Industry Top Trends 2017
Transportation

Overview

- **Ratings Outlook**: Rating trends across the transportation industry are mostly stable, though there has been an increase in negative bias, which mostly reflects the elevated pricing pressure in the shipping sector and the challenges that companies in some developing economies are facing as the growth of global trade slows.

- **Forecasts**: We expect that transportation credit ratios will be generally stable over the next two years, though there will be some variation among the different subsectors. For the railroads, we expect that their revenue should begin to increase once again as the decline in the volume of North American coal shipments slows and their fuel surcharges increase with higher fuel prices. In the air freight and logistics space, there were several large mergers in 2016 and we expect that these companies will see their revenue growth return to historical levels. Meanwhile, the leasing companies and railroads have the highest margins in the sector and we anticipate they will continue to trend upward. As for the airlines, their margins and credit ratios peaked in 2015—aided by low fuel prices—but have slipped a bit since then.

- **Assumptions**: Our baseline forecast suggests that global GDP growth will increase modestly, supported by an improving U.S. economy. However, there is significant political uncertainty at present—notably regarding policies of the Trump administration and uncertainty about the U.K.’s withdrawal from the European Union (Brexit)—which could hamper world trade, lead to higher interest rates, and further strengthen the U.S. dollar.

- **Risks**: Reduced global trade, political tensions, and further strengthening of the U.S. dollar are the key risks currently facing the transportation industry. A reduction in the volume of global trade will not only directly affect some transportation companies but could also undermine the economies of countries that rely on commodity exports. A strong dollar could create problems for transportation companies that have to pay for their equipment (e.g., aircraft and marine cargo containers) and fuel in dollars but are currently unhedged and do not generate a significant proportion of their revenue in dollars. Additionally, an uptick in uncertainty—economic, political, or both—could raise risk premiums in the credit, equity, and currency markets, potentially raising costs or reducing the availability of funding.

- **Industry Trends**: Consolidation continues to be a major theme in some sub sectors, notably the leasing, container shipping, and logistics industries, where market presence and improved economies of scale provide a clear advantage. Mergers in the more labor-intensive and complex industries, such as the airlines and railroads, are more challenging and may be blocked by regulators due to concerns over reduced competition. Environmental regulations have also become a greater focus for the shipping, trucking, and airline sectors.
Ratings trends and outlook

Global Transportation

Chart 1 – Ratings distribution

Chart 2 – Ratings distribution by sub sector

Chart 3 – Ratings outlooks by region

Chart 4 – Ratings outlooks by sub sector

Chart 5 – Ratings outlook net bias by region

Chart 6 – Ratings outlook net bias by sub sector

Chart 7 – Ratings outlooks

Chart 8 – Ratings outlook net bias

Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending December 31, 2016
Industry forecasts

**Global Transportation**

Chart 9 – Revenue growth (local currency)

Chart 10 – EBITDA margin (adjusted)

Chart 11 – Debt / EBITDA (adjusted)

Chart 12 – FFO / Debt (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

**Airlines**

1. **Global air traffic growth will remain strong at 5%**
   
   Despite slowing economic growth in some regions and the disruption from numerous geopolitical, security, and labor-related events in Europe and the Middle East, global air traffic growth has remained fairly strong. We expect this trend to continue in 2017 and anticipate that global air traffic growth will likely moderate only slightly to about 5.0% for the year compared with 6.3% in 2016 (per The International Air Transport Association, a global airline industry trade group), supported by an increasing volume of traffic in the higher-growth developing countries. Although the previously widespread concern among investors that a slowing Chinese economy would undermine the aviation sector has eased, air traffic in the region is slowing somewhat and could represent a downside risk to our forecast. Moderately higher oil prices, and the likely response by the airlines to raise their fares to offset them, could also decelerate global air traffic growth.

2. **Moderately higher fuel prices**
   
   With oil prices (Brent and West Texas Intermediate [WTI]) higher than during most of last year--our energy team expects oil prices to average around $50 per barrel this year--airlines will have to face higher jet fuel costs. This should be manageable for the airlines that have done a good job of hedging their fuel costs and for those that mostly generate their revenue in dollars or operate mostly in mature markets where they can reasonably expect to recapture much of the increase through higher fares. However, the cost burden could be more onerous for airlines based in countries whose currencies have depreciated against the dollar (e.g. Mexico)--a trend that could worsen if the U.S. decides to raise import tariffs.

3. **Low cost airlines continue to expand**
   
   Low cost airlines continue to expand at the expense of the traditional high cost, full-service airlines, particularly in Europe and parts of Asia. In the more mature markets in North America, airline market shares have been more stable and the cost advantage of the larger low-cost airlines is not as pronounced. Some Asian airlines have adapted the low-cost model for long-haul flights, and a few others are pioneering the model on their trans-Atlantic routes. While not considered low-cost airlines in the traditional sense, the rapidly growing Middle Eastern airlines have a sizeable cost advantage on their established European and Asian competitors and have captured substantial market share on certain routes.
Shipping

1. **Dry-bulk shipping rates will likely bottom out gradually**
   We believe that dry-bulk ship operators will continue to face tough industry conditions, aggravated by the considerably--and sustainably--diminished level of commodity imports in Asia, which is by far the largest global importer of iron ore and coal. In our view, the recent notable improvement in charter rates in the fourth quarter of 2016 (albeit following record lows in early 2016) remains particularly vulnerable to uncertainty about future demand from China. Nevertheless, our expectations for slowing global fleet expansion, ongoing vessel scrapping, and sustained low single-digit trade growth will likely trigger a moderate overall improvement in average time charter rates this year.

2. **The tanker market will likely soften amid accelerated supply**
   We expect that oil and oil-product shipping conditions will be generally supportive over the next 12 months and anticipate that tanker time charter rates will remain well above their operating cost break-even rates. Nevertheless, we forecast that average rates will come down this year--from relatively strong levels in 2015 and the first half of 2016--owing to the accelerated delivery of new tonnage that will outstrip the growth in tanker demand. We think that crude tanker ton-mile demand will soften following announcements by OPEC and non-OPEC producers that they will slash oil output this year, which will likely have a knock-on effect on export volumes. Meanwhile, oil-product inventory levels appear to be elevated, which will likely constrain demand to some extent.

3. **Overcapacity is here to stay and will impede the container ship segment**
   We believe that container ship charter rates will remain depressed in 2017, reflecting the sector’s overcapacity and the weak demand for container ships from container liners, which are facing volatile freight rates and are struggling to remain profitable (and have therefore taken measures to cut the cost of their chartered-in tonnage). With persistently high scrapping, no stimulus to place new orders (with limited contracting activity since late 2015), and capital constraints, the imbalance between demand and supply in the container ship segment will likely ease somewhat as we move into late-2017 and 2018. Consequently, while we do not anticipate that there will be any rebound in average container ship rates in 2017, rates will likely recover gradually in 2018. Meanwhile, the container liners could face a recalibration of freight rates on some major trade lanes to more sustainable levels in 2017 on improving trade dynamics, higher bunker fuel prices, and supply-side adjustments, which will be partly offset by the persistent and rapid deliveries of ultra-large containerships that were ordered in previous years.
**Railroads**

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<th>Moderate revenue growth as volumes (and prices) slowly rise</th>
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<tr>
<td>1</td>
<td>After two years of declining revenue due to the combined impact of the soft energy markets and a strong dollar, the North American freight railroads are starting to see a reprieve, stimulated by increased grain movements (due to the record U.S. fall grain harvest and related increase in crop shipments), a pick-up in intermodal traffic (driven by improving service levels and increasing consumer spending), and the bottoming out of coal shipment volumes (due to natural gas price increases and growth in the demand for metallurgical coal exports). Canadian railroads could benefit from the strong U.S. dollar, which makes exports from Canada to the U.S. or overseas more competitive.</td>
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<th>Shareholder rewards are creeping back up, but capital spending (as a percentage of revenue) continues to decline</th>
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<td>2</td>
<td>We expect the trend of declining railroad capital spending to continue over the next year. Improving productivity and operating efficiency and lower volumes mean that most companies’ equipment needs are not as great as previously thought. As such, locomotive and freight car orders are being pushed out, reducing some of the year’s planned spending. Other capital spending uses include the installation of Positive Train Control (which has declined as the regulatory deadline approaches), ongoing track maintenance, and expansion projects. Depending on the business and tax outlook for the industry, which is currently unclear, the railroads may take advantage of rising free cash flow to increase their share repurchases.</td>
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<th>Rising fuel prices are net neutral to earnings</th>
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<td>3</td>
<td>Fuel prices have started to rebound due to OPEC’s recent agreement to cut production, and we expect oil prices to remain above 2016 levels over the next year (S&amp;P Global’s forecast for WTI is $50/bbl for 2017). We expect this to have a net neutral impact on the railroads because most of the benefits from fuel surcharge increases will be offset by the rising fuel costs. However, recent advances in fuel and operating efficiency should help offset some of the increase in fuel costs.</td>
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Transportation Equipment Leasing

1 Diverging supply and demand trends
Aircraft lessors continue to enjoy strong demand for their narrow-body aircraft, though there has been some pressure on the lease rates for larger wide-body planes. Low oil prices did not weaken the demand for new, fuel-efficient aircraft (though the lease rate premium they command versus older planes has narrowed) and we do not expect that the recent modest rebound in fuel prices will have a large impact either. In contrast, marine cargo container lessors have suffered from overcapacity and lower lease rates due to weak global trade volumes and the bankruptcy of a large shipping line. The risk of elevated import tariffs or trade wars related to the new U.S. Administration’s future plans could further exacerbate this problem. The declining volume of coal and crude oil shipments has placed added 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 Administration.

2 Continued access to low-cost financing
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 enjoy ready access to 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.

3 Continued mergers and acquisitions
Lessors in many sectors were quite active in undertaking mergers and acquisitions (M&A) during 2016. In January 2016, Bohai acquired aircraft lessor Avolon and--later in the year--Avolon agreed to acquire CIT’s aircraft leasing business (the transaction is expected to close in the first half of 2017) to form the world’s third largest aircraft lessor. Additionally, marine cargo container lessors TAL and Triton combined in mid-2016 to form the largest marine cargo container lessor. In the railcar leasing sector, Japanese bank SMBC announced that it intends to acquire American Railcar Leasing. The ability to improve their economies of scale and market coverage and the relatively small number of staff at these companies make leasing mergers especially attractive, just as long as the buyer does not overpay. We expect that there will be continued M&A activity in this industry in 2017, although the size of the transactions will likely be smaller than those seen in 2016.
## Key risks and opportunities

### Airlines

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<th>A strong dollar and other rising costs</th>
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<td>If the U.S. dollar continues to strengthen because of higher tariffs or rising interest rates, it could place renewed pressure on airlines in developing countries that have limited dollar revenue but must pay fuel and aircraft ownership costs in dollars. Exchange rates have also shifted significantly among the currencies of the major developed economies, though rated airlines in these regions (particularly Europe) tend to be fairly well hedged. Rising labor costs are also an issue, specifically for the big U.S. airlines, and a shortage of pilots is a long-term concern that is affecting the entire industry.</td>
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<th>Trade wars could slow the global economy and discourage travel</th>
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<td>Brexit, a new U.S. presidential administration, and the political reactions that these events might provoke among certain trading partners remain a concern to the extent that they could slow the pace of global economic growth. Furthermore, changing policies on trade and immigration could impact the long-standing trend toward globalization that has hugely benefited the airlines. We do not foresee a dramatic impact from these issues, absent a global recession, though even a change at the margin could lead to empty seats and trigger a new round of fare discounting until airlines are able to react to the weakening demand by adjusting their capacity.</td>
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<th>Geopolitical risk and terrorism remain ongoing threats</th>
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<td>Multiple security events in Europe have somewhat slowed the volume of air traffic to certain destinations. Business travelers tend to react more quickly to these events than leisure travelers because they generally book their tickets closer to the time of travel and companies are more likely to institute targeted travel bans out of safety concerns. However, both kinds of travel tend to recover fairly quickly after such an incident, as has been the case in Europe. Still, if these events escalate, or if authorities respond by increasing security measures such that it makes travel to certain destinations less attractive, it could lead to a more serious disruption.</td>
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## Shipping

| 1 | **The demand outlook is increasingly uncertain**  
A slowdown in trade volumes, which is the key engine of global shipping growth, would be detrimental to the already oversupplied shipping industry. We forecast that solid trade volume growth, particularly in the developing economies, will stimulate global trade during the coming year, though there are clear risks to the demand outlook. A sharper slowdown in consumption in China would harm the global shipping industry, which has aggressively invested in new tonnage over the past few years believing that China's increasing consumption would deliver consistently solid economic growth. Further risks to our forecast include the uncertainty surrounding the negotiations over the U.K.'s withdrawal from the European Union and a possible shift in U.S. trade policy, which could negatively affect international trade relationships and cross-border investment flows. |
| 2 | **The appetite for shipping loans continues to diminish**  
Further weakness in the appetite for shipping lending poses another possible downside risk. Amidst rising provisions for bad debt, escalating debt restructurings, depressed ship values, and prolonged fragile shipping prospects, banks may become even less willing and more selective about who they lend to, which could make financing more expensive in the year ahead. That said, we expect lending to remain accessible for shipping companies that have solid balance sheets, good operating track records, and/or time charter coverage backed by reputable counterparties, although at potentially higher rates and with stricter terms than before. Conversely, tighter lending conditions could prove to be a useful brake on the pace of new orders and fleet expansion. |
| 3 | **Heavy scrapping is critical to correct excess capacity**  
Global fleet statistics indicate that the continued heavy scrapping of older tonnage is a critical supply-side measure to help correct excess capacity and restore charter rates to commercially viable levels, especially for bulk-carrier and container ship owners. With gloomy industry prospects, new regulations, and ageing fleets, we believe that conditions are suitable for yet another wave of scrapping following a record year in 2016. We are nevertheless mindful that the pace of demolition slowed towards the end of last year, which typically happens when owners perceive possibly better times ahead. If aggressive ordering resumes or scrapping slows, it will interrupt the industry's rebalancing and could limit any improvement in charter rates. |
## Railroads

### Risk from uncertainty surrounding new U.S. Administration

The new Administration’s focus on domestic manufacturing carries risks for some U.S. companies (e.g., auto original equipment manufacturers (OEMs) or suppliers) that have shifted their production to Mexico. Specifically, the Administration’s plans to renegotiate the North American Free Trade Agreement (NAFTA), raise a tax on imports, and build a border wall between Mexico and the U.S. present several risks for the North American freight railroads. These decisions will be especially significant for Kansas City Southern (KCS), as the company’s Mexican franchise accounts for about half of its revenue. Although such measures present more risk for KCS than its peers, all railroads stand to suffer from these actions as about 30% of U.S. carloads are tied to international trade (per the Association of American Railroads). Canadian railroads are also at risk because a border tax on Canadian products coming into the U.S. would be very detrimental to their business (cross border traffic between the U.S. and Canada accounts for around 30% of Canadian National Railways’ and Canadian Pacific's revenue).

### Opportunities from new U.S. Administration uncertainty

The greatest potential benefits for the railroads may come from the Administration and Congress’ potential tax policies and fiscal stimulus plans, particularly the potential changes in corporate taxation. A reduction of the U.S. corporate tax rate and the faster write-off of capital expenditures could help the railroads improve their net earnings, though they already carry substantial deferred tax liabilities and cash tax rates are currently close to Congressional Republican’s proposed 20% rate (book taxes are higher at around 37%). Increased infrastructure investment could also boost the movement of aggregates and other building products across North America (including those associated with building a border wall with Mexico). More broadly, the railroads should benefit to the extent that any fiscal stimulus boosts the U.S.’ near-term economic growth. Regulatory and energy policies that favor coal could also help at the margin, though we do not foresee a major resurgence in coal production because low natural gas prices are the major reason that utilities are switching from coal.

### Capturing market share from trucking

The rebound in fuel prices and the elevated costs of regulatory mandates on trucking (e.g., electronic logging devices and hours of service limits) could provide an opening for railroads to chip away at trucking’s share of the freight market in North America. Trucking also faces longer-term challenges from a driver shortage, which the new regulations will exacerbate.
### Transportation Equipment Leasing

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<td><strong>Lease rentals for aircraft and marine cargo containers (the two global leasing sectors) are usually denominated in U.S. dollars. The stronger U.S. dollar could negatively affect customers in these sectors, particularly as oil (and thus fuel costs) is also generally denominated in dollars. Although aircraft lease payments would become costlier for airlines that do not generate a substantial portion of their revenue in dollars, the alternative option of purchasing aircraft will be similarly affected. The more serious issue is the financial viability of the lessors’ customers and thus their ability to continue to make payments. Expenses related to bad debt have historically not been a significant problem for equipment leasing companies, though lease rates (and thus their revenue) will suffer if they have to repossess equipment and lease it out to other customers in a weak market.</strong></td>
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<td><strong>The risk of rising tariffs and trade wars could take a toll on already soft global trade volumes, which would hurt container lessors. Aircraft lessors may be indirectly affected to the extent that reduced trade and overseas investment dampens the growth of business air travel. If less trade translates into slower global GDP growth, both business and leisure travel will be affected, as will most transportation sectors and the leasing companies that serve them.</strong></td>
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<td><strong>Leasing is a capital-intensive business and higher debt costs or reduced access to capital would hurt transportation equipment leasing companies. Recently, there has been an abundance of capital in the aircraft leasing sector from various sources, including the public capital markets, and on attractive terms. Other sectors (such as, railcars, truck lessors, and car renters) have also taken advantage of the capital markets, mainly to refinance their debt. We don’t expect that modestly higher interest rates will have a material impact on transportation equipment lessors’ access to capital. 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. Any disruption in the capital markets would be equally negative for the transportation equipment lessors' customers, particularly those in the largely speculative-grade transportation sectors, such as airlines, shipping, and trucking, potentially boosting the demand for leasing as a financing alternative.</strong></td>
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Industry developments

Rising interest rates will increase costs in the capital-intensive and fairly highly leveraged transportation sector. Still, we do not see believe that this will have a materially negative effect as long as any increase is gradual and expected. Most balance sheet debt is fixed rate (see Chart 15 below) and off-balance-sheet leases are also overwhelmingly fixed rate. Pension liabilities represent a significant debt-like liability for some transportation companies and rising rates should cause reported pension liabilities (and thus deficits) to shrink, though these levels are also affected by many other factors. Equipment leasing companies carry the greatest debt burden, though these companies are generally careful to use debt with terms at least as long as that of their leases and avoid fixed/ floating rate mismatches. Higher interest rates tend to correlate with higher lease rates (as leasing is an alternative to secured borrowing), though rates are also a function of the supply and demand balance of a given type of equipment.

Financial policy

Most transportation companies have significant ongoing capital expenditure needs, which leave them with little free cash flow. Still, some--mostly those rated investment grade--companies have boosted their dividends and share buybacks as their operating cash flow has increased in recent years (see Chart 17 below). This is most common among the North American freight railroads, where the largest seven companies are all rated in the investment-grade category and most have substantial dividend and buyback programs.

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Related research

- Brexit Adds To Ongoing Challenges For U.K. Exposed Rated Airlines, But Strong Credit Metrics Offer Some Protection, July 26, 2016
Cash, debt and returns

Global Transportation

Chart 13 – Cash and equivalents / Total assets

Chart 14 – Total debt / Total assets

Chart 15 – Fixed versus variable rate exposure

Chart 16 – Long term debt term structure

Chart 17 – Cash flow and primary uses

Chart 18 – Return on capital employed

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