rates (ADRs) for hotels as supply continues to pour into the market. We also anticipate pressure on retailers and retail real estate as tourists are more cost-sensitive and because online shopping is a small but potential threat for brick-and-mortar stores.

Israel

Our outlook for the income producing real estate sector in Israel remains stable for the next year as lower financing costs and sufficient headroom under credit metrics protect companies from a potential decline in properties’ rent level. We estimate that companies will maintain adequate interest coverage and leverage ratios in the upcoming year.

In 2017, there was a relatively stable 2%-3% growth rate in same properties’ NOI year-over-year but a more moderate 0.5%-1% growth rate in rent levels, lower than in previous years. The gap can be partially explained by increased property-management fees. Occupancy rates in high-quality assets remain high--around 97%-100%--and we continue to see large investments in the offices segment. New spaces are rented out rapidly even in the saturated Tel Aviv metropolitan area.

In the coming two years, we expect that excess office and commercial space and increasing online sales may pressure NOI and occupancy rates downward in older properties but not necessarily affect rated real estate companies that have new and high-quality properties. We also believe that potential moderate interest-rate hikes over 2018-2019 wouldn’t significantly affect assets’ capitalization rates.

Latin America

We expect real estate entities to benefit from the solid supply/demand fundamentals in the region. As the industry is still at an earlier stage than mature markets such as in the U.S. and Europe, we believe that real estate companies in Mexico and Brazil have large opportunities to increase their portfolios through accretive M&A transactions that will generate high value through attractive cash flows and capital appreciation. Economic recovery will be a key milestone for Brazilian REITs’ performance through 2018. In Mexico, the key risk is related to the NAFTA renegotiation, which could have moderate negative effects over the industry over the longer run if NAFTA is cancelled, factors that we will continue to monitor.
Financial policy

U.S. REITs
Credit protection measures, particularly debt to EBITDA and fixed-charge coverage, have improved, but we expect these to remain stable in 2018. We believe stable demand fundamentals should continue to support asset prices longer term, but note that we are probably late in the recovery cycle. Many REITs are already posting peak level operating metrics for occupancy and annualized base rents (ABRs). As a result, we think further upside is relatively limited.

Access to capital markets also remains favorable for rated REITs. There has been higher debt issuance in 2017, which could slightly surpass issuance in 2016. We expect debt issuance to remain flat to slightly up in 2018, but the pace of M&A activity could drive more significant increases. Industrials, retail, data centers, and other nontraditional REITS (telecom) were among the largest issuers of debt in 2017. Credit spreads for investment-grade issuers continue to narrow, reaching their lowest levels after the last economic downturn. Interest rates remain historically low, and many REITs still find it attractive to refinance at these rates.

We expect the pace of M&A activity to moderately increase and financial policies of U.S. REITs to remain largely stable. Most transactions have been funded by equity, further enhancing the credit profiles of U.S. rated REITs. REITs have been net sellers of assets in the past two years, and we expect more acquisitions to drive growth. Many rated REITs have largely completed their repositioning strategies, and asset valuations are stabilizing. We believe both the debt and recovery of equity prices to be effective funding sources of capital for future acquisitions or development activities.

EMEA REITs
Supportive market conditions and a rise in valuation have resulted in slow but steady improvement in loan-to-value (LTV) ratios. We believe that this provides some headroom to credit metrics should market conditions deteriorate and property valuation drops. We also note that most REITs have kept a high level of interest hedging and extended their debt maturity profiles in recent years. The favorable environment on the equity market also means that more REITs in EMEA, especially the most under-leveraged ones, may be considering M&A, IPOs, or a possible listing in 2018. Share buy-backs could also lead to increased gearing, albeit still acceptable for our current ratings.

APAC REITs
Many rated entities retain sufficient buffer within their financial policies to take advantage of debt-funded opportunities or deal with unexpected economic or financial shocks. This is in the context of REIT policies that are usually referenced to a debt-to-asset measure. After calibrating these gearing targets to payback and coverage credit measures, we view rising interest rates as a potential threat. In light of the potential for interest costs to increase, a number of rated issuers have sought to lengthen their debt-maturity profiles and tap currently favorable onshore and offshore debt markets. In addition, the utilization of share buybacks has emerged over the past year and has been principally funded from asset sales proceeds. While we view these actions as shareholder-friendly, they are undertaken with reference to the buffer that the manager wishes to retain relative to their gearing target.

LATAM REITs
We anticipate real estate companies to maintain prudent financial policies toward debt, showing a gradual improvement in credit metrics in 2018. In general, we also expect real estate entities to proactively refinance, although general elections in Mexico and Brazil will likely bring some volatility in the markets. In our view, upcoming M&A activities will be selective and accretive to existing portfolios in terms of asset characteristics, and mainly funded through equity issuances. We continue to expect solid cash flow generation, which will help sustain dividend distribution payouts and maintain flexibility to exercise their share buy-back programs, depending on market conditions.
Related Research

- Rated Spanish Real Estate Companies Are Well-Positioned To Withstand Political Tension In Catalonia, Oct. 10, 2017
- Japan Corporate Credit Spotlight: General Contractors; Real Estate, Oct. 4, 2017
- Real Estate Trends For German Residential Market, Oct. 2, 2017
- Real Estate Trends For French Office Market, Oct. 2, 2017
- Industry Credit Outlook: Asia-Pacific Sector Outlook September 2017: Net Negative Outlook Bias Eases Further, Sept. 27, 2017
- Japan's Major Diversified Real Estate Companies Can Weather Approaching Market Correction, Aug. 28, 2017
- Australia's Retail REITs Will Need To Shine As Digital Storm Threatens Retailers, Aug. 14, 2017
- While EMEA's Retail REITs Remain Resilient, e-Commerce Is A Growing Threat, July 6, 2017
- Real Estate Trends In Europe: Mid-2017 Update - Retail, July 4, 2017
- Credit FAQ: What Does Amazon's Purchase Of Whole Foods Mean For Ratings In Grocery And Other Sectors?, June 22, 2017
- REITrends: Retail REITs Stubbed Their Toe In The First Quarter While Other Sectors Kept Their Stride, June 19, 2017
- ICSC Conference: Amid Persistent Retailer Woes, REITs' Credit Quality Has Held Up Fairly Well, June 19, 2017
- Nordic Real Estate Companies See Their Funding Structures Improve, Backed By Strong Market Fundamentals, May 23, 2017
- Steady U.S. Economic Growth Will Bolster A Shaky Foundation In The CRE Market; Apr. 19, 2017
- Lay Of The Land: U.S. REITs Can Weather Interest Rate Hikes Amid Expectations For Growth, Apr. 3, 2017
- Europe's Logistics Property Industry Has Good Growth Prospects Due To The Rise of E-Commerce, Feb 16, 2017
- Policy Tightening For China's Property Sector Shows No Signs Of Abating, Feb. 16, 2017
Cash, debt, and returns

Global REITs

Chart 229 – Rental revenue growth

Chart 230 – Return on capital employed

Chart 231 – Cash and equivalents to total assets

Chart 232 – Total debt to total assets

Chart 233 – Fixed vs. variable-rate exposure

Chart 234 – Long-term debt term structure

Sources: S&P Global Market Intelligence, S&P Global Ratings calculations
Industry Top Trends 2018
Retail and Restaurants

Overview

- **Ratings Outlook:** Rating trends across retail and restaurants will remain negative in 2018, even if more than half the outlooks remain stable. A shifting competitive landscape for most retail sectors--driven by consumer preferences and global e-commerce trends, are contributing factors to the solidly negative outlook bias.

- **Forecasts:** Overall, we expect mixed revenue growth--some companies or subsectors will experience revenue declines (negative same-store sales or store closings) while others will have revenue growth (favorable sector dynamics). Slow economic growth in the West will also constrain revenue growth for some.

- **Assumptions:** We assume slow but continued global GDP growth, some wage growth in developed markets (good for consumer spending, also possible pressure on margins), and continued significant investment in e-commerce by most retailers--even in sectors previously considered less vulnerable to e-commerce.

- **Risks:** Companies strive to adapt to shifting consumer preferences with limited success, while consumers become even more cautious and hardwired to seek discounts. Trade, tariff, or tax regimes develop in several nations that disrupt existing retail supply chain economics or raise costs and pressure margins. Higher-rated issuers shift capital allocation more aggressively towards shareholders.

- **Industry Trends:** Many dynamics are intensifying, including investments in online commerce and delivery logistics; continued growth of successful retailers with world-class supply chains; powerful demographic trends rooted in the millennial generation; and tepid economic growth in many markets.

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Ratings trends and outlook

Global Retail and Restaurants

Chart 235 – Ratings distribution

The majority of our ratings are speculative-grade; during 2017 the percentage of ratings in the CCC category has risen reflecting distress in the U.S. retail sector. We do not expect much upward rating migration in categories with stronger investment-grade ratings given industry dynamics and slow growth, investment, M&A, and financial policy shifts in light of real and potential activists.

Chart 236 – Ratings distribution by region

The dominance of speculative-grade ratings is consistent across regions. The 'B' category dominates the rating scale.

Chart 237 – Ratings outlooks

Most rating outlooks are stable, but the vast majority of the non-stable outlooks are negative and we expect this to continue. The shift toward negative outlooks continued over the past year.

Chart 238 – Ratings outlooks by region

In all regions, negative outlooks outweigh positives. This negative bias has been growing during 2017, and reflects local industry and in some cases economic challenges and company specific execution.

Chart 239 – Ratings outlook net bias

The sector has had a negative bias over the past few years, but the trend has accelerated in the past several quarters, reflecting strategic and financial policy choices and underperformance in a challenging environment.

Chart 240 – Ratings net outlook bias by region

The negative outlook bias has been consistent in North America and Latin America, but has moderated some in APAC and Western Europe.

Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending Sept. 30, 2017
U.S. and Canada: We expect continued economic growth in the U.S. in 2018, but without much positive impact on the credit quality of the retail companies we rate. In 2015-2017, there were many more downgrades than upgrades, and this trend accelerated in 2017. As of late October 2017, 34% of outlooks were negative versus just 4% positive. The specter of defaults continues to loom large over the rated universe: About 17% of the rated portfolio was in the ‘CCC’ category, about double the level of the financial crisis. The performance of issuers in the department store and specialty apparel sectors are the most challenged, along with a mixture of other retail concepts. So far, there have been no defaults in the restaurant space in 2017 despite many restaurants carrying a high debt burden from private equity ownership. Discounters continue to do well and the dollar store segment also continues to expand. We assume the 2017 holiday season will be weak for the segments that have struggled over the last few years. However, we certainly do not see a slowdown in the growing preference for shopping online.

In Canada, we expect operating conditions to remain relatively stable through 2018 with modest consumer spending growth of 1.6% offset in large part by cost inflation. As of late October 2017, all of the Canadian retailers in our rated portfolio have stable outlooks.

EMEA: About 79% of the ratings in EMEA are speculative-grade, with EMEA food retailers still in the relatively stable camp when compared to the rest of the EMEA retail subsectors—mainly apparel, departmental stores, and pubs and restaurants. About 47% of the overall EMEA retail ratings are in ‘B’ category with 11% of outlooks across all ratings being negative.

As retail remains intensely competitive, we believe the outlook for the sector is stable to negative with increasing negative bias, although a majority of the companies in the rated portfolio still hold on to a stable outlook. In many cases, the outlook has stabilized following a downgrade, and headroom under the existing ratings has shrunk. We have seen very few upgrades over the course of 2017, mostly underpinned by debt refinancing improving maturity profiles and stabilizing the capital structures. On the other hand, most of the negative rating actions were in apparel and general merchandising segments, affecting both specialty retailers and departmental stores.

We expect these negative trends to continue over the course of 2018, given the overall challenging retail trading conditions amid an increasingly aggressive competitive environment. As retailers invest in logistics, IT, and supply and distribution networks alongside optimization of their store footprint, we expect that capital investment will stay elevated. We have seen a high number of opportunistic refinancing and repricing transactions along with sporadic recaps in the high-yield space due to benign financing environments across Europe.

We believe the European Central Bank (ECB) would continue to support lending and would not be changing its 0% main refinancing rate until inflation is at about 2% in the EU, which we expect to be the case by 2019/2020. That said in the U.K. the Bank of England recently raised the base rate from 0.25% to 0.5% - the first rate rise in over a decade. Although it is too early to gauge the impact of this move, we believe that this will clearly put some pressure on disposal incomes of UK consumers.

Faced with the change in consumer habits, unrelenting competitive pressure (aggravated by value, discount, and pure-online players), retailers are stepping up their merchandising, cost rationalization efforts, and investment in omnichannel capabilities, which constrains flexibility of free operating cash flow. As organic growth remains subdued, shareholder-friendly moves such as special dividends, share buybacks, and recaps will further erode rating headroom in the event of any operating underperformance.

Latin America: Our outlook for Latin America is stable to negative. In Brazil, we expect gradual improvement in sales and profitability in 2018, as much lower inflation and interest rates coupled with lower household indebtedness should boost consumption after more than two years of poor macroeconomic conditions. However, we have negative outlooks on all Brazilian retailers as a result of the negative outlook on the sovereign rating of Brazil because companies are already at the maximum number of notches above the sovereign rating we believe these can be.

In Mexico, we expect a challenging economic environment to maintain the industry’s growth in the low-single-digit area in 2018. Consumption trends in Mexico might face downside risks next year.
depending on inflation and interest rate trends (which have been increasing recently), exchange rate volatility, and economic activity. However, sustained growth in consumer credit, record-high remittances, and a low unemployment rate have the potential to somewhat offset these risks.

Asia-Pacific (APAC): We expect a negative bias to continue, but to a more moderate degree. This is because we have taken rating actions in 2017 already and thus we expect the credit quality of Asia-Pacific retailers to be somewhat stabilized. Moderate prospects of economies in the region also support the trend. Nonetheless, among subsectors, we believe Japanese general merchandise stores (GMSs) and Chinese department stores need to be watched. This is because of not just intense competition but also the aggressive stance of capital investment and acquisitions.

Industry forecasts

Global Retail and Restaurants

We expect slow revenue growth for the sector overall. In North America, we anticipate slower revenue growth but at rates a bit above GDP given some still growing subsectors. In Western Europe, revenue growth will stay moderately positive. In APAC, we expect more stable revenue growth. In Latin America, growth partly reflects recovering economies.

We anticipate margins will remain fairly flat or perhaps improve a bit as ongoing restructuring gains traction for the industry overall and that is also the case by region.

We think the sector will deleverage slightly over the next two years, with continuing lower leverage trends in all regions. It is unlikely that aggregate deleveraging will be sufficient to trigger wide-spread upgrades. We think some growth in EBITDA, rather than significant reduction in debt will account for most of the deleveraging. Any lower leverage in the speculative-grade segment would signal potential dividend recapitalizations or sale on sponsor-owned retailers.

We assume aggregate cash flow to debt as measured by FFO/debt will have roughly bottomed out in 2017 but we do not expect any large improvements.

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.
U.S. and Canada industry forecast

In the U.S., we expect many companies to report flat or declining same-store sales and further store closure announcements, albeit perhaps not to the extent of the last year. This will lead to decreased revenue for sectors such as department stores and specialty apparel, unless a consistent trend of same-store sales growth emerges, which would be better than our base-case assumption. Other segments will show revenue growth and net store openings. We think wage growth will finally accelerate, and not just because of rising state or local minimum wage requirements. This will pressure margins in some segments, such as restaurants. So far, low unemployment has not been a big catalyst for small-ticket retail spending.

In Canada, we generally assume flat to modest growth in same-store sales over the next couple of years. This incorporates our view that improving macroeconomic conditions should translate into consumer spending growth, albeit at a slower pace than in 2017. Profit margins may be pressured for some retailers, as many provincial governments move ahead with plans to increase minimum wage. For instance, the province of Ontario, which accounts for about 40% of Canada’s population, plans to raise its minimum wage roughly 30% by Jan. 1, 2019. In our opinion, the size and pace of the increase will pose a significant challenge for retailers to sustain current profit margins. We believe the anticipated labor cost inflation could be offset in part by higher retail prices, adding self-checkout counters, automating distribution centers, and other initiatives to improve productivity.

European industry forecast

Despite a macroeconomic slowdown across Europe, so far European retailers have reported generally stable to marginally negative top lines and EBITDA margins—with the exception of mid- and up-market apparel and general merchandising retailers, for which we have seen toughening conditions. We expect these trends would continue in 2018 with most of retailers showing a very low rate of revenue growth down to a marginal decline for some, and softening profitability. We expect many will expand their online operations in a bid to mitigate the impact of the decline in physical stores.

As is the case in the U.S., in the medium term, we expect the retail sector will face multiple challenges related to volatile demand and the ongoing structural shift, with growing importance of e-commerce and the ability to sell across multiple platforms. On top of that, one big uncertainty is linked to foreign currency headwinds, especially sterling, euro exchange rates, and monetary policy developments on both sides of the Atlantic. The same would also have a ripple effect on demand, commodity prices, labor costs, and capital expenditure.

European food retailers will continue to benefit from nondiscretionary demand and industry consolidation, and should be able to pass through input cost inflation or counterbalance with merchandising strategies. Therefore, the top line growth will remain subdued and EBITDA margins will stay broadly stable, albeit challenged by discounters and pure online players increasing their penetration in high-margin categories such as fresh and chilled.

On the other hand, apparel retailers and department stores are in a relatively difficult spot. This mainly stems from inherent weather- and fashion-related risks, fierce competition from fast-fashion and online retailers, and U.S. dollar-denominated procurement. As companies invest in refocusing their merchandising and pricing strategies, logistics, and omnichannel platforms, we expect further erosion to profitability with margins falling over the next 12 months.

Latin America industry forecast

In Latin America, we expect mild same-store sales growth due to a gradual improvement in consumer confidence and still-challenging macroeconomic conditions in general. But some large players have significant organic expansion plans and have been showing strong execution even amid the recent economic downturn, which should drive some revenue growth. In Brazil, the lower level of basic interest rates should result in a reduced debt burden, allowing for stronger cash flow generation. In line with expected gradual increases in cash flow generation, we would likely see decreasing leverage for rated retailers in the region.
APAC industry forecast

Ongoing urbanization and higher wages in China and ASEAN countries, together with relatively sound GDP growth and positive consumer sentiments, will support growth in total retail sales of high-single- to low-double-digit growth over the next 12 months. In developed, mature markets such as Japan and Australia, we expect total retail sales to grow at low-single digits. While consumer confidence is somewhat better than in 2017, intense competition and oversupply of stores remain. Although physical stores still dominate the consumption in both markets, the online retail sales growth significantly outstrips the total retail sales growth of physical stores, especially in China. In Japan and Australia, because of maturity of home markets, we expect retailers to invest more in overseas business expansion, including M&As.

Key assumptions

**Retail and Restaurants**

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<thead>
<tr>
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<th>Slow global GDP growth</th>
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<tr>
<td>1</td>
<td>Slow GDP growth will be the norm in most Western countries. For others (China for example), growth will moderate but remain above other regions.</td>
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<th>Interest rates will rise in certain markets</th>
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<td>2</td>
<td>Increased rates in the U.S. in 2018 will likely be the most notable “scheduled” increase as quantitative easing (QE) is unwound. Rising rates in other regions remain subject to more sustained economic recovery.</td>
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<th>A more inflationary environment</th>
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<tr>
<td>3</td>
<td>We expect an increased likelihood of rising wages and continued mixed news on energy prices as challenges for retail, even if higher wages could help consumer spending. We are seeing food deflation easing as expected in late 2017.</td>
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**Slow global GDP growth will be the norm for now**

We think **U.S.** GDP growth will pick up in 2018 to about 2.3% from around 2.1% in 2017, with consumption spending moderating to around GDP growth from a faster rate in 2017. We expect unemployment to decline further in 2018 to 4.1%. Average hourly private sector earnings have recently shown strength, possibly breaking out of a 2.5% rate of growth rut. Our U.S. Chief Economist, Beth Ann Bovino, sees household balance sheets on stronger footing. “While the labor market continues on its solid trend despite weather-related hiccups, the latest indicators from the Federal Reserve’s Financial Accounts of the United States (previously known as the Flow of Funds Account) paint a picture of sustained progress as American households continue to repair their balance sheets while indicating that the post-crisis deleveraging phase may have bottomed out. Data until second-quarter 2017 reveal that household wealth has been boosted by rising home and equity prices, and household debt has been growing relatively slowly, contributing to a healthy household balance sheet. (Note: Those in hurricane-affected regions did take a hit on their balance sheets in August and September.)"

In **Canada**, improvement in commodity markets and a recovery in energy sector output contributed to above-trend real GDP growth in the first half of 2017, which averaged 4.1%. We expect average GDP growth to moderate to 2.0% in the second half of 2017 and 2.1% in 2018. We also expect consumer spending to moderate to about 1.6% in 2018 from 1.9% in 2017 and should translate into slower revenue growth for Canadian retailers exposed to discretionary spending.

The Brexit vote has cast a shadow on **U.K.** growth, which is projected to slow down from 1.4% expected for 2017 to 0.9% expected for 2018, with eurozone growth expected to remain at 1.8% in 2018 versus 2.2% expected for 2017. Even though the election results are in line with the expectations, however, the overall uncertainty did result in a slowdown across Europe. Further, details around the U.K.’s divorce with Europe have not been finalized, which results in looming pressure across the sector and creates some uncertainty about the U.K.’s future trade relations with the rest of Europe. Macroeconomic prospects across the **eurozone** are still relatively positive but capital expenditures and overhead costs are being...
tightly managed across Europe as retailers focus on maintaining EBITDA margins and free operating cash flow, and as consumers are increasingly focused on price and value retailing.

In Latin America, we expect GDP growth of 2.1% on average for 2018 compared to our expectation of 1% in 2017. In Brazil, after more than two years of recession, we believe GDP growth coupled with lower unemployment and higher disposable income should improve consumer confidence and drive stronger same-store sales and top line growth for retailers. In Mexico, we expect GDP growth at 2.3% in 2018, supporting positive consumption expectations. Although retailers in the country could face moderate challenges given their exposure to discretionary spending, we believe demand will continue to grow, although at a slower pace, and same-store sales growth will remain in the low-single-digit area throughout next year.

In Asia-Pacific, our baseline scenario GDP forecast is mid-5% for 2018, mostly flat compared to 5.4% in 2017; however, the growth rate varies among the countries; in China it should reach mid-6% for 2018; in ASEAN countries about 5%; Australia high-2%; and Japan low-1%. We have seen overall good macroeconomic momentum indicators in 2017. Retail sales are currently trending upward in most of the region’s economies. Nonetheless, in the some retail formats, such as department stores in China and GMSs in Japan, intense competition (amongst themselves and against online retailers) constrains the growth.

Gradually rising interest rates presents a risk for consumer spending

In the U.S., we forecast economic growth of 2.1% in 2017 and 2.3% in 2018 (assuming current fiscal policies), near full employment, and a strong medium-term economic path. These will likely justify three rate increases in 2018. While rising rates have the potential to slow spending, rising wages and solid consumer confidence (some of the highest levels since 2001) could support consumer spending. We think consumers’ focus on other ways to spend (autos, technology, health care) is as much a driver of retail spending as the impact of rising rates.

During 2017, the Bank of Canada raised its policy rate by 50 basis points (bps) in response to an improving economic outlook. We expect the rate will be raised to 1.75% by the end of 2018 from 1.0% as of late October 2017, which should contribute to slower consumer spending growth in Canada. Furthermore, heavy consumer debt burdens, rising interest rates, and the surge in real estate valuations since 2015—particularly in Toronto and Vancouver—elevates the risk of a housing correction in Canada. Although we consider it unlikely, such an event could significantly erode consumer confidence, curtail discretionary spending, and weigh on same-store sales (sales at stores open a year or more) and profitability of Canadian retailers.

We believe financing conditions in Europe will continue to be relaxed and do not expect the ECB to materially change its 0% main refinancing rates until we see sharp inflation in the eurozone. We expect inflation to remain at about 1.6% for 2018 and remain well under 2% to 2020, at least for the eurozone. The U.K., however, paints a different picture, with the March 2019 deadline at which the U.K. must formally leave the European Union. Furthermore, we have recently seen the Bank of England raising rates in the U.K. for the first time in over a decade. However, as the deadline nears, consumer confidence is slipping, and we have seen more frontloading (i.e. heightened M&A activities) in the high-yield space as companies take advantage of cheap funding, accelerating some capital expenditure for future years to be ready for the uncertain post-Brexit era.

Interest rates should remain flat at 7% in Brazil in 2018, after significant cuts over the past several months (from 13.8% in the end of 2016), which should allow for stable to improving household indebtedness and sustained adequate conditions for consumption recovery. Also, companies will continue to face lower interest burdens, improving interest coverage metrics as issuers carry mostly floating-rate debt. In contrast, the Mexican central bank has increased its policy rate by 125 bps as of September 2017 after raising it by 250 bps in 2016, with no more hikes expected in 2017 and a slow, downward trend in the next year, reaching 6.5% at the end of 2018. We believe higher interest rates could somewhat affect retailers, as an important share of revenues is generated through their credit divisions. However, we believe consumer-lending dynamics will remain solid, growing slightly above 10% during 2018, as both credit supply and demand will still be relatively strong, despite the still slow economic growth.
For Asia-Pacific, we expect policy rates to increase moderately in 2018, with some exceptions, such as China and Japan. We do not expect the higher interest rate to constrain consumer confidence significantly in emerging markets in Asia-Pacific, due to the strong appetite for consumption. Nonetheless, the higher interest rates would hit some retailers with weaker credit metrics. EBITDA interest coverage ratios of retailers in the speculative grade is already quite low, and there is less room to absorb the impact of rising interest rates. In this region, we also believe the dominance of bank lending for corporate borrowing helps mitigates refinancing risk.

Inflationary environment

In the U.S., our economists expect stronger demand and reduced excess supply to boost wages and consumer prices next year, which is good for retail, with core Personal Consumption Expenditure (PCE) likely to reach the Fed’s target of 2% at some point in 2017. We see headline PCE peaking at 2.5% in the third quarter, before low oil prices drop out of the calculation and the dollar’s strength diminishes—though inflationary pressures above 2% will probably prove temporary, in our view. Food deflation has been a headwind for grocers, but we anticipate it will subside later this year. If new trade policies create upward price pressure in the supply chain, this could hurt margins if companies cannot pass them through to consumers.

In Canada, we assume food price inflation of less than 1% for 2018 driven in large part by higher operating costs (labor in particular), a portion of which is likely to be passed on to consumers through higher prices. That said, we believe the rate of inflation will be somewhat constrained by the highly promotional and competitive environment in food retail. We also expect annual traffic growth at discount banners to be more than double that of conventional banners in the food segment over the next few years. This is an ongoing trend that should have a deflationary effect on prices.

Compared to previous periods of deflation, 2017 is a year of emergence of input cost inflation, and we expect this to continue for EMEA in 2018. Weakening home currencies and price increases by food suppliers continues to put pressure on margins for European food retailers, which requires balancing competitive position and an extent to which they are able to pass on the input cost inflation to the end consumer. We have already seen some flash points of higher prices between grocers and consumer goods companies. At the same time, we see the return of food inflation as a somewhat positive development for food retailers, particularly the larger players, providing greater flexibility on pricing.

In Mexico, the increase in energy prices during the beginning of 2017, including the liberalization of gasoline prices, triggered the escalation of inflation. As of August 2017, the inflation rate reached 6.7%; however, we have seen signs that inflation has started to moderate in the last few weeks and expect inflation to decrease to 6% by year-end 2017 and to 4% by 2018. A prolonged inflationary cycle could have negative repercussions for disposable income at the household level, and would bridle consumer spending. On the other hand, lower inflation of around 4% in Brazil in 2018 (after 8.7% on average in 2016) reduces labor cost pressures that have hurt Brazilian retailers recently, which should drive profitability improvements.

In APAC, many emerging countries are exposed to commodity price fluctuation, and producer price inflation continues to outrun consumer price inflation. Inflation in many countries, including China, Indonesia, Australia, and Japan remains low and stable, but we expect retailers to be beleaguered by higher labor costs and rent increase.
Key risks and opportunities

Retail and Restaurants

1. Adapting to shifts in consumer preferences is critical

Consumers in most regions continue to look for value (despite almost a decade having passed since the financial crisis). Meanwhile, millennials' buying habits (including brand choices) are affecting retail in new and complex ways that retailers are trying to address. Technology has driven a high degree of price transparency to which many traditional retailers are struggling to adapt.

2. Intensity of e-commerce will continue to shape most retail segments

E-commerce is disrupting almost all segments of retail to greater or lesser degrees, with no end in sight. However, it's not all downside for those retailers that can manage their physical footprint while building successful online capabilities. We think signs of winners and losers are emerging now, although the upheaval of the retail landscape will continue.

3. Geopolitical shifts

Recent election results have not (yet) disrupted the status quo to the extent some predicted. But retail growth prospects around the world are competing with evolving geopolitical trade impacts on companies, consumers, supply chain, trade relationships, and evolving economic tensions and policies.

Shifting consumer preferences and competition for share of wallet will confound the best efforts of many retailers.

The steady and persistent shifts in consumer spending patterns, which drive demand for most rated retailers, do not seem likely to reverse. Consumers are sensitive to prices and tend to seek the best bargains. We believe this trend took root during the financial crisis and the ensuing economic slowdown, but has since become entrenched in consumers' habits. At the same time, in the U.S. the millennial generation is now the most populous generation and their retail behavior is the largest population cohort. Rampant growth in online sales has created more price transparency and made comparisons easy for a range of products. We don't think improved consumer confidence and spending and some growth in disposable income will offset these challenges in 2018 for rated companies, since for many consumers this is a permanent change in how they shop.

Increasing price sensitivity has also spurred the growing acceptance of discount stores (and off-price retail broadly), which continue to open in large numbers, in sharp contrast to most traditional retailers who hope a smaller footprint will enhance the customer experience. We believe these trends will continue in 2018 as a result, and retailers will need to work to differentiate themselves further by creating focused brands that communicate price, value, and quality more clearly.

Of the three largest food retailers in Canada, we believe Loblaw Cos. Ltd. is in the best position to benefit from consumers' preference for discount prices given our view that more than 50% of its grocery stores feature discount formats versus about 35% for Metro Inc. and 10% for Sobeys Inc.

Hypermarkets and supermarkets are losing some ground to convenience store formats across EMEA, and there is a considerable shift of consumers toward visiting smaller format neighborhood shops to 'top up' and larger stores to 'stock up'. Accordingly, there is a strong momentum of retailers who are optimizing their store networks to meet this consumer trend and maintain their share of the consumer's wallet by focusing on expanding their supermarket and convenience store formats. The trend has also reduced the average shopping basket size at hypermarkets that just account for 16.8% of selling space and 21.1% of revenues in 2016 vs. 17.2% of selling space and 22.6% of revenues in 2011. [Source: Euromonitor]
Strong growth of discounters and expansion of their fresh food offerings threatens to destabilize the market position of traditional grocers. Intense price competition underscores the importance of cost control. We expect to see a continuous gradual movement towards convenience store formats and the retailers are prudently managing SKU (stock keeping units) rationalization as well as seeking to raise physical space utilization.

The Latin American retail market remains more fragmented compared to the more mature markets in the U.S. and Europe. In several Latin American countries, more than 60% of the market corresponds to mom-and-pops and/or the informal market. In any case, retailers also have been focusing on understanding consumer needs and preferences in order to remain relevant in their markets. Over the past years of economic downturn in Brazil, for instance, consumers migrated from traditional supermarkets to cash-and-carry formats. As a result, retailers’ strategy for opening new stores has been focusing on cash-and-carry.

In Japan, middle-class consumers will remain very selective about prices and the quality of daily necessities. We have also seen in Australia that consumers are more focused on prices and retailers were forced to cope with increasing penetration of discounters. Not only in Japan but even in China, consumers have been shifting their preference to enjoy services and leisure in physical stores. To cope with this, retailers have scraped and rebuilt old retail formats into shopping centers with entertainment offerings. Given such investment requirements, we expect retailers’ leverage to remain high.

**E-commerce continues to expand for almost all retail sectors; winners and losers will begin to emerge, but it’s not a winner-take-all game**

E-commerce evolution has already shown that previously successful retailers may not remain so. At a minimum, their growth rates will slow if they do not execute e-commerce strategies well. Simply closing stores in oversaturated sectors will not be a sufficient ingredient for future success.

Strong internet sales growth still is only around 10% of total U.S. retail sales, yet e-commerce has a disproportionately large impact on the traditional retail sector. The suggestion that Amazon may enter a segment of retail is usually sufficient to trigger a drop in market value of even well-established players in that sector. Most traditional retailers are spending significant sums to increase their technological capabilities and shift their go-to-market strategies, such as reevaluating physical footprints. It is not easy to reformat parts of the business model including supply chain and distribution networks, while enhancing customers’ store experiences. At the same time, pure online operators are building a physical presence—if not rapidly, then with significant fanfare. Two dramatic recent examples were Wal-Mart’s purchase of Jet.com in 2016 and Amazon’s purchase of Whole Foods in 2017. Most retailers these days have an objective of faster delivery and giving customers the traditional touch and feel of the product. We think the consumer is comfortable with multiple channels and that many retailers are working to catch up. Because of this, we do not see e-commerce penetration diminishing, but neither do we imagine the vast majority of sales in most segments occurring online.

Grocery is a good example of how the mixture of brick-and-mortar and online channels are evolving. In the U.S., grocery online penetration is low, Amazon is not dominant, and large traditional grocers have all been investing in and testing different online formats (such as click-and-collect). We would expect to see a similar dynamic in other retail segments, such as pharmacy and auto parts. In others segment—apparel, electronics, and office supply for example—the landscape is further along in share capture by e-commerce. This does not mean that long-term winners and losers are determined—each retailer competes constantly and must evolve to stay relevant.

In Canada, we expect online retailers will continue to take share from traditional brick-and-mortar. However, this should occur at a slower pace than in the U.S. because of Canada’s relatively small market, dispersed population, and the entrenched market position of retail incumbents. In our opinion, these characteristics create barriers to entry for online retailers. We believe apparel and general merchandise retailers are among the most exposed to the threat of online competition. Defensive measures employed may include click-and-collect or home delivery. Retailers may also invest to acquire or develop brands in an attempt to differentiate their product offering from online retailers.
Similar to the U.S., we expect the penetration of online sales within the Canadian grocery retail segment to remain low. This reflects the large portion of revenue generated from fresh produce, meat, and dairy products that many customers prefer to select in person to ensure quality. However, we expect shifting consumer preferences to accelerate growth of online grocery sales, with household products and dry and canned goods among the categories leading the trend. In response, many Canadian grocers have introduced click-and-collect or home delivery services in select markets. We also believe grocers will gradually shift to a product mix more resilient to online competition, which could result in a smaller store format over time.

E-commerce growth in mature European markets is slowing down—France and the U.K. recorded growth of just 8% in 2016 versus double-digit growth of former years. In line with the global trend in other markets, such as the U.S, we do not expect e-commerce to diminish either in role or in absolute amounts. It remains an important channel for traditional brick-and-mortar retailers to hold on to their customer base. We see households and customers switching to online for ‘stocking up’ and replenishment, but for ‘feel of the product’, some customers would likely still prefer to visit the store. E-commerce growth seems to crossing all product categories, especially household goods and appliances, furniture, beauty products, perfume, and apparel.

Discounters, who have a sound value proposition, so far have been able to withstand the e-commerce onslaught. We could see further pressure on retailers’ top and bottom lines as online further evolves, delivery options improve, and e-commerce penetration increases. Convenience, stock availability, and price transparency are the top reasons for consumers to shop online instead of in-store experience. A number of new developments in technology have opened up a new battlefront for retailers in their quest for a larger share of the customer’s wallet. These technologies stand to completely alter the way customers shop.

Retailers that were early to invest in digital capabilities reap competitive benefits from using their customer data for personalized marketing, raising the basket size by promoting add-on products and merging shopping experience across mobile, website, and store platforms. As this trend continues, IT spending is becoming a nondiscretionary component of retailers’ costs and capex.

In Latin America, e-commerce is still very small compared to overall retail revenues, in part due to the still-low penetration of the internet in households. Online sales represent less than 5% of total sales for most of the retailers that we rate, and we expect that in the near future retailers would not see significant profits generated through this channel. Nevertheless, we believe online sales represent a growth opportunity in the longer term and expect large retailers to continue investing heavily in technology, integration, and commercial strategies. As a sign of things to come, Amazon recently started a marketplace for electronics and appliances in Brazil, which could reduce growth prospects for current players in the market.

We think strategies to capture soaring demand for online retailing are an urgent priority for physical retailers in Asia-Pacific. In our base-case, we expect online retail sales will continue to mark strong double-digit growth a year in the next one to two years, significantly outstripping total retail sales growth. In particular, our base-case forecast of mid-30% year-on-year growth in online retail in China is much higher than the global average. However, we think many offline businesses will be unable to capitalize on the shift in consumer preference to online shopping and will miss opportunities that allow pure online retailers to further penetrate the market. Accordingly, we don’t expect online retail’s strides to drive strong growth for many retailers in the region in the coming years. Furthermore, growth and further acceptance of online retail will relentlessly undermine the profitability of offline stores, because the top reason consumers shop online is to find the best prices, and this is causing price erosion of products and services.

Geopolitical shifts

Changes following recent elections have not yet triggered the extreme scenarios on trade flows, tariffs, and taxes that could influence or disrupt the global retail margins and supply chain. However, we still think an undertone of protectionist initiatives could impact retail sales, perhaps through deterioration of consumer confidence in export-driven markets like China, Japan, Mexico, and Canada.
We also continue to think many rated retailers need to improve their supply chains—and many are working on it, but more needs to be done in 2018. Supply chain effectiveness has always been a key to success in retail, but the stakes are even higher now with the consumer so focused on value and e-commerce. The benefits and economics from more timely merchandise flow and lower inventory are tangible. The discounters, supported by their supply chain and logistics skills, have benefitted from consumers’ greater sensitivity to price and/or private labels and the sector has expanded rapidly, hurting traditional apparel retailers.

Though the Brexit vote has added some uncertainty to the cocktail, the French and German elections were not surprising. Eurozone growth is becoming increasingly inclusive and increasingly supported by investment and construction, with economic recovery midcycle and Brexit mayhem looming. The new trade, quota, and tariff landscape has yet to be revealed, but we are already witnessing retailers rearranging supply chain agreements. Until the formal U.K. departure in March 2019 we expect retailers to work aggressively toward cost optimization and supply chain effectiveness, to maintain market shares and resist price increases that could hurt top lines. We believe discounters have more headroom because of lean structures and their focus on efficiencies, and therefore we expect to see blurring lines between discounters and supermarkets going forward. Grocers are increasingly pushing their private-label brands to compete with discounters on every front where possible.

In Mexico, we still expect the renegotiated NAFTA will largely preserve the cross-border trade and investment links between Mexico, the U.S., and Canada; however, their ability to achieve a new agreement is still a major question mark, increasing market volatility going forward.

Uncertainty around ongoing NAFTA negotiations is also a key risk for Canadian retailers. After three rounds, there’s little evidence to suggest NAFTA partners (U.S., Mexico, and Canada) are making progress in reaching a new deal. An unfavorable outcome for Canada could have a negative impact on the country’s trade balance, employment levels, and consumer confidence.
Cash, debt, and returns

Global Retail and Restaurants

Chart 245 – Cash flow and primary uses

Chart 246 – Return on capital employed

Chart 247 – Cash and equivalents / total assets

Chart 248 – Total debt / total assets

Chart 249 – Fixed versus variable rate exposure

Chart 250 – Long term debt term structure

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
Overview

– **Ratings Outlook:** The outlooks on our ratings of global technology companies remain mostly stable, reflecting the relatively solid overall underlying operating fundamentals, with a modest negative bias primarily due to operating weakness at certain legacy technology companies, especially in hardware, and because of higher financial leverage, mostly at sponsor-held companies, which leaves them with less room to accommodate operating headwinds.

– **Forecasts:** We expect hardware revenues to grow in the low-single digit percentages in 2018 as we anticipate improving sales in the smartphone, server and enterprise networking equipment markets. Partially offsetting this growth will be the challenging prospects in storage hardware, reflecting the ongoing migration of corporate IT workloads to the public cloud from on-premise environment, and another year of decline, albeit decelerating, in the telecom networking equipment market.

– **Assumptions:** Although we expect revenue in the semiconductor industry to grow nearly 20% in 2017, the industry remains inherently volatile. Nevertheless, we expect to see modest growth in 2018 due to growing diverse end markets, such as autos and industrials, as well as tight memory supply that is likely to persist through the first half of 2018. However, we remain cautious over the longer term because of heightened capital spending in the industry and growing investments in China which could result in oversupply.

– **Risks:** Repatriation of foreign earnings poses a potential credit risk to technology issuers if they were to become more aggressive in their shareholder returns than what we currently expect from their financial policies. We do not expect companies with large net cash positions to be negatively impacted by elevated shareholder returns. But if a borrower with a limited ratings cushion increases shareholder returns, thus raising leverage per our calculation, this may trigger a review of the company’s credit ratings.

– **Industry Trends:** Software as a service (SaaS) is driving almost all of the growth in software applications with healthy double-digit growth rates. We expect this trend to continue over the next several years because of the benefits that accrue to both customers (lower upfront costs, easier implementations, better scalability, and budgetary flexibility) and providers (recurring revenue, larger addressable markets, and faster innovation). Oracle and Intuit are two companies that bear out the case for SaaS.
Ratings trends and outlook

Global Technology

Chart 251 – Ratings distribution

Chart 252 – Ratings distribution by region

Chart 253 – Ratings Outlooks

Chart 254 – Ratings Outlooks By Region

Chart 255 – Ratings Outlook Net Bias

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Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending September 30, 2017
Industry forecasts

Global Technology

Chart 257 – Revenue Growth (Local Currency)

Chart 258 – EBITDA Margin (Adjusted)

Chart 259 – Debt / EBITDA (Median, Adjusted)

Chart 260 – 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.
Key assumptions

**Technology**

1. **Muted hardware sector growth reflects migration to the cloud**
   
   We expect overall revenue in the hardware sector to grow in the low-single-digit percentages in 2018, similar to our growth expectations for 2017. We anticipate improving sales in the smartphone, server and enterprise networking equipment markets in 2018, while the PC market remains roughly flat. Partially offsetting this growth, however, is the challenging prospects in storage hardware (HDD and external storage systems) as corporate IT workloads continue to migrate to the public cloud from on-premise environment. We also expect to see another year of declines in the telecom networking equipment market, albeit at a decelerating pace, owing to technology transition in wireless broadband.

2. **Semiconductor sales to slow in 2018 after a strong 2017**
   
   We expect semiconductor industry revenue to grow nearly 20% in 2017 to over $400 billion. This gain reflects supply shortages in memory as well as good growth in other segments such as analog and discrete offerings. The industry remains inherently volatile, but we still expect modest growth in 2018 because of diverse and growing end markets, such as auto and industrials, and tight memory supply that is likely to persist through the first half of the year. We remain cautious beyond 2018 given the current level of heightened capital spending as well as growing investments by China.

3. **SaaS will drive software industry growth**
   
   SaaS is driving almost all of the growth in software applications with healthy double-digit-percentage revenue growth. We expect this trend to continue over the next several years because of the benefits that accrue to both customers (lower costs, easier implementations, better scalability, and budgetary flexibility) and providers (recurring revenue, larger addressable markets, and faster innovation). Oracle and Intuit are two companies that bear out the case for SaaS.

**Muted growth in the hardware sector reflects migration to the cloud**

We expect the smartphone market in 2018 to grow in the low- to mid-single-digit percent area despite market saturation in developed countries. The market will likely receive a boost in late 2017 and into 2018 from Apple’s new iPhone release. We expect that all models, but especially iPhone X, will be well-received and lead to higher sales and average selling prices because of new features such as faster chip processors, more durable glass displays, wireless charging, and better cameras. Samsung’s release of its Galaxy S8 in the first half of 2017 was well received, and the company’s performance in 2018 will depend on the timing of its next smartphone refresh. We expect smartphone sales in China from Huawei, OPPO and Vivo to continue their declining trend because of longer replacement cycles and increasing smartphone penetration in developing countries, especially India and Southeast Asia.

We expect the server market in 2018 to also grow in the low- to mid-single-digit percent area, just as it has in 2017. Increasing workload processing needs, whether in public cloud, enterprise, or in Internet of Things (IoT) deployments, will propel growth. The risk here, however, is the increased utilization rate due to the consolidation of workloads with server virtualization, or the faster pace of cloud migration (servers in the cloud environment tend to have higher utilization rates). Asian original design manufacturers (ODM) have gained share at the expense of branded original equipment manufacturers (OEM) as they are the preferred vendors of hyper scale cloud providers.

The PC market looks to be essentially flat in 2018, reflecting flat to modestly higher revenues in the notebook PC segment and continuing declines in desktop and workstation sales. We expect the three largest PC vendors—HP Inc., Dell Technologies Inc., and Lenovo—to outperform the market as they gain share from ODMs.
Networking equipment sales are also likely to be flattish in 2018, with enterprise product refreshes in Ethernet switches to 40G/100G, better network security features, and wireless local area networks (WLAN) offsetting declines in traditional router sales. The threat of software-defined networking is present, but the disruptive impact to the industry will be gradual. The telecom networking equipment market continues to experience declining demand from mobile telecom operators and price pressures from Asian competitors. Mobile operators’ investments in GSM/EDGE (2G) and WCDMA/HSPA (3G) technologies are decreasing now that network coverage is essentially complete. Investments in LTE (4G wireless broadband technology) networks are also slowing now that network coverage has reached more than 55% of the global population. Although the expansion of IoT could support growth through the increasing use of smart devices over 4G networks and—eventually—5G technology (via 4.5G, an intermediate stage before 5G), we don’t expect this to translate into significant revenues for equipment vendors until at least 2020.

We expect the hard-disk-drive (HDD) storage market to decline in the high-single-digits percentages in 2018, as the benefit from an elevated NAND (a HDD substitute) pricing environment in 2017 will be less of a tailwind for HDD over the next year. The external storage systems market is also expected to decline by low-single-digit percentages in 2018, primarily as workloads migrate to the cloud, where storage utilization tends to be more efficient. Hyper scale cloud providers prefer to design their own storage systems and purchase ODM equipment.

Because of market saturation, we believe that sales in the global TV market will rise, at best, by the low-single-digit percentages in 2018. However, we expect sales of premium televisions, such as those with ultra-high definition (UHD), to grow much faster. Samsung Electronics Co. Ltd. and LG Electronics Inc. are leading brands in the premium segment. We expect them to maintain their market positions and profitability, partly with the help of lower panel costs over the next few quarters, despite lower unit sales to emerging Chinese brands. We believe that display panel makers will not be able to sustain their strong profitability into 2018 because of significant capacity additions (notably in China) in the second half of 2017 and in 2018. This is likely to create an oversupply that will depress panel prices. More organic light emitting diode displays (OLED) in the premium smartphone market could also pressure companies that are unable to catch up with this technological shift over the next one to two years. We anticipate that Samsung will benefit most from the evolution because of its leading technology and scale.

Finally, we expect that shipments of printers in 2018 will be flat. Although sales are supported by a moderate recovery in the global economy, the decline in printer use is ongoing. We have seen growing competition and market saturation in recent years, and industry profitability has eroded. Companies now generate high margins on consumables such as ink and toner cartridges versus printers. Thus, we think that the lower-tier companies will face more challenges and we expect further industry consolidation.

**Semiconductor growth slows in 2018**

2017 has been a standout year for the semiconductor industry. Gartner, Inc. currently expects the industry to grow nearly 20% in 2017, exceeding $400 billion in total revenues, with the memory segment growing over 50%. The primary reason for such strong memory growth is the current supply shortage and resulting higher average selling prices (ASP) as the industry rebounds from the recent PC-driven down cycle. Since the middle of 2016, we have seen memory producers, particularly in DRAM, report consecutive double-digit quarterly revenue gains, primarily from cloud providers. Despite supply constraints, NAND continues to take share from hard disk drives as a storage medium, particularly when performance and speed are deciding factors. However, the growth isn’t isolated to just memory. Analog, discretes, and sensors are all expected to grow above their historical averages. In all, 2017 is likely to be the strongest yearly growth since the aftermath of the Great Recession in 2010.

Looking ahead, we see the overall semiconductor industry exhibiting more modest growth in 2018. We maintain our view that the industry remains inherently volatile, but it is no longer dependent on PC-driven cycles and now include stable and growing areas such as automobile and industrial markets. Although global auto sales are expected to be relatively flat in 2018, more and more
semiconductors are used in cars for driver assistance systems, entertainment, and of course in electric vehicles. Industrial users, from manufacturers to the healthcare industry, are also incorporating greater silicon content in devices they utilize, providing a boost for many semiconductor companies. Our expectation for Apple, Inc. to generate strong iPhone sales in 2018 should also contribute to the semiconductor industry's overall growth.

We continue to see favorable end-market demand for memory over the coming year, as most consumption needs have shifted to smartphones, data centers, autos, and IoT applications, and away from PCs. We expect DRAM unit demand to rise further, while ASPs will decline modestly and stabilize as the industry moves to more advanced technology nodes. We expect that NAND supply will remain tight into the first half of 2018 with some normalization in the second half amid the industry's costly and time-consuming migration to 3D NAND.

Over the long term, we expect the industry's revenues will generally track global GDP growth, so that strong growth years such as 2017 will be offset by periods of revenue declines. In particular, we maintain a conservative posture towards memory producers as current memory supply shortage is likely to be resolved through the completion of major technology migration and ongoing aggressive capital spending to ensure capacity gains, as indicated by even stronger growth from semiconductor equipment manufacturers such as Applied Materials and Lam Research. Moreover, China is making sizable investments to build out its local semiconductor industry, which could lead to an imbalance in supply and demand, and make it even more difficult to determine the size and scope of the next downturn.

SaaS will drive software industry growth

The SaaS delivery model is driving the majority of total software application revenue growth, and we expect that trend to continue over the next several years. International Data Corp. (IDC) expects the global application software market will have grown at a compound annual growth rate 5.5% between 2013 and the end of 2017, with SaaS applications having grown 23%, and traditional models having grown less than 1%, resulting in SaaS's share of the application software market increasing to 31% in 2017 from 17% in 2013. We expect these trends to persist over the next several years driven by benefits to both software purchasers and sellers, and because many of the companies we rate are still in the early stages of rolling out SaaS products.

SaaS offers a number of benefits to software users as well as software developers. Customers often find a lower total cost of ownership as the SaaS provider can more efficiently manage technology hardware and maintenance. Customers also find lower up-front costs and less complex implementations making it easier for new customer to purchase, they get better ability to scale applications across their enterprises, and they can make software expenditures more predictable and shift software spending from capital expenditure budgets to operating expense budgets. Software providers, for their part, can gain a more recurring and predictable revenue base, bring product innovations to market faster, and expand their addressable market since lower up-front costs can open up opportunities to gain less well-capitalized customers.

Two interesting examples are Oracle and Intuit. For several quarters, Oracle’s total revenue had been falling because of declines in perpetual license sales, even as revenues from its small SaaS business were growing. In its most recent quarter ended August 2017, however, Oracle’s revenue grew almost 4% pro forma for its acquisition of NetSuite, as SaaS revenue is now large enough to offset the decline in perpetual license sales. Intuit has been selling SaaS consumer tax and small business software products for several years with very good results. Revenue from the consumer tax business has grown in the high-single-digit percentages or more over the last several years as online offerings make it easy for consumers to use the software and it has enabled them to grow the do-it-yourself tax preparation category and their share within the category. On the small business side, the company’s online offerings grew 30% in fiscal 2017 (ended in July) compared to 8% for its desktop offerings. Intuit does not promote online over desktop, so the difference clearly shows customer preference for SaaS.
Key risks and opportunities

1. **Tax reform and repatriation will test companies' financial policies**
   - The repatriation of foreign earnings—a major item in the proposed U.S. tax reform package before Congress—poses a potential credit risk to technology issuers if they were to become more aggressive in their shareholder returns than what we currently expect from their financial policies. We generally don’t expect companies with large net cash positions to be negatively impacted by elevated shareholder returns. But if a borrower with limited ratings cushion increases shareholder returns, thus raising leverage per S&P calculation, this could trigger a review of our rating on the company.

2. **LBO leverage remains high amid supportive market**
   - Supportive credit markets continue to enable high leverage in new leveraged buyouts (LBOs) transactions, with the median leverage remaining over 7x for the fourth consecutive year. Furthermore, an increasing share of weaker businesses pursuing leveraged loan financing has led to increase in ‘B-’ rated issuers.

3. **Emerging technologies offer an upside**
   - Some key emerging trends will help overall IT growth in the medium to long term, but some segments of the industry, like those dealing with GPUs and advanced memory architecture, are already leading the way. The proliferation of digital commerce and internet-ready devices, coupled with the increasing need for real-time interactions, are generating an immense amount of data in the cloud. Analyzing and optimizing that data will lead to opportunities for corporate users to automate and streamline operations using advanced computing and artificial intelligence.

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**Potential tax reform and repatriation will test companies' financial policies**

Tax reform in the U.S. has the potential to meaningfully impact corporate cash flow. The proposed lowering of corporate tax rate from 35% to the 20% range would benefit all companies, but we note that most technology companies don’t pay the maximum rate because of various deductions, so the actual cash benefit would vary. Proposals to reduce interest expense deduction would hurt all issuers, but specifically private-equity owned, highly-leveraged speculative-grade issuers. This in turn could lower purchase price multiples and potentially leverage applied to these transactions. At the very least, we believe it would create a pause in transactions as sponsors considered any new tax structure.

S&P Global Ratings views repatriation as a potential credit risk if issuers were to become more aggressive in their shareholder returns than what we assume in our forecasts and assessments of financial policy. The improved accessibility to offshore cash under the proposed tax reform could provide both economic incentives and pressure on management to revise its financial policies and capital allocation strategies. The depletion of surplus cash, if not accompanied by debt repayments, could raise adjusted leverage and pressure credit metrics as S&P nets surplus cash against debt when calculating leverage.

Specifically, we expect share repurchases will increase significantly, although this is likely to take place over multiple quarters if not years. Both one-time special dividends and dividend hikes are also likely to increase. As for debt, we believe that some companies (mostly large, cash-rich companies) would set aside cash to pay off debt or meet upcoming maturities. We believe borrowing among large technology companies will slow once cash is repatriated.

Overall, we see a decline in net cash balances and, with it, rising leverage for some and reduced cushion for others. Specifically, large cash holders could return a significant amount of repatriated
cash to shareholders, although we wouldn’t expect this to lead to meaningful rating actions because these borrowers would mostly be reducing their cushion with respect to the ratings. On the other hand, borrowers who are cash neutral or in net debt positions despite having large cash balances will have to manage a delicate balance between equity holders and debtholders. If a borrower with limited ratings cushion opts to use repatriated cash for repurchases, thus raising leverage per our calculation, we may review the rating for a potential downgrade.

**Technology LBO leverage remains high amid supportive market**

Investor appetite for leveraged buyout loans has remained strong in 2017, and the technology sector continues to see strong interest from financial sponsors. Taken together, these two trends have contributed to significant leverage LBO targets in the technology sector, where leverage has remained over 7x for the past four consecutive years. We continue to see financial sponsors aggressively adjust EBITDA calculations to give advance credit for restructuring activities, expected margin expansion, and changes in deferred revenue, although we typically only see this adjustment made for rapidly growing software companies. Some recent transactions in which we have seen particularly aggressive accounting adjustments include Viewpoint, Ivanti Software (formerly LANdesk), and Procera LPI (Sandvine).

Furthermore, although median leverage levels have remained broadly consistent over the past three years, we have seen a broad decline in credit quality for new deals, largely due to increased LBO activity among weaker businesses. Since Jan. 1, 2017, nearly 50% of new LBO transactions have been rated ‘B-’ at launch, compared to approximately 40% in 2016 and only 15% in 2015. Although credit conditions appear to remain broadly sanguine in this sector of the market, we note that McAfee reducing its recent loan package could indicate reduced investor appetite for technology LBOs. Given extremely high leverage and weakening credit quality, we believe that many firms could face challenges refinancing or finding incremental funding for M&A and other strategic investments.

**Emerging technologies offer long-term upside**

**Artificial intelligence (AI)**, a field consisting of subjects including machine learning and complex robotics, is garnering increasing attention. AI requires tremendous computing power to operate autonomously. We believe that over the next few years many industries are likely to incorporate AI to automate work and simplify operations. A major catalyst accelerating AI is the repurposing of GPUs to train large networks of computer models, so that machines can perceive and perform tasks the way humans do. Nvidia has clearly benefited from this. We recently upgraded the company two notches to BBB+ and maintain a positive outlook on the rating.

**Blockchain** is a single public ledger that uses heavy computing power to record any transaction on a decentralized basis. This platform can enable any exchange of goods or services digitally, coded by computers, in real time, without any intermediaries. The unique and encrypted computer network also ensures security and reduces human errors and fraud. While we see Blockchain as most disruptive to the financial industry, it will probably also create opportunities for technology enablers with scale.

**Augmented reality and virtual reality** have been identified by industry analysts as the next computing platform, succeeding smartphones. These technologies help bridge both real and virtual worlds so that physical and digital objects can co-exist and interact in real time. They create opportunities for major smartphone producers, such as Apple and Samsung, to market new hardware products as a way to protect their leadership positions. They also create a platform for others, like Facebook, Microsoft and Google, to gain entry into the next stage of computing with applications for advertising and ecommerce.

Lastly, we think that **autonomous vehicles** are slowly but surely to make their way into consumer homes. IHS Markit reported in 2016 that the ramp up will be slow initially and reach about 16% of new vehicle sales worldwide by 2035, with most sales in developed markets. Nvidia is a key competitor in this space as GPUs have been deployed as the “brains” of autonomous vehicles that can process information at billions of inputs per second. Intel is also participating in this emerging...
technology with the acquisition of Mobileye this year, a company that essentially develops a nerve center for driverless cars.

All of these trends are interrelated in the future of our digital economy. They lead to tremendous growth in data creation and necessitate the speed of delivering data. Over the next few years, this dynamic will continue to prompt the industry to reassess data center architectures, optimize storage needs, and enhance software and service offerings to generate growth.

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Cash, debt and returns

Global Technology

Chart 261 – Cash flow and primary uses

Chart 262 – Return on capital employed

Chart 263 – Cash and equivalents / total assets

Chart 264 – Total debt / total assets

Chart 265 – Fixed versus variable rate exposure

Chart 266 – Long term debt term structure

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
Overview

- **Ratings Outlook:** Ratings in the sector should remain largely stable through 2018, even as we have a larger negative bias on rating outlooks than in 2016. We attribute this change to weaker balance sheets, as well as structural and competitive factors in maturing markets, especially the U.S. Excluding the U.S., however, our outlook bias is trending favorably with a positive outlook bias in Western Europe, and improving trends in Asia-Pacific (APAC) and, to some extent, Latin America (LatAm). Negative ratings and outlooks in LatAm may not fully reflect industry credit quality as some ratings are affected by sovereign trends.

- **Forecasts:** We project flat-to-low single digit percentage revenue growth in more developed markets such as Canada, Western Europe, Japan and Australia, and modest erosion in the U.S., reflecting market maturity, intense competition, and secular pressure in several wireline services. We believe cable companies in the U.S. and integrated telecom companies in Western Europe will post stronger growth than their peers. Developing markets in APAC and LatAm should see higher (if slowing) growth versus other regions. We expect stable-to-improving profitability and free cash flow in most markets from cost control and operating leverage. Credit metrics are expected to improve given solid cash generation and operators’ desire to bolster balance sheets.

- **Assumptions:** We assume existing market and pro-competition regulatory structures will keep competitive risks high, leading to only modest price gains at best. Developed markets will see ongoing pressure in voice, legacy data, and video, while broadband (wireline and wireless) will prove to be an increasingly pivotal offering. Against the backdrop of improving market conditions, emerging markets should see improved unit and revenue growth. We anticipate companies will focus on customer retention, bundling, and cost control to improve margins. Capital intensity should remain relatively stable for most markets and, with lower debt costs, should help boost free cash flow.

- **Risks:** Risks in the telecom and cable sector include intense competition, structural cord-cutting trends in fixed-line voice and video, and the capital-intensive nature of the industry to support the ongoing demand for data. Pro-consumer regulatory mandates in certain jurisdictions such as Mexico, Australia and India pose short-term risks for incumbents. These risks may drive additional price compression, higher attrition, lower EBITDA, higher capex, and weaker credit metrics. Any policy shift toward more aggressive shareholder returns or substantially debt-funded mergers and acquisitions (M&A) could hurt the financial risk profiles and ratings of many issuers.

- **M&A:** We expect more M&A in the U.S. than other regions given the need for scale to protect profitability and hedge against heightened competition, revenue diversity and technology shifts. Future combinations will likely be driven by the convergence of distribution systems and vertical integration. In APAC, operators will be looking for growth in new geographies and products. We expect M&A in Europe to be more subdued given the lacklustre regulatory appetite there for additional industry consolidation that could harm competition. In LatAm, we believe that regulation and balance sheets are likely to inhibit M&A.
Ratings trends and outlook

Global Telecommunications

The rating distribution is weighted in the speculative-grade category, due to the high leverage to support the capital-intensive nature of the sector as well as aggressive financial policies.

The highest incidence of investment grade ratings is at the "BBB+" level with the majority coming from Western Europe and supported by entrenched market positions and relatively modest leverage.

Stable outlooks have decreased to 75% from 77% a year ago while negative outlooks have increased to 15% from 11%.

Predominantly stable outlooks across all regions led by Western Europe and North America.

Out global telecom and cable outlook has had a predominantly negative bias since 2013, and has weakened in 2017.

Net outlook bias has weakened in the U.S., improving elsewhere.

Source S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending September 30, 2017.
North America

In North America we expect broadly stable ratings, although with an increasingly negative net outlook bias, primarily because of aggressive competition in wireless and secular industry declines in the wireline segment amidst more leveraged balance sheets. An acceleration of M&A in the U.S. because of a more supportive regulatory environment could also pressure ratings, depending on financing plans. In Canada, industry concentration, operational discipline, and balanced shareholder policies should alleviate balance sheet concerns and support ratings stability.

Europe

Our outlook for European telecom ratings is stable, supported by a continued soft recovery for integrated telecom providers. It is also the only region with a positive outlook bias, driven mainly by improving financial profiles. Western Europe has the highest portion of stable outlooks at over 80%, and Europe’s is about two-thirds overall. However, there is fragility in the picture as growth prospects remain low in Europe’s fragmented, mature, and highly penetrated markets. And while balance sheets have improved over the last year, financial profiles remain at the weak end for the ratings of many issuers. Our forecast incorporates the benefit of improving trends to provide more financial headroom and help ease leverage pressure. We have a stable outlook for cable ratings as well, where continued topline and EBITDA growth in the mid-single-digit percentage range remain offset by aggressive shareholder returns and M&A appetite.

Latin America

The rating bias on LatAm issuers is mostly unchanged from the prior year. The region maintains the highest negative bias at about 35%, though stable outlooks continue to predominate at about 65%. Negative outlooks mostly reflect somewhat high debt leverage, a highly competitive environment, a slow economic recovery that limits the near-term growth prospects of these issuers, and the negative outlook on Brazil’s sovereign rating.

Asia Pacific

In APAC, overall ratings trends remain stable. We expect steady regional GDP growth and increasing mobile data consumption to support telecom operators’ credit quality despite ongoing capital investment needs. A modest negative outlook bias is mainly due to intensifying competition in some Southeast Asian countries and Australia.
Industry forecasts

Telecommunications – Fixed and Wireless

Chart 273 – Revenue Growth (Local Currency)

Chart 274 – Revenue Growth (Local Currency)

Chart 275 – EBITDA Margin (Adjusted)

Chart 276 – EBITDA Margin (Adjusted)

Chart 277 – Debt / EBITDA (Median, Adjusted)

Chart 278 – Debt / EBITDA (Median, Adjusted)

Chart 279 – FFO / debt (Median, Adjusted)

Chart 280 – 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.
Key assumptions

Telecommunications

1. **Broadband pivotal to industry growth**
   
   We assume technological shifts will continue to pressure voice, video, and legacy data revenue. However, we expect demand for high-margin broadband (wireless & wireline) to remain strong. Service bundling initiatives should support modest overall revenue growth in most markets except for the U.S. Improving economic conditions and penetration of high-growth offerings in developing markets should allow for mid-single digit percentage revenue growth.

2. **Competition and regulation limit profitability improvement**
   
   We expect competition to remain intense given market maturity and the increased commoditization of services. Regulatory mandates favoring more competition will limit industry consolidation, and market share imbalances will prevent significant improvements in near-term industry profitability. Issuers, nonetheless, have substantial opportunities to cut costs and improve subscriber economics through stickier bundles and differentiated offerings.

3. **Stable capital intensity should drive free cash flow growth**
   
   Capital spending levels will remain high across the industry. Spending will be aimed at broadband infrastructure, with telecom companies expected to invest in fiber builds and wireless capacity. Telecom providers in emerging markets will accelerate their 4G investments while the U.S. players embark on 5G wireless investment. We expect wireless spectrum spending to be somewhat subdued relative to recent years given the timing of auctions and the evolution of 5G technology. However, we expect capital intensity (the ratio of capital spending to revenue) to remain relatively stable. Combined with lower borrowing costs, that should help boost free cash flow.

North America

In the U.S. **wireline** segment we expect mid-single-digit percent revenue declines, as consumers continue to switch to wireless and move to cable rather than digital subscriber line (DSL) broadband subscriptions. Cable can provide a superior customer experience as it can be faster, owing to the cable service internet specification (DOCSIS) 3.1 technology. In the business segment, we also expect wireline companies will continue to face aggressive competition from the cable operators, which are building their market share. While we expect modestly lower levels of capital spending to preserve cash flow, we also believe that wireline providers will need to invest more in their networks to effectively compete with cable in the long-run. Furthermore, in our opinion, cost-cutting alone is unlikely to be sufficient to offset the revenue erosion that is leading to smaller margins for the wireline companies.

In **wireless**, we expect low-single digit percent revenue declines in 2018 based on very limited subscriber growth and lower average revenue per unit (ARPU). This reflects heightened price competition, as all the carriers are now offering unlimited plans. Despite more aggressive promotional activity and the launch of unlimited plans from AT&T and Verizon, we still expect Sprint and T-Mobile will continue to take share in the post-paid segment (although subscriber gains should moderate). Our assumptions about the industry’s long-term growth and competitive intensity could change, however, if a merger reduced the number of major U.S. wireless providers to three from four.

The **cable** industry’s strength reflects its strong broadband subscriber base and growth in the business telecom segment. There are also modest video customer losses. All things considered, we expect low- to mid-single-digit percent revenue growth for cable providers in 2018. Margins should be relatively stable as rising programming costs are offset by growth in higher-margin broadband offerings. We also see stable capital spending in the cable business because upgrading to DOCIS...
3.1 is relatively low-cost and can be offset by lower capital spending on customer premises equipment (CPE).

As a result, we expect that credit metrics will remain largely stable in 2018, barring any significant debt-funded acquisitions. In the long term, 5G wireless service could take share away from cable broadband. But given the lengthy time needed to deploy 5G and uncertainty about its profitability, we don’t yet see it as a near-term threat.

Europe

In Europe, we expect competition will remain intense, reflecting market fragmentation and mature conditions in its highly penetrated markets. Because growth prospects are weak, we expect to see continued cost cutting as a major path to higher profitability. Our forecasts also assume that mobile prices will stabilize: Market consolidation and more converged service offerings have helped moderate competition in many markets. The monetization of mobile data is also helping offset the commoditization of voice and short message service (SMS). At the same time, ARPU trends have improved modestly as a result of tactical price increases in fixed broadband, and increased penetration of multi-play products, supported by improved internet protocol television (IPTV) and high-speed broadband offerings. Despite largely complete 4G wireless rollouts, we assume that capital spending will average 19% of revenue over the next two years as telecom companies compete with cable and upgrade capacity. Meanwhile, cable growth will rely on adding broadband customers and cross-selling bundled products. But cable growth will moderate as the performance advantage over telecom companies narrows and penetration plateaus within their existing geographic markets. We expect capital spending at cable operators to average 22% of revenues over the next two years.

Latin America

We expect mid-single-digit percent revenue growth in 2018, as macroeconomic conditions gradually improve, especially in Brazil and Argentina. We expect industry dynamics to continue to be driven by the migration of fixed-to-mobile and voice-to-data. Pre-paid migration to hybrid and post-paid plans is a favorable trend that will hold through 2018 and should support EBITDA margins in the 35% area. In addition, we expect an increase in 4G wireless coverage across most operators, which should drive higher data usage and revenue. In Mexico, we believe that EBITDA margins will remain constrained by fierce competition, high subscriber acquisition costs in the wireless segment (on account of post-paid subscriber growth), and increased content charges in the pay-TV segment, which are exacerbated by the peso’s weak exchange rate with the U.S. dollar.

APAC

In APAC, demand for mobile data is likely to remain strong and an avenue of growth, even as wireline voice revenue continues falling. That supports modest overall growth for most telecom operators. We expect intense competition in developing markets such as India and Thailand because smaller players are adopting aggressive pricing strategies to increase market share. We also expect overall capital expenditures to remain elevated because of the ongoing investment needs for 4G and fiber-based broadband. Key credit measures, such as debt to EBITDA, are likely to remain stable for most operators. The exception is likely to be at some companies in South-East Asia where competition is fierce and capital spending needs are high.
## Key risks and opportunities

### Telecommunications

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<th>Competition</th>
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<td>1</td>
<td>The key risk for both telecom and cable providers remains aggressive competition, which could increase churn, add pricing pressure, and affect cash flow—particularly in more mature markets. We believe that competitive risks could rise as distribution systems converge and carriers fight to protect customer relationships. Given that the industry requires large investments, it's critical for many companies to grow larger and minimize customer attrition. Major new investments can create opportunities that allow companies to differentiate their offerings from their rivals, particularly in the early stages of a new technology.</td>
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<th>Technology shifts and changes in consumer preferences</th>
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<td>2</td>
<td>Thanks to technological advances and changing consumer preferences, companies are seeing higher demand for data and video. But intense industry competition and the commoditization of these services can limit the chance to benefit from these trends. In the wireline industry, traditional landline phone service is being hurt by wireless. In cable, consumers have increasingly cut (or reduced) conventional television in favor of over the top (OTT) video. Cable providers have a natural hedge with their broadband product, but it’s critical for them to keep churn low, sometimes accomplished by bundling products to provide additional value. Companies can mitigate the threat of disruptive technologies, such as OTT, and preserve credit quality with prudent investments that maximize competitive position (such as fiber and next generation wireless), sustainable product differentiation, and products and services that earn a strong return.</td>
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<th>M&amp;A and financial policies</th>
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<td>3</td>
<td>Slowing growth, rising competition, and low borrowing costs are driving companies to aggressively pursue M&amp;A. Companies seek to increase scale, lower costs, limit competition, or diversify their business model to achieve the vertically integrated models we see in the U.S. The risk is that some large debt-funded transactions won’t deliver sufficient long-term returns. In addition, pressure to return capital in a low-growth, low-interest rate environment has led to increased dividend payouts and share repurchases, which can pressure balance sheets. While our ratings assume that issuers will adhere to more balanced financial policies, increasing shareholder return will continue to be a risk for their credit profiles.</td>
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We see **competition as the primary risk** across all regions and industry sub-sectors. Although demand for data is strong, competition among traditional rivals (and non-traditional players) are weighing on prices and forcing operators to provide discounted or lower-priced, stripped-down bundles. Secular shifts, including wireline and (more recently) video cord-cutting, remain a challenge for fixed-line telecom operators and non-converged cable companies, in particular. Data monetization has been positive for the mobile sector worldwide, but as with voice and SMS, maturing products can quickly become commodities with few differentiating features to support pricing. Data appears headed down a similar path, with operators in many markets adding ever more gigabytes (Gb) into existing plans at minimal or no extra cost, thereby eroding the upside potential of customers migrating to larger buckets as their consumption rises. In the U.S., most providers now offer unlimited data packages, and are also offering value-added content to differentiate themselves. Similarly, in France, Free raised its 20 euro 4G data bucket to 50Gb from 20Gb last year for all existing customers, and this year they have made it unlimited for all their bundled customers, pressuring data pricing for the entire market. We are skeptical that consumer data demand can keep growing by 50% (or more) per year. If data does become a commodity like voice and SMS, we believe the risk of a prolonged period of price compression increases. And while bundling allows some operators to sell more products, we typically see price erosion per product (given bundle discounts), requiring continued growth of multi-play penetration to avoid losing market share. This could be difficult to sustain given the substitution effects we see in the U.S.
Although we see less new spectrum available over the next 12-18 months than in the recent past, higher-than-expected or ill-timed wireless spectrum spending is an ongoing risk for the sector. Competitive pressures or governments looking to boost revenues would be the main reasons for higher spending on spectrum. In APAC, for example, while we see a low-to-moderate likelihood of significantly higher spectrum costs, the impact would be felt most acutely among the smaller, second-tier players.

In Latin America we continue to expect a highly competitive environment where the largest players will continue to focus on investments that strengthen service quality and market position. Capital investments should remain between 15% and 20% of revenue, mostly for network upgrades and expansions, both in fixed and mobile networks. More specifically, we expect sizeable investments for 4G and the deployment of fiber optic networks. Some smaller players may take a similar route. In some cases we could also expect some aggressive pricing campaigns.

Another important risk for Latin America in 2018 relates to the effect of general elections in Colombia (May 2018), Mexico (July 2018), and Brazil (October 2018). The outcome of these elections could introduce a measure of market volatility that might delay certain investment decisions. In addition, uncertainty surrounding U.S. trade and immigration policies still weigh on consumer confidence, particularly in Mexico.

U.S. telecom providers already have aggressive shareholder-friendly financial policies, which include large dividend payout ratios, although the pace of share repurchases has declined as issuers have focused on allocating capital to acquiring spectrum licenses and/or M&A. Balance sheets are stretched at these issuers, who are funding acquisitions with large equity components in order to preserve credit metrics. However, using equity to fund these deals can constrain discretionary cash flow as dividends increase. In the wireline segment, secular industry declines and integration missteps from recent acquisitions have forced some of these companies to reduce dividends. In cable, financial policies are generally less aggressive, and these companies often use free operating cash flow for share repurchases and acquisitions rather than dividends. Stock buybacks offer more financial flexibility than dividends to pursue M&A and network investment. The unknown is whether tax reform will happen in the U.S. While we believe that tax reform would likely improve free operating cash flow for the telecom and cable operators, we expect that incremental cash flow would likely be allocated to shareholders and capital expenditures, rather than debt reduction.

Financial policy has generally supported our current ratings in Europe, with management teams scaling back dividends in the first half of the decade to compensate for weak operating performance and the high investment needs associated with 4G implementation. As noted earlier, we expect elevated capital spending despite 4G rollouts largely being complete. We also forecast steadily rising dividends as telecom companies return to breakeven and slightly positive growth. As a result, we see modest cash flow risk that stems from investor pressure to increase shareholder returns after several years of weak equity performance. This could become a rating concern because balance sheets for several telecom issuers are still at the weak end of the existing rating limit and because higher capital spending is constraining free operating cash flow. In our current forecast we expect an average mid-single-digit percent growth in dividends for the top 13 European rated telecom companies over the next two to three years. We view this as sustainable in light of growing discretionary cash flow, which should provide scope for de-leveraging. However, a rise in shareholder returns that outpaces a rise in cash flow could pressure ratings.
Industry developments

Lower appetite for M&A outside of the U.S.

In the U.S., we expect M&A activity to accelerate in 2018 due to a more benign regulatory environment. However, unlike previous waves of telco and cable M&A, potential combinations could include issuers from different sub-sectors, such as telco and media companies as well as wireless and cable. Speculation around these types of combinations are driven by the potential longer-term convergence of distributions systems, vertical integration, revenue diversity, technology shifts, and changes in consumer preferences. For example, in late 2016, AT&T announced that it would acquire diversified media company Time Warner Inc. for US$85 billion. We expect this transaction to close before the end of 2017.

Other factors are also contributing to the flurry of M&A activity. In the fixed-line industry, consolidation has largely been the result of declining revenue and the need maintain profit margins from increased economies of scale. In wireless, aggressive competition and mature industry conditions have led to pricing pressure and weak service revenue growth. Moreover, the scale intensity of the industry and ongoing capital spending and spectrum requirements imply that consolidation could give rise to healthier industry conditions. In cable, programming expense pressure and rising competition from OTT providers are prompting acquisitions among some of the mid-sized cable operators.

In Europe, we see reduced prospects for M&A, with the exception of in-market convergent consolidations, which we think regulators would view as creating stronger competition incumbents, and thus welcome. However, we think sharp differences in valuations, financial policy and capital structure could complicate deals, as has been the case in the long-mooted transaction between Vodafone and Liberty Global. Notably though, after several years of consolidation, regulators have taken a harder line on in-market mobile M&A, with the European Commission blocking 2016 transactions in Denmark and the UK, and requiring steep concessions in Italy that will result in a new fourth player Iliad. Given this track record and focus on consumer protection, we do not anticipate further in-market consolidation for the next two years. We also see little chance of cross-border consolidation as the typical M&A benefits (spectrum, infrastructure, and cost synergies) are largely absent with non-overlapping markets.

France remains a particular market of consolidation interest given that consolidation attempts have been made twice in the last three years. But Bouygues Telecom’s results have sharply rebounded and with its commercial success in 4G over the last year, the four operator market structure seems more viable today than one or two years ago, raising doubts as to whether the competition authority would be receptive to another attempt. And as Iliad builds out its own 4G network, the value of acquiring Bouygues’ infrastructure diminishes.

Regulation – quest for industry balance creates uncertainty

As noted, the U.S. regulatory environment appears more benign under the new administration than it was a year ago. Since the beginning of the year, the Republican-led Federal Communications Commission (FCC) has undone or removed from consideration many Democratic-led initiatives that were passed under the previous administration, including set-top box reform, “special access” reform and certain consumer privacy rules. Perhaps most importantly, it has launched a notice of proposed rulemaking (NPRM) to address the following:

- End Title II regulation of the internet by reclassifying ISP’s and “information service” under the lighter touch Title I classification.
- Eliminate the “general conduct standard” for reviewing possible violations of open internet principles not covered under the rules.
- Determine whether to keep, modify, or eliminate the so-called bright-line open internet rules against blocking, throttling and paid prioritization of internet access.
- Reinstate mobile broadband as a private mobile service.
We expect a resolution to come in the December timeframe that will most likely be a 3-2 partisan vote to reverse Title II classification of broadband providers. This would eliminate the general conduct standard that potentially allows the FCC to expand its regulatory reach, therefore reducing the risk of price regulation of broadband providers by the FCC. We believe the concepts of no blocking and no throttling of internet traffic are less controversial and could be retained while the fate of paid prioritization is less certain. Separately, if ISP's return to Title I jurisdiction, then the Federal Trade Commission (FTC) would reclaim privacy-rule oversight under a more lenient approach that does not require consumers to opt-in to sharing of data (as the previous FCC administration had required for ISP’s). We believe this could open the door for more targeted advertising and data monetization opportunities for ISP’s.

However, unless a more permanent Congressional solution to Title II regulation can be reached – which we view as unlikely given partisan divide and a range of other high profile initiatives to tackle - we believe the Title II debate will continue. Therefore, over the longer-term, the threat of more intense regulation could return under a new administration.

In Europe, regulation remains a key risk. In our recent global telecom & cable webcast poll, 48% of participants cited regulation as the primary risk to Europe’s telecom sector, more than double the next cited risk (high investment needs). In addition to the chilling impact on M&A, which we describe in the section above, we view network and rate regulation as the key risks. Between the two, we believe network regulation poses an increasing risk to operators, while rate regulation is now on the decline as mobile termination rates (MTRs) are already at very low levels, leaving operators less exposed to further MTR reductions, and Europe’s roaming phase out completed earlier this year.

Network regulation encompasses wholesale access to networks such as MVNOs in mobile, and local loop unbundling in fixed. While such access regulation has been in place for years with regard to mobile and incumbent copper networks, national regulatory authorities have increased pressure on operators by opening discussions on cable access and fiber access. Regulators have also more formally pushed to separate some incumbents from their networks to make them truly independent wholesale providers.

In the UK this has so far resulted in a legal separation of Openreach from BT and we believe structural separation could be reconsidered if the regulator (Ofcom) is not satisfied with the ability of current measures to yield greater independence, service levels, and investment within the next two to three years. In Italy, the government has also taken a more vocal stance in advocating for the separation of Telcom Italia’s assets as a means to more efficiently and independently ensure network investment, and also to potentially address concerns around foreign ownership of a strategic national asset.

If such regulatory pressure leads to the stripping of telecom assets, we would generally view it as negative to business profiles, with incumbents losing one of their key competitive advantages, their comprehensive networks and resulting wholesale operations. The ratings impact would be determined on a case by case basis with the use of any sale proceeds and/or transfer of debt to the network entity potentially strengthening financial profiles, providing an offset to weakened business profiles.

LatAm has seen a series of regulatory changes over the last few years to modernize the sector, which have transformed industry dynamics and the competitive landscape. The common theme of regulators across the region has been to foster competition in the market and protect the end consumer. For 2018 we are not expecting major regulatory changes, although certain initiatives are under way. Brazil, for instance, may change its fixed-line segment from a concessions model into an authorizations scheme. This initiative is still under review, and the timing for approval is uncertain. In Mexico, legal controversy on the zero-interconnection-rate regime was resolved and the regulator is currently defining the interconnection rate that will apply, beginning in January 2018.

In APAC, competition in part has been stoked by regulatory changes aimed at improving consumer access in terms of connectivity and cost. Such initiatives have ranged from paving the way for new
entrants in Singapore and Australia to mandating price reductions for interconnection, mobile roaming, and termination rates fees in Indonesia as well as the Philippines. Also, in Australia, the establishment of the government-driven National Broadband Network (NBN) will structurally separate the incumbent Telstra’s fixed-line services, resulting in intensifying competition in the country’s fixed broadband market.

5G wireless – no panacea for slow growth

The U.S. wireless carriers have been at the forefront of 5G wireless, in contrast to other global carriers who expect 5G will evolve at a more moderate pace. In our view, large U.S. carriers have the incentive to be aggressive in their deployments in order to differentiate their wireless networks given the mature industry conditions and intense price-based competition for 4G wireless services, which are increasingly being commoditized.

We expect the first iteration of 5G will be a fixed wireless broadband service. AT&T and Verizon are already conducting trials of a fixed wireless product, which might offer customers very fast data speeds that are comparable with existing cable broadband products and also expand their reach beyond their existing wireline footprints; this could represent a longer-term threat to the cable broadband moat. Moreover, the cost to deploy and maintain a fixed wireless network can be less expensive than deploying fiber directly to the home because last mile access usually represents the largest portion of the deployment cost.

Nevertheless, we believe there are several risks associated with an accelerated 5G deployment strategy, and the near-term financial benefits are unproven. Furthermore, despite faster speeds, greater availability, and lower latency, using high-frequency wireless bands that have weaker propagation makes 5G fixed wireless services better suited to dense, urban markets. Moreover, it is highly uncertain whether a wireless-based broadband service can be as reliable and as economical as a wired connection on a per bit basis, especially as consumer demand for data and video grows. We are wary that risks associated with 5G mobile networks are even greater. Unlike previous wireless technologies, we expect that 5G will not be widely available for some time. Instead, we expect deployments will focus on denser, urban areas, which will initially limit the addressable market and could prove challenging to market efficiently. At the same time, the build-outs associated with dense fiber for wireless backhaul, small cells, and the acquisition of wireless spectrum licenses, could burden the balance sheet while the 5G use cases and revenue take some time to develop. Finally, the ability to monetize these investments in 5G are likely several years away, especially since a mobile 5G standard hasn’t yet been finalized.

European telecom companies appear to be taking a more cautious view of 5G. We think that’s likely to continue until a compelling economic use case emerges to support investment. We’ve yet to see an example of a killer application nearing maturity that would specifically require the speed and low latency of 5G to help drive adoption. But in the meantime, European carriers and markets that are ahead of the curve in terms of fiber deployment will have an advantage because of the very dense fiber networks that 5G will eventually require. We think operators in Spain, Portugal, the Baltics and Nordics, and increasingly also Italy and France, are positioning themselves well for 5G if and when it does get rolled out more broadly.

We expect Japanese and Korean carriers will adhere to their planned timelines to roll out 5G in 2019 or 2020, even though 5G’s technological standards have not been confirmed at this stage. Their stable performance and healthy balance sheets means that they have the financial capacity to make initial 5G investments. SK Telecom and KT Corp, both of Korea, plan to provide a test 5G service during the Winter Olympics in February next year.

As noted, the investment in 5G could be substantial for carriers. This will likely come from three broad areas; deep fiber investments, cell site and core network elements (including related software, data center and IT support), and additional mid to high-band wireless spectrum, which facilitates very high speeds and supports much higher capacity. Compared to prior generations of wireless technology, we believe deeper fiber investments would entail an investment with a much longer-tail return. Capital spending for the other two areas will likely prove to be similar to that of 4G through its technological cycle. Integrated telecom operators who need to make these
investments to remain competitive with cable rivals therefore are strategically better positioned to pursue these investments in the medium term, as they have the ability to leverage the fiber investments across their fixed-line and wireless business.

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Related research

- Q&A: The Global Telecom And Cable Industry Faces Intensifying Competition In 2018, Nov. 10, 2017
- Despite Continued Growth, U.S. Data Centers May Face Long-Term Risks From Financial Pressures And Uncertain Tech Developments, Oct. 30, 2017
- Why Internet Companies Could Challenge U.S. TV And Cable Networks For Future Sports programming Contracts, Oct. 12, 2017
- The Smartphone Dilemma For Southeast Asian Telcos: Invest More For Lower Returns Or Face Irrelevance, Aug. 14, 2017
Cash, debt and returns

Global Telecommunications

Chart 281 – Cash flow and primary uses

Chart 282 – Return on capital employed

Chart 283 – Cash and equivalents / total assets

Chart 284 – Total debt / total assets

Chart 285 – Fixed versus variable rate exposure

Chart 286 – Long term debt term structure

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
Industry Top Trends 2018

Transportation

Overview

- **Ratings Outlook:** The sector’s rating outlooks are more than three-quarters stable, with twice as many negative outlooks than positive amongst the remainder. The most challenging industry fundamentals are in shipping, where vessel oversupply continues to cause weak charter rates in some sub-sectors.

- **Forecasts:** We expect continued moderate revenue growth, fairly-stable margins, and stable-to-modestly-positive credit ratios for global transportation companies over the next two years, with some variation by sub-sector.

- **Assumptions:** Our baseline forecast foresees gradually accelerating global economic growth, with real GDP rising 3.6% in 2017, 3.7% in 2018, and 3.9% in 2019. We do not expect regional growth rates to vary much from recent levels, with the exception of Latin America, which is recovering from very weak conditions in 2015 and 2016. However, currently uncertain political and policy decisions, notably involving Brexit, NAFTA, and proposed tax cuts in the U.S., could influence future trade flows, foreign exchange rates, and economic performance. S&P Global Ratings expects crude oil prices to remain close to current levels with Brent and WTI prices around $50 in 2017 and 2018, increasing to $55 in 2019. This provides fairly favorable conditions for most transportation companies.

- **Risks:** Unfavorable economic and oil price trends, while not expected, could pressure earnings and credit quality. FX movements can affect global trade volumes and thus freight transportation, and currency weakness versus the U.S. dollar makes it costlier for non-U.S. transportation companies to pay for oil, acquire dollar-denominated equipment such as aircraft, and service dollar-denominated leases or secured debt to finance equipment. If current trade negotiations (Brexit, NAFTA) lead to materially higher tariffs and reduced trade, freight transportation companies would suffer—mostly shipping and trucking in Europe and railroads and trucking in N.America. Package express companies such as FedEx and UPS are closely involved in complex global supply chains. Our preliminary view of proposed U.S. corporate tax changes is that they would have minimal to modestly positive effects on the credit quality of U.S. based companies.

- **Industry Trends:** Consolidation continues in some equipment leasing sub-sectors (aircraft and marine cargo), and in the container liner, trucking and logistics industries, trends we expect to persist, given economies of scale. Airline consolidation is largely complete in N.America, but struggling airlines in Europe, Asia, and Latin America may be acquired by competitors or simply disappear, leaving survivors with increased market share. Trucking is a fragmented industry under pressure from rising labor and regulatory costs in North America, prompting consolidation. Tighter environmental regulations are particularly affecting shipping and airlines. One potentially favorable byproduct of increased regulation in those and other sectors such as trucking is the likely retirement of some older equipment, which could help the balance of supply and demand.
Ratings trends and outlook

Global Transportation

Chart 287 – Ratings distribution

Chart 288 – Ratings distribution by sub sector

Chart 289 – Ratings outlooks by region

Chart 290 – Ratings outlooks by sub sector

Chart 291 – Ratings outlook net bias by region

Chart 292 – Ratings net outlook bias by sub sector

Chart 293 – Ratings outlooks

Chart 294 – Ratings outlook net bias

Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending September 30, 2017
Industry forecasts

Global Transportation

Chart 295 – Revenue growth (local currency)

Chart 296 – EBITDA margin (adjusted)

Chart 297 – Debt / EBITDA (median, adjusted)

Chart 298 – 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.

We expect continued moderate revenue growth, fairly stable margins, and stable-to-modestly-positive credit ratios for global transportation companies over the next two years, with some variation by sub-sector. The most volatile sector continues to be shipping, where rated companies are recovering from very weak rates in 2016 due to vessel overcapacity and China’s slowing growth rate. Airline credit ratios are slightly weaker (but still strong by historic standards), influenced by rising labor costs and share buybacks in North America and a competitive landscape in Europe, which we expect to moderate as consolidation will likely follow recent major bankruptcies. By contrast, freight railroads, again driven mostly by results in North America, are recovering from soft industrial production and coal shipments of the past several years, and average credit quality continues to be solid.
### Key assumptions

#### Airlines

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<td>1</td>
<td><strong>Global air traffic growth continues at a healthy pace</strong>&lt;br&gt;Global air traffic (revenue passenger kilometers) is currently expanding at around 7% annually, above the long-term trend of around 5%, fueled by generally satisfactory economic conditions, stable fuel prices, and the spread of low-cost (and low-fare) airlines. We expect growth to cool somewhat, as planes are already quite full (load factor in excess of 80%, according to the International Air Transport Association, IATA) and fares are creeping upwards in some regions, but to remain healthy. The leading international airlines based in the Persian Gulf have slowed their aggressive growth after disappointing earnings, and several bankruptcies in Europe (Alitalia and Air Berlin) could trim some capacity there.</td>
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<td>2</td>
<td><strong>Oil prices remain fairly stable at around $50/barrel</strong>&lt;br&gt;Global oil prices have exhibited reduced volatility, mostly remaining within a range of $40 to $60 over the past several years. Aircraft fuel prices can vary also with the balance of supply and demand from refineries on a regional basis. When a hurricane disrupted production at many U.S. refineries along the Gulf of Mexico in August 2017, the spread between jet fuel and crude oil widened and fuel prices jumped. However, we expect such events to have only a temporary effect. For airlines whose currencies fluctuate significantly against the dollar, oil and fuel prices may exhibit additional volatility.</td>
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<td>3</td>
<td><strong>Low cost airlines continue to spread</strong>&lt;br&gt;Low cost airlines have captured significant market shares and influenced pricing, particularly in North America and Europe. The low-cost airlines have also differentiated somewhat based on levels of service provided (e.g. “bare-bones” service on Ryanair, contrasted with more generous offering on easyJet) and operating costs (“ultra-low-cost” Spirit Airlines, contrasted with higher labor costs at the more mature Southwest Airlines). In Europe, low-cost airlines continue to expand aggressively, and are willing to lower fares to keep their planes full. Some are venturing from an original focus on national or regional routes to longer international flights, initially in Asia and more recently on selected trans-Atlantic routes. Their cost edge on such routes tends to be less, because labor costs (where they have an advantage) account for a smaller proportion and fuel and aircraft ownership costs (where they do not, and may even be at a disadvantage) relatively more. Also, a low-cost airline’s higher aircraft asset utilization (flying more hours per day) is harder to achieve on intercontinental routes, where time zones and airport curfews limit flexibility to schedule flights.</td>
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Shipping

**Record-low vessel order book bodes well for dry bulk rates**

Dry bulk demand growth will likely exceed fleet growth in 2017, supporting a significant rebound in rates from rock-bottom levels. We forecast, for example, average time charter (TC) rates for Capesize ships of $13,000/day in 2017 and $14,000/day in 2018, up from the industry average of about $7,300/day in 2016, according to Clarkson Research (CRSL). Our base-case assumptions reflect the recent recovery in rates, promising demand dynamics for iron ore and coal from Asia (which is by far the largest global importing region of iron ore and coal) and industry supply-side adjustments, such as vessel scrapping, deferral or cancellation of ships on order, and muted ordering of new tonnage. Slowing global fleet expansion in 2018, combined with sustained low single-digit trade growth--provided China carries on with its imports of high quality commodities--bodes well for dry bulk rates in 2018. We think a large-scale M&A activity is unlikely in the dry bulk sectors given the lack of tangible benefits for the acquirers. The expansion will mainly occur through direct acquisition of newbuilds or second-hand vessels--frequently via distressed deals.

**Tanker rates should rebound**

Average tanker charter rates will likely come down in 2017 following already soft rates in 2016, owing to the accelerated delivery of new tonnage outstripping stable growth in tanker demand, partly constrained by the slash in oil output by OPEC and non-OPEC producers and by high oil and oil-product inventory levels having a knock-on effect on export volumes. That said, overall we expect demand conditions will stay steady in 2018, assuming that oil prices don't unexpectedly pick up significantly. We forecast stable crude oil price in 2018 at $50 per barrel and note that low oil prices are a positive factor for oil demand and trade, and generally benefit tanker rates. From 2018, we expect a recovery in rates against a backdrop of tighter demand-and-supply conditions. Based on the size of current tanker orderbook, we believe that product tanker rates will rebound faster than the crude rates. For example, we forecast rates for medium-range product tankers to improve to an average of $13,000-$15,000/day in 2018, following a likely decrease to $12,000-$13,000/day in 2017 (compared with $14,000-$15,000/day in 2016, as reported by CRSL). We foresee average crude oil tanker Suezmax rates improving to $19,000/day in 2018, following a likely drop to an average of $18,000/day in 2017 from $27,300/day in 2016, as reported by CRSL. As for the dry bulk sector, we expect that growth will occur mainly through newbuilds and acquisition of second-hand vessels, rather than through mergers.

**Container liner oversupply still a concern**

Freight rates on major trade lanes are recalibrating to more sustainable levels for container liners this year, based on decent trade dynamics, higher bunker fuel prices, and supply-side measures, such as vessel demolition or lay-up and rationalization of networks, thanks to dynamic consolidation between container liners. These positives, however, may be counterbalanced by rapid deliveries of ultra-large containerships during the remainder of 2017 and 2018. These vessels were ordered a few years ago when the industry projections were much brighter, but the inflating fleet capacity now poses a risk to the recent rebound in freight rates, which will ultimately depend on future supply discipline of the leading container liners. According to CRSL, the current order book for post-panamax containerships--which have a capacity of more than 15,000 twenty-foot equivalent unit (TEU)--may almost double the size of the global post-panamax fleet. Accordingly, we forecast flat to slightly negative growth in freight rates in 2018, following the materially stronger average rates in 2017. We think that another round of consolidation is likely among container liners in search of scale and network enhancements, cost efficiencies and stronger bargaining positions. The most recent acquisition of Neptune Orient Lines' container shipping and terminals activities by CMA CGM S.A. in 2016 and CSAV's container liner activities by Hapag-Lloyd AG in 2017 demonstrate tangible cost savings achieved.
Railroads

**Continued moderate revenue growth as volumes and prices rise**

After three years of declining revenues due to weakness in coal, crude oil, and some industrial markets, in 2017 North American freight railroads have seen a reprieve, and we foresee further gradual gains in 2018. Coal traffic appears to have bottomed out, helped by a pickup in demand for metallurgical coal exports. Intermodal traffic has picked up, driven by improving railroad service performance and increasing consumer spending. Reduced auto shipments, from cyclical peak levels, have partly offset the positive trends. The Canadian railways’ growth momentum should continue into 2018. With improving commodity prices, railways are not only seeing improved volume but also better pricing.

**Capital spending eases, but shareholder rewards remain significant**

We expect the trend of declining railroad capital spending to continue over the next year. Improving productivity and operating efficiency and the reduced volumes of the past several years mean that most companies’ equipment needs are not as great as previously forecast. As such, locomotive and freight car orders are being pushed out, as excess capacity is parked. Capital spending on the installation of Positive Train Control is trending down as the regulatory deadline for implementation approaches. Ongoing track maintenance spending tends to be fairly stable and expansion projects are case specific. With better earnings and somewhat lower capital spending in 2017, railroads have applied rising free cash flow to share repurchases. Proposed (but still uncertain) U.S. tax law changes could boost free cash flow further, some of which would likely flow into increased dividends and buybacks. Still, we expect the North American railroads to manage their shareholder returns such that their credit metrics remain stable to improving through 2018 and appropriate for their ratings.

**Fuel price fluctuations are net neutral to earnings**

Fuel prices increased in 2017 and we expect oil prices to remain above 2016 levels through 2018 (S&P Global’s forecast for WTI is $50/bbl for 2017 and 2018). We expect this to have a net neutral impact on the railroads because the higher costs are roughly offset by fuel surcharges. Ongoing advances in fuel and operating efficiency provide a gradual long-term positive.
Supply and demand trends vary by sector

Aircraft lessors are enjoying strong demand for their narrowbody aircraft, but lease rates for larger widebody planes remain under pressure. Low oil prices have not weakened airlines’ demand for new, fuel-efficient aircraft (though the lease rate premium they command versus older planes has narrowed) and has actually increased demand for older aircraft. Beginning in late 2016, marine cargo container lessors began to see increased demand and higher lease rates as global trade volumes improved, capacity tightened, and equipment prices rose significantly. However, the potential for higher tariffs or even trade wars related to Brexit and changing U.S. trade policy pose future risks. The reduced volume of coal and crude oil shipments in North America placed pressure on some railcar lease rates, and we do not predict a fundamental reversal of this decline even with the potentially less-restrictive environmental regulations promised by the U.S. Administration.

Ready access to capital markets

We forecast that lessors will maintain their access to capital at favorable rates, even with our expectation for gradually rising interest rates. The assets of most lessors are typically easy to finance, either on a secured or unsecured basis. These companies generally have committed bank facilities and have increasingly also borrowed in the public capital markets. We believe that the lessors will be able to pass through any increases in funding costs to their customers by raising their lease rates when interest rates increase, absent a weak supply and demand balance in the market for each type of leased equipment.

Active M&A Continues

Several major leasing sectors have seen a wave of mergers and acquisitions (M&A) during 2017. In April 2017, Avolon acquired CIT’s aircraft leasing business to form the world’s third largest aircraft lessor. In August 2017, Dubai Aerospace Enterprise acquired AWAS. In the railcar leasing sector, Japanese bank SMBC acquired American Railcar Leasing in June 2017. The opportunity to improve economies of scale and market coverage and the relatively small number of staff at these companies make leasing mergers attractive. The main risk, heightened by very liquid capital markets, is overpaying for acquisitions. We foresee continued M&A activity in 2018, although the size of the transactions will likely be smaller than those seen in 2017.
Key risks and opportunities

Airlines

1. Rising labor costs
   Many airlines face a long-term shortage of pilots and mechanics, as training (particularly for pilots) is lengthy and expensive and the industry has been expanding in excess of population and GDP growth for many years. Unions representing employees at large North American airlines have capitalized on consolidation and healthy profits to secure higher wages, undoing much of the cost cutting that occurred earlier in bankruptcy reorganizations. Airlines are vulnerable to strikes, which quickly cause heavy losses, and may be inclined to buy labor peace with generous settlements. However, struggling airlines under pressure from low-cost competitors face a very different dynamic, and the resolution of labor issues can be critical to survival in a bankruptcy case such as Alitalia.

2. The future direction of “globalization”
   Airlines have been the beneficiaries of a long-term trend towards increased trade and an expanding global middle class. We do not see a change in direction as regards the growing middle class (particularly in Asia) with an interest in travel. However, a backlash in some countries against immigration and free trade carries the risk of eroding business and leisure travel somewhat. In the case of Brexit, the U.K. will have to negotiate new aviation treaties to replace its current status within the European Union, which could cause interim disruption.

3. Geopolitical risk and terrorism
   Airlines are particularly vulnerable to terrorism and fears arising around threatened or actual wars. Mostly, the effects of such threats are transitory, although potentially serious in the short-term. Travel in Europe has bounced back after a series of terrorist attacks, but tensions on the Korean peninsula have dampened travel in some parts of Asia and the Pacific (e.g. to Guam, which the North Korean leader threatened explicitly). An outright conflict there would have a more pronounced and widespread effect, particularly if it escalated to nuclear weapons. A similar, but even more unpredictable threat to air travel is epidemic disease, which had a sharp but brief impact on travel during the outbreak of SARS (Severe Acute Respiratory Syndrome) in 2002-2003.
Shipping

**Acceleration of new build orders and slowdown in scrapping**

In view of the sector’s historically poor supply discipline, there remains a risk that ordering of new vessels will accelerate, in particular in sectors which have low order books and improving prospects (such as dry bulk shipping), leading to destabilization of the improving demand-and-supply conditions and tension on capacity utilization. According to CRS, the current order book for dry bulk ships, for example, is at a record-low of 8%, as a result of subdued contracting for several quarters. Furthermore, in our opinion the additional demolition of older tonnage remains a critical supply-side measure to help correct excess capacity and restore charter rates to sustainable and commercially viable levels, first and foremost for bulk-carrier and containership owners. We are nevertheless mindful that the pace of demolition has slowed in recent quarters, which typically happens when owners perceive possibly better times ahead. If new orders accelerate or scrapping materially slows, this will impair the industry rebalance and delay the recovery in charter rates.

**Subdued global trade volumes**

A drop in global trade volumes, a key engine of global shipping growth, would be damaging to an industry, which struggles to bring demand-and-supply into balance. We forecast solid growth in developing economies, in particular, to stimulate global trade in 2018, although there are clear risks in the demand outlook. A slowdown in commodity imports and consumption from China, in particular, would harm the global shipping industry, which heavily invested in new tonnage a few years back believing in China’s ability to deliver a consistently solid economic growth. Further risks encompass the uncertainty surrounding Brexit negotiations, or a shift in U.S. trade policy, which impact international trade relationships and cross-border investment flows.

**An OPEC-led crude oil production increase**

A decision by the Organization of Petroleum Exporting Countries (OPEC) producers to increase oil output for geopolitical reasons and/or to strengthen market share would (i) keep oil prices low, and (ii) stimulate global oil trades and oil consumption, historically a key demand driver for the crude oil tanker market and charter rates. Most importantly, low bunkering (ship fuel) costs would support vessel operators’ earnings across all shipping segments.

That said, currently the OPEC-led production cuts remain the key trigger likely to hinder growth in global oil supply in 2018. Further production cuts and a surge in oil prices would likely undermine oil demand, disrupt oil trades, and have an adverse knock-on effect on the crude tanker segment, in particular, which has to absorb a glut of new tonnage hitting the water in the next quarters.
## Railroads

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<th>Risk from Restrictive Trade Policies</th>
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<td>The Trump Administration is threatening to retreat from long-standing trade agreements, particularly the North American Free Trade Agreement (NAFTA). We expect that auto manufacturers would be most affected since they have integrated their supply chains among the U.S., Canada, and Mexico, and railroads carry many of the parts that move across those borders. Grain (particularly U.S. exports to Mexico) and other commodities would also be affected by any higher tariffs. Overall, the Association of American Railroads (the trade group for North American railroads) estimates that about 30% of U.S. rail carloads are tied in some fashion to international trade. That said, much would depend on the form and severity of any tariff increases or trade restrictions, and S&amp;P Global Ratings’ base case is that changes to NAFTA will not have a severe impact overall on regional trade and GDP.</td>
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<th>Opportunities from potential U.S. tax changes</th>
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<td>We believe the U.S. railroads would be beneficiaries if potential changes in corporate taxation become effective. While final details remain uncertain, a lower corporate tax rate would benefit the railroads, which currently pay significant cash taxes. In addition, potential faster write-off of capital expenditures would benefit this capital intensive industry. Limits on the deductibility of interest payments would be a partial offset, but likely less significant than rates and capital expensing. More broadly, the railroads would be affected by whatever changes to economic growth result from tax changes.</td>
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<th>Continued growth in intermodal traffic by rail</th>
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<td>With challenges facing the trucking industry that we don’t expect to abate, we anticipate that railroads will continue to gain market share from trucking companies. In our view, higher costs of regulatory mandates (e.g., electronic logging devices and hours of service limits), and the continuing truck driver shortages, in combination with improving service performance from the railroads, could provide opportunities for railroads to gain share of the freight market in North America. Longer term, if self-driving trucks become widespread, railroads’ current cost advantage against trucking could narrow, however.</td>
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Transportation Equipment Leasing

Risks from weak customers

Aircraft and marine cargo containers lessors’ customers—airlines and shipping lines—are often weak credits. In 2016, many marine cargo container lessors were hurt by the liquidation of a major Korean shipping line and several took write-offs and impairment charges related to their exposure. Ultimately, a high percentage of the containers were re-possessed and re-released in a subsequent stronger demand environment, cushioning the impact on lessors. Aircraft lessors have likewise endured a series of high profile airline bankruptcies in 2017, but most lessors managed the risks capably. Often, they gradually reduced their exposure to troubled airlines by shifting aircraft as their leases expired or negotiating for early return of planes. As has generally been the case, the aircraft lessors were able to place the planes with new airline customers with minimal time off-lease, albeit sometimes at lower rates. Aircraft leases generally include security deposits and maintenance reserves in the case of weaker credits. Expenses related to bad debt have historically not been a significant problem for equipment leasing companies in general, although lease rates (and thus their revenue) will suffer if they are forced to re-lease the equipment in a weak market.

Risk of equipment obsolescence

The risk of obsolescence varies among leasing sectors. For marine cargo containers it is relatively small, as these containers do not incorporate much technology and are built to standard specifications. Aircraft, by contrast, are much costlier and embody technology that changes over time. Each new generation of planes tend to be more fuel efficient and often can fly further; they are also always more costly than their predecessors. High oil prices generally magnify the benefits of new technology, and there have been concerns that the prices and lease rates sought for the newest planes would suffer following the plunge in oil prices earlier this decade. Thus far, the lease rate premium for new planes has narrowed, but the benefits of longer range, lower maintenance costs, and airlines’ desire to hedge against potentially higher future oil prices and tighter environmental regulation has supported demand for the new planes. At the same time, the lower oil prices provided a temporary reprieve for older planes in aircraft lessors’ fleets. Trucks and autos also face gradually tightening fuel and emission standards, but the lessors’ holding periods for these are much shorter and obsolescence tends not to be a material factor.

Access to capital

Leasing is a capital-intensive business. For several years, there has been an abundance of capital for most transportation leasing sectors from banks, and secured and unsecured capital markets bonds, at attractive pricing. There has been concern about banks reducing their lending due to potential tighter capital requirements. The direction of those regulations has recently become more uncertain as European regulators seek stronger capital cushions but the U.S. position is unclear. Up to a point, higher borrowing costs can be passed through in the form of higher lease rates, but a change that significantly affects banks without comparable changes in public capital markets could shift the mix and total amount of available funding. The equipment that the transportation lessors own is generally considered good collateral and can support borrowing, albeit at lower advance rates and higher interest rates during periods of stress. At the same time, lessors have in some cases gained market share (albeit in a shrinking market) when banks and public capital markets pulled back from financing transportation companies directly in a downturn.

Under S&P Global Ratings’ policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.
Cash, debt and returns

Global Transportation

Chart 299 – Cash flow and primary uses

Chart 300 – Return on capital employed

Chart 301 – Cash and equivalents / Total assets

Chart 302 – Total debt / Total assets

Chart 303 – Fixed versus variable rate exposure

Chart 304 – Long term debt term structure

Source: S&P Global Market Intelligence, S&P Global Ratings calculations