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 North 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 North 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 1 – Ratings distribution

Chart 3 – Ratings outlooks by region

Chart 5 – Ratings outlook net bias by region

Chart 7 – Ratings outlooks

Chart 2 – Ratings distribution by sub sector

Chart 4 – Ratings outlooks by sub sector

Chart 6 – Ratings outlook bias by sub sector

Chart 8 – 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 9 – Revenue growth (local currency)

Chart 10 – EBITDA margin (adjusted)

Chart 11 – Debt / EBITDA (median, adjusted)

Chart 12 – FFO / Debt (median, adjusted)

Source: S&P Global Ratings. 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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| 1 | **Global air traffic growth continues at a healthy pace**  
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. |
| 2 | **Oil prices remain fairly stable at around $50/barrel**  
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. |
| 3 | **Low cost airlines continue to spread**  
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. |
### 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 though 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

### 1. 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.

### 2. 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.

### 3. 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.
## Transportation Equipment Leasing

### 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

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<th>Key risk or opportunity</th>
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<tr>
<td>1</td>
<td><strong>Rising labor costs</strong></td>
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<td>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.</td>
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<td><strong>The future direction of “globalization”</strong></td>
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<td>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.</td>
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<td><strong>Geopolitical risk and terrorism</strong></td>
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<td>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.</td>
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### 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 CRSL, 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 container ship 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.
**Risk from Restrictive Trade Policies**

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&P Global Ratings’ base case is that changes to NAFTA will not have a severe impact overall on regional trade and GDP.

**Opportunities from potential U.S. tax changes**

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.

**Continued growth in intermodal traffic by rail**

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.
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-leased 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.

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Cash, debt and returns

Global Transportation

Chart 13 – Cash flow and primary uses

Chart 14 – Return on capital employed

Chart 15 – Cash and equivalents / Total assets

Chart 16 – Total debt / Total assets

Chart 17 – Fixed versus variable rate exposure

Chart 18 – Long term debt term structure

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