SCOPE Scope Ratings

Corporate Credit Outlook Q2 2022

Corporates credit trends will diverge in the face of sharply rising geopolitical risk amid war in Ukraine, supply-chain problems, inflation, tighter financial conditions and a complex ESG regulatory landscape.

Corporates, Scope Ratings GmbH, 29 March 2022

info@scoperatings.com | www.scoperatings.com | Bloomberg: RESP SCOP

Executive summary

The war in Ukraine is exacerbating existing supply chain constraints and raising input costs for corporate borrowers just as central banks are set to tighten financial conditions in response to the worst inflation data in decades. Rising inflation will favour sectors that can pass-through costs, possess pricing power and/or have inelastic demand. Supply-chain disruptions will bite across the board, affecting cyclical sectors the most severely.

Partially offsetting these adverse trends will be catch-up spending by households after the pandemic, rising capital expenditure, and generally improving corporate balance sheets.

This in general favours sectors with either inelastic demand (e.g. **utilities, health care, consumer staples**) and/or sectors with high pricing power. They include **pharmaceuticals, healthcare, consumer staples, IT, telecommunications, discretionary consumer goods** and **real estate** – all likely beneficiaries of a more inflationary 2022. On the other end of the scale are industrial, materials and energy companies which may struggle to pass on higher input costs to customers.

Supply chain issues will persist into at least mid-2022. While slower economic growth and softer demand should ease this topic, the war in the Ukraine is affecting certain trade routes and goods, and global supply chains remain vulnerable. Orders were strong in the manufacturing sector in 2021 and disrupted supply chain led to a depletion of inventories.

The combination of high energy prices, lower economic growth and increased interest rates in addition to supply-chain disruptions points to downside risk for profit margins at firms in cyclical sectors like automobiles and construction in the short-term.

The likelihood of bigger shareholder pay-outs and more debt-financed mergers and acquisitions, after record deal-making in 2021, also have implications for corporate credit quality this year. M&A activities are often debt funded and burden the acquirers balance sheet. In Scope's rating universe there are several examples where such corporate actions have not just led to a temporary deterioration of credit metrics, but the negative impact was significant enough for a negative rating action. Still low financing costs and cash cushions on balance sheet pose the risk of overspending in future M&A, amplified by a potentially weaker outlook for equity markets. Many companies are looking for opportunistic deals to acquire new technology and deepen their digital transformation.

More nuanced is the outlook for capital expenditure, set to vary hugely by sector. A dearth of suitable, low-risk projects and scepticism about the long-term outlook for commodity prices may ensure **mining companies** prefer to pay out excess cash than invest it, while the war in Ukraine and sanctions in Russia are set to put intense short and longer-term pressure on **European utilities** to invest heavily in infrastructure. For **integrated oil and gas companies**, coping with sanctions on their activities in Russia combines with regulatory pressures aimed at encouraging the shift away from fossil fuels.

Overall, Scope's corporate credit ratings declined slightly during the pandemic, with the median corporate moving from BBB+ towards BBB. More importantly, Scope's credit ratings outlooks have moved towards a diverse picture of more positive as well as negative outlooks.

Around 9.7% of our corporate credit ratings outlooks are negative, with the largest portion stemming from hard hit sectors like airlines and retail real estate that also have seen most of the downgrades. Consumer goods, grid utility companies and in several smaller corporates also have negative outlooks.

An increasing proportion of companies – now standing at 7.5% – has positive credit ratings outlooks, mostly within pharmaceuticals and business services. However, outlooks also improved across the corporate spectrum for companies which have emerged strongly from the pandemic.

Contents

Executive summary 2

War in Ukraine constrains corporate credit outlook 4

Supply chain issues persist 4

Diverging Ratings Trends Ahead 4

ECB's cautious monetary tightening favours euro area companies 7

Likelihood of bigger shareholder pay-outs, debt-financed mergers 7

ESG factors will remain top of the agenda for management teams 8

Annex I: Related research 8

Scope Corporate Ratings Sector Ratings

Olaf Tölke
Managing Director, Head of Corporate ratings
o.toelke@scoperatings.com

Thomas Faeh
Executive Director, Corporate ratings
t.faeh@scoperatings.com

Sebastian Zank
Executive Director, Corporate ratings
s.zank@scoperatings.com

Dierk Brandenburg
Managing Director, Head of ESG & Credit research
d.brandenburg@scoperatings.com

Henrik Blymke
Managing Director, Corporate ratings
h.blymke@scoperatings.com

War in Ukraine constrains corporate credit outlook

The war in Ukraine is exacerbating existing supply chain constraints and raising input costs for corporate borrowers just as central banks are set to tighten financial conditions in response to the worst inflation data in decades.

Rising inflation will favour sectors that can pass-through costs, possess pricing power and/or have inelastic demand. Supply-chain disruptions will bite across the board, affecting cyclical sectors the most severely.

We expect these negative trends to be partly offset by catch-up spending by households after the pandemic, rising capital expenditure, and generally improving corporate balance sheets.

This in general **favours sectors with either inelastic demand (e.g. utilities, health care, consumer staples)** and/or sectors with high pricing power. They include **pharmaceuticals, healthcare, consumer staples, IT, telecommunications, discretionary consumer goods and real estate** – all likely beneficiaries of a more inflationary 2022. On the other end of the scale are industrial, materials and energy companies which may struggle to pass on higher input costs to customers.

Supply chain issues persist

We believe supply chain issues will persist into at least mid-2022. While slower economic growth and softer demand should ease this topic, the war in the Ukraine is affecting certain trade routes and goods, and global supply chains remain vulnerable. Orders were strong in the manufacturing sector in 2021 and disrupted supply chain led to a depletion of inventories.

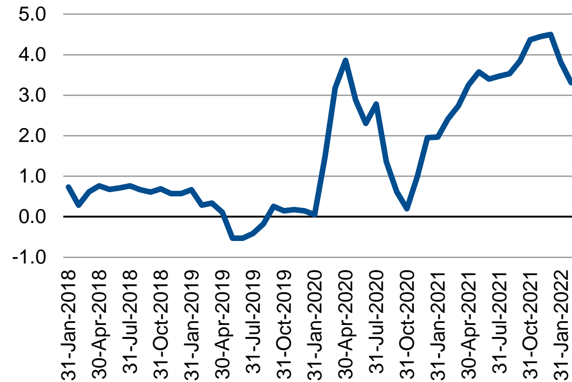
Semiconductors are in high demand and inventories low, as a recent warning of a manufacturing stillstand by the Biden administration signalled, with a stock level of less than 5 days, down from 40 days in 2019.

The situation for sea freight transportation will remain difficult, with China sticking to its 'no Covid strategy' resulting in closure of harbours and quarantine periods for ships. We expect little change in China's approach judging by the government's response to the outbreak in Shenzhen in March, despite the spread of the milder but more contagious coronavirus variants.

Some relief in supply-chain bottlenecks might stem from the sharp rise in energy prices in Europe which has led to increased costs for manufacturing and crimped disposable income for households, which together with uncertainty around the war might set back growth in consumer confidence and demand.

The combination of high energy prices, lower economic growth and increased interest rates in addition to supply-chain disruptions points to downside risk for profit margins at firms in cyclical sectors like **automobiles and construction** in the short-term.

Figure 1: Global Supply Chain Pressure Index



Source: FED New York, Scope Ratings

Diverging Ratings Trends Ahead

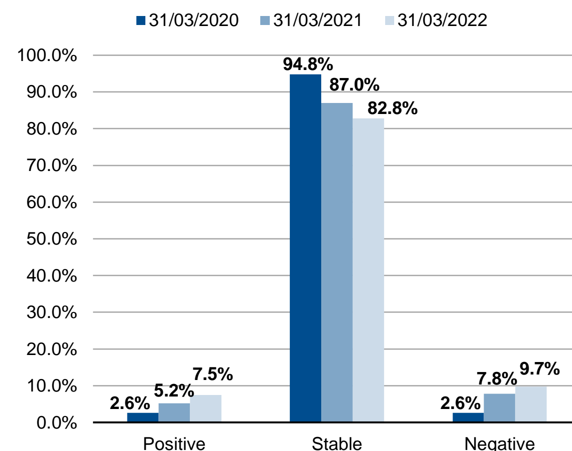
Overall, Scope's corporate credit ratings declined slightly during the pandemic, with the median corporate moving from BBB+ towards BBB.

More importantly, Scope's credit ratings outlooks have moved towards a diverse picture of more positive as well as negative outlooks.

Around 9.7% of our corporate credit ratings outlooks are negative, with the largest portion stemming from hard hit sectors like airlines and retail real estate that also have seen most of the downgrades. Consumer goods, grid utility companies and in several smaller corporates also have negative outlooks.

An increasing proportion of companies – now standing at 7.5% – has positive credit ratings outlooks, mostly within pharmaceuticals and business services. However, outlooks also improved across the corporate spectrum for companies which have emerged strongly from the pandemic.

Figure 2: Scope's Outlook distribution '



Source Scope Ratings GmbH

Utilities and Energy

European utilities are directly affected through exposure to Russia and indirectly affected through upward price pressure on natural gas and wholesale electricity prices. The latter favours electricity generators with the lowest production cost, which runs from hydro, nuclear, unregulated renewables to gas and coal. Companies which can charge pass on higher procurement costs to customers will also benefit. At the other end of the scale this is to the detriment of European energy suppliers who are not properly hedged, locked into long-term delivery contracts and therefore cannot pass on increased commodity prices to retail and commercial/industrial customers. In addition, there are companies that are directly dependent on Russia, like Finland's Fortum where Russia contributes 10-20% of recurring EBITDA or Germany's Uniper, which generates 20% of its EBITDA from Russia. Scope put Uniper under review for possible downgrade this month.

The war exposes Europe's strategic dependency on Russian energy imports, the continent's gas storage limitations, and the energy sector's exposure to regulation and political intervention. While the latter softens the impact on customers, such price caps or windfall taxes threaten highly needed investments into power generation.

High benchmark oil prices are good news **Europe's integrated oil and gas** exploration and production (E&P) divisions around the globe. Exceptionally high European natural gas prices are most relevant for the region's direct suppliers such as Equinor ASA and Wintershall Dea AG. Large LNG suppliers such as Shell PLC and TotalEnergies SE also benefit from strong demand. On the other hand, high energy prices put pressure on refining and petrochemicals margins of the European O&G companies such as Poland's PKN Orlen SA, Hungary's MOL PLC and Austria's OMV AG.

Due to political pressure, BP PLC, Equinor and Shell had to abandon projects and shares in Russian state-controlled oil companies. TotalEnergies and Wintershall Dea have frozen investments and five European companies (Engie, OMV, Shell, Uniper and Wintershall Dea) have buried their investments in the Nord Stream 2 pipeline. The impact on the companies' business is significant as Table 1 below demonstrates though we expect credit metrics to withstand the exit.

Figure 3: European IOCs' exposure to Russia's energy sector

European E&Ps	% of 2021 EBITDA	% of total prod'n	% of reserves	Main exposure
Wintershall Dea	15-25%	48%	61%	Minority stakes in Urengoyskoye and Yuzhno-Russkoye fields, Nord Stream and Nord Stream 2
BP	5-10%	33%	47%	19.75% stake in Rosneft
Total Energies	5-10%	~20%	24%	19.4% stake in Novatek, stakes in Yamal LNG, Arctic LNG
OMV	5-10%	~20%	16%	25% stake in Yuzhno Russkoye field, financing to Nord Stream 2
Shell	<5%	4%	n/a	Exploration projects, Sakhalin LNG, financing to Nord Stream 2
MOL	<5%	4%	n/a	Limited exposure (51% stake in small Baitugan field)
Equinor	<5%	2%	n/a	Exploration projects
Eni	<5%	n/a	n/a	Exploration projects, stake in Blue Stream gas pipeline
Repsol	<5%	n/a	n/a	Exited Russia in January 2022
PKN Orlen	<5%	n/a	n/a	No to very limited exposure

Source company accounts, Bloomberg, Scope research

Airlines

The **European airline sector** faces a double blow because Russia's invasion of Ukraine leads to higher jet-fuel prices and disruption of long-haul flight paths over Russia. This will further delay the rebound of post-pandemic passenger traffic and therefore squeeze profits. Our outlook of the sector remains negative.

Fuel is the first/second biggest cost items representing 15-35% of operating costs and driving profitability. During the last decade carriers hedged their fuel bills for 1-2 years in advance, a strategy that turned sour during the pandemic when fleets were grounded. Most carries abandoned hedging strategies and are now vulnerable to kerosine price shocks. Russian airspace restrictions lead to disruptions and longer flight times between Europe and Asia, while the end of government support and fierce competition squeeze margins further.

Mining

The credit outlook for the upstream **mining industry** is positive as buoyant commodities prices and strong cash flows increase headroom relative to companies' financial targets, strengthen their liquidity and improve the earnings growth. For example, Anglo American will be positively affected by high copper and platinum price with no exposure to Russian assets or sales.

Despite the positive trend, we expect capital expenditure to remain subdued. There is a scarcity of attractive mining assets to develop in accessible and stable markets. Despite recent prices rises, most mining companies also remain sceptical about long-term prospects of notoriously cyclical metals prices.

The picture is mixed for the downstream sector (smelting, refining, metal processing), where rapid cost inflation for gas, electricity, metals, freight and other inputs creates challenges for many producers. Particularly vulnerable are those focused on commoditised products or products at risk of substitution, for example the replacement of aluminium caps for bottles with cheaper plastic alternatives. There are some positive examples such as Norsk Hydro, which very positively affected thanks to aluminium no exposure to Russian assets or sales

Russia is a significant supplier most notably of palladium and other platinum group metals in addition to nickel, aluminium, iron ore, and copper. Ukraine, a significant producer of titanium and iron ore, is host to one of Europe's largest reserves of uranium, titanium, manganese, mercury and coal.

Although sanctions have yet to be imposed on Russian metal exports, self-sanctioning by buyers and shippers has already affected market prices because producers who relied on Russian feedstock look for alternative suppliers at a higher cost.

Construction

The **construction industry** already faced significant profit margin challenges in the last few years from skyrocketing building materials prices, delivery bottlenecks and a scarcity of raw materials.

Russia's invasion of Ukraine has exacerbated these trends by contributing to further price rises especially because Russia is an important producer of metals used in the manufacturing of stainless steel.

Cost inflation challenges profit margins because construction companies typically have little room to adjust pricing for existing contracts. Prices are fixed months or even years ahead of completing a project, rendering companies vulnerable to price shocks until completion.

The impact on credit profiles will be varied, with larger and geographically more diversified companies being able to withstand short-medium term pressures, while smaller and geographically concentrated companies might face more difficulties in managing rising construction material prices, also due to problems in sourcing essential materials, endangering their ability to complete projects. The latter will result in less predictable and more volatile cash flows and profitability, impacting their credit quality.

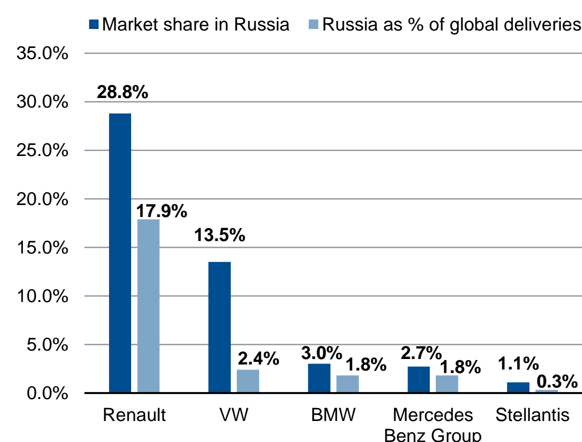
Autos

Europe's **auto makers** have limited direct exposure to Russia, but they are vulnerable to the ripple effects of sanctions and the war in Ukraine which, while hard to quantify, will weigh on vehicle output, input costs and demand in Europe.

With few exceptions, the largest European carmakers have limited direct exposure to Russia and Ukraine. Russia and Ukraine combined represent merely 2% of global light vehicles sales despite representing a population of nearly 200 million people.

In Russia itself, the most prominent player is Renault through its own operations and majority owned subsidiary AvtovazPJSC, the largest Russian carmaker known for its Lada brand. With a sizeable contribution to its unit sales (~18%), production (~20%) and profit, Russia was undeniably a pillar of Renault's recent performance.

Figure 4: European automakers' exposure to Russia



Source company accounts, AEB statistics, Scope research

While the sector's direct exposure to Russia and Ukraine is limited and manageable, we see more risks stemming from indirect exposure related to trade/supply disruption, higher energy/input costs, rising inflation and weaker consumer confidence. We expect that EU automotive production, which was set to rebound in 2022 thanks to an easing of the chip shortage inH2, will fall short of expectations.

Consumer Goods

European **consumer goods companies** face small or modest near-term consequences from the widening boycott of Russia, sanctions and war in Ukraine given mostly limited exposure to the relatively underdeveloped Russian market.

For suppliers of non-discretionary consumer goods, the risks are relatively mild, related to political pressure to exit Russia, supply-chain challenges and the squeeze on disposable household income by higher energy prices.

For now, it is mass-market branded goods suppliers – Apple Inc., Adidas AG, H&M AB, IKEA, Nike Inc., Puma SE, among others – which have led the way in suspending operations, sponsoring or commercial ties in Russia due to brand and governance (ESG) considerations. Luxury brands like Hermès International have followed suit. Russia's contribution to overall revenue of non-durable goods suppliers is typically in mid-to-low single digits for diversified food

and drinks groups – while some specialist suppliers with local production such as Denmark's Carlsberg A/S (around 15% of revenue, 10% of EBITDA affected) or Danone (operating Russia's largest dairy business) are more exposed.

Retailers

Only a handful of large **international retailers** are exposed to the Russian market, ensuring most companies will be directly affected by sanctions imposed on the Russian economy. French retailers Auchan supermarket (8-10% of sales in Russia) and sports-good company Decathlon as well as German wholesaler Metro AG (close to 10% of sales in Russia) and its electronic-goods spin-off Ceconomy AG have direct exposure to Russia and Ukraine. Unlike large consumer brands, few retailers have so far left Russia, Amazon being the most prominent example.

Take real estate as an example, where inflation in most segments is passed through to customers through indexed rents, except for housing where there is often a political component to increasing rents. Interest payments make up one the sector's most important cost items. Ultra-low interest rates and lengthening debt maturities have kept costs down for several years. Locking in higher interest rates will take time, happening more slowly than increases in income. The outlook for residential, logistics, and prime commercial real estate remains positive, though data centres face growth pains (see our research here), while bricks-and-mortar retail remains under pressure given the continued consumer shift to e-commerce.,

Healthcare

Healthcare and pharmaceutical companies benefit from inelastic demand and pricing power. The sector continues to perform well in 2022 thanks to innovation and promising late-stage drug development pipelines. Demand from governments and NGOs likely shoring up vaccines, treatments and medical equipment in the medium term. Sizeable financial cushions and a favourable cash flow outlook allowing them even to increase debt; only a return to aggressive debt-funded M&A would threaten the positive trajectory.

ECB's cautious monetary tightening favours euro area companies

Besides sectoral differences, monetary policy is diverging across Europe, favouring euro area firms, assuming no prolonged war in Ukraine, compared with the US and other countries where central banks are moving faster to tighten monetary policy. While policy rates in the euro area are expected to remain at accommodative, central and eastern European central banks, the central bank of Norway and the Bank of England have been more hawkish and have already started to hike rates, with further increases likely.

Likelihood of bigger shareholder pay-outs, debt-financed mergers

Last year was the best year since 2007 for M&A activity in Europe according to Bloomberg, with the value of pending and completed deals totaling USD 1.8trn. On a global scale, publicly disclosed deals reached all-time highs of USD 5.1trn, 57% higher than in 2020 and breaking the previous record set in 2007. According to investment banks, volumes will likely increase in 2022, with financial sponsors holding record firepower of USD 900bn for potential deals and continuing to raise funds.

Such M&A activities are often debt funded and burden the acquirers balance sheet. In Scope's rating universe there are several examples where such corporate actions have not just led to a temporary deterioration of credit metrics, but the negative impact was significant enough for a negative rating action. Germany's Voith GmbH as an example has a history of expensive M&A transactions and its upcoming acquisition of the remaining stake in Voith's hydro unit stretched a strained financial risk profile, leading to a credit downgrade. In Hungary, 4iG Nyrt had a similar experience. Unilever's recent unsuccessful takeover attempt of the consumer healthcare part of GlaxoSmithKline at high multiples. The deal would have been debt financed, involved sharply higher leverage on a deteriorating financial risk profile due to inflation and other pressures to the detriment of bondholders.

M&A and hefty shareholder pay-outs are pro-cyclical.

Given possible peak equity valuations today, they generally don't favour bondholders. Still low financing costs and cash cushions on balance sheet pose the risk of overspending in future M&A, amplified by a potentially weaker outlook for equity markets. Many companies are looking for opportunistic deals to acquire new technology and deepen their digital transformation.

ESG-driven M&A is becoming more and more common, especially in the **energy sector** as companies jettison higher-cost, high-carbon activities as they diversify away from fossil fuels towards renewable energy, hydrogen, carbon capture, energy storage and retailing among others. BP PLC, Royal Dutch Shell PLC and Totalenergies SE are examples in Europe.

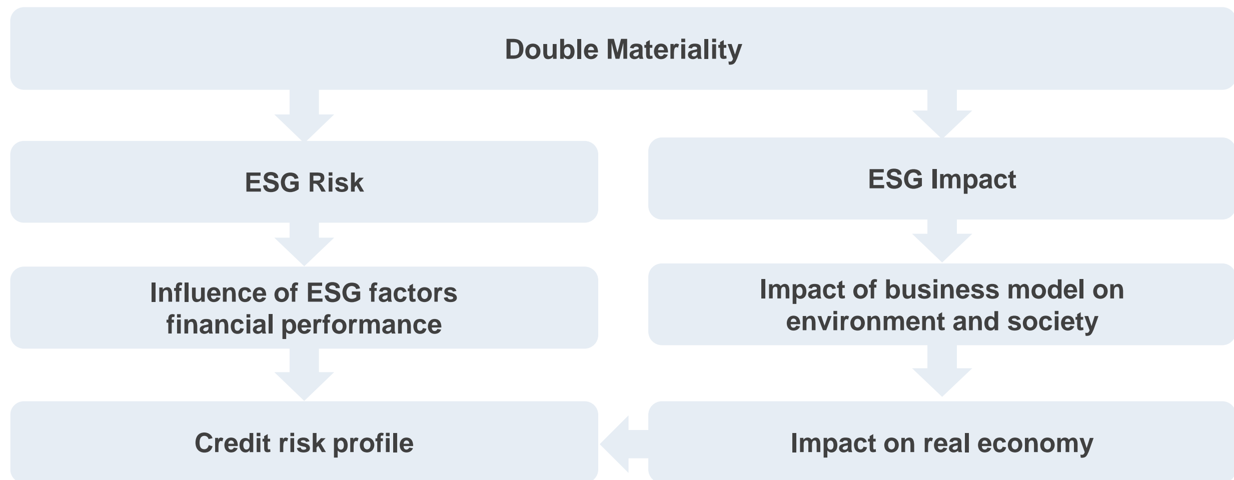
Any M&A-related credit risks in the **oil and gas sector** should be set against the benefits from capex discipline, an expected recovery in energy demand amid constraints on supply, combined with geopolitical tensions, which are pushing up prices and boosting cash flow. Potential financial headwinds include tightening environmental regulations, higher CO2 prices, shifts in oil markets from sanctions on Russia and more output from Iran, plus shareholder pressure for more generous dividends and share buybacks.

ESG factors will remain top of the agenda for management teams

EU Taxonomy and its initial focus on climate change will shape a significant part of the debate about corporate sustainability in 2022, so we see ESG research increasingly re-emphasising impact assessment over ESG-linked risk. Accounting for supplier footprints and emissions in final consumption aligns directly exposed industries ("risk") and their neighbouring sectors ("impact"). This "double materiality" of ESG risk and ESG impact will shape the debate over disclosure and accounting materiality and influence discussion of how best to assess corporate ESG profiles under a taxonomy such as the EU's.

ESG impact and ESG risk analysis are converging over the long-term because one actor's ESG impact drives another actor's ESG risk and vice versa. This applies especially for the systemic risks posed by global warming. Large corporates and regulators increasingly focus on indirect reporting of emissions accruing in the value chain ("scope 3"). (see Scope's research here).

Figure 5: Feedback loop: ES impact and risk



Annex I: Related research

Limiting Russian oil and gas imports: Europe's delicate balancing act, 25 March

Russian demand for rouble gas payments complicates EU-Russia energy stand-off, 17 March

The Wide Angle – For European banks, exiting Russia and Russian business is a must, 24 March

Fertiliser makers face feedstock, energy squeeze as Ukraine war roils chemicals sector, 22 March

Scope withdraws its ratings for the Russian Federation, 17 March

Russia's economy to shrink significantly in 2022 due to war in Ukraine, sanctions, 15 March

Scope places Uniper's BBB+ rating under review for possible downgrade, 14 March

Europe rethinks nuclear power as longer-term market, climate, security fix, 11 March

Russia-Ukraine war raises stagflation risk for sovereign, corporate credit quality, 10 March, watch video discussion

Europe's auto industry faces more supply-chain disruption, rising input costs amid war in Ukraine, 9 March

Higher materials and energy prices, supply-chain disruption strain construction margins, 7 March

European oil & gas: risks rise for Europe-based companies with Russia-Ukraine crisis, 4 March

Europe's retailers: Auchan, Metro among few directly exposed to Russian economy, 2 March

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

23 Boulevard des Capucines
F-75002 Paris

Phone +33 6 62 89 35 12

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid

Paseo de la Castellana 141
E-28046 Madrid
Phone +34 91 572 67 11

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

Disclaimer

© 2022 Scope SE & Co. KGaA and all its subsidiaries including Scope Ratings GmbH, Scope Ratings UK Limited, Scope Fund Analysis GmbH, Scope Investor Services GmbH, and Scope ESG Analysis GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided 'as is' without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or other damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party as, opinions on relative credit risk and not a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings GmbH at Lennéstraße 5, D-10785 Berlin.