Corporates Outlook 2024

Stable outlook with a negative bias: inflation, high interest rates and slack demand weigh down on key sectors, including real estate and chemicals.

Corporate Ratings, Scope Ratings GmbH, February 2024

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Executive summary

Our credit outlook for European non-financial corporates for 2024 is neutral with a negative bias. This bias relates to ratings for companies in some specific sectors and high-yield issuers which will come under pressure from any delay in the economic recovery amid significantly increased funding costs. Such pressure is likely to persist even with the gradual economic upturn that we expect in the second half of the year. European companies face a year of transition as many are still coping with the lingering impact of last year's perfect storm of high interest rates, high inflation, sluggish economic growth and mounting geopolitical tensions.

The mixed outlook for the year reflects the stable credit quality predominantly for investment-grade issuers and a deteriorating trend in some sectors and for non-investment-grade companies. We expect a higher number of defaults overall compared with 2023. The **11 sectors** we cover in our Corporate Outlook are: automotive, business services, chemicals, consumer products, construction, oil & gas, pharmaceuticals, real estate, retail, telecommunication services, utilities.

Five of our sector outlooks are **stable** (**automotive, construction, pharmaceuticals, retail, telecommunication services**), **two** are **positive** (**oil & gas, utilities**) and **four** (**real estate, consumer products, chemicals and business services**) are **negative.**

The main trends:

- Market demand in general remains low. Customers in cyclical sectors (chemicals, capital goods) are only slowly replenishing stock that they had built up during pandemic and were able to run down in the immediate aftermath. Europe's real estate sector remains mired in a cyclical downturn.
- We expect a gradual upturn in economic activity from the middle of 2024 as the global economy heads for a soft landing this year: 1.1% GDP growth in the euro area, 2.2% in the US and 4.4% in China. See our Sovereign Outlook 2024.
- Consumer and industrial confidence indicators – while having gradually improved lately – are still well below long-term averages.
- The prevailing combination of inflation – energy prices remain elevated, wages are rising – and significantly increased funding costs remain a drag on corporate performance particularly in some parts of Europe such as in Germany, explaining the country's subdued economy. The most vulnerable industrial sectors are building construction, real estate, and chemicals.
- Barring any further geopolitical shocks amid Russia's war in Ukraine and Israel's war against Hamas, this year will be one of transition for companies. The adverse trends in credit quality last year – external shocks, cost pressures, high funding costs, less easy access to funding and low economic growth – will gradually fade as inflation slows further, interest rates peak and growth recovers.
- While inflation has come down from its peaks over recent quarters, we believe a return to significantly lower levels will take time. European companies remain vulnerable to further supply-side shocks.
- Funding costs have risen significantly in 2023 and now are likely to remain about twice as high as before monetary tightening began in the aftermath of the pandemic.
- Access to refinancing has become significantly restricted, especially for companies without investment grade (IG) credit ratings, mirroring banks' greater reluctance to extend credit, with alternative lenders unlikely to fully plug the gap.
- Refinancing requirements are high. European-based issuers' bond refinancing volumes are running at about EUR 500bn a year in 2025 and 2026, significantly higher than the 2019-2022 average.
- Corporate capital expenditure is likely to stabilise this year compared with 2023 considering the continued squeeze on cash flow particularly for companies unable to translate higher operating and funding costs into higher selling prices. Levels of working capital should also remain stable.
- Pressure on cash flow will also constrain any increase in discretionary spending on shareholder remuneration and mergers and acquisitions.

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Trends and challenges 2024

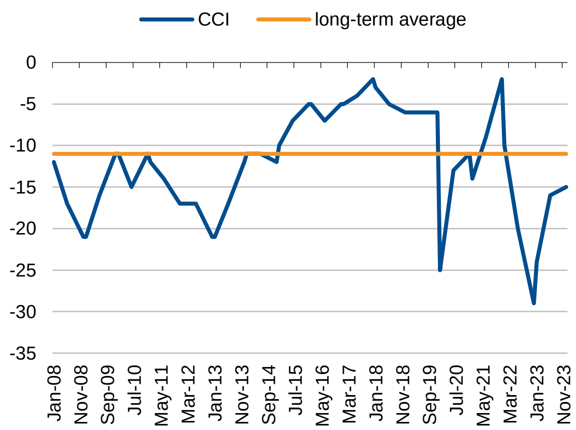
Our baseline economic forecast for 2024 is for the global economy to avoid a hard landing as the interest rate cycle turns after two years of tightening monetary policy. We assume an economic recovery in the euro area, with 1.1% growth, up from around 0.7% last year, including below-average growth for Germany. For a full range of macroeconomic forecasts, see our Global Economic Outlook 2024.

A slow rebound, favourable as that is for European companies, does not automatically translate into better credit quality across all sectors. The year ahead will be one of mixed credit outcomes for European non-financial companies.

Market demand will increase only gradually, likely in the second half of the year. Some sectors, like real estate and to some extent construction, are still in the middle of a cyclical downturn, while other cyclical sectors like chemicals and capital goods are grappling with slack end-demand. The discretionary parts of consumer products and retail sectors are suffering from weak consumer sentiment. Many industrial customers had increased inventory in the final two years of pandemic-related supply-chain disruptions and are hesitant to return to more robust spending patterns. Consumer demand is still held back by the combination of high energy costs and inflation more generally, visible in still low consumer and industrial confidence. Sentiment is running below long-term averages.

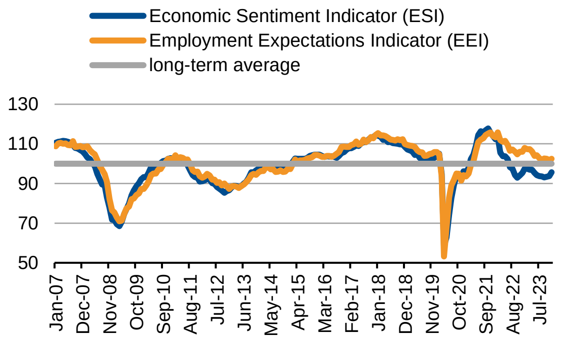
Operating conditions will remain difficult across the sectors we cover for most this year except for the energy sector – oil & gas and utilities. However, the risk of deteriorating credit quality is mainly an issue for smaller, less diversified, non-IG firms.

Figure 1: Consumer confidence still below average (CCI: Consumer Confidence Index)



Source: EU Commission

Figure 2: Economic sentiment not improved yet



Source: EU Commission

It is worth noting that underlying corporate performance tended to be broadly resilient in Europe in the first nine months of 2023. Fourth-quarter results from last year are yet to be reported. Robust earnings and cash flow featured in most sectors. Financial debt was stable. Companies maintained ample liquidity, predominantly among investment-grade-rated issuers. Finally, the comparison with the previous year was off a high base given inflation-driven increases in selling prices benefitted many sectors during 2022.

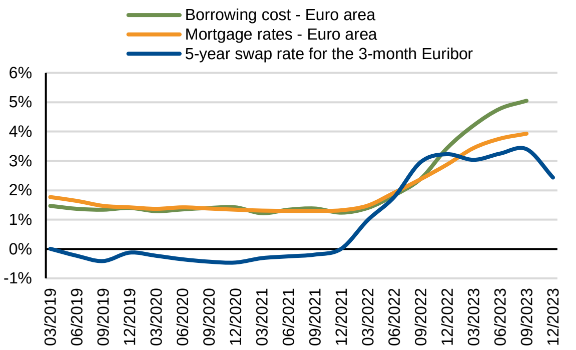
Credit quality is highly likely to come under pressure in 2024 even if credit conditions are set to gradually improve through the year. The main challenges for companies with the weakest credit profiles in 2024 are:

- managing exposure to significant refinancing risk at significantly higher interest rates and weakened access to external funding
- avoiding covenant breaches
- coping with operating earnings coming under pressure if the economic recovery is greatly delayed
- adapting to continued high levels of energy prices, especially in Germany
- absorbing the impact of inflation-adjusted wages especially in sectors with strong collective bargaining
- building up operating and financial buffers in cases of further external shocks or cutbacks in government spending

Thus, for many companies the prevailing combination of high costs – energy prices remain elevated, wages are rising – are likely to lead to lower cash flow generation in 2024, exacerbated by significantly higher funding costs. Companies unable to raise selling prices are thus likely to see their credit quality deteriorate further. Building construction and real estate are among the most vulnerable sectors due to their reliance on debt financing for the upfront capital required for development projects. Chemicals suppliers are still contending with high input prices (energy, raw materials) and weak demand from some of their most important industrial customers.

While inflation is expected to gradually come down during 2024 as the ECB's tighter monetary policy bears fruit, corporate cash flow will shrink from levels in 2023, mainly due to higher energy bills and wage increases, notably in industries with strong trade unions, given tight labour markets across much of Europe. Pressure on cash flow will ensure management's discretionary spending on shareholder remuneration and M&A will remain conservative, with capex stable overall.

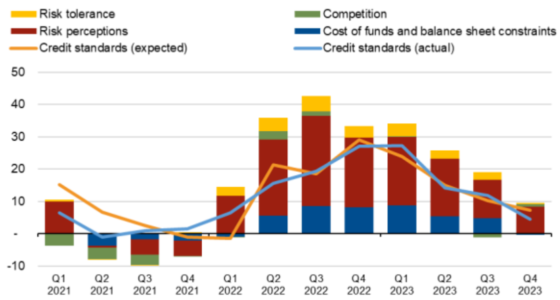
Figure 3: Funding costs are significantly up



Sources: ECB, Investing.com, Scope

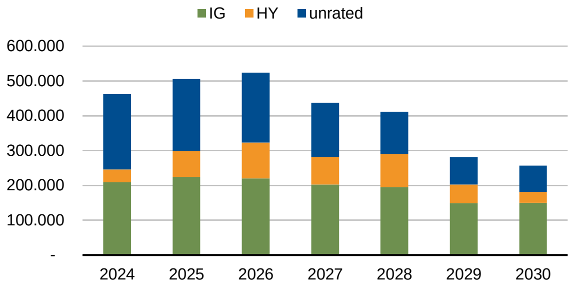
Funding costs have risen significantly over the course of the past year, so, even if rates fall further this year, average corporate funding costs will at least remain twice as high as before the start of the monetary tightening in 2022 (**Figure 3**). Such tight financing conditions represent a challenge for already highly leveraged companies, which need to refinance and/or hold floating-rate debt. The combination of higher interest rates and falling inflation means the underlying real interest rate will be much higher in the future. In addition, we see access to funding increasingly difficult for many high-yield borrowers as banks have become significantly more restrictive in their lending decisions. In addition, we don't believe that alternative lenders can fully bridge the funding gap.

Figure 4: Tightening bank lending standards



Source: Macrobond, ECB, Scope

Figure 5: Persistently high bond refinancing volumes (in EUR m)



Sources: Bloomberg, Scope

The challenging funding conditions are most difficult for companies with cyclical business models and/or lacking diversification by product, sector or geography. In the worst case, default is a real threat as these companies might find it difficult to retain access to capital markets or bank funding. This is also underlined by relatively high bond refinancing requirements until 2026.

We thus expect a year of higher number of defaults in Europe in 2024, compared with 2023, not necessarily in our rating universe which entails many large, diversified and thus more stable credit quality, but in sectors which already have a clear-cut negative outlook, and which consist of many smaller, less diversified and unrated companies (consumer goods, construction, retail).

To be sure, relatively small sized enterprises (small and medium-sized enterprises (SMEs), non-IG companies lacking diversification and/or those which are already highly leveraged have the most fragile credit profiles. These firms risk finding it increasingly difficult to generate enough EBITDA in 2024 to avoid defaulting on interest cover covenants, especially if exposed to a high degree of variable interest-rate debt.

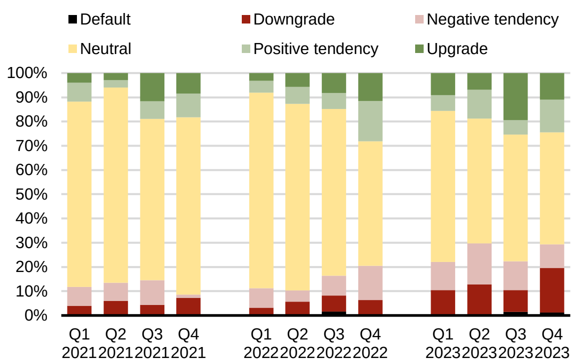
Rising defaults in 2024 partly reflect a catch-up from the low incidence two to three years ago due to the support for business and households provided by most governments during the Covid-19 pandemic. Investment-grade rated companies are likely to continue avoiding rating downgrades in 2024 in line with the soft landing we see for the economy – excluding any that embark on debt-financing mergers and acquisitions.

Government support is one source of potential relief, especially for high-yield issuers. A good example is in Hungary where we have wide coverage with about 80 ratings mainly for SMEs. The government has subsidised funding programmes (Baross Gábor, Széchenyi) equivalent to EUR 9.6bn of support, which can significantly lower corporate funding costs for eligible firms. Nevertheless, these entities depend on the provision of government assistance. Considering the strain on public finances in Hungary, we expect a gradual reduction in subsidies in 2024.

Ratings migration shows negative shift

Our rating actions already reflected a negative bias through 2023 (**Figure 6 below**). Many SME ratings already carry a Negative Outlook or are on review for possible downgrade. These companies might find it increasingly difficult to avoid further downgrades or even default unless economic conditions improve faster than expected in H1 2024.

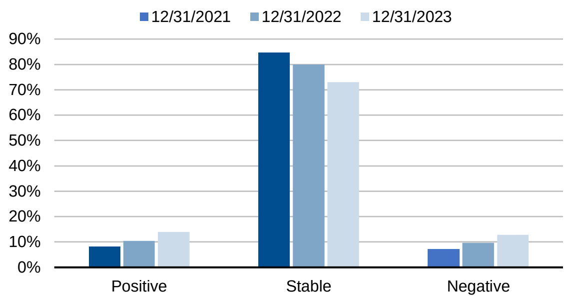
Figure 6: Negative rating actions have increased



Source: Scope

Downgrades and Negative Outlooks now represent about 30% of all ratings in our universe. The large share of positive rating actions can be explained by predominantly large IG-rated credits in the sectors with a positive or stable outlook (oil & gas, utilities, pharma) and by some SMEs in Hungary, where past ratings reflect a very cautious assessment of issuers' credit quality, hence some recent upgrades.

Figure 7: Corporate rating outlook distribution



Source: Scope

Regardless of these factors, those companies for which credit quality is already under pressure will find it increasingly difficult to avoid further downgrades or even default unless they take decisive action to bolster liquidity and strengthen balance sheets.

Among our non-financial corporate ratings in 2023, the number of stable outlooks fell to 73% of the total from 85% at the end of 2021 (**Figure 7)**. The number of negative and positive outlooks rose, with 13% negative one (up from 7% in 2021) and 14% positive outlook.

Scope's Corporate Ratings team covers about 290 issuers overall, predominantly in Europe, with 60% IG and 40% high-yield.

Table 1: European corporates outlook for 2024 for 11 core sectors, with direction of key trends

	12-Month View					
Name	**Operating trends**	**Capex**	**M&A**	**Issuance**	**Shareholder returns**	**Political & regulatory backdrop**
Automotive	↘	↗	→	→	→	↗
Business Services	→	→	↗	↘	→	↗
Chemicals	↘	↘	↗	↗	↗	→
Construction	→	→	↗	→	↗	→
Consumer Products	→	↗	→	→	→	↗
Oil & Gas	↘	→	→	→	↘	→
Pharmaceuticals	→	→	→	→	↗	→
Real Estate	→	→	→	→	↘	→
Retail	→	→	→	→	→	↗
Telecommunications	→	→	→	→	→	→
Utilities	↗	↗	→	↗	↘	→

Corporate Sector Outlooks 2024

Automotive

Stable

The outlook is stable for the automotive manufacturing sector

The stable outlook reflects our expectation that European automotive manufacturers will remain resilient in 2024 despite fading momentum in demand for new vehicles, more intense price competition and persistent cost inflation. The industry can fund the substantial investments needed for its transformation towards low- and zero-emission vehicles – primarily the shift from internal combustion engines (ICEs) to electric vehicles (EVs) – due to the companies' ample financial flexibility. Robust liquidity and prudent financial policies characterise the industry's credit profile. We expect bond issuers in the sector to maintain comfortable credit metrics.

Here are the main trends supporting and constraining the credit quality of automotive manufacturers in 2024:

Key trends supporting credit quality	
+	Raw material tailwinds, cost-reduction opportunities
+	Healthy balance sheets, substantial net cash position (industrial operations), strong liquidity buffers
+	Credit metrics to remain robust despite higher capital expenditure and R&D needs
Key trends threatening credit quality	
–	Macroeconomic uncertainties, geopolitical tensions adversely affecting global auto demand and trade flows
–	Slower revenue growth and moderate decline in profitability as the price-mix shifts
–	Further increase in capex and R&D, primarily driven by the regulation-driven EV transition

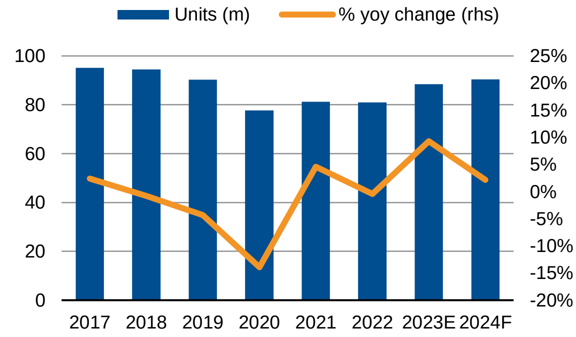
Slower top line growth amid price competition, less favourable product mix

Global vehicle sales are expected to grow at a pedestrian pace of around 2% in 2024, amid macroeconomic uncertainties, geopolitical tensions including potential trade disruptions, tight credit conditions and still-soft consumer confidence. This is in contrast with the rebound of around 9% in 2023, courtesy of the elimination of lingering supply-chain bottlenecks, which helped manufacturers to deliver on their long order backlogs.

For automotive manufacturers, top-line growth will weaken in 2024 to an estimated 2.8% from 11% on average in 2021-2023 as the main revenue drivers of the past few years fade. Consumer demand is softening, visible in the slowdown in quarterly order intakes. The product mix is normalising after a long period in which it was tilted toward higher-margin vehicles as manufacturers took advantage of the gap between supply, limited by supply-chain constraints, and robust pent-up post-pandemic demand.

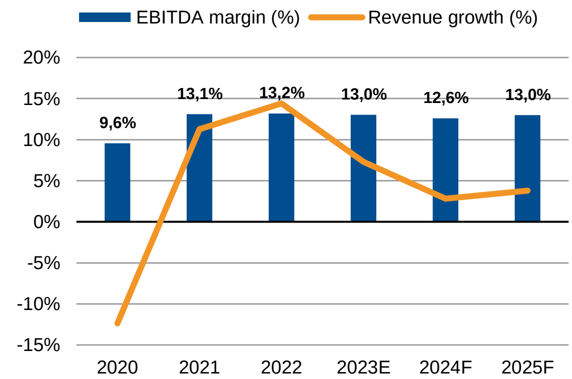
As the auto market moves from supply-led to demand-driven performance, pricing reflects this shift from a seller's market to a buyer's market in becoming more competitive. Incentives are on the rise again and prices are softening after three years of an unusually tight supply-demand balance, which had lifted net prices to unexpectedly high levels. Price competition is the toughest in the EV segment. Several automotive players insist that they are maintaining disciplined pricing through "value or volume" strategies, but competition on prices will be difficult to avoid completely given the risk of losing market share. In this context, premium manufacturers, notably Mercedes-Benz Group due to its move upmarket into the luxury segment, will be more resilient than mass-market manufacturers, which will be forced to improve cost competitiveness, illustrated by recent potentially far-reaching measures announced by the Volkswagen brand.

Figure 1: Global light vehicle sales history and forecasts



Sources: LMC Automotive, GlobalData, Scope Ratings (estimates)

Figure 2: Average EBITDA margin and revenue growth for automotive companies under coverage



Source: Scope Ratings (estimates)

Moderate decline in profitability after strong post-Covid margin recovery

We forecast a moderate decline in the sector's profitability from historically high levels. Raw materials costs are starting to ease and turn into a tailwind for manufacturers after the sharp cost increases experienced after 2021. Elsewhere, inflationary pressure is persisting, mainly related to labour costs, energy costs, further supplier compensation costs and some persistent logistics and supply chain constraints in some regions. Labour costs are expected to rise more markedly for those original equipment manufacturers exposed to the new labour agreements concluded in North America between employers and the United Auto Workers and Unifor trade unions in Q4 2023, principally for Stellantis NV, the owner of the Chrysler, Ram, Dodge and Jeep brands.

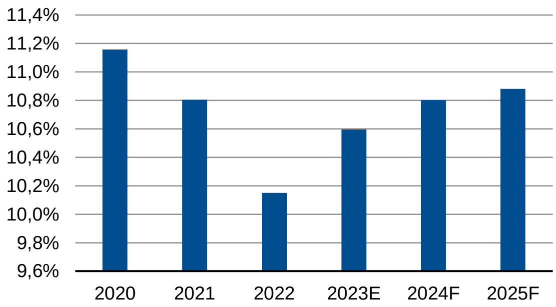
To offset inflation, the industry will accelerate efforts to lower fixed costs by reducing headcount and enhancing existing cost-competitiveness measures. They range from increasing the proportion of platforms and parts shared across different products and brands, optimising the companies' manufacturing footprint, digitalising processes and moving to direct customer sales to save on distribution costs. We anticipate a strong focus on battery-EV cost reduction to address the slower-than-expected improvement in EV contribution margins (revenue minus variable costs) due to two factors: the price war initiated by Tesla early in 2023 and the growing competition from low-cost Chinese EV manufacturers, led by BYD Co.

While our analysis focuses on the industrial businesses of automotive manufacturers, we monitor closely the risks associated with their captive-finance operations. After two extraordinarily strong years (2021-2022), we expect further normalisation of profitability (as measured by return on equity), reflecting higher cost of credit risk from historical lows in 2021, lower interest margins due to higher refinancing costs, passed on to customers with a time lag, and less supportive used-car prices, which had triggered high residual values and high remarketing gains.

Further increases in capex and R&D will remain manageable

The industry will preserve its capacity for cash generation despite continued pressure on investment spending (capex and R&D) related to the industrial and technological transformation the sector is going through. These needs are primarily driven by environmental regulation focused on replacing ICE-powered vehicles with EVs, which has required the automotive manufacturers to invest massively in new vehicle architectures, EV line-ups, battery cell and component manufacturing, while repurposing existing ICE production lines. While the industry has earmarked significant funds for future technologies (electrification and software), which are expected to peak in 2025-2026, the recent slowdown in the pace of EV adoption has led some automakers to scale down their EV investments and reassess the pace of their EV model rollout. In any case, more selective and greater prioritisation in investment decisions is likely, with no major M&A activity except for EV-related, bolt-on acquisitions and partnerships, and the continuation of prudent financial policies. The companies will retain some flexibility in total shareholder remuneration after the generous share buybacks in the past two years.

Figure 3: Capex and cash R&D ratio (as % of industrial revenues) for covered automotive manufacturers



Source: Scope Ratings (estimates)

All in all, the automotive manufacturing industry is in a healthy situation today, despite the mild short-term pressure on profitability. The industry has the capacity to fund investment due to significant liquidity buffers, and low leverage given the limited external debt in the company's industrial operations, reflected in sizeable Scope-adjusted net cash positions.

We expect automotive manufacturers to maintain robust credit metrics. As such, financial risk profiles of the industry's players remain the main support for issuer ratings.

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Business Services

Negative

Scope has a negative outlook for the European Business and Consumer Services sector.

Operating profitability in general is under pressure while the sector's financial risk profile is strained by high interest rates and increases in working capital. This in turn is increasing indebtedness and potentially squeezing liquidity. Scope-adjusted EBITDA to interest cover and cash absorption of M&A are both decreasing.

Companies with market-leading and diversified service offerings, a high proportion of recurring revenues and reasonable access to funding will cope with difficult trading and tight financial conditions. Growing reliance on automation and building market share – organically and through M&A – to expand their service offerings should help contain costs and gain pricing power. The industry can look forward to good medium-term growth prospects and benefits from medium to low substitution risk.

Environmental risks are generally low but social and governance remain high-profile issues, particularly for asset-light companies in the sector.

Here are the trends supporting and constraining the credit quality of European business and consumer services companies in 2024:

Key trends supporting credit quality
+ Replacing services is cashflow intensive and needs time in the case of talent acquisition hence substitution risk is medium to low
+ Decreasing acquisition multiples and future interest-rate cuts
+ Strong growth prospects for the market in the medium term due to expanding service offering and general increase in need for services
Key trends threatening credit quality
– Pressure on top line (discretionary services, government contracts) and on operating profitability (wages, inelastic cost structures)
– Pressure on financial risk profiles and on liquidity (high interest rates, working capital swings due to inflation and slowing customer payments)
– Cash absorbtion of M&A, necessary to reach economies of scale in fragmented markets and to diversify services offering

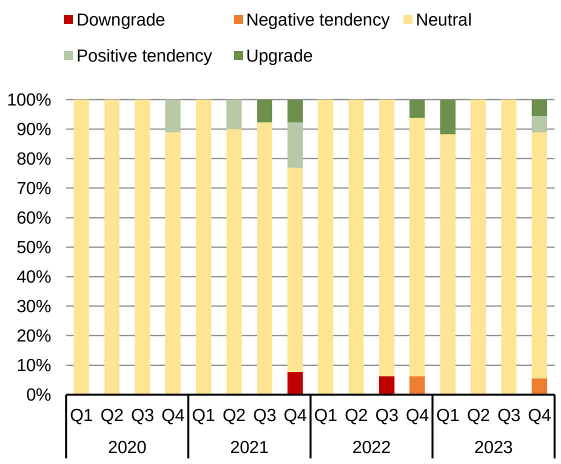
Credit quality and outlook for rated services corporates

In the past three years, our coverage of services corporates has doubled and is further complemented by our fast-growing point-in-time ratings portfolio. At YE 2023, 89% of sector ratings have Stable Outlooks so we do not expect significant rating changes in the portfolio in the next 12-18 months. The rated portfolio consists of SMEs and larger corporate. The latter generally better equipped to face the negative sector outlook. Nevertheless, unfavourable macroeconomic factors are causing difficulties in underlying markets and may adversely affect services corporates (e.g. real estate agencies, and companies providing services linked to the construction market). Covenant headroom is decreasing, fuelled by working capital swings driven by inflated top lines, longer customer payments and cash absorption of M&A.

Many services companies have mitigated this risk by broadening their service offerings and diversifying their target markets. We expect more downward ratings pressure on services companies with a high share of discretionary services, especially for asset-heavy services linked to manufacturing industries and for asset-light agency services linked to sectors with a negative outlook.

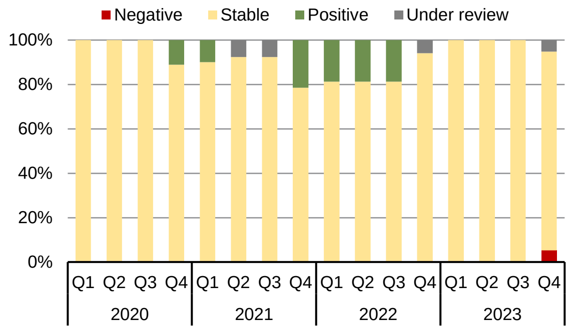
Historically a large portion of positive rating actions have been linked to M&A, since acquisitions improve buyers' market positions and diversification. We expect M&A to drive any upward movement in our ratings as economies of scale and diversification are the weak spots in the business risk profiles of most of our rated entities. Although external financing remains expensive, prominent market players with sufficient internal and external resources may continue to pursue inorganic growth strategies, typical for the business services industry.

Figure 1: Rating actions services corporates



Source: Scope Ratings

Figure 2: Outlook distribution services corporates



Source: Scope Ratings

Smaller and less diversified companies are more vulnerable to profit and cashflow shifts in current market conditions, as they are reliant on a small number of clients while most sub sectors are highly competitive. Slower customer payments, meanwhile, may put real pressure on liquidity.

As we pointed out in recent research on corporate defaults, registered business failures and/or defaults rose sharply in 2023 year over year. Business services are far from being the most affected sector and are the only sector where there was no negative ratings drift in the first nine months of last year (see **Figure 1**). Companies in our rated universe are relatively diversified and have moderate scale. Increasing bankruptcies typically relate to micro enterprises that do not reflect our rated universe.

Negative rating factors can be mitigated by an expanding services market in general, hence the good medium-term growth prospects. There are three principal favourable factors at play here:

(i) customers demand flexibility around which services corporates can offer; the alternative being cash-flow intensive and requiring time (e.g. purchase/rental of assets, in-sourcing related services, hiring and developing talent)

(ii) labour shortages can be solved by outsourcing, through temporary staffing or importing workers, which boosts the top line of human-resources services corporates, consulting and other services companies

(iii) small, bolt-on acquisitions are typical, with buyers currently benefiting from falling valuations, and often require no large extra financing to purchase a top-five competitor in a fragmented market.

Pressure on top line and on operating profitability

The business services market in the European Union grew at a high rate of 8.5% in 2022, but growth for the sector saw sluggish growth in 2023. The slight market contraction late last year will likely continue in the first half of 2024. The contraction in growth was much lower than in the construction, real estate and retail sectors. A high share of business services is not discretionary. Business services are more stable than manufacturing or energy-intensive businesses because replacing them is cash-flow intensive and results in less flexibility.

Pressure on operating profitability that may impact the sector's business risk profile stems from four principal sources:

(i) a decrease in discretionary services and revenues arising from framework contracts, due to negative market sentiment and cost cutting in most sectors

(ii) shrinking government order books due to high budget deficits and sluggish growth prospects; time delays between winning tenders and actual orders

(iii) labour shortages giving rise to wage growth that is not automatically passed through. This can be mitigated by automation, albeit this takes time, know-how and funding

(iv) the underlying business may have a negative outlook (e.g. real estate agencies, services linked to the construction sector).

Pressure on financial risk profile and liquidity

In 2024, we expect some pressure on the sector's financial risk profile and liquidity. We expect a moderate increase in indebtedness related to working capital inflation and potential M&A. Capital expenditure is unlikely to increase debt, though investment needs are generally low in the case of asset-light companies. In the case of asset-heavy corporates, we expect flat or decreasing investments with low to moderate financing needs.

With debt rising, leverage will increase moderately, measured by Scope-adjusted debt/EBITDA, and cash-flow cover will remain volatile. This may not put downward pressure on existing credit ratings, but decreasing covenant headroom is an increasing risk.

Scope-adjusted EBITDA/interest cover will decrease based on our baseline assumptions that rates will stay higher for longer. Nevertheless, we believe that most central banks have already reached peak official rates and that the first cuts by the major central banks will start no later than the second half of 2024. However, even if underlying interest-rate pressures ease, overall borrowing costs will remain at least twice as high as before the start of monetary tightening in 2022 while credit conditions will remain tight. Hence funding will be limited and expensive for highly leveraged services corporates.

Sector consolidation and automation key to preserving credit quality

Consolidation remains at the top of the industry's agenda, driven by the attractions of economies of scale, bargaining power and diversification of service offerings. Bolt-on acquisitions are ideal to expand human capital and the knowledge base, and to diversify across regions.

Services are a very diverse sector. Most markets are fragmented, and clients often use multiple service providers, hence there is room for consolidation.

Because of low unemployment and labour shortages, we expect further pressure on personnel expenses and on retaining workers, which may endanger profitability. Efficiencies from automation and standardisation are key to preserving credit quality.

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Chemicals

Negative

Chemicals sector outlook shifts to negative from stable: cost control, cash preservation in focus

Leverage in Europe's chemicals sector will start to improve this year after peaking in 2023, although a return to more typical levels will have to wait until 2025 given the prolonged cyclical downturn the industry is experiencing. Offsetting high raw materials and energy costs remains a challenge. Cost control and protecting cash flow are still industry priorities, visible in the postponement of some capital expenditure and reductions in dividends, limiting any worsening in credit metrics. The business outlook is more stable, with all companies in the sector confronting the after-effects of the pandemic and Russia's escalation of its war in Ukraine in 2022. Within the European sector and the generalised pressure on credit metrics, we do not foresee significant changes in market shares. Companies with geographically diversified production will benefit from being relatively less exposed to Europe's high energy prices than purely Europe-based rivals. Cost cutting will drive a likely only modest improvement in profitability this year compared with 2023.

Here are the main trends supporting and constraining the credit quality of chemicals companies in 2024:

Key trends supporting credit quality

+ Efforts to streamline costs and contain operational expenses
+ Some companies' decisions to specialise in a narrower range of products might lead to improved profitability, but only by 2025 and beyond

Key trends threatening credit quality

− High energy costs impact operational expenses and cost structures

− Price increases cannot always be passed through

− Delayed rebound, with the sector not expected to recover until 2025

Prolonged downturn as destocking continues

The downturn experienced by the chemicals sector since late 2022 will persist in 2024, with no recovery until well into 2025 (**Figure 1, next page**). Aggregate revenues for the 18 companies that we cover will stagnate at 2023 levels. The lack of revenue growth is common to the sector except for those firms with annual cost pass-through agreements, typical of industrial gas suppliers such as France's Air Liquide SA.

The main contributor to the deficiency in topline growth is customer destocking, with roots going back to the overstocking during the Covid pandemic. Despite the European chemicals sector's well-diversified profile, encompassing geographical diversity and a clientele from various industries, the problem of excess inventory is lingering. Consequently, the persistent lack of topline growth poses a significant challenge for the sector, requiring strategic rather than ad-hoc solutions.

Industrial consumers of chemicals changed the way they managed inventory in the pandemic, moving from "just in time" to "just in case", which led to a build-up in stocks and subsequent reduction in new demand as economic growth slowed. Even though the pandemic is behind us, inventory levels are yet to return to pre-Covid norms.

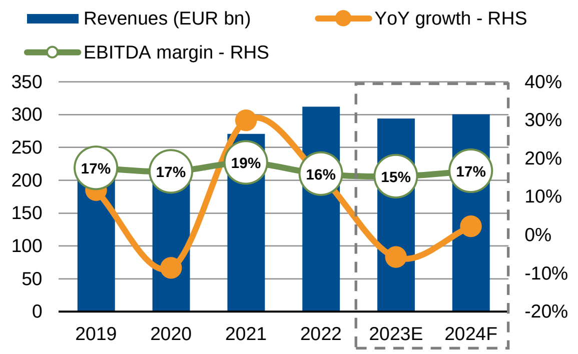
Higher interest rates in past two years have not helped. It has made economic sense for customers to liquidate inventories rather than finance them, in turn affecting the performance of the European chemicals industry. Aggregate Scope-adjusted debt as a multiple of EBITDA for the companies we cover rose 2.5x in 2023, back up at the levels in 2020 at the height of the pandemic (**Figure 2, next page**).

Nevertheless, a likely economic recovery in 2024, bolstered by possible interest rate cuts, should start to rub off on the sector, even if this recovery may not materialise for European companies until well into 2025, hence our negative credit outlook.

Evidence of the pressure facing European companies is widespread. German specialty chemicals supplier Lanxess SA reported unprecedented low capacity-utilisation rate last year. Management forecasts that a return to the break-even point in terms of capacity utilisation could take place in 2025 but might happen only in 2026.

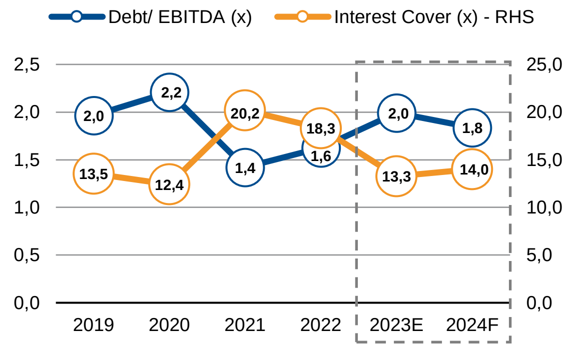
Among firms re-assessing investment plans, integrated chemicals supplier BASF SE has cut capex by EUR 4bn, with likely a long-term impact on revenue growth, which will not be as strong as initially forecast.

Figure 1: Profitability Decline in 2023, Marginal 2024 Recovery Amid Persistent High Energy Costs.



Sources: Scope Ratings estimates

Figure 2: Deteriorating Financial Metrics: 2023 and partial recovery in 2024



Sources: Scope Ratings estimates

Profit margins recover only slightly as energy costs remain high

Profitability will improve only a little for Europe's chemical companies this year. We forecast aggregate Scope-adjusted EBIDTA margins of 15.2%, up from 13.6% last year, but well below the 18% recorded in 2021. The modest recovery in 2024 will result from operational cost savings, job losses and deferrals of non-essential expenditure.

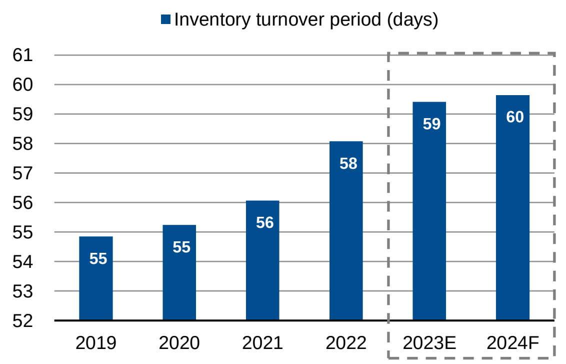
However, companies will likely have to find deeper savings or risk some deterioration in credit quality. Energy costs, a major expense for the sector, will be hard to compress as European electricity utilities have locked in elevated prices for 2024-26.

The picture looks brighter from next year on when profitability should improve for the European sector. First, the return to more normal inventory management will bolster demand. Secondly, structural transformations in the industry unfolding during 2024 will help corporate performance in 2025 through improved cost control and better cost absorption, the latter linked to higher utilisation of industrial capacity.

Three cases exemplify this transformation. First, if the Abu Dhabi National Oil Co. (Adnoc) completes its planned EUR 11bn acquisition of Covestro AG, the United Arab Emirates firm has said its primary objective is to focus on developing high-value projects, pointing to an improvement in future profit margins.

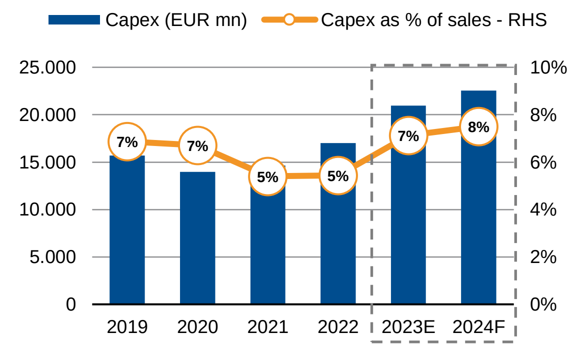
Secondly, Bayer SE is looking at a potential split between its pharmaceutical and agricultural chemicals arms, potentially helping improve the performance of both businesses. Thirdly, specialty chemicals company Syensqo SA, spun off from Belgian firm Solvay SA, aims to focus on innovative sectors such as electric car batteries, lightweight plastics, and green hydrogen, likely resulting in slightly increased profitability this year, with a bigger improvement in 2025.

Figure 3: Inventory levels are expected to return to normal levels post 2024



Sources: Scope Ratings estimates

Figure 4: Visible Capex Containment, Yet Multi-year Investments Mask Immediate Effects



Sources: Scope Ratings estimates

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Construction

Stable

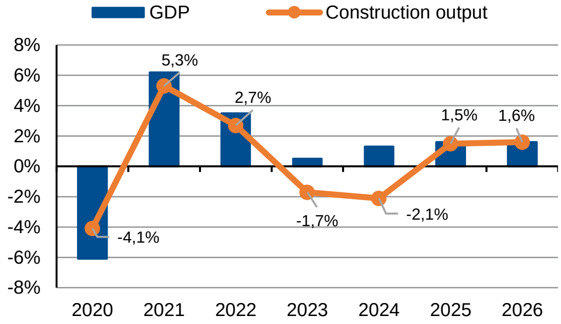
Scope maintains its stable outlook for European construction, construction materials sector

The outlook remains stable overall for the European sector, mainly supported by activity related to public infrastructure programmes and moderating materials cost inflation even though input prices remain high. Companies with a high share of civil-engineering and/or concessions activities – typically larger construction firms, generally more diversified across different business segments and with a broad geographical reach – will perform the best. In contrast, the credit quality of smaller companies, more exposed to the building segment, which are often less diversified and vulnerable to changing market conditions, is more likely to deteriorate. High interest rates and labour shortages continue to cloud the sector's outlook.

Here are the main trends supporting and constraining the credit quality of construction and construction materials companies in 2024:

Key trends for credit quality
+ Government stimulus and substantial EU funds for infrastructure projects
+ More modest increases in cost of input materials
+ Healthy order backlog particularly in civil-engineering sector, providing visibility on future revenue
Key trends threatening credit quality
- Labour shortages and persistent inflation continue to squeeze thin margins
- High interest rates and cooling demand in the building segment

Figure 1: GDP and construction output in European countries 2020-2026, YoY



Sources: EUROCONSTRUCT, Scope Ratings

Impacted by inflation, higher rates, and weaker demand, construction output in Europe will contract by 2.1% in 2024, according to consultancy Euroconstruct (December 2023). However, there is a bifurcation between the building and the infrastructure segments. While construction output in the building segment has increased in recent years before declining as interest rates rose in 2023, infrastructure construction has proved more resilient. Euroconstruct forecasts that the civil-engineering segment is unlikely to experience a decline before 2025.

Government stimulus for large-scale infrastructure projects, aimed at offsetting the impact of the pandemic and investing in the energy transition, has boosted the construction sector in Europe, Latin America and the US – regions where European companies are active. Large contractors have benefitted from public infrastructure programmes and have built up long construction backlogs in the past two years, providing revenue visibility in the next few years, despite the challenges of high interest rates and sluggish economic growth. A robust backlog as well as geographical diversification will support the companies' performance even if the European economy remains weaker than baseline expectations.

Overall, credit quality for companies in the sector is mostly stable. Larger construction groups are generally more diversified across different segments with exposure to civil engineering and broad geographical diversification outside Europe[1]. Size supports a company's ability to participate in tenders, translates into stronger bargaining positions, and provides better access to raw materials, as bigger companies can purchase in bulk.

Public procurement projects are often too large for smaller construction companies to undertake. The smaller firms will remain under pressure in 2024 as they are typically more exposed to building construction and less geographically diversified, hence more sensitive to the gradual economic recovery. While EU contractor

[1] Larger European companies in Scope's coverage generate over 50% of revenues outside of Europe.

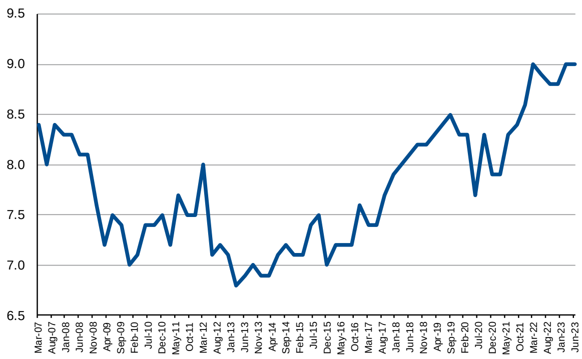
bankruptcies have picked up speed in various countries[2], most defaults are related to micro-sized construction companies, which are not part of our rated universe. We expect defaults to remain elevated through 2024 among this group of companies given the decline in residential construction[3], where these companies have most of their exposure.

We recorded few negative rating actions in the construction sector in 2023, mainly Outlook revisions to Negative on non-IG companies in the 'B' rating category. Over the next few quarters, most of the companies in the 'B' category will have lower, although still positive, free operating cash flow (FOCF) and adequate liquidity. However, we cannot rule out negative rating actions if a company's order backlog significantly shrinks, resulting in a weaker financial risk profile, or if liquidity deteriorates.

Construction order backlog at record high

The construction sector is benefitting from a healthy order backlog, running at an unusually high level of nine months in Q2 2023 mainly linked to infrastructure projects. This is credit positive as it provides good visibility for 2024 revenues. The order backlog of the largest European contractors reached record highs. For example, the order backlog of Spain's ACS Group stood at around EUR 75bn as of end-September, up 9% from end-December 2022, bolstered by energy and transport projects in high growth markets (US, Australia, and Europe).

Figure 2: European construction sector: months ensured by current backlog



Source: Statista, Scope Ratings

In Europe, funding from the European Commission and national governments for the renovation of roads and railways, in line with the ambitious objectives of the EU Green Deal, has played a crucial role in fostering growth in the construction sector. Similarly, the US expects a substantial increase in infrastructure investment in 2024 through the impetus of President Joe Biden's Bipartisan Infrastructure Law aimed at modernising roads, bridges, and tunnels, with a focus on reducing carbon emissions and enhancing safety. The continued investment in infrastructure in the EU and US indicates a strong period ahead for the construction industry, underscored by the creation of the world's second biggest infrastructure-investment firm through Blackrock's USD 12.5bn acquisition of Global Infrastructure Partners earlier this month. Similarly, Switzerland's Holcim Group plans to spin off its US activities by mid-2025 to maximise the valuation of the business.

Slowdown in the building construction to continue

The outlook appears less favourable for construction companies with greater exposure to building construction. Tightened credit conditions are constraining demand, hence the downturn in residential construction, with several projects being delayed or stopped due to clients' inabilities to obtain financing, leading to project cancellations and jeopardising the revenue visibility associated to the related order backlog (see Scope's Corporate Real Estate Outlook 2024) as opposed to that associated with public procurements. Sluggish economic growth in Europe is holding back household and corporate spending. However, some offsetting factors include government programmes to encourage refurbishment of old residential building stock, and private-equity and foreign investment in certain sectors, like logistics and data centres[4].

Low profitability margins will continue to be a challenge

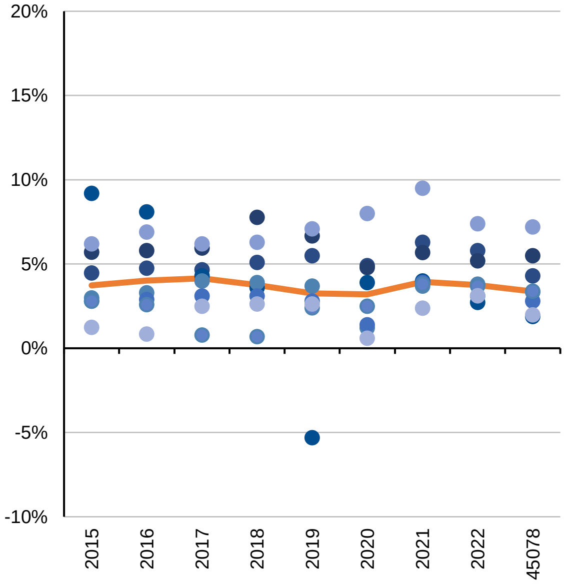
Construction companies are grappling with persistently low profit margins despite robust order backlogs, representing the sector's most significant challenge. Raw materials prices have risen sharply in recent years, partly due to trade disputes and supply-chain bottlenecks. Though these pressures are easing, construction costs, particularly for materials like steel and timber, remain high. Management's underestimating of the extent of inflation has eroded the quality of the order backlog for many firms, although there is limited flexibility in adjusting pricing for existing contracts.

[2] Here more information on Hungary and Spain.

[3] EUROCONSTRUCT predicts a 12% decline in housing deliveries between end-2021 and end-2025, particularly in Germany, France and the Nordic countries.

[4] This is the case for Hungary, where continued foreign investment in industrial building projects is benefitting Hungary's bigger companies in the sector. See Hungary: construction sector unsettled by low volumes, thin margins, uncertainty over EU funds.

Figure 3: Top European contractors – reported EBITDA margin of construction activities



Note: Median of top construction companies (Vinci, Grupo ACS, Ferrovial, Eiffage, Bouygues, Skanska, Strabag).

Source: public information, Scope Ratings

The industry is also facing a labour shortage, leading to wage inflation as firms strive to attract and retain workers. This shortage is expected to persist, with the demand for labour outstripping supply in 2024.

We anticipate that average EBITDA margins will remain stable, hovering below 5% in 2024. We expect stable profit margins for larger, global companies, but more volatile ones for smaller, less diversified construction firms. Large companies are better positioned to cope with the high costs of raw building materials and energy.

M&A activities include expansion in the concessions segment

As profit margins in their core segment of construction are very low, various industry players have shifted their strategies towards expanding the concessions segment of their businesses, expecting to benefit from recurring income and higher margins through infrastructure management. Companies such as Spain's Ferrovial SA, ACS Group, and Sacyr SA have focused on increasing the volume of their concessions businesses and raised funds through the sale of non-strategic divisions, equivalent to more than EUR 8bn in the past three years. Raising the proportion of concession-related business will help companies to weather economic downturns and stabilise operating performance.

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Consumer Goods

Slightly Negative

The outlook is stable for non-discretionary, negative for discretionary consumer products

The credit outlook for European consumer products companies in 2024 is split between the stable prospects for non-discretionary suppliers and much less favourable ones for suppliers of discretionary goods. For the first group, a modest recovery in profitability underpins credit quality. Revenue growth will be limited but falling raw materials costs will offset rising wages, increased advertising costs and the risk of higher logistic costs. The outlook for suppliers of discretionary consumer products is negative, reflecting the risks of a prolonged cyclical downturn in demand. Diversified investment-grade issuers will maintain comfortable credit metrics, but high-yield issuers face deteriorating interest coverage and increasing refinancing risks, given high interest rates.

Here are the main trends supporting and constraining the credit quality of consumer products companies in 2024:

Key trends supporting credit quality	
+	Declines in most raw material prices in the entire sector will support gross margins
+	Unemployment levels to remain very low in Europe amid increasing wages, supporting disposable incomes
+	Leverage ratios not expected to deteriorate, particularly for non-discretionary issuers
Key trends threatening credit quality	
–	High interest rates, weakening EBITDA interest coverage and widening refinancing risks for high-yield issuers, especially for non-discretionary issuers
–	Uncertain economic prospects and geopolitical risks affecting consumer confidence and logistic costs affecting the entire sector
–	Weak revenue growth for both subsectors that is attributed to soft demand, an unfavourable product mix, and limited room for additional price increases

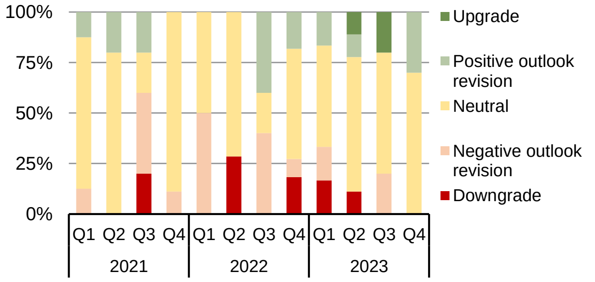
Credit risks still concentrated in discretionary consumer products sector

Ratings for the consumer products companies that we cover have been under pressure since the return of inflation, with negative rating actions outpacing positive ones in the past three years, although that pressure eased in H2 2023 as cost inflation began to fade.

Rating actions for issuers in the non-discretionary consumer products subsector in the past 12 months have been more positive than negative, although this reflects the profiles of the companies that we cover, which operate in less cyclical sub-industries, including for example food and alcoholic beverages. In addition, several high-yield issuers in the sector in Hungary benefitted from government subsidies and temporarily invested in high-yielding fixed deposits, lifting their cash balances.

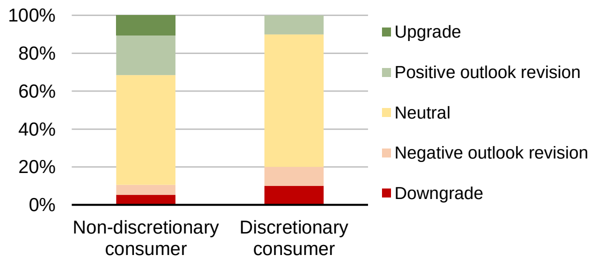
The less favourable outlook for discretionary consumer issuers reflects their vulnerability to unfavourable shifts in consumer demand combined with the currently high interest environment. A failure in adequately recovering pre-inflation EBITDA levels or a further drop in profitability would put serious strain on EBITDA coverage levels, especially for high-yield issuers. Our rating actions for issuers in the discretionary subsector in the past 12 months have been more negative than positive, reflecting the challenges from high inflation and weak consumer confidence.

Figure 1: Scope rating actions on consumer products issuers during 2021 - 2023



Source: Scope Ratings

Figure 2: Scope rating actions in 2023 – split of non-discretionary vs. discretionary consumer products

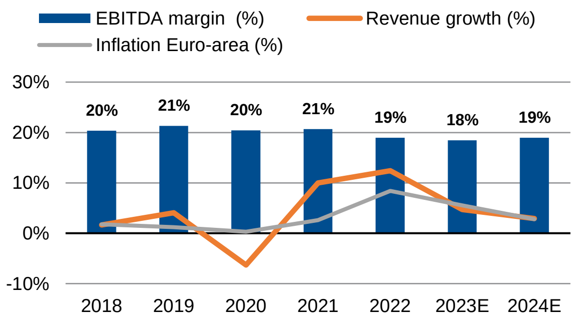


Sources: Scope Ratings

Less room to raise prices as inflation eases; demand looks sluggish

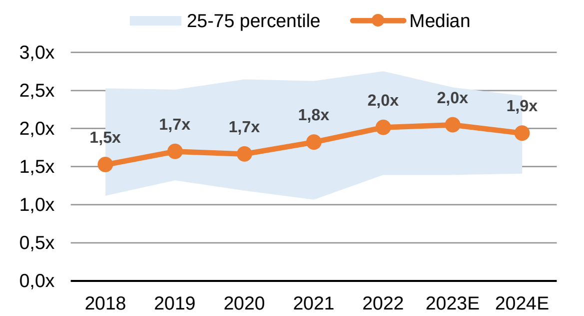
Consumer product companies will struggle this year to repeat the price increases, which drove the organic revenue growth recorded in 2023 to offset shrinking sales volumes as consumers increasingly switched to cheaper, discount goods from premium, branded products. Given this backdrop of a weaker product mix, the sector faces weaker topline growth due to softer consumer demand and limited headroom for further price increases as headline inflation eases worldwide. Consumer confidence remains weak although recovering. One reason is the uncertain economic outlook. Real GDP growth will only slowly recover in Europe in 2024 while it will slow down in China and Japan. Another is geopolitical, with continued implications for supply chains. Russia's intensified war in Ukraine is approaching its third year. Conflict is spreading in the Middle East after Hamas's attack on Israel last October, disrupting maritime trade through the Suez Canal and Red Sea. Sea traffic has also been interrupted by the drought affecting water levels in the Panama Canal. However, there are some supportive factors on the economic front. Unemployment levels in the largest developed economies will remain very low in 2024. Coupled with increased wages, disposable incomes should hold up, even if that will be partly offset by reduced state spending as governments tighten their budgets after a long period of providing household support during the pandemic and energy shock.

Figure 3: Average EBITDA margin and revenue growth for a selection of covered large consumer product issuers



Sources: Scope Ratings estimates, Eurostat

Figure 4: Scope-adjusted debt/EBITDA for a selection of covered large consumer product issuers



Sources: Scope Ratings estimates

Moderate recovery in profitability on lower input costs

Profitability will recover moderately in 2024 mainly due to falling raw material costs rather than price increases. We see improvements in gross margins for processors of most agricultural products, plastics – which is also relevant for packaging, and cotton. However, while improving, profitability will remain subdued compared with historical levels. This is partly a consequence of rising wages, still elevated energy costs and potentially higher logistics costs. Management will also likely spend more on advertising and promotion for their branded products to recover market share lost to suppliers of cheaper/non-branded, privately labelled goods. Non-discretionary investment-grade issuers with a global footprint and widely diversified across product categories will be shielded from potential demand shocks in selected regions or markets unlike their smaller, less diversified peers. For discretionary products, the weak consumer confidence may limit volume growth or headroom for pricing actions and keep profitability subdued.

Deteriorating interest coverage and refinancing risk for high-yield issuers

Average leverage for our entire portfolio coverage, measured by Scope-adjusted debt/EBITDA, is unlikely to deteriorate materially in 2024 given recovering EBITDA and the net positive impact of inflation on absolute profitability versus indebtedness. Nevertheless, for suppliers of non-discretionary products, management is more likely to put improved cash flow towards capital expenditure and acquisitions after a few years of holding back.

For 2024, we expect a further deterioration in interest cover, although such deterioration will be manageable for investment-grade-rated issuers, which have the balance sheet flexibility. Interest cover, measured by Scope-adjusted EBITDA/interest expenses, deteriorated in 2023 on rapidly growing interest expenses. Interest cover has again become a relevant metric even for investment-grade-rated issuers after years of extremely low interest rates. Maintaining interest cover is more of a challenge for high-yield (and discretionary consumer issuers), which saw funding costs rising much faster than investment-grade (and non-discretionary peers) over the past year. As a result, the former group has limited capacity to absorb further declines in profitability to preserve interest cover metrics and liquidity.

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Oil & Gas

Positive

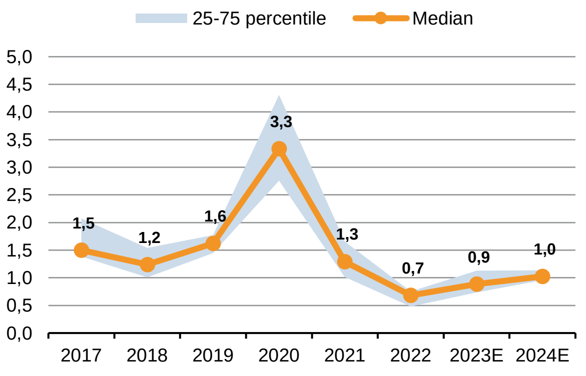
Scope maintains its positive credit outlook for the integrated oil and gas sector.

The financial profiles of integrated oil and gas companies (IOCs) will remain strong for a prolonged period as the industry benefits from elevated commodity prices and margins which had provided a big boost to earnings and cash flow in 2022 and 2023. Nevertheless, modest declines in energy prices and a likely revival of environmental pressures on the fossil-fuel sector this year set the stage for less pronounced rating upside compared with last year.

Here are the main trends supporting and constraining the credit quality of oil and gas companies in 2024:

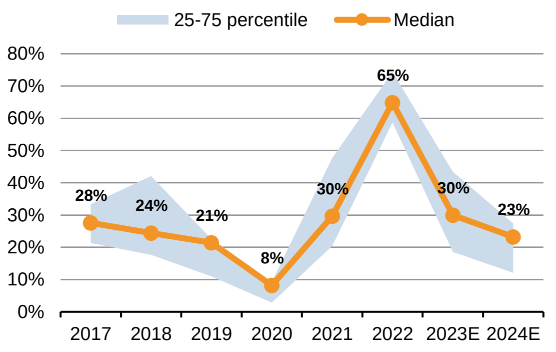
Key trends supporting credit quality	
+	Cash generation to remain strong despite modest declines in energy prices and accumulated impact of inflation on cost base
+	Prudent financial policies: capital spending to stabilise, total shareholder remuneration to remain flexible
Key trends threatening credit quality	
–	Environmental considerations reemerge as a top priority, although primacy of energy security will ensure no immediate pressure on business risk profiles

Figure 1: Leverage (Scope-adjusted debt/EBITDA)



Sources: Scope data based on nine covered oil and gas companies

Figure 2: Cash flow cover (Scope-adjusted FOCF/debt)



Sources: Scope data based on nine covered oil and gas companies

Cash generation to remain strong despite moderation of energy prices

Volatility remains the norm in oil and gas markets given the uncertainty surrounding a variety of economic and geopolitical issues (please refer to Scope's 2024 Global Economic Outlook). Considering the inelastic nature of the oil and gas markets the supply-demand balance is crucial for price development. According to the International Energy Agency, world oil demand rose by 2.3 mb/d to 101.7 mb/d in 2023 and is expected to further grow to 102.9 mb/d in 2024 (i.e. +1.2 mb/d YoY), mainly driven by global economic trends, efficiency improvements and a growing electric vehicle fleet. World oil output growth is estimated at 1.9 mb/d to 102.0 mb/d in 2023 with additions originating from non-OPEC+ countries led by the US, Brazil and Guyana being partly offset by OPEC+'s production cuts. While the global oil market was largely balanced in 2023, a lot will depend on OPEC+ ability to extend and even deepen production cuts to avoid a potential oversupply as non-OPEC+ production is projected to grow by 1.5 mb/d in 2024.

In the absence of major shocks (e.g. a dramatic escalation of the conflict in the Middle East, a break-up of OPEC+ or a global economic recession), we expect oil and gas prices to continue to ease from 2022 highs with Brent oil price averaging between 70 and 80 USD/bbl and Dutch TTF gas price around 30 EUR/MWh. We also expect refining margins to normalise towards multi-year averages.

Helping offset the pressures on revenue growth is the industry's lean cost structure. Faced with the inflationary effects on operating expenditures -- staff costs, purchased materials and services – that have accumulated over the past two to three years, IOC management is looking to cut costs along the entire value chain. In addition to potential savings resulting from M&A, accelerated automation and digitalisation may help permanently lower industry costs by using robotics, internet-enabled equipment, and AI-techniques. The IOCs are targeting multiple areas. Predictive maintenance can improve reliability and reduce operational risks such as oil spills. Other benefits are likely to emerge from the use of advanced analytics, machine-learning algorithms and data-driven process optimisation. As a result, cash generation remains strong despite a less favourable oil market.

Capex to stabilise, total shareholder remuneration to remain flexible

Capital expenditure will stabilise at around 2023 levels on average following the rapid recovery from the pandemic-driven cuts in investment. However, investment priorities and capex intensity vary among IOCs (Oil and gas sector: contrasting IOC low-carbon capex strategies change risk profiles.) Capex volumes will reflect market uncertainty and financing conditions, not forgetting the impact of inflation on project costs.

Considering the moderating prices and healthy balance sheets, we expect M&A activity to continue into 2024 mainly driven by growing focus on economies of scale, bargaining power and portfolio high-grading in the sense of seeking low-cost, low-emission assets. Scale is increasingly important in the sector not only for boosting profitability, but also for relevance with investors to ensure access to diverse sources of capital. Nevertheless, we are unlikely to see European IOCs pursuing megadeals similar in size to ExxonMobil's USD 60bn bid for Pioneer Natural Resources or Chevron's plan to acquire Hess for USD 53bn. The more conservative European approach reflects less ambitious growth strategies in hydrocarbons, the lower equity valuations of the companies than their US peers which impede stock-based transactions, and greater focus on preserving strong balance sheets.

Shareholder returns are likely to follow the operating trends as healthy balance sheets are on the top of management agendas. Regular dividends to remain unchanged or grow moderately at the cost of less generous share buybacks and special dividends, thereby diminishing total shareholder remuneration.

Debt issuance is likely to pick up somewhat, it will remain at low levels and will be mainly focused on refinancing of debt maturities as the sector continues to generate solid free operating cash flow. Exceptions from this general trend are likely to be companies with heavy investment spending, both organic and inorganic.

As a result of robust cash generation and prudent financial policies, we expect IOCs to maintain strong credit metrics.

Environmental considerations jostle with energy security

Energy security concerns took centre stage in political and business discussions involving the industry after Russia's escalation of its war in Ukraine nearly two years ago, but now we expect environmental considerations to play a bigger role again. The COP28 agreement to transition away from fossil fuels is one example, although the tangible impact of revived regulatory and investor scrutiny will likely be in the medium and long term rather than in 2024. The energy transition remains hugely complex involving a multitude of stakeholders with diverse interests and the pace of policymaking determined by nearer-term objectives, not least residual concerns about energy security.

Growing pressure on IOCs' business risk profiles remains manageable because of the rather remote prospects of peak oil and gas demand. Ensuring that households and industry have easy access to affordable energy is crucial, economically and politically. In addition, the IOCs are making some progress in their own business adaptation/transformation towards a lower-carbon future while benefiting from the ample profitability of their legacy businesses due to favourable commodity prices.

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Pharmaceuticals

Stable

The outlook is stable for the pharmaceuticals sector

US and European companies can look forward to another year of favourable trading conditions, underpinned by robust operating profit margins and strong cash flow. With balance sheets healthy and central bank interest rates likely at their peak, pharma executives will eye bolt-on acquisitions to plug gaps in portfolios or shift strategic focus to faster-growing segments while avoiding transformational, debt-financed deals that would put credit ratings at risk.

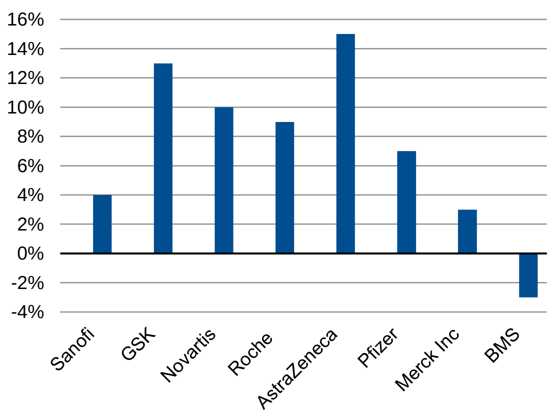
Here are the main trends supporting and constraining the credit quality of pharmaceutical companies in 2024:

Key trends supporting credit quality
+ Most players are able to extract good, GDP-plus types of growth rates, based on product innovations and demand growth, thereby over-compensating for patent expiries, non-performing pipelines and lower revenues since the pandemic crisis
+ Credit metrics are expected to at least stay on their robust levels of the last few years, based on unchanged good operating cash flow generation
+ Financial policy appears to be generally more conservative in Europe, while US players tend to be more shareholder value oriented
Key trends threatening credit quality
– Discretionary spending in the US
– Diversified business models coming under shareholder value pressure (Bayer, Merck)

Favourable operating conditions

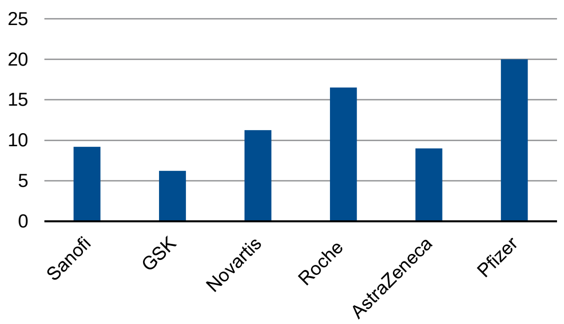
Pharma sector operating profit margins will remain at healthy levels, translating into continued solid 2024 free operating cash flow generation for a select number of big pharma players (**Figure 2**). Covid-driven revenue declines in 2023 have been an issue only for the more specialised companies (which Scope does not cover), as well as for Pfizer, which has ploughed its excess cash flows of the last three years into M&A. Most European players, including Merck KGaA (life-sciences exposure to Covid-related revenues), have coped well with the impact of the post-pandemic normalisation of revenues in terms of its impact on credit quality. Most of the sector's companies generated comparatively high revenue growth in the first nine months of 2023 on a currency- and Covid-adjusted basis (**Figure 1**), and well above GDP growth. This has been driven by a combination of innovation in areas such as respiratory syncytial virus (RSV) vaccines and treating obesity, new product launches which have offset the impact of expiring patents and generally supportive underlying trends such as shifts to healthier lifestyles and rising life expectancy in many countries.

Figure 1: Continued high sales growth rates… (first nine months 2023, yoy)



Sources: Company accounts

Figure 2: … and free operating cash flow levels (FOCF, in EUR bn)



Sources: Scope Ratings estimates

Credit metrics show financial headroom, rating stability

Moderate to strong revenue growth for the world's biggest pharma companies by sales (**Figure 1**), flat operating-profit margins and rich cash flows are fundamental credit strengths, set to at least remain stable in the short to medium term, subject to the scale of dividend distribution, share buybacks and M&A deals (see below). It is durably high operating margins combined with modest working capital requirements and capital expenditure that explain the sector's ample free operating cash flow (FOCF) (**Figure 2**).

Assuming no major disruptions to operating business conditions – and given the sector's success in adapting to the Covid aftermath – discretionary spending on dividends, buybacks and M&A is the last remaining 'spoil sport' with the potential to damage credit metrics for the sector (see below).

Financial policy considerations

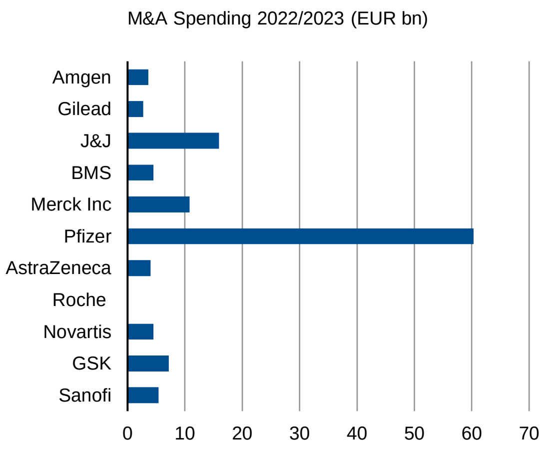
Financial policy is generally of little concern for the sector's credit quality overall, although European pharma companies remain more conservative than their US peers judged mainly on M&A spending levels and shareholder remuneration.

However, even Pfizer, the biggest M&A spender of the moment, is far from endangering its credit quality given the ample liquidity generated through the pandemic mostly from its Covid vaccine and treatments. The US firm had more than USD 40bn of liquidity on 1 October 2023.

In addition, many pharma companies have spun off newly designated non-core activities, predominantly consumer healthcare, providing additional proceeds for acquisitions and paying down financial debt and/or pension obligations.

More companies are likely to follow suit in prioritising specialisation rather than diversification, judging by the pressure for changes in management at long-term sceptics of such an approach like Germany's Bayer AG and Fresenius SE as their share prices have underperformed the rest of the sector. M&A may become more tempting for European companies – at least to some extent.

Figure 3: Comparison M&A spending, Europe vs US (2022 and 2023)



Sources: Company accounts

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Real estate

Negative

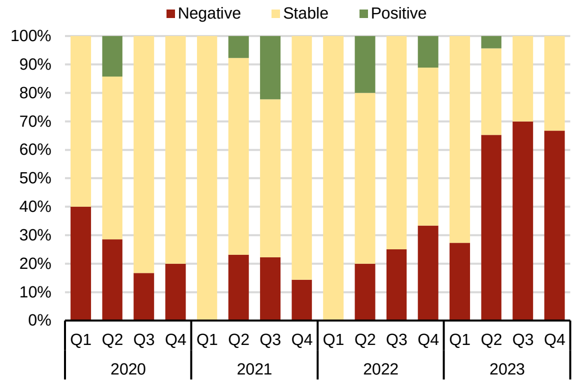
Scope maintains its negative outlook for the real estate sector

The credit outlook in European real estate is set to diverge further: stable for those companies with higher-quality assets, low leverage, robust business models and sufficient scale to refinance debt falling due without sacrificing investment for future growth – and negative for companies lacking these attributes. Increased distressed selling of assets will lead to repricing of older properties, particularly those requiring investment to meet tightening environmental standards. The problem is concentrated in the offices sector, especially for non-prime assets, amid some signs that the market is bottoming out in the industrial and retail segments.

Here are the main trends supporting and constraining supporting and constraining the credit quality of real estate companies in 2024:

Key trends supporting credit quality
+ First rate cuts by major central banks in H2-2024
+ Price adjustments for retail and logistics properties bottoming out
Key trends threatening credit quality
- Limited or expensive refinancing options
- Shift in demand especially for non-prime office properties and increase in tenant defaults
- Further decline in property values and debt protection
- Higher investment to meet tightening environmental standards

Figure 11: Rating actions real estate corporates[5]



Source: Scope Ratings

The European real estate sector is facing a cyclical downturn, expensive and/or limited refinancing options and increased liquidity requirements, as well as structural changes including a higher focus on enviromental compliance and shifts in demand in some commercial real-estate segments.

The sector will continue to experiencee declining valuations and deteriorating interest coverage through 2024[6], leading to continued downward pressure on ratings.

Additional ratings pressure follows an increase in the proportion of negative rating actions taken on property companies in 2023[7]. The actions were concentrated in the Nordic countries and Germany. The drivers have been the sharp rise in borrowing costs, particularly in the Nordics, the widening of capitalisation rates, felt most acutely in Germany, and the collapse in demand for homebuilders and commercial developers.

Bankruptcies will run at elevated levels this year, but we do not expect the recent default of the Austria-based Signa Group to have significant consequences for the rest of the sector. Commercial and residential property developers will likely account for the largest shares of property company insolvencies in 2024 as they did in 2023 with the likes of Development Partner AG, Gerchgroup AG and Project Immobilien Group AG. This group of companies still faces high pre-financing requirements due to increased construction costs, even if inflation subsides further this year, and the longer time it is taking to close sales. These firms are also likely contending with hard loan-to-value (LTV) covenant breaches due to lower gross developed values. Underlying these challenges is the subdued demand from institutional and retail property buyers, which is likely to be slow to recover even though yields will likely cease widening to the degree they did last year.

[5] Negative rating actions: Outlook change to Negative from Stable or Stable from Positive; Downgrade; under review for possible downgrade

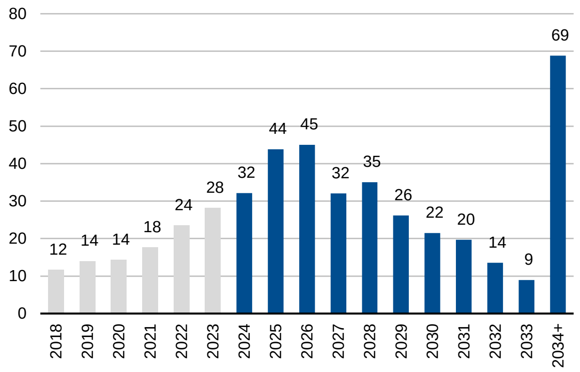
[6] The median interest cover of our extended peer group fell to its lowest level in H1 2023 (3.2x) since 2016 (3.0x). This compares to 4.1x at YE 2022.

[7] Eight of the 36 companies we track in the property sector have a Negative Outlook at the end of 2023.

Mortgage rates should stabilise at or around current levels as confidence grows that the interest rate cycle has peaked.

Refinancing challenge amid rising liquidity needs

Figure 2: Maturing capital market debt (European issuers with outstanding capital market debt of more than EUR 10m; EUR bn)



Sources: Bloomberg, Scope Ratings

European real estate firms need to refinance capital market debt of around EUR 120bn maturing in 2024-26, an increase of around 75% compared with 2021-2023. At the same time, refinancing options are limited. Banks are not necessarily expanding their loan books in the sector. If borrowing is available, it is expensive as pricing in debt and equity capital markets has soared, especially for high yield issuers. Often, the financing is simply unavailable if debt yields[8] are below current borrowing costs or leverage is such that there is no buffer against a drop of up to 20% in property values in some segments by YE 2025 – hence the scale of t'e sector's refinancing challenge.

At the same time, liquidity needs stretch beyond refinancing maturing deb. Real estate firms are grappling with weak demand for new property developments, high construction and borrowing costs, rising environment-linked capital expenditure, a crisis in affordable housing, increasing tenant defaults, and structural shifts in demand in some commercial property segments.

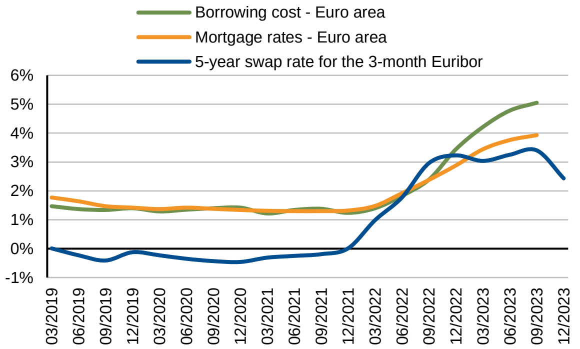
Rental income subject to shift in demand and increase in tenant defaults

Property companies are also exposed to rising bankruptcy rates among their tenants, concentrated among some more fragile sectors, partly related to the withdrawal of Covid-related state support, such as information and communication (defaults increased YoY by 37% in the year to end-September 2023 according to Eurostat) and transport and storage (26%). However, the number of corporate bankruptcies is broadly in line with pre-Covid levels. Hence, companies with higher quality and diversified portfolios should avoid sharp declines in income by finding new tenants even if existing tenants' default or their credit quality deteriorates. Vacancy rates remain low in the residential and logistics sectors, for example, with the vacancy rate for the latter at 4.3% at end-Q3 2023 according to JLL.

Shifts in demand, particularly out of non-prime office and retail space as space requirements decline due to an increasing proportion of remote working and the continued growth of e-commerce, will weigh on future rental incomes after the fillip for rental income from CPI-linked leases fades, assuming inflation continues to moderate in 2024.

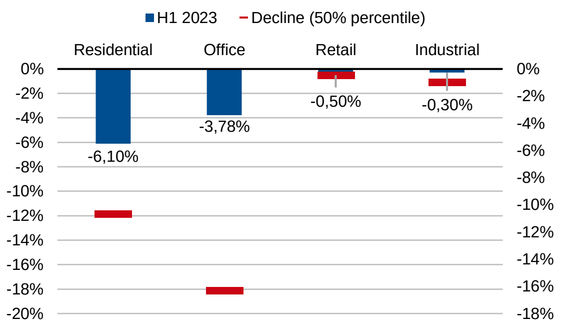
Interest cover under pressure as borrowing costs remain higher for longer

Figure 3: Funding costs



Sources: ECB, Investing.com, Scope Ratings

Figure 4: Expected decline in fair values (YE 2022 to YE 2025)[9]



Sources: public info on selected peers, Scope Ratings estimates

Our base-case assumption is that higher rates will prevail for longer. Nevertheless, we believe that central

[8] Ratio of total annualised cashflow generated by collateral and available for debt servicing relative to the outstanding principal balance of a commercial real estate (CRE) loan.

[9] Reflects structural shifts in investor demand for industrial properties between 2016 and 2019, with spreads to risk-free yields converging with that of other commercial property types. Structural shifts in demand for office properties are not reflected. Based on: (i) prime yields as of end-September 2023; (ii) risk free returns as of end-September 2023; (iii) Scope's assumption on sustainable spread between yields and risk free returns for A-located, prime properties in Continental Europe and; (iv) Scope's assumptions of rental growth as of January 2024.

banks in major economies have already reached the peak of their rate increases in the current economic cycle. Provided no further external major shocks occur, we expect the first likely rate cuts by major central banks will start in the second half of 2024. These expectations are more hawkish than those priced into markets – which expect earlier and more significant rate cuts. However, even if the underlying interest rate pressure eases, overall borrowing costs will remain at least twice as high as before the start of monetary tightening in 2022. In addition, highly leveraged real estate companies or those with cyclical or weakening business models will encounter rising borrowing costs this year, while they will stabilise for stronger peers.

The rapid rise in borrowing costs from 2022 onwards has hit hardest those companies that rely on short-term funding or have limited hedging such as Nordic companies and property developers. While the cost of unhedged debt is expected to peak in Q1 2024, higher borrowing costs will take their toll across the sector as the refinancing of an ever-growing pile of maturing debt begins, putting more pressure on interest coverage.

Real estate firms exposed to sectors with a favourable supply/demand imbalance, such as residential and logistics, and with relatively low leverage, will be able to absorb the impact of higher interest rates due to stable and growing rental income in the short to medium term. For property companies in other sectors such as non-prime offices and/or those with high leverage, high interest costs will squeeze credit quality.

Further decline in property values

Uncertainty over the direction of interest rates this year is diminishing. However, asset sales, whether “motivated”[10] or distressed, are likely to increase, undertaken by more companies than those just with good access to investment markets, such as Vonovia SE. The German company plans to sell another EUR 3bn in 2024 after EUR 3.7bn in 2023. Bid-ask spreads will narrow and the investment market will slowly reopen through the year. However, asset sales will put pressure on values as sellers will have to accept steep discounts to enable buy-side financing. Some property companies will also need to undertake major revaluations to restructure their balance sheets to ensure the availability of future financing.

In addition, pricing will likely fragment on the basis of property quality, with the heavy repricing of older, less energy-efficient and less environmentally-friendly buildings. Investors are increasingly mindful of the investment challenges the industry faces. Real estate is the largest energy-consuming sector in Europe, accounting for around 40% of total energy consumption and a third of carbon dioxide emissions. In essence, financing the estimated EUR 225bn to EUR 600bn of annual investment[11] across Europe's real estate stock needed to meet the EU's target of being carbon neutral by 2050, without compromising its social role in providing affordable housing and commercial space, may only be achievable through a massive revaluation of property assets and loss of economic wealth for owners – unless extra state support emerges.

As a result, we expect further declines in the value of offices and residential assets, and non-prime property in general, even though valuations for retail and industrial assets have likely bottomed out (**Figure 4**).

Deleveraging vital to preserve credit quality

Companies will need to focus on deleveraging as fair values and interest cover remain under pressure. With market values set to decline across the sector, despite some signs of a bottoming-out in the industrial and retail segments, the release of capital through asset sales and debt repayments will remain essential for keeping credit metrics stable. At best, large and moderately leveraged real estate companies will be able to defend their credit quality, while shrinking portfolios could impact other real estate companies' abilities to diversify cash flow and maintain profitability levels, putting additional pressure on credit ratings. At worst, capital release will not be sufficient and companies will have to modify/restructure their liabilities, ultimately increasing the number of defaults within the sector in 2024.

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[10] Motivated sales are sales that issuers are willing to make to free up capital to assure a smooth refinancing of maturing debt well in advance.

[11] Calculation: European property stock: ¾ considered inefficient, needed renovation rate: 3% per year equalling 750 million sq m in floor space, estimated costs EUR 330-800 per sq m in deep renovation / Sources: European Commission, Buildings Performance Institute Europe, Scope Ratings.

Retail

Stable

Scope maintains its stable outlook for the retail sector

The credit outlook for the sector will remain stable this year despite weak consumer confidence contributing to little or no growth in demand. Retailers are adapting to the difficult trading conditions through tighter control of costs – helped this year by decelerating inflation – and of inventories and greater focus on profitable sites and regions. However, credit quality will diverge between larger firms, benefitting from diversification and economies of scale, and smaller enterprises, more sensitive to stagnating demand. Competition for market share from e-commerce firms remains a challenge for bricks-and-mortar retailers of discretionary goods.

Here are the main trends supporting and constraining the credit quality of retail companies in 2024:

Key trends supporting credit quality

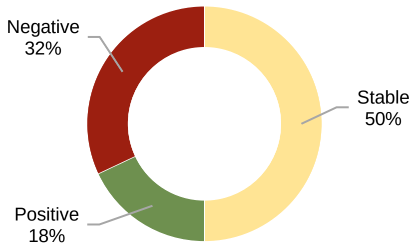
+ Price inflation is slowing down, easing pressure on profit margins
+ Improving net working capital following recent inventory optimization
+ Less supply disruption and lower logisit costs

Key trends threatening credit quality

– Rising rental costs
– Heavy capital expenditure needed for those retailers wanted to expand e-commerce, multichannel sales
– Increasing competition from online platforms pose a continued threat to the market share of traditional retailers

The European retail sector will remain under pressure underpinned by the slowdown in growth in sales volumes that started at the beginning of 2022. More frugal consumer behaviour, in particular for discretionary goods, has now lead to stagnating demand. Still, retailers will likely offset related pressures on cash generation due to efficiency programmes, increasing customer retention, more flexible inventory management and tighter focus on profitable locations and products. Scaling back plans for expanding growth in the number of bricks-and-mortar outlets will help. However, some investment in customer retention through marketing campaigns and enhancing multichannel sales experiences will be crucial to offset shinking demand.

Figure 1: Rating outlooks in 2023 – Retail Corporate



Sources: Scope Ratings

Flat demand but operating costs fall, especially for discretionary retailers.

Consumer confidence will remain weak and growth in retail demand will be negligible this year, with latest Eurostat data confirming the downward slope in retail volumes in Europe. However, retailers will benefit from existing and new efficiency programmes in holding profit margins steady. Larger companies, such as Germany's Ceconomy AG in electronic goods, have shown resilience to the economic downturn, with relatively stable EBITDA in 2023. Likewise, other retailers with large networks such as France's Fnac Darty SA and Germany's Otto GmbH & Co KG are similarly well positioned, benefitting from geographical diversification and multiple product line-ups. They will offset declining or stable sales volumes with ancillary services and own-label products, which generate typically higher margins. On the other hand, smaller retailers will suffer more from weak demand and struggle to cover overheads, especially if they depend on fewer points of sale.

Food retailers' profit margins to remain stable

We expect non-discretionary retailers to maintain their margins as inflation eases. In 2023, the largest food retailers fought to keep market share against discounters as shoppers chased lower prices. For instance, UK retailer Tesco PLC counteracted the effects of inflation on costs, reporting only slightly lower profit margins through a combination of price increases, a strong performance at wholesale subsidiary Booker, and significant cost savings. Tesco's 'Save to Invest' programme delivered more than GBP 500m in saving. Tesco and rival Sainsbury PLC have withstood the consumer shift to discounters in 2022 and 2023, with market share broadly unchanged over the past two years. In 2024, retailers will likely keep prices stable and continue promotion campaigns and personalised services to retain market positions. Lower energy costs and efficiency measures implemented in 2023 will support profit margins.

Inventory control, lean physical networks, multi-channel strategy in focus

Efficient distribution and inventory management are crucial in the retail sector to protect profitability and cash flow when trading conditions are difficult, so we expect that to be as much the focus for management this year as it was in 2023. Retailers have focused efforts on reducing inventory, cutting costs and improving net working capital.

Retailers will prioritise energy and rental savings over expanding the number of physical outlets they operate, likely to be streamlined to focus on the most profitable sites and countries. Sales from physical stores will still account for the lion's share of retail sales as customers have returned to high-street shopping in a partial reversal of the huge shift to online sales during the pandemic. With the increase in footfall all over Europe, retailers will have to continue to invest in enhancing the consumer experience and the related employee training, with staff and marketing costs increasing. Most retailers, as they did in 2023, will pass on these costs to customers in the form of higher prices, with no adverse impact on profit margins.

Competition from the dominant online retailers such as Amazon.com and new entrants such as Shein (Roadget Business Pte Ltd.) and Temu (WhaleCo Inc.) – two Chinese platforms selling fashion and electronic goods – will remain a threat to traditional retailers. Larger retailers are better positioned to keep their market share as they will continue to pursue multichannel sales initiatives, which will account for most of capex in 2024. As an example, Ceconomy AG is heavily investing in customer retention, aiming to increase sales with loyalty members by 60% by FY 2025/26. The group expects to achieve this goal through the launch of its myMediaMarkt concept in eight countries by FY 2024/25 and extend the all-channel communication platform to its markets by FY 2023/24.

For smaller retailers, thinner profit margins and the high cost of financing will make it difficult to undertake such investment when they face pressure on leverage and interest cover from poor trading conditions and high interest rates in a fiercely competitive industry. This explains the divergence in default risk in the sector, based largely on the size of the company and level of corporate indebtedness now that the era of ultra-low interest rates has ended.

Analyst

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Telecommunication Services

Stable

Scope maintains its stable outlook for the telecommunication services sector.

Telecommunications services are typically a stable business in terms of revenues and profitability. Capital expenditure on mobile licences and networks has levelled off for many years. In contrast, fixed-line capex is high, primarily for the roll-out of fibre networks in Europe, which is set to continue in the coming years. M&A will remain elusive, as the number of possible targets is limited in Europe, synergies are negligible in cross-border deals, and the competition authorities are opposed to national mobile consolidation. Some European telecoms firms are likely to dispose of smaller foreign businesses and telecoms infrastructure, improving credit quality on the margin.

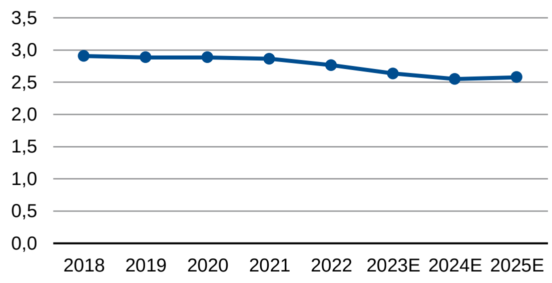
Here are the main trends supporting and constraining the credit quality of telecommunication services companies in 2024:

Key trends supporting credit quality	
+	Stable revenues and profitability, stable leverage
+	No significant cash outflow related to increase in 5G coverage
+	No significant M&A expected in the European sector
+	Disposal of subsidiaries (foreign) and assets (mobile towers + fibre)
Key trends threatening credit quality	
–	Levels of capex on fibre networks to remain high, on average

Stability in revenues, margins and leverage

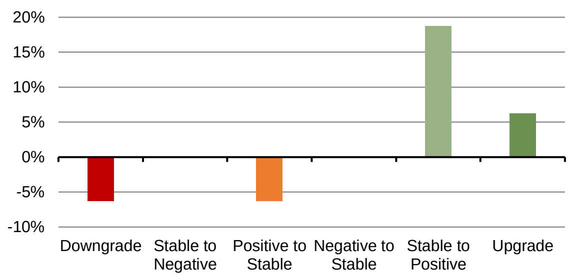
The leverage of European telecommunication companies has remained, on average, remarkably stable over recent years, with Scope-adjusted debt/EBITDA at around 2.7x. We expect that to stay the case or decline slightly in 2024. This is due to stable revenues and margins this year and longer term. Capex will remain high, although without preventing dividends from increasing slowly. As a result, beyond changes specific to some issuers, there was no marked trend in outstanding ratings/Outlooks in our sector coverage during the past twelve months.

Figure 1: Average SaDebt/EBITDA for European Telecommunications operators (2018-2025E)



Sources: Companies, Scope Ratings

Figure 2: Change in ratings and Outlook for Scope-rated Telecommunications companies in FY 2023



Source: Scope Ratings

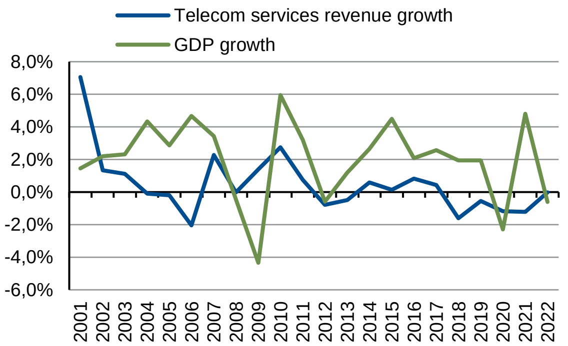
We still expect the telecommunication services companies in Europe to deliver flat revenues in the coming years, if not slight increases, demonstrating the maturity of the industry and its low cyclicality, notably during the pandemic. The European telecoms market is saturated. The entire adult population has access to a mobile phone and broadband, allowing only marginal increases in operators' customer bases, while sufficient competition and regulation prevent any increase in prices in real terms.

Increased usage of mobile data also does not translate into substantial increases in revenue. This is fully illustrated by the advanced Finnish mobile market. Here, average consumption is about 40 GB per month per user (a world record), with an annual average growth rate of 32% over the past eight years, yet mobile revenues are growing only slowly (+3% on average), and not compensating for the decline in the use of fixed-line services.

Similarly, we also believe that the current lobby from telecommunication operators to have content-providers (Netflix, Google, etc.) pay to access their networks (so-called "fair share") will not bring any additional revenues, as they have failed to convince most European governments and regulators, including the Body of European Regulators for Electronic Communications (Berec), of their case.

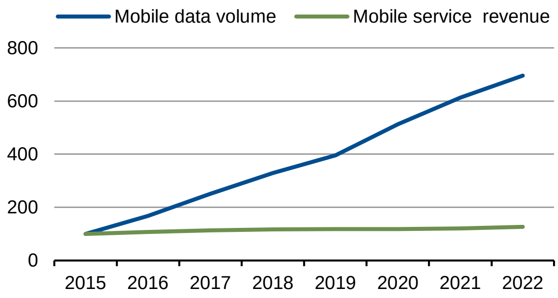
Profit margins will remain, on average, at very similar levels to those of the recent past, even in an inflationary environment, as operators will continue to clamp down on costs, not least related to personnel, visible in the 3-5% average yearly decline in numbers of employees in the sector.

Figure 3: Telecom revenues growth and GDP growth in Sweden, 1999-2022



Sources: PTS, World Bank, Scope Ratings

Figure 4: Mobile data volume and mobile revenue increase in Finland (2015=base 100)



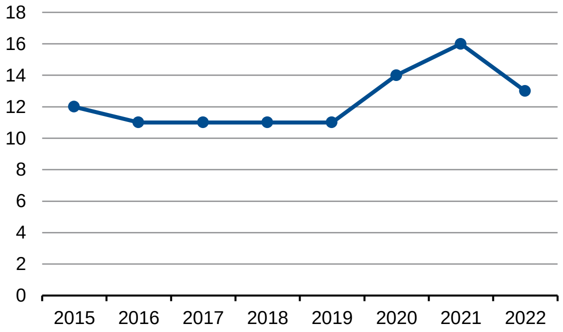
Sources: Traficom, Scope Ratings

5G brings no significant increase in cash outflows

Most 5G spectrum in Europe have now been allocated through auctions at reasonable prices, and the risk that unexpectedly expensive auctions suddenly increase operators' leverage is now remote. This is due to the almost total absence of any new mobile operators entering the market in major European countries (except for Belgium and Portugal), and the very limited additional revenue generated by 5G usage. The 26 GHz band, which is the last block of 5G spectrum, is still to be allocated in most countries but will attract limited interest from operators. Investment in this remaining spectrum will be marginal.

Beyond spectrum sales, the introduction of 5G has not led to any significant increase in mobile network investment, which has remained stable over the recent years, as it was after the introduction of 4G, as simply the newest technology replacing older standards. This is well illustrated by mobile capex (excluding licences) in Finland, the first European country to allocate 5G licences, where spending over the past eight years has steadied at around 13% of mobile services revenue.

Figure 5: Mobile capex (excluding licences) in Finland as a % of mobile revenue, 2015-2022



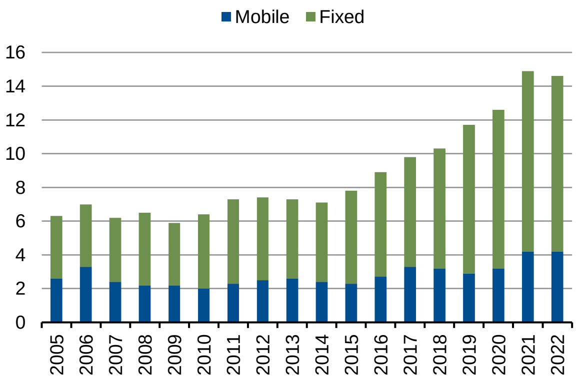
Sources: Traficom, Scope Ratings

Fibre capex remaining at a high level

The main driver for the capex (excluding licences) increase for European telecommunications companies is fibre roll-out in European countries. In France, fixed capex (of which about 45% is directly fibre) represents about 72% of the total telecom capex in the country over the past five years. We estimate that fibre-to-the-home (FTTH) now represents on average about 38% of all broadband lines in Europe, a level that will increase if governments are to meet their targets for providing high-speed communications to households and business.

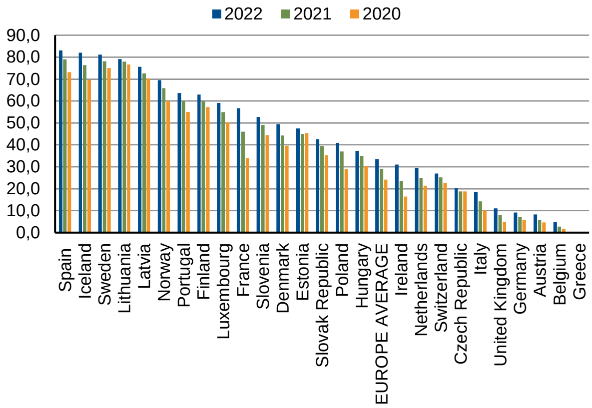
Still, the roll-out of fibre differs significantly from one country to another. In Spain and France, most of the roll-out is already done and we have started to see a decline in capex. The opposite is true in countries like Belgium, Italy and Germany, with capex here is set to rise as fibre roll-out is running significantly below the European average. Rolling out fibre networks is a lengthy and progressive process, so the related capex will remain elevated in the coming years in Europe even if we do not expect any significant increase in overall fibre investment in the region.

Figure 6: Telecom capex in France, €bn (2005-2022)



Sources: ARCEP, Scope Ratings

Figure 7: % of fibre in broadband per country, 2020-22



Source: OECD

Limited M&A, and minor disposals

European telecoms operators will undertake little large-scale M&A in the coming years, as large transnational deals between European players offer no meaningful synergies. And we see little chance for non-European players to take over a major operator in Europe, as governments regard domestic companies as strategic assets. National deals are now almost impossible as most cable operators in the EU are now in the hands of telecoms companies. Domestic consolidation among mobile operators is de facto blocked by the regulatory authorities, notably the European Commission, on competition grounds. Consequently, there will be no significant increases in leverage due to M&A in the sector in the coming years.

Deal making is not entirely off the table. European operators will continue to sell smaller telecommunications businesses in foreign, mostly emerging-market, countries, as these assets are generating less and less growth as markets mature. In addition, European operators will continue to sell some infrastructure assets (mobile towers, parts of fibre networks) to specialist companies or financial investors, moves that will underpin credit quality.

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Utilities

Slightly Positive

Subsector prospects diverge: positive for integrated utilities, power generators; stable for grid/network operators

Europe's integrated electricity utilities and power generators can look forward to reinforced credit profiles this year, although the change is less pronounced than it was at the beginning of 2023. The favourable ratings drift witnessed last year has further to run as displayed by a wide range of Positive rating Outlooks. Underpinning the improvement in credit quality are above-average power prices and ample operating profit margins.

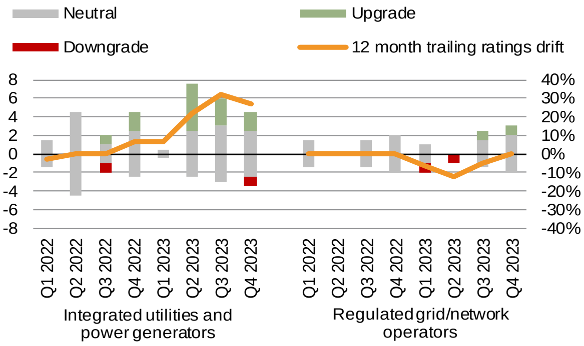
For regulated grid/network operators, the downward pressure on credit ratings will likely diminish compared with the past two years. Grid operators have largely determined the action they need to take to maintain credit quality in the face of continuously rising capital expenditure. The catch-up on unearned revenues from previous years, increasing regulated tariffs and the likely peak in the interest-rate cycle provide favourable tailwinds – at least in terms of preserving current credit ratings.

Here are the main trends supporting and constraining the credit quality of European utilities in 2024:

Key trends supporting credit quality	
+	Favourable hedged and unhedged wholesale prices are bolstering operating margins and cash flow (Integrated utilities and power generators)
+	Better aligned energy procurement and customer pricing strategies, which avoid operating losses in energy supply (Integrated utilities and energy suppliers)
+	Greater willingness to adjust financial policy to match net earnings after capex (All utilities)
+	Changed interest rate environment and lower applicable prices for grid losses lead to a rebound of profitability and operating cash flow (Grid/network operators)
Key trends threatening credit quality	
–	Continued high capex requirements weigh on free operating cash flow and require external funding (All utilities)
–	Economic viability of growth investments threatened by increased funding costs and construction costs (Integrated utilities and power generators)

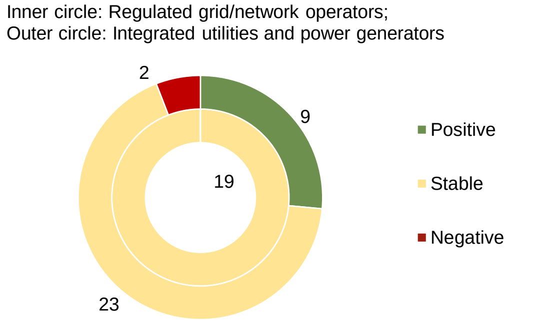
Eased ratings pressures on regulated grid operators, further upside for integrated utilities and power generators

Figure 1: Integrated utilities and power generators: Ratings drift in 2023 significantly positive with further upside; Drift for ratings of grid/network operators has returned to stable



Source: Scope Ratings

Figure 2: Further ratings upside on power generators as signaled by Outlook distribution as of YE 2023 (number of ratings)



Source: Scope Ratings

Continued above-average prices to benefit lower-cost power producers

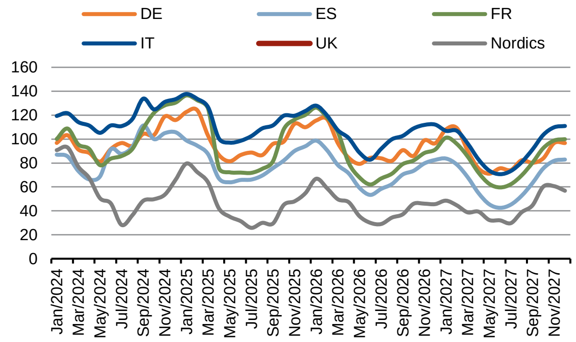
Prices for energy commodities have fallen from their peaks in 2022, but we are still far away from a normalised market, providing the backdrop for stable if not improving credit ratios for integrated power utilities, particularly those with lower-cost production.

Electricity prices across major European markets remain more than two times as high as they were before Russia's escalation of its war in Ukraine nearly two years ago. Utilities regularly hedge a large part of future generation volumes either on energy exchanges or through bilateral contracts, a practice which now ensures favourable pricing for 2024 and beyond. Favourable futures prices for 2024 and beyond (**Figure 3**) as well as the scale of and prices for hedging volumes for electricity generation at the largest European utilities (**Figure 4**) provides ample evidence of the tailwinds for European electricity suppliers.

Price hedges for 2024 have largely been closed during 2021-2023 based on elevated wholesale prices and price expectations on gas procurement, which is still the dominant factor when setting prices in the merit order. As such, contracted prices range between 45-150 EUR/MWh as reported by large European incumbents, which is well above the historical average of 20-50 EUR/MWh. Such a price environment provides for solid margins and cash flow support for utilities, which operate a large portfolio of low-cost generation capacities such as renewables including hydro and nuclear, most notably in the Nordics, France and Switzerland. However, the picture is bleaker for utilities largely dependent on coal- and gas-fired power plants, but much depends on prices for commodity procurement, notably coal, gas and CO_2 certificates.

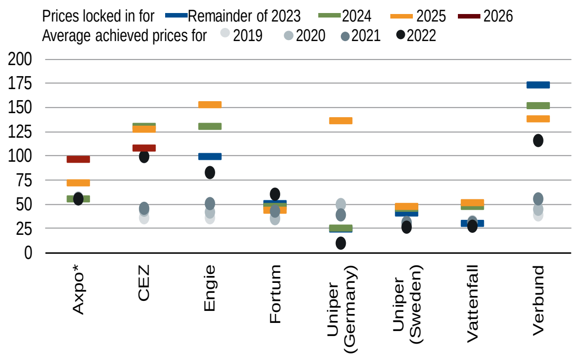
Lower prices for a large segment of European utilities will materialise only in the medium term as things stand. Indeed, any escalation in geopolitical tensions, affecting energy-commodity rich countries and/or disruptions in the supply of coal and gas to Europe, with repercussions for energy markets would delay the return to normalised energy prices. Governments might have to step in again to cushion the impact on households and business with price caps.

Figure 3: Wholesale electricity forward prices in major markets well above historical averages (EUR/MWh)



Sources: Bloomberg, Scope Ratings

Figure 4: Hedged electricity prices for major European power generators well above historical price levels (EUR/MWh) reported in the last quarterly update



* Axpo has an end-Sept. financial year, so hedging ratios shown for 2023/24, 2024/25 and 2025/26

Sources: companies, Scope Ratings

The sector is also less exposed than it used to be to volatile market conditions. Most utilities with exposure to power supply have implemented strategies over the past few years to synchronise procurement and selling prices, thereby ensuring slightly positive wholesale and retail margins. However, there are still some utilities with still poorly hedged procurement and customer pricing still accruing operating losses. After considerable disruption in the past three years, the power-supply segment is now stabilising. Many pure-play suppliers in liberalised markets such as the UK, Germany and Italy have been crowded out of the market since 2021 by rivals with more flexible pricing strategies or stronger balance sheets. Integrated utilities that incurred operating losses in supply have offset them with solid earnings in other business segments. Overall, exposure to energy supply should not adversely impact corporate balance sheets as happened in the past three years.

Utilities face mounting capex related to Europe's energy transition

Europe's utilities face growing pressures to invest more heavily in taxonomy-aligned assets that accelerate the energy transition while contending with continued pressure on profit margins in conventional fossil-fuel based power generation. The EU's updated Renewable Energy Directive of November 2023 has raised the bar for the proportion of electricity derived from renewable sources to a minimum of 42.5%, up from 32%, by 2030[1]. This implies about a doubling of the share of renewable-energy output over the next seven years.

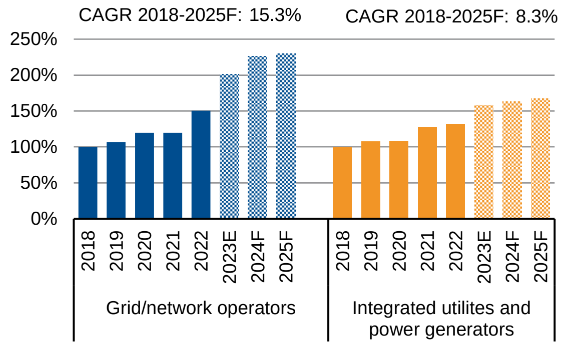
To meet this target, utilities will have to invest more in low-carbon generation capacity in addition to power grids to ensure the networks can cope with greater loads of intermittent electricity -- and transport it over longer distances. Investments in renewables and grids are scheduled to make up around three quarters of all capex for integrated utilities, bringing the capex exposure of these two segments to around 80-85% of the whole sector.

Aggregated capex for the 33 European power utilities, excluding grid operators, that we rate will increase at a compound annual growth rate (CAGR) of 8.4% in 2022-2025, rising to EUR 81.6bn in 2025 from EUR 75.9bn this year and EUR 75.6bn in 2023. This growth is in line with that in 2018-2025 (**Figure 5**).

In contrast, for the 19 European grid operators in our coverage, the three-year CAGR 2022-25 will run at a much higher rate of 15.2%. This represents a remarkable step up from the average of 12.6% for the longer period of 2018-2025.

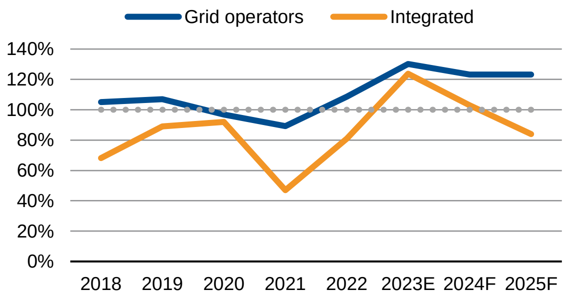
Grid operators are increasingly turning to external funding to meet this capex challenge given their operating cash flow is insufficient to cover their capex requirements in contrast with integrated utilities (**Figure 6**).

Figure 5: Supercharged: European utilities' capex runs at faster rhythm (2018-25E) - capex indexed, 2018 = 100



Sources: Companies, Bloomberg consensus, Scope Ratings estimates

Figure 6: Capex/operating cash flow of 53 covered entities



Sources: Scope Ratings estimates

Companies adapt to meet capex challenge, preserve credit quality

Mounting capex puts persistent pressures on utilities' free operating cash flow and external funding, as well as leverage and interest coverage, but Europe's utilities are adapting.

First, utilities are largely managing shareholder expectations on shareholder remuneration by balancing short-term shareholder pain through modest dividend distribution during the transition phase with the promise of medium-to long-term gains with the creation of more sustainable business models.

Secondly, asset rotation or optimisation remains an important source of external funding with the least possible detrimental effect for consolidated EBITDA and operating cash flows.

Thirdly, utilities remain among the most frequent users of hybrid debt for which the advantage of the securities' equity component for the purposes of calculating debt leverage is usually greater than the disadvantage of paying higher coupons compared with conventional bonds.

Lastly, utilities retain ready access to market funding given the clear objectives for which they are raising debt, unlike some other sectors disrupted by the abrupt shift in the interest cycle in the past couple of years.

Consequently, while many utilities are expected to report little or even negative free operating cash flows, which would worsen leverage and credit profiles, downward ratings pressure overall is limited. The sector on average should maintain its leverage multiples, measured by Scope-adjusted debt/EBITDA: between 2x and 4x for integrated utilities and power generators and between 4x and 6x for regulated grid/network operators will remain solid commensurate with existing rating levels or even provide further upside if sustained in the context of power generators.

Higher interest costs look largely absorbable by capital-intensive sector

Mounting capex and the need for more external funding – particularly for grid/network operators – puts pressure on debt protection metrics such as interest coverage particularly when interest rates have risen and are likely to remain high. Higher interest paired with inflated construction costs can also threaten the economic viability of some power projects, as we have seen most notably with cancellations of plans to build offshore wind installations.

However, higher interest rates do not pose a broader threat to the utilities sector's credit quality. First, utilities tend to use fixed-rated debt, with the exception being among Nordic utilities for which exposures to floating-rate debt can run up to 20%. The result is that interest cost increases pertaining to floating rate debt, refinancing and new debt-funded investment have only a gradual impact on credit metrics.

Secondly, regulated grid/network operators are largely beneficiaries of rising interest rates as regulated tariffs will increase over time to reflect the rise in the cost of capital, feeding through to higher profit margins and operating cash flow. Higher tariffs will thereby support capex and interest coverage, reversing the pressure on ratings during the long period of ultra-low interest rates, which hit network/grid operators' profitability.

Lastly, higher interest payments are going to be offset by higher operating earnings from existing and new investment, providing little long-term pressure on interest coverage. Consequently, integrated utilities and power generators will benefit from solid average interest cover of more than 10x. For network/grid operators, the average ratio will range from 7x to 10x.

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