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Ratings

Lights Dimming

European Corporate Credit Outlook, Midyear 2022

July 28, 2022

This report does not constitute a rating action

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European Corporate Credit Outlook Midyear 2022

Key Takeaways

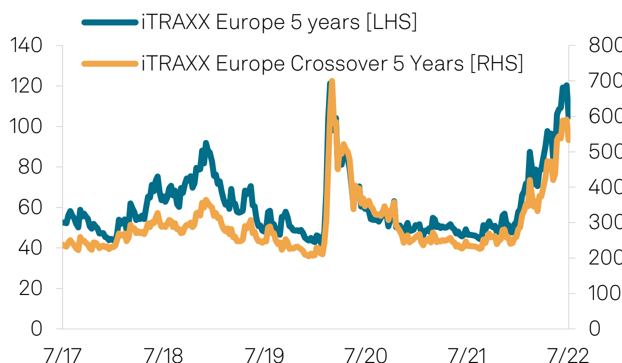
- The credit outlook is unraveling as recession risks mount. Higher interest rates, soaring costs, slumping confidence, financial market volatility, and cost of living pressures are likely to take their toll. These are likely to start to show up in second-quarter results.
- Even so, the corporate sector enters this downturn relatively well prepared. Pandemic stimulus bolstered cash balances and locked in cheap financing, helping explain the gap between weakening sentiment and resilient credit trends.
- Our stress scenarios suggest a mild or short recession could be easily weathered. A more severe recession would stretch financial metrics beyond pandemic levels and pressure ratings further. A gas supply shock as winter approaches could be particularly difficult for the most exposed sectors.

Recession risks to the fore

The growing risk of a relapse into recession remains the elemental threat overhanging European corporate credit. This is reflected in a sharp rise in corporate bond spreads; credit default swaps returning to pandemic-era highs (see chart 1); and a slump in European bond issuance, particularly for speculative-grade issuers (see chart 2). The U.S. yield curve has decisively inverted, a strong indication of likely recession (see chart 3), even if the European yield curve is yet to follow. Risk premiums were uncomfortably low at the start of the year, and a degree of adjustment was likely and welcome as financial and growth conditions normalized after a powerful recovery. But the scale of repricing of risk assets indicates a confluence of factors that threaten a sharp downturn at best and a potentially severe recession at worst.

Chart 1

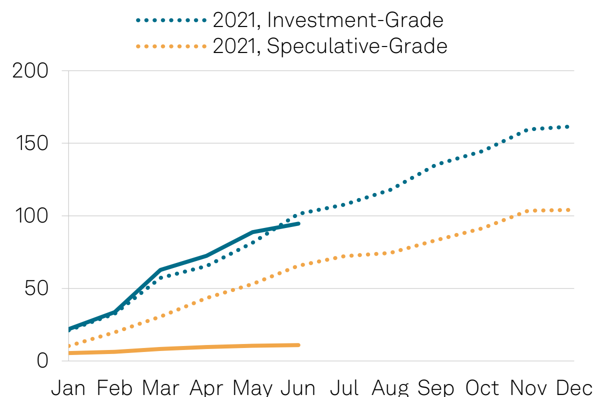
Credit Default Swaps Indices Back To Pandemic Highs



Source: S&P Global Market Intelligence, Refinitiv. Data as of July 25, 2022.

Chart 2

European Nonfinancial Bond Issuance Down 37% Year To Date



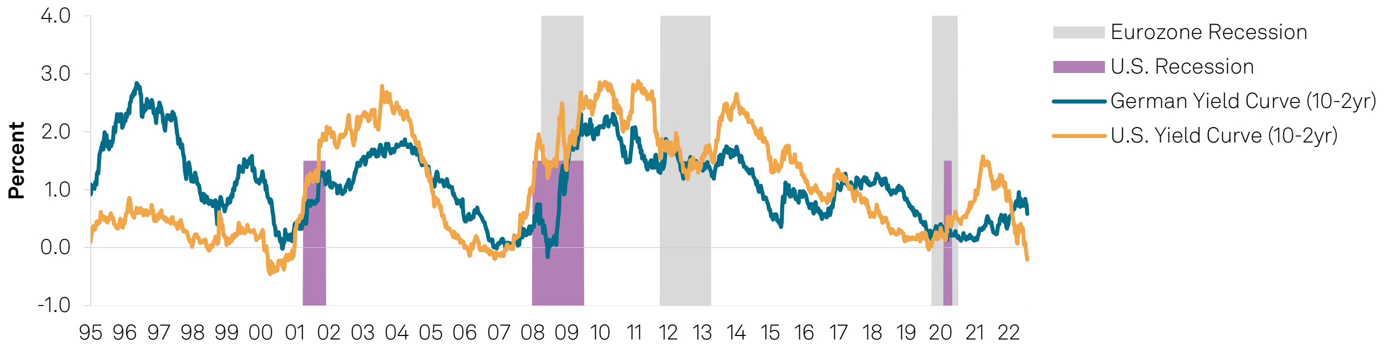
Source: Refinitiv, S&P Global Ratings. Data as of June 10, 2022.

Inflationary pressures have become near ubiquitous. Surging costs are a near universal theme in the industry updates below, encompassing material, energy, logistics, and labor. In some cases, the increases have been extreme. The spot price for European natural gas, a key energy source for some building materials subsegments, is about six times higher than in the same period in 2021. The failure by major central banks to anticipate and control the inflation surge is forcing a monetary tightening that could tip economies into recession. Worryingly, many of the

factors that have sent prices surging remain in effect. Global supply chains are still struggling to reset following the pandemic, not helped by China's ongoing efforts to eliminate COVID-19 through tough restrictions. The Russia-Ukraine war has added another layer of disruption to energy, raw material, and food supplies, as a result of sanctions, countersanctions, and shipping restrictions. This is all adding up to a cost-of-living crisis for consumers that threatens revenues and margins for sectors most exposed to discretionary spending.

Chart 3

Eurozone And U.S. Yield Curves And Recessions



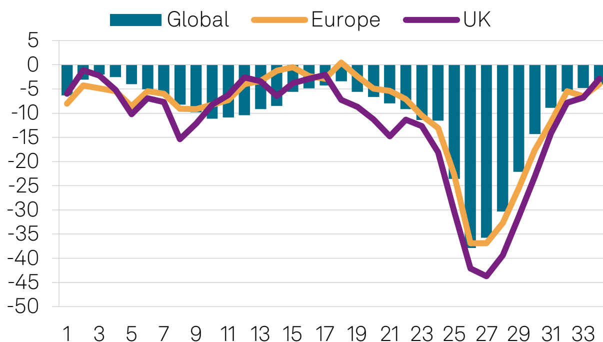
Source: Refinitiv, National Bureau of Economic Research (NBER), Euro Area Business Cycle Network (EABCN), S&P Global Ratings. Shaded areas denote recessions for the eurozone (light gray) as determined by the EABCN and for the U.S. (purple) as determined by the NBER. Yield curves calculated as 10-year minus 2-year yields for Refinitiv government bond indices.

Credit trends resilient despite growing risks

Credit trends have been resilient this year despite the deteriorating risk environment. Year-to-date defaults in Europe are running at half the rate seen last year. Although we expect the European trailing 12-month speculative-grade corporate default rate to hit 3% by March 2023, from 0.7% in March 2022, this is line with the average default rate seen since 2002, half the peak rate of the pandemic, and a third of the peak seen in the global financial crisis. Forward-looking indicators of our outlooks on ratings improved over the last quarter, albeit very marginally. The European nonfinancial corporate net negative bias, an indicator of potential ratings actions, stood at 3% at the end of June, down from 16% a year ago (see charts 4 and 5).

Chart 4

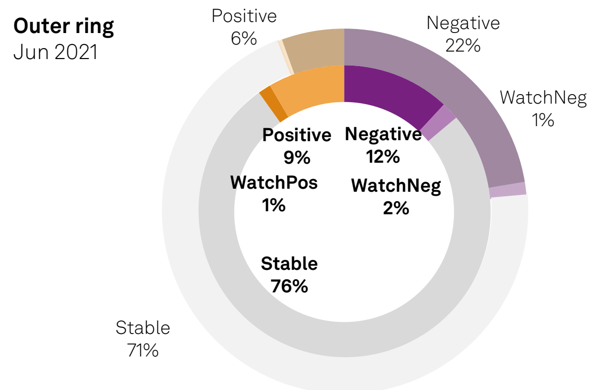
Nonfinancial Corporate Net Outlook Bias



Source: S&P Global Ratings. Data as of end-quarter through June 2022.

Chart 5

European Nonfinancial Corporate Ratings Outlook



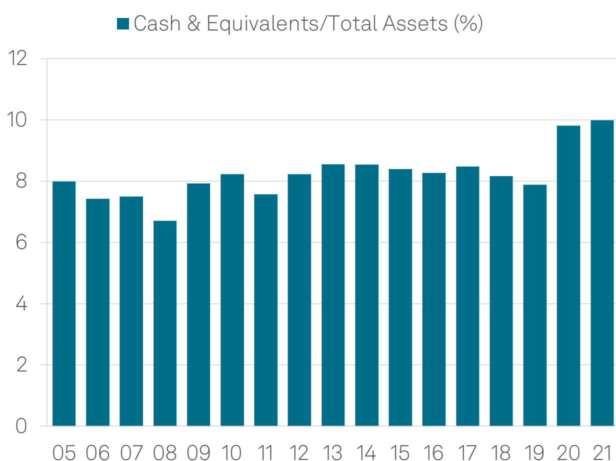
Source: S&P Global Ratings Data as of end-quarter.

Companies are reaping the benefits of a sustained period of benign financing conditions and an ability to manage cost pressures. European nonfinancial corporates increased holdings of cash and equivalents as a percentage of total assets to a new high last year (see chart 6) and locked in exceptionally low interest rates for debt financing. The benefits of cheap financing are likely to persist for some time. Only 5% of nonfinancial issuers rated 'B-' and lower from EMEA (Europe, the Middle East, and Africa) have debt maturing before the end of 2022.

In terms of cost pressures, it's rare to find a sector that hasn't been able to manage these by passing them on, hedging them some way, or by boosting volumes. Quarterly profit trends up to the first quarter show how margins recovered to prepandemic levels and beyond (see chart 7).

Chart 6

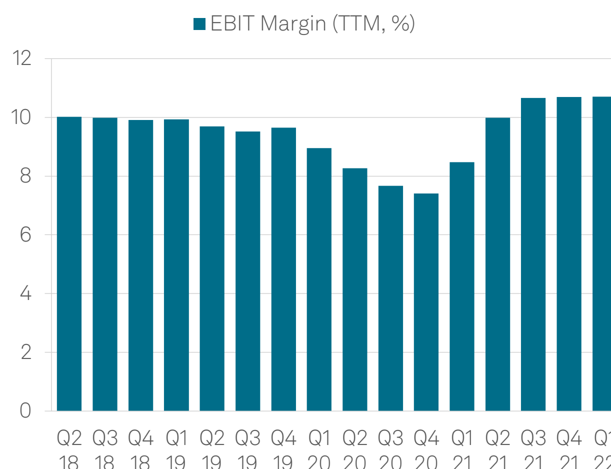
European Nonfinancial Corporates Have Increased Cash Holdings To A Record Level...



Source: : S&P Capital IQ, S&P Global Ratings. Data for European nonfinancial corporate entities currently rated by S&P Global Ratings.

Chart 7

...And Cost Pressures Have Not Yet Adversely Affected Profit Margins



Source: : S&P Capital IQ, S&P Global Ratings. Data for European nonfinancial corporate entities currently rated by S&P Global Ratings. Based on companies reporting data quarterly.

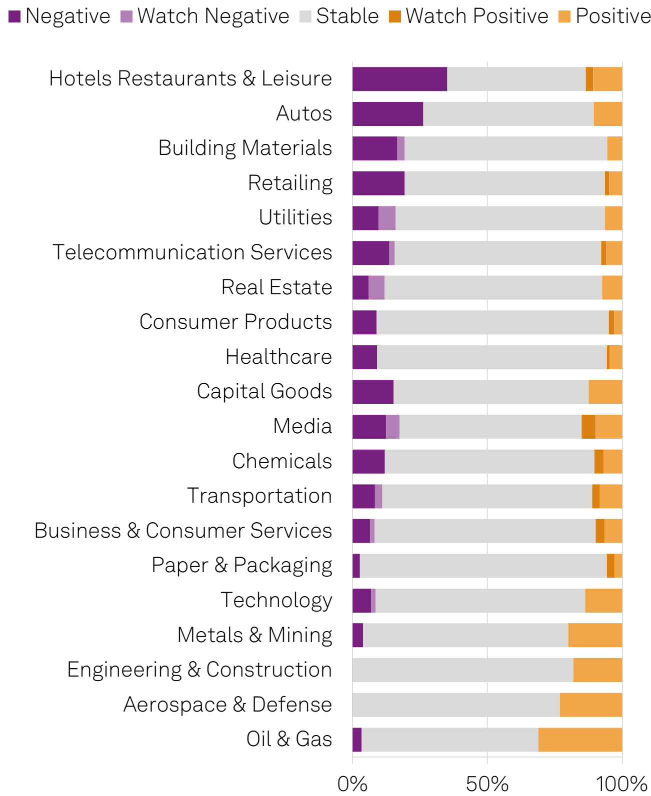
Credit quality trends are much more nuanced at the sector level. Chart 8 shows the current net outlook bias by sector with the most negative at the top, while chart 9 shows how the bias changed over the last six months. Some themes:

- Of the sectors seeing improving net outlook biases, most continue to illustrate the benefits of recovery and pent-up demand in the aftermath of the pandemic (media, leisure, oil and gas, transportation).
- This applies to aerospace and defense too, but with the added momentum derived from a reassessment of defense spending in the wake of Russian aggression in Ukraine.
- For hotels, restaurants, and leisure, the improvement has been substantial, but the sector still has the largest proportion of negative outlooks of any European sector.
- Of the sectors where the net outlook bias is deteriorating, building materials, autos, utilities, capital goods, and chemicals represent where cost inflation--particularly energy-related--and ebbing demand are starting to bite.
- The deterioration in metals and mining is more a result of resolving credit outlooks, but also some pressure being felt on costs.

Chart 8

European Ratings Outlook Distribution By Industry

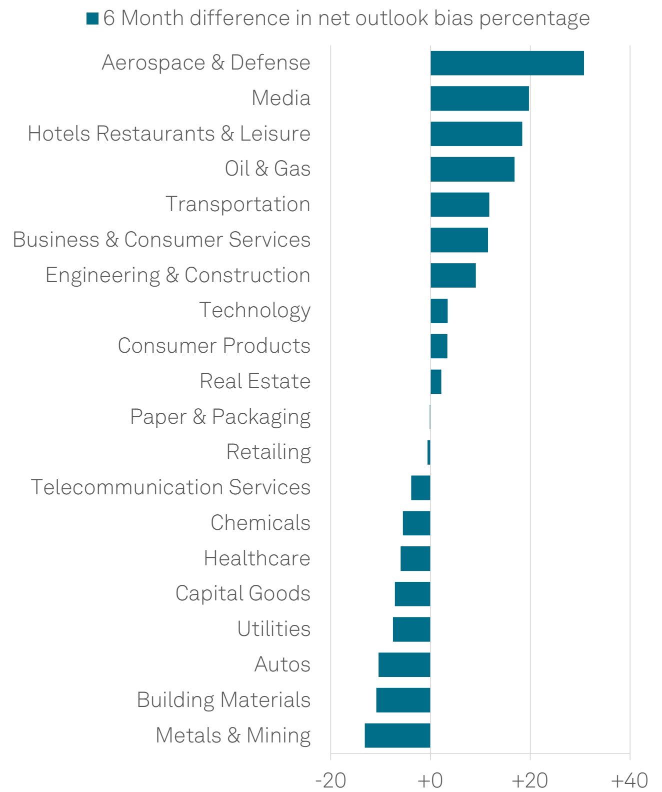
Ranked by net outlook bias (most negative at top)



Source: S&P Global Ratings. Ratings data as of end-June 2022.

Chart 9

6-Month Change In European Industry Net Outlook Bias



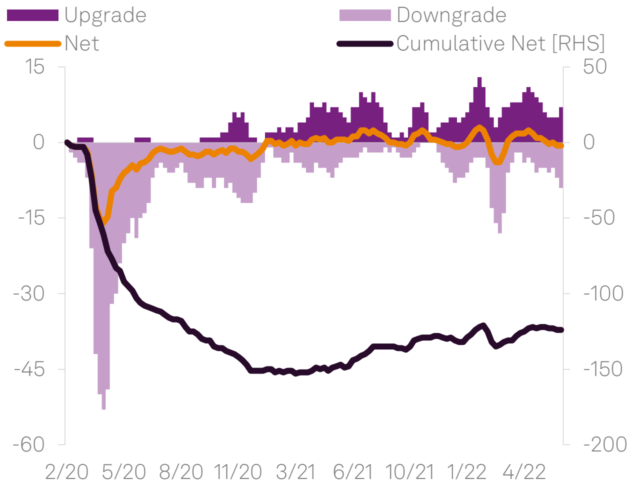
Source: S&P Global Ratings. Ratings data as of end-June 2022.

But credit quality remains depleted

Despite resilient credit trends, credit quality has not fully recovered from the pandemic. Stimulus and the recovery bought invaluable time for those companies hardest hit by the pandemic, but credit quality has been constrained by higher debt levels and continuing uncertainty about cash flow for many weaker credits. In terms of cumulative rating changes seen in European speculative-grade ratings since the onset of pandemic (see chart 10), the downward shift in credit quality is still apparent. This illustrates both the direct impact of COVID-19, which saw the share of 'CCC' category ratings surge, as well as a secular increase in the proportion of ratings that are 'B' category (see chart 11). The latter arguably shows the combined effect of a prolonged period of stimulative monetary policy and the consequent "search for yield" that increased risk tolerance. Chart 12 shows the shares of these ratings categories by sector.

Chart 10

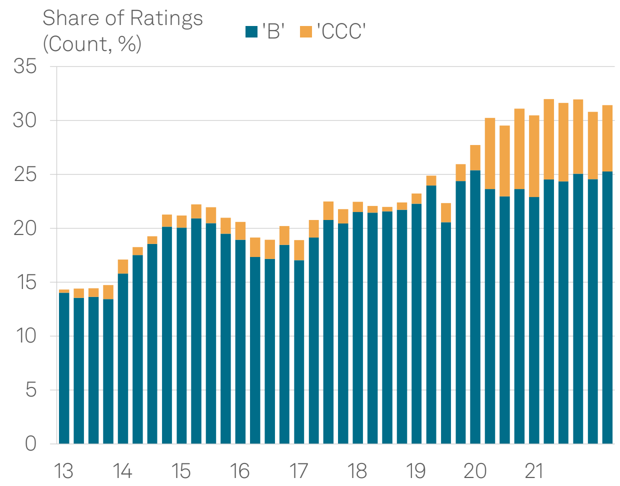
European Nonfinancial Corporate Speculative-Grade Ratings Upgrades And Downgrades Since February 2020



Source: S&P Global Ratings. Downgrades, upgrades, and net show the 4-week trailing sum. Cumulative net changes are the absolute sum of net ratings changes since Feb. 3, 2020.

Chart 11

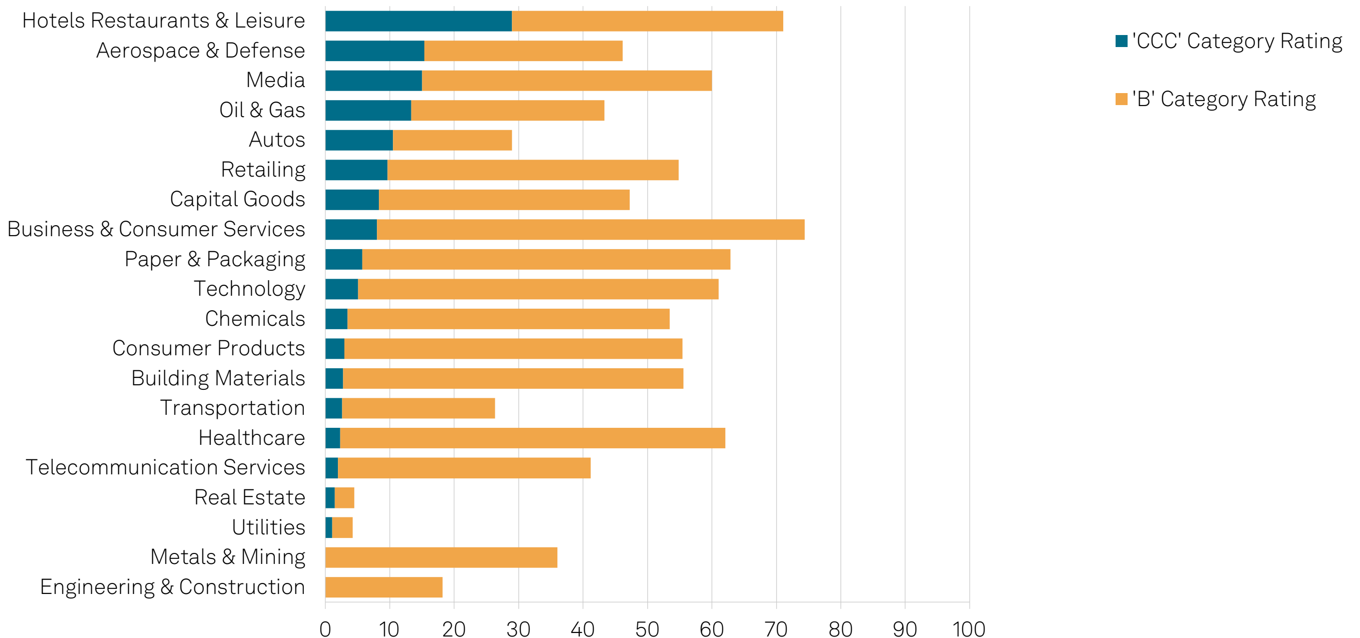
Weaker Issuers Now Account For Over A Third Of All European Nonfinancial Corporate Ratings



Source: S&P Global Ratings.

Chart 12

European Nonfinancial Sectors: 'B' and 'CCC' Category Ratings As Percentage Of Total



Source: S&P Global Ratings. Data as of end-June 2022.

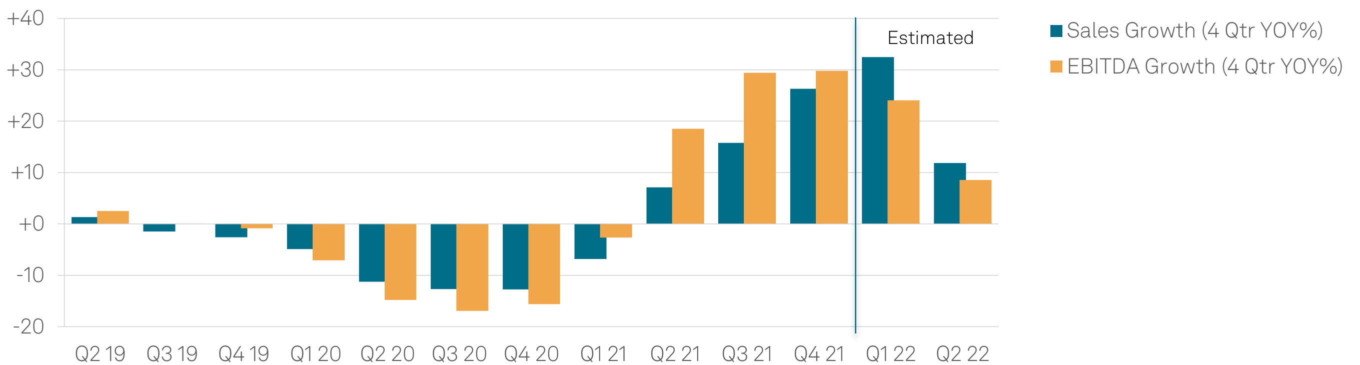
Profits and margins to come under sustained pressure

In our view, growth rates and profitability are likely to come under strain in coming quarters. It seems highly unlikely that a combination of higher interest rates, still-high cost inflation--particularly energy--slumping confidence, financial market volatility, and more cost-conscious customers will not start to take a toll on corporate profits. It is early days in the second-quarter results season, but we expect to see an increase in profit warnings and a deterioration in overall results. Chart 13 shows sales and EBITDA growth for rated European nonfinancial entities that report quarterly. Early results suggest growth is still positive but ebbing rapidly.

Chart 13

Rated European Nonfinancial Corporates: Trailing Four-Quarter Sales And EBITDA Growth

Prior Four Quarters Year-On-Year Percentage Growth, USD

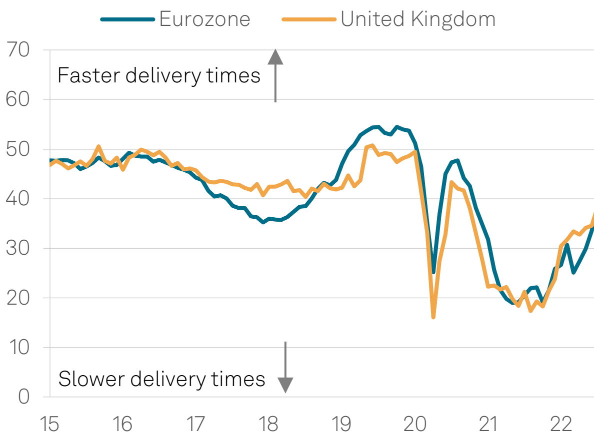


Source: S&P Capital IQ, S&P Global Ratings. Based on companies reporting data quarterly. Q1 and Q2 2022 figures are estimates based on 387 and 77 companies, respectively, that have reported results for those quarters. An average of 555 European rated companies report quarterly earnings, approximately half of the total rated universe. Data as of July 26, 2022.

Chart 14

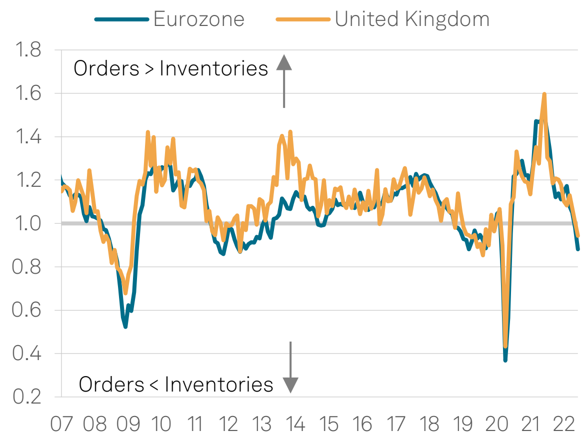
S&P Global Eurozone and U.K. Manufacturing PMI

a) Suppliers' Delivery Times



Source: S&P Global Ratings, CIPS. Data to July 2022.

b) Orders To Inventories Ratio



Source: S&P Global, CIPS. Data to June 2022.

Evidence of supply chain and inventory trends will also be important. PMI data from S&P Global Market Intelligence [new branding guidance] shows encouraging signs that suppliers' delivery times are improving (see chart 14), which could be the silver lining of a downturn, helping

disrupted supply networks recover. On the other hand, orders to inventories are falling sharply (see chart 15), which suggests working capital risks are building. Given continuing supply chain issues, we expect European automakers and suppliers will build inventories and unfinished products to avoid unnecessary production halts (see page 13). Similar pressures are apparent for European retailers (see page 25). Risks to gas supplies and other essential raw materials may force European industrial manufacturers more broadly to take similar steps. **Elevated working-capital needs pose significant credit risks**, **particularly if a rapid downturn eliminates assumed demand.**

Europe's energy crisis could bring severe challenges

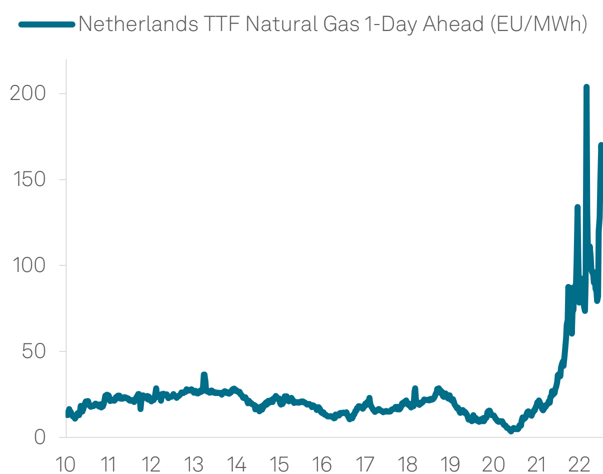
A recession triggered by gas shortages could be tough. For European industries, there is clear concern that, with winter looming, gas supply cuts by Russia to dependent European countries could have severe consequences, ranging from margin pressure to curtailed production in industrial sectors such as building materials, capital goods, and chemicals. Prices are already extraordinarily elevated. Current TTF natural gas prices (see chart 15) are currently 8.5x the average from 2010 to the end of 2020 and the impact of higher feedstock and energy prices are already being felt. BASF reported that chemical industry production fell 2.6% in Europe in the second quarter, in contrast to a 3.1% increase in China and a 2.5% increase in North America.

Given Russia's faltering military campaign in Ukraine and the significant dependency on Russian gas for some European countries, including Germany, it seems highly likely that gas supplies will continue to be politicized. Continued cuts in gas flows are likely, particularly as winter approaches, with the objective of inhibiting Western military support for Ukraine. Chart 16 shows physical gas flow through Greifswald Opal and Nel, the pipelines that pump gas on from Nord Stream 1's arrival point in Germany. Flows had already been cut to around 40% of capacity in the run-up to annual pipeline maintenance and reportedly fell to 20% on July 28.

Chart 15

European TTF Natural Gas Prices

Euros per Megawatt Hour

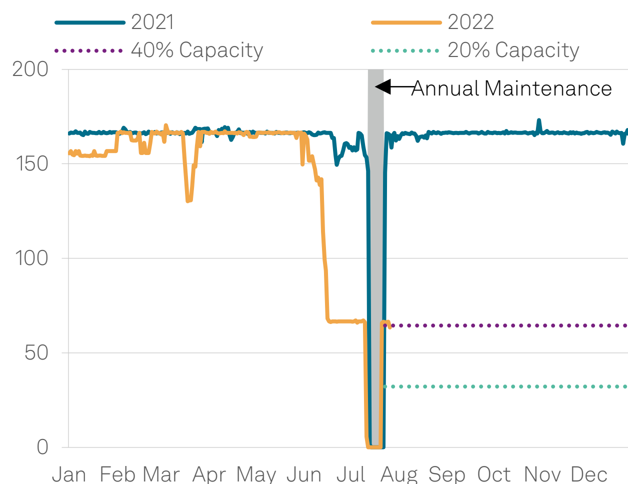


Source: Refinitiv, S&P Global Ratings. Data to July 26, 2022.

Chart 16

Nord Stream 1 Gas Flows From Russia To Germany

Daily Flow, Mil. Cubic Meters, OPAL, and NEL Entry Points



Source: ENTSOG, S&P Global Ratings. Data to July 26, 2022.

What recession could mean

Renewed recession would pose significant risks for ratings on European speculative-grade entities. We have recently applied three hypothetical downturn scenarios to the European speculative-grade nonfinancial entities that we rate to assess the impact of varying degrees of downturn (see "Recession Risk And Ratings: What Recession Could Mean For European Speculative Grade Nonfinancial Corporates," June 23, 2022). The most severe - a full recession - would deliver a 20% fall in EBITDA by end-2023, in line with previous earnings recessions.

European corporates are well positioned to weather milder downturns relatively unscathed. Financial metrics might deteriorate, but not beyond pandemic peaks, and pressure would be confined to the most vulnerable issuers.

A full recession scenario would stretch financial metrics beyond pandemic levels and pressure ratings further. This scenario could increase adjusted median 2023 leverage to 7.8x versus a pandemic peak of 6.6x and our base-case assumption of 5.3x. Some 50% of speculative-grade issuers would have negative free operating cash flow versus 30% last year.

'CCC' category ratings are most vulnerable, but downgrade risk is wider in the full recession scenario. Chart 17 shows base-case median adjusted debt/EBITDA projections for 2023 by ratings category and the impact on median ratings of the three scenarios, and chart 18 shows the implied change in leverage. In the full recession scenario, all 'B' ratings would have a median rating as high or higher than 'CCC+' ratings under the base case.

Chart 17

European Nonfinancial Speculative-Grade Median 2023 Debt/EBITDA By Rating Under Different Stress Scenarios

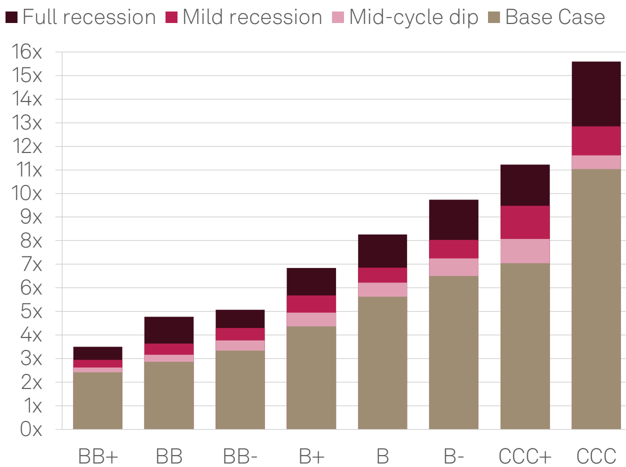
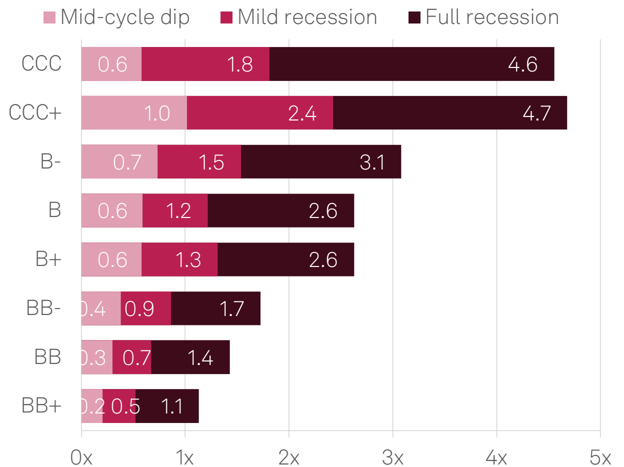


Chart 18

Incremental European Nonfinancial Speculative-Grade Median 2023 Debt/EBITDA By Rating Under Different Scenarios (Difference With Base Case Assumptions)



Source: : S&P Global Ratings. Based on current ratings as of June 6, 2022.

Related Research

- Industry Top Trends Midyear 2022: Relapse, Recession, Resilience, July 25, 2022
- U.S. Corporate Credit Outlook Midyear 2022: Bracing For A Bumpy Ride, July 20, 2022
- If Stagflation Strikes, Loss-Making Corporates Will Double Globally, July 12, 2022
- Credit Conditions Europe Q3 2022: Pain On The Horizon, June 28, 2022
- Recession Risk And Ratings: What Recession Could Mean For European Speculative Grade Nonfinancial Corporates, June 23, 2022
- The European Speculative-Grade Corporate Default Rate Could Rise To 3% By March 2023, May 18, 2022.
- [SLIDES] Russia-Ukraine Conflict: Implications For European Corporate And Infrastructure Sectors, March 16, 2022

Aerospace and Defense

War raises budgets, but benefits are years away

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What's changed?

The Russia-Ukraine conflict has resulted in some of NATO's top spenders hiking defense budgets. Leading NATO members continue to urge other members to increase their spending toward the 2% of GDP target. However, this will not result in a short-term windfall for aerospace and defense (A&D) companies because it can take years for funds to pass from the point of political approval, through budget allocation, and the tendering process, then to companies that win contracts.

Airbus continues to raise narrowbody production rates. The company targets producing 65 per month by summer 2023 (production fell about 40 per month in the worst of the pandemic) and the plan is to raise this to 75 per month through 2025.

Widebody production remains muted, and cargo has peaked. We do not expect long-haul international travel demand or demand for wide body planes to recover to pre-pandemic levels until at least 2024. The demand for cargo rose during the pandemic, but we believe this has peaked.

What to look out for?

Russia reduces or cuts off Europe's gas supply. This would undoubtably have a negative impact on A&D issuers, as would be the case across many industries, regardless of how well issuers are managing rising energy costs.

The commercial aerospace supply chain might not keep up with Airbus' ambitions. Delays and shortages of certain components could drag on the supply chain as the company pushes to raise production rates to a historical high.

Inflation has been manageable but isn't making the post-pandemic recovery easier. Many A&D issuers are either well hedged, have high levels of inventory or critical materials, or have contract structures, meaning they can pass through much of the raw material and energy cost increases. This stands for 2022, but management teams have expressed that a prolonged period of high-single-digit inflation through 2023 would become more of a challenge.

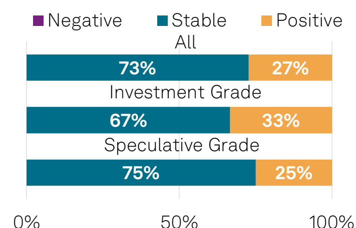
What if there's a recession?

The impact on defense companies would be far less than in other industries. European governments, as seen during the pandemic, would continue to prioritize defense spending and ensure that defense production continues. Issuers might need to grapple with short-term labor and raw material cost volatility.

Air travel recovery could falter. Reduced demand would result in lower sales for original equipment manufacturers, component suppliers, and service providers. Orders for new aircraft would likely be less affected, due to pent-up demand.

Rating Trends

Outlook Distribution

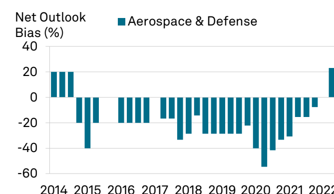


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	3	8	11
Downgrades	0	2	2
Upgrades	2	0	2

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



Related Research

- U.K.-Based Aerospace And Defense Company BAE Systems PLC Upgraded To 'BBB+'; Outlook Stable, June 28, 2022
- France-Based Aerospace And Defense Company Thales Upgraded To 'A-' On Stronger Credit Ratios; Outlook Stable, June 10, 2022
- Airbus SE Outlook Revised To Stable On Strong Operating Performance; 'A/A-1' Ratings Affirmed, March 30, 2022
- Industry Top Trends 2022: Autos, Jan. 25, 2022

Autos

Market conditions weaken in Europe

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What's changed?

Input cost inflation is here to stay. Mainly an issue for auto suppliers as passing on excess costs with original equipment manufacturers (OEMs) will delay the recovery of profitability post-pandemic. Less of an issue for OEMs as long as pricing and mix remains strong, as is still the case in first-half 2022.

Consumer confidence is already weakening. Lack of visibility on the Russia-Ukraine conflict, expected rising interest rates, and COVID-19 resurgences have translated into plummeting consumer confidence in Europe and likely dampen the recovery of auto sales in 2023, while large order books support sales in 2022.

Supply side shortages will ease, but not end, in second-half 2022. Expectations of a vigorous rebound in production look increasingly uncertain. We expect the stop-and-go production mood could well continue in the next six months, weakening OEMs' capacity to deliver on record high order books and suppliers' ability to ride on full production recovery.

What to look out for?

The pricing dynamic on new and used cars is not sustainable in Europe. Pricing has allowed OEMs to more than offset low volumes linked to supply shortages and cost inflation. We expect pricing to contribute less to revenue growth.

Higher prices of energy, raw materials, freight, and labor will pressure profitability. We expect weaker margins that will be more manageable for OEMs than suppliers. Margin pressure could be further exacerbated by continued strong sales volumes for electric vehicles (EV), which typically have lower gross margins.

Inventory will increase. To avoid unnecessary stops to production, we expect OEMs and suppliers to build inventories of material and unfinished products, which could weigh on operating cash flow.

What if there's a recession?

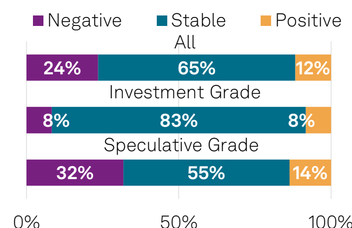
Auto suppliers will be less exposed than OEMs to weakening demand at first. Passenger car inventories in Europe have bottomed out, so we believe auto suppliers with substantial operations might be more protected in a mild recession and weakening demand because of the need to rebuild inventories.

Weak sales in Europe could extend to 2023. After a decline in light vehicles sales estimated in the mid-single-digit range in 2022, a recession could result in stagnating sales of around 16 million units in the region (down from 20 million-21 million in 2019).

EV mix progression could temporarily slow in Europe. The continent could lose momentum in the progression of EV mix (14.0% in 2021, up from 8.5% in 2020) as consumers might delay purchasing EVs, typically a second vehicle for short distance trips.

Rating Trends

Outlook Distribution

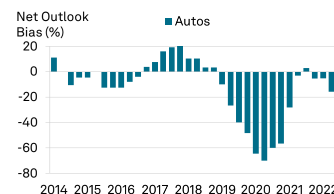


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	12	22	34
Downgrades	0	2	2
Upgrades	2	3	5

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



Related Research

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Global Auto Sales Forecasts: Russia-Ukraine Conflict Imperils Recovery, March 22, 2022

Industry Top Trends 2022: Autos, Jan. 25, 2022

Building Materials

Cost inflation weakens margins and reduces rating cushion

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What's changed?

There are significant indirect effects from the Russia-Ukraine war. The conflict and the related governments' responses have further intensified the inflationary and highly volatile cost environment. So far, most companies have passed through these costs to clients, though with some lag, reflecting resilient-if-slowing demand. Nevertheless, we expect 2022-2023 margins to be well below 2021 levels.

Energy costs have risen further. Already-significant cost inflation in 2021 has been amplified, notably for power, oil, and natural gas. The latter, a key energy source in some subsegments, display a spot price of about 6x higher than in the same period in 2021.

The outlook bias has turned negative. Following negative rating actions since March 2022, 20% of the portfolio has a negative outlook, compared with 7% at Jan. 1, 2022. All negative outlooks relate to speculative-grade companies.

What to look out for?

The energy supply could be interrupted. The risk of a natural gas shortage in Europe has escalated since June, following Gazprom's decision to cut supply to several countries. A lack of gas in the sector would likely force some companies to stop production. This might translate into negative rating actions for less diversified companies, or where available rating headroom is limited.

Carbon dioxide (CO_2) reduction is still a priority. Companies' plans to reduce CO_2 emissions are irreversible, protecting business models ahead of significant carbon cost increases. The Carbon Border Adjustment Mechanism the EU Parliament voted on in June is even more ambitious than the initial plan from July 2021.

Refinancing risk is limited for now. Most private-equity-owned companies refinanced their capital structure in 2019-2021. Nevertheless, new funding at much higher rates will likely add pressure to free operating cash flow.

What if there's a recession?

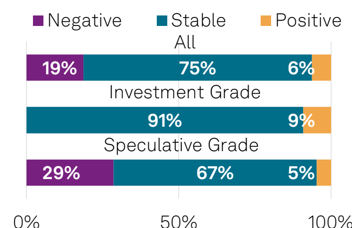
Weakened demand will further constrain profitability. We anticipate that average volume growth in 2022 will still be positive, at about 1.5%. A recession in 2023 likely means zero or negative volume growth as households will likely postpone their spending. This will limit companies' abilities to pass through inflation costs to clients, adding significant pressure to margins and cash flow.

Negative rating actions will largely center in the speculative-grade category. We anticipate that those companies less diversified by geography and with high leverage will suffer the most. Negative rating actions could exceed those during the pandemic due to pressure from both demand decline and high inflation.

Financial policy will be key in preserving investment-grade ratings. If companies do not moderate their shareholder remuneration, rating headroom built in 2021 will quicky disappear, which could further stress the ratings.

Rating Trends

Outlook Distribution

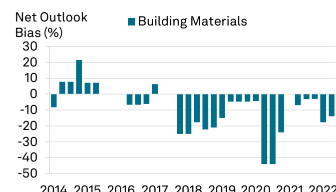


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	11	21	32
Downgrades	0	1	1
Upgrades	1	0	1

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



Related Research

Credit FAQ: How The Russia-Ukraine Conflict Affects European Building Materials Companies, March 29, 2022

Capital Goods

Supply risk overshadows order backlog

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What's changed?

Material cost inflation and supply chain challenges are increasing. Inflationary stress has intensified, putting margin pressure on weak positioned companies, while well positioned companies can still pass on most price increases. Component availability remains a constraint and has broadened testing the flexibility of production networks, sourcing power, leading to higher inventory levels (an increase in safety stock or unfinished goods).

Orders will moderate while backlogs continue to build. Reflecting increasing economic risks and as pent-up demand fades, we expect order intake to moderate in the second half as also indicated by steadily drop in the purchase manager index. Meanwhile, backlogs keep climbing with solid demand, price effects, and tight output. Increased interest rates could strain construction exposed companies over the medium term.

End market recovery and completed restructuring has led to positive rating actions in the first half. Rating actions materialized, mainly in the 'BB' category (five) and has been fueled by faster-than-expected end-market recovery, bringing operating performance to pre-COVID-19 levels or above, supporting deleveraging efforts and improving financial flexibility (in all cases). Rating actions have been supported by completed restructuring efforts (in three cases).

What to look out for?

Gas supply risk and rising energy costs might weigh on competitiveness. Reduced gas supplies to Europe due to the Russia-Ukraine conflict would likely lead to energy cost disadvantages and tremendous pressure on local supply chains, disadvantaging companies with large supply chain, production, or customer exposure to Europe.

Lower-rated companies face refinancing risks. With rising interest rates, weak performing highly leveraged companies might be not able to refinance because the interest burden could become unsustainable even with a like-for-like refinancing.

Acquisitions aim to boost modest growth. Most companies will continue supplementing growth and corporate development with acquisitions and divesting in their industrial repositioning efforts.

What if there's a recession?

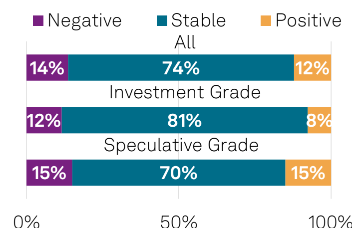
A technical recession with a short duration should be digestible for most. The capital goods industry is typically a late-cycle mover and should benefit from its order backlog, which is elevated by higher pricing and soft order executions on component shortages.

A robust commodity and infrastructure sector might offset a chill in cyclical and discretionary sectors. Investment to diversify European energy resources and energy efficiency, as well as U.S. infrastructure bill and EU recovery funds, should provide a tailwind to capital goods activity over the next several years.

A recession from a gas shortage could be rough. Supply chains would face unprecedented challenges because gas is widely used in processing and production of components. It would also likely lead to intense cost pressure on high energy costs, high interest rates, and depressed demand.

Rating Trends

Outlook Distribution

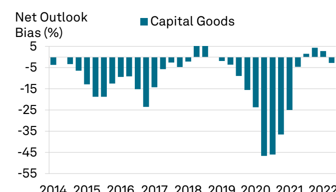


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	26	40	66
Downgrades	0	0	0
Upgrades	1	6	7

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



Chemicals

Slowdown, looming gas shortage dim second-half outlook

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What's changed?

Companies grapple with strong inflation. Across energy, raw materials, and logistics, the sector has been confronted with massive increases in input-costs since second-half 2021. Most issuers have passed on these headwinds through a strong focus of value over volumes and displayed better pricing power compared with previous inflationary periods.

Demand is at a tipping point. 1H 2022 saw still robust demand and pricing power across the sector despite supply-chain disruptions alongside the Russia-Ukraine conflict and continued lock-downs in China. Many companies reported high (in some cases record) first-quarter results and we anticipate only moderate softening in second-quarter results. For second-half 2022 and into 2023, we anticipate weaker results associated with lower volumes and less favorable pricing on increased economic risks and inflationary pressure.

The sector outlook dims on the slowdown and mounting risks. Many chemicals issuers entered the year with some rating headroom after a strong year 2021 and this buffer has increased year-to-date 2022 in many cases. We still see possible negative rating actions given the mounting risks and potential slowdown in operating results. While still 80% of chemical ratings are on a stable outlook, the proportion of negative outlooks has more than doubled since year-end 2021.

What to look out for?

Natural gas supply cuts loom. Since June 2022, the risk of natural gas shortages has risen following material supply cuts by Russia to several European countries. Consequences of a natural gas shortage could range from margin pressure to curtailed production. This might stress ratings on highly exposed or less diversified issuers.

Demand is weakening. Following a robust first half, we anticipate a demand slowdown in second-half 2022 and continued inflationary pressure. We lowered our expectation for volumes and take into account that companies might find it harder to pass on higher input costs compared with the first half, affecting margins.

Refinancing risk is under control for now. Chemical issuers, with few exceptions, have taken advantage of the favorable refinancing conditions in the past few years and we see limited sector-wide refinancing risk for the remainder of the year.

What if there's a recession?

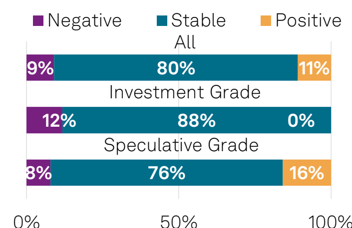
We expect weaker earnings and credit metrics. Most chemical issuers entered 2022 with some rating headroom. In a recession, we believe that cyclical parts of the sector such as petrochemicals will see weaker credit metrics as lower demand weakens margins and cash flow. We would expect more resilient performance even in a recession for industrial gases, agriculture, and nutrition.

Speculative-grade issuers are more at risk. Given usually higher leverage, less rating headroom, and limited geographic diversification, we consider speculative-grade issuers at higher risk of negative rating actions.

Adjusted financial policy could preserve investment-grade ratings. Our investment-grade issuers usually have more room to maneuver and can curb shareholder remuneration and higher capital spending to preserve ratings.

Rating Trends

Outlook Distribution

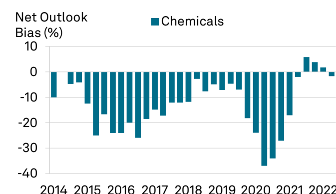


Ratings Statistics (YTD)*

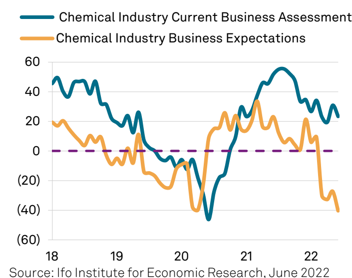
	IG	SG	All
Ratings	17	38	55
Downgrades	0	0	0
Upgrades	1	2	3

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



IFO Sentiment Survey for German Chemical Industry



Source: Ifo Institute for Economic Research, June 2022

Consumer Products

Continued price increases test resilience of brands

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What's changed?

The rise in input and operating costs is unrelenting. Consumer products companies continue to pass on price increases to consumers as they battle significant increases in input prices and operating costs.

Excess household savings and sizable pent-up demand prop up spending. The tailwind from pent-up demand, backed by high household savings, will continue somewhat supporting consumer spending for now, which augers well for sectors relying on trade consumption such as beverages and food services.

Yet persistent inflation has begun to erode consumer confidence. Inflation has reached peaks not seen in decades, and this, together with geopolitical conflicts, has begun to dent consumer confidence. Higher prices on essentials have hit disposable income, leaving less room for discretionary spending.

What to look out for?

Consumer spending is likely to slow. As they spend down savings and face higher food, fuel, and energy bills, consumers will increasingly turn more cautious and begin to moderate spending toward the end of this year.

Working capital requirements will be elevated. As supply-side disruptions continue, companies have less room to maneuver working capital and trade terms as their main priority is to secure supplies on time to prevent stock outages.

Flexibility in passing price increases to retailers will become more critical. Retailers, keen to maintain their price perception, will become more discerning as branded consumer goods companies continue passing on higher prices. Brand strength and price-value appeal will become more prominent in negotiations with retailers.

What if there's a recession?

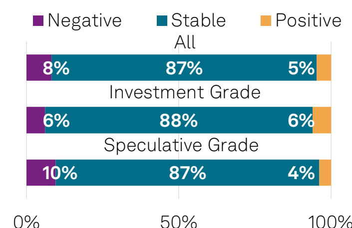
Consumers will cut back on discretionary spending and trade down. Sales volumes will fall as price conscious consumers increase their take up of private label and discount products. Branded consumer goods companies will curtail price rises and take a hit on margins to stem volume declines.

Better capitalized investment-grade companies will fare better. Geographically diversified companies, with solid brands and pricing power, will remain resilient. Investment-grade consumer goods companies that continue to return cash to shareholders can moderate these to preserve their credit quality.

Companies with inflexible cost structures and limited room to pass through higher prices will see credit quality weaken further. This will be the case particularly for highly leveraged companies in the subsectors most exposed to high raw material prices, such as packaged foods and personal hygiene products.

Rating Trends

Outlook Distribution



Ratings Statistics (YTD)*

	IG	SG	All
Ratings	33	53	86
Downgrades	0	10	10
Upgrades	1	4	5

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias

Related Research

Consumer Goods: Unrelenting Inflation Puts Pricing And Brand Power To A Grueling Test, July 13, 2022

European Retailers: Forced To Raise Prices While Wary Of Consumers Cutting Back Spending, June 9, 2022

Russia-Ukraine Conflict Will Test Agribusiness Supply Chain Efficiencies And Consumers' Appetite For More Food Inflation, March 18, 2022

Health Care

Inflationary pressures on margins

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What's changed?

Outlook no longer has a positive bias. Our outlook for the sector and across all four major subsectors is stable, but with inflation possibly persisting into next year, the labor-intensive services subsector could face downside pressure.

Pharma outlook has improved. As the larger companies de-levered, as legislative activity was quiet, and as COVID-19 leant a halo effect (as well as a financial windfall for some), our outlook on the pharmaceutical subsector improved to stable from negative. Pharma mergers and acquisitions (M&A) has also been strangely muted, though we expect an uptick.

Volumes are back up. Patient volumes have largely recovered to pre-pandemic levels, with organic growth offsetting decline in COVID cases.

What to look out for?

Margin compression. We are projecting mid-single-digit revenue growth for the health care industry in 2022 and 2023. But with inflationary pressures potentially lasting into 2023, higher costs on health care products, transportation, and especially labor will weigh on EBITDA margins and cash flows.

Ability to pass on costs to payors. Negotiations with providers will be difficult, and health care companies will have to absorb higher costs at least temporarily. This should not be an issue for high-rated issuers, but others could see ratings pressure.

Further impact from COVID-19. The recent COVID wave in Europe and the omicron variant led to disruptions, but a steep drop in COVID-related admissions could lead to top-line misses should the recovery in non-COVID admissions lag.

What if there's a recession?

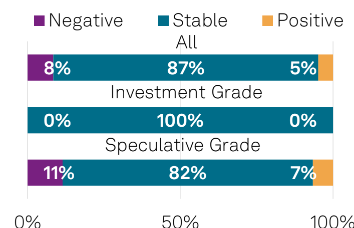
Potential drag on top-line growth. A steep recession will weigh on revenues, given the discretionary component of health care and increasing out-of-pocket costs. However, we believe the decline is manageable and industry will see continued, albeit lower, growth.

Loosening of labor market? A recession could be a positive for the hard-pressed service providers, such as hospitals, that have seen significantly elevated labor costs, especially on nursing.

Delay in return to normal. While the healthcare industry remains largely insulated from a recession, many companies' patient and acuity mixes have yet to normalize, pandemic uncertainties remain, federal aid monies have dried up, and inflation remains persistently high.

Rating Trends

Outlook Distribution

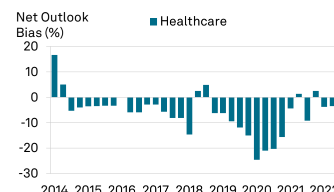


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	22	61	83
Downgrades	0	3	3
Upgrades	0	3	3

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



Related Research

How Business Strength Varies Across Top Branded Pharmaceutical Companies, June 17, 2022

Pharmaceutical Industry's Credit Prospects Brighter Due to Deleveraging, Disciplined M&A Spending, and Subsiding Legal and Reimbursement Risks, May 23, 2022

The Outlook for Health Services Sector is Stable, with a Positive Bias, March 21, 2022

Homebuilders and Developers

Challenged by softer demand, higher costs and supply chain

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What's changed?

Higher lending rates and inflation are denting real estate purchasing power, inducing lower demand for newly built residential units. Sales are mostly paid through mortgage loans in Europe and savings accumulated during the pandemic are shrinking due to high inflation.

Costs are on the rise and might not entirely be passed on through price increases. Property developers and their subcontractors are highly exposed to raw material costs, such as steel and cement prices, which have already increased significantly.

New supply remains constrained. Supply chain bottlenecks and labor shortages are limiting volume capacity and delaying deliveries. In some countries, administrative hurdles and low land availability also limit permit granting.

What to look out for?

Developers' sales growth and EBITDA margin will likely soften, mostly in 2023-2024. This is after two years of price increase and some margin expansion.

Built-to-rent investors might be the most affected. Higher interest and caps on rent indexations in some countries to limit inflation's impact on households' purchasing power could undermine expected returns and overall purchase decisions.

Government incentives could be key to supporting demand. First-time buyer schemes, tax exemptions, and bloc acquisitions of social housing initiated by some European governments have proven strong factors in developers' sales.

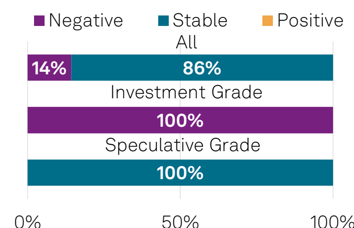
What if there's a recession?

Sales volume and prices would likely contract. Households' economic situations would worsen and further limit their real estate purchasing power.

Property developers would likely increase leverage to fund working capital needs. This would lead to lower cash flow and higher costs.

Rating Trends

Outlook Distribution



Ratings Statistics (YTD)*

	IG	SG	All
Ratings	1	6	7
Downgrades	0	0	0
Upgrades	0	1	1

Ratings data as of end-June 2022. * Year-to-date

Hotels, Gaming, and Leisure

Broad-based rebound continues, but economic risks grow

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What's changed?

The recovery. European leisure operators are on track heading into second-half 2022 to post their best annual performance since pre-pandemic 2019 results, largely uninterrupted by pandemic measures. However, the focus has turned from post-pandemic recovery to potential impacts from increasing economic and geopolitical risks, especially for issuers depending on international travel.

Cost inflation. Costs have been increasing meaningfully since the beginning of the year. Energy, fuel, labor, and financing costs should contribute to upward pressure on costs for the year. Labor remains most significant for rated issuers and so far, has been managed well, but more pressure could come. For now, price increases are offsetting costs, with prices accepted and demand strong.

Retail gaming rebound. In contrast to the challenging comparative period in first-half 2021, the rebound in retail land-based gaming revenue in Europe is underway, with some operators recording quarterly numbers ahead of those in 2019.

What to look out for?

Discretionary spending. With growing economic risks, including persistently high inflation and increasing interest rates, we expect competition to become more intense for leisure spending dollars in household discretionary budgets.

Travel leisure. Pricing trends in 2022 have been very strong. However, with high inflation across Europe, labor shortages, rising COVID-19 infections and geopolitical impacts, we expect pricing to normalize by year-end, following a summer flagged to benefit from strong pent-up demand and dynamic pricing.

U.K. gaming regulation. U.K. gaming operators remain exposed in the near term to the outcomes of the anticipated Gambling Act review white paper. Gaming operators have adopted a number of safer gaming measures ahead of the release, while the paper is expected in third-quarter 2022.

What if there's a recession?

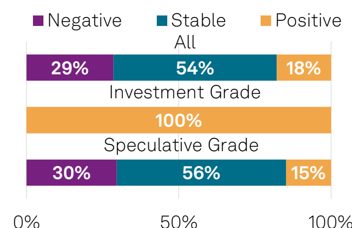
Travel and lodging. In a recessionary environment, we would expect corporate and group to be more pressured than leisure, international and long haul to be more exposed than local, regional domestic, and staycation providers, and midscale and budget brands more resilient than upscale. Franchised and managed lodging should be better positioned vs owned and leased in an increasing rental cost environment.

Gaming. We consider lottery relatively well positioned from a product profile perspective. Operators in markets with particularly strong structural online growth should likely benefit, offsetting any specific product category weakness. Higher-fixed-cost operations will be more affected.

Capital structure and refinancing risk. Rated European leisure issuers are almost exclusively speculative-grade and improvement in credit ratios into 2022 has relied on rebounded earnings, rather than balance-sheet repair. Access to capital and refinancing risk remain important key credit factors in any recession.

Rating Trends

Outlook Distribution

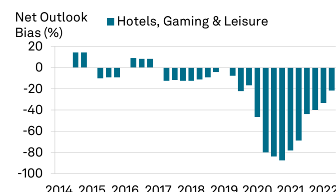


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	1	28	29
Downgrades	0	0	0
Upgrades	0	9	9

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



Related Research

European Hotel Industry Fears Inflation And Travel Reticence Could Scupper Its Strong Recovery, June 13, 2022

Media and Entertainment

Dark sequel: Pandemic survivors to face a new plot twist

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What's changed?

In first-half 2022, most companies performed strongly. Advertising outpaced GDP growth, and out-of-home (OOH) advertising and physical events recovered. Despite a worsening economic outlook, we haven't seen a pullback in advertising spending. Demand for TV and film content remains strong.

Costs are on the rise. Rising wages and talent acquisition lead to weaker margins. Broadcasters continue investing in content and direct-to-consumer (DTC) streaming.

There were several defaults in our rated portfolio. Ahead of interest rate rises, companies rushed to refinance. In cases where capital structures were unsustainable, we treated these transactions as distressed and akin to default. We could see more in the next 12-24 months for companies rated in the 'CCC' category.

What to look out for?

Weaker growth and consumer confidence. We expect lower GDP growth in 2022-2023 and think consumer confidence will dwindle as inflation persists. This could lead to a pullback in advertising (especially digital, which has shorter lead times than traditional), and lower consumer spending.

How business models adapt. The ability to raise prices will be key. In response to weaker subscriber demand, streaming platforms owners introduced free ad-supported options, but they haven't yet reduced programming budgets. There is also a lot less acquisition activity than in 2021, despite lower valuations.

Recovery in travel. As the economic outlook worsens, international travel continues to recover from pandemic lows, and we think easing of restrictions (for example in China) and more normal travel patterns into 2023 will support OOH advertising, as well as trade shows and live events.

What if there's a recession?

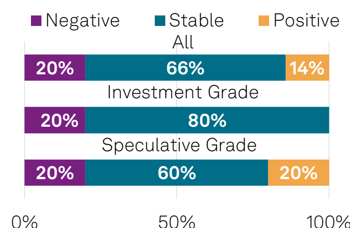
Digital media faces a big test. Digital advertising accounts for more than 65% of the industry and continues to grow at double-digit rates thanks to shift to digital media consumption. But it will likely also react more swiftly than traditional advertising to a drop in global growth and consumer spending.

Not all subscriptions are recession-proof. Businesses that rely on B2B subscriptions (such as data, information, and analytics providers) are generally resilient to recessions. But DTC platforms will likely suffer from consumers reducing discretionary spending, which will hurt their top lines and profits.

Companies with high leverage and exposure to affected industries will suffer. Classified and price comparison platforms could be hit by a drop in demand for autos and other products affected by supply chain issues, decreased ecommerce activity, fewer property and car insurance transactions, and lack of energy tariff switching due to rapidly rising prices.

Rating Trends

Outlook Distribution

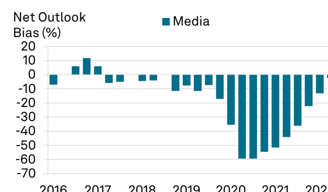


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	10	25	35
Downgrades	0	2	2
Upgrades	0	2	2

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



Related Research

Digital Marketing Group S4 Capital Off Watch Neg On Governance Review And 2021 Results; Ratings Affirmed; Outlook Stable, June 27, 2022

Universal Music Group N.V. Assigned 'BBB/A-2' Ratings; Outlook Stable, May 31, 2022

Publicis Groupe 'BBB' Ratings Affirmed; Outlook Stable, May 10, 2022

Metals and Mining

Margins contracting but cash flow is adequate for most

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What's changed?

Prices correcting. Chinese lockdowns and recession fears are signaling a likely turn in the cycle for mining and metals companies. Prices that had been strong are typically still above historical averages. But even with supply challenges, demand expectations are now the key factor for prices.

Increasing costs. Diesel, power, machinery, wage bargaining, and now financing costs have been rising as inflation spikes and works its way through value chains.

Decreased Russian and Ukrainian supply. Sanctions and logistical challenges have removed significant volumes of steel, nickel, palladium, coal, and other commodities from European and global markets. Lost sales hit affected producers hard and market and supply chain disruptions continue emerging.

What to look out for?

Rising costs. Production outages can be severe for some, but higher costs are increasingly important for all producers. Differentiators include issuers' overall starting level, currency exposure, and companies' ability to adapt.

Chinese growth hit again by lockdowns. With our revised Chinese 2022 growth forecast now at 3.3%, additional disruption would imply deeper and longer impact on commodities' demand, especially if global inventories recover significantly.

Sustainability and funding. Companies' differing emphases on operations and long-term strategy are becoming more important for investors and lenders.

What if there's a recession?

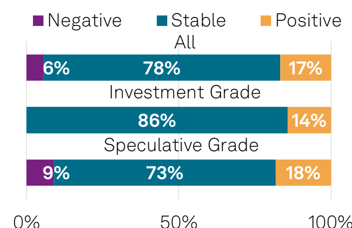
Commodities and price fluctuations. Prices will move if recessionary fears intensify or crystallize. Some high-cost producers could retrench production expectations in 2023.

New developments halting. The limited development response to expected energy transition demand will moderate, but funded existing plans will likely proceed.

Balance sheets and financial policies. Lower debt than 2015 levels and financial frameworks and distribution policies that were already tested in 2020 are likely to cushion the credit impact of a short or moderate recession.

Rating Trends

Outlook Distribution

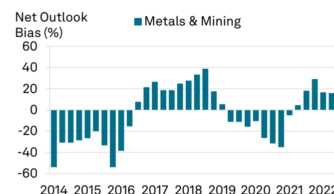


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	7	11	18
Downgrades	0	0	0
Upgrades	2	10	12

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



Related Research

Metal Price Assumptions: Shortages Worsen And Prices Spike As Conflict Roils Metals Trading, March 18, 2022

Oil and Gas

As good as it gets for producers and refiners?

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What's changed?

Hydrocarbon prices. Oil prices have risen further due to the global supply shock linked to the Russia-Ukraine conflict, compounding an already tight market. Market concerns persist about Russian oil exports since additional supply will likely remain limited. Record natural gas prices in Europe are pulling up prices in the U.S., as demand for liquefied natural gas leaps on shortages in Europe.

Ensuring supply is paramount. At least for the near term. Potential natural gas shortages in Europe and possibly higher oil prices have shifted priorities to securing supply--while weaning the EU off of Russian hydrocarbons--from addressing climate change.

Refining margins. Gasoline, distillate, and jet fuel margins are historically high, for now. Insufficient global capacity and strong demand for refined products, plus an EU ban on most Russian oil imports, have aggravated the shortages.

What to look out for?

Hydrocarbon prices may keep climbing. Natural gas prices could soar as Europe tries to trim its exposure to Russian gas by two-thirds and replenish inventory levels to 80% of capacity by Nov.1--ready for the heating season. Even if this works, Russia could cut remaining supply to Europe, thereby sparking another spike in global natural gas prices. Given the low global inventory, additional reductions in Russian exports could push up oil prices.

Fiscal policy and investment. We don't see meaningful step-ups in producers' spending despite high hydrocarbon prices, inflation, and supply chain issues. Markets are still dictating public producers should pay down debt and reward shareholders, and companies have made emissions pledges.

Policy headwinds, demand pullback. To tackle high gasoline, diesel, and energy prices, the U.S. and the EU, among other authorities, are enacting or considering policies that impact oil and gas groups, including crude export bans or windfall profits taxes. Higher retail prices seem to be tempering demand.

What if there's a recession?

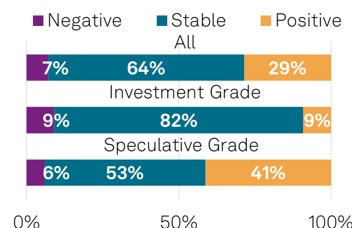
Lower hydrocarbon prices. The questions are about the severity and the duration of a recession. Balances in the oil and natural gas markets would improve with softer demand, allowing prices to decline. However, in a mild recession, oil and natural gas prices are unlikely to decline and stay below midcycle prices given the supply constraints

Rating actions. Downgrades for investment-grade issuers in the upstream industry probably would not rival prior cyclical troughs given debt reduction seen since 2020.

Refiners likely to pull through. Refining companies have significantly improved their credit profiles, using rising free cash flow to repay debt raised during the pandemic and retain more excess cash after rewarding shareholders. Credit ratios should reach pre-COVID-19 levels, softening economic headwinds.

Rating Trends

Outlook Distribution

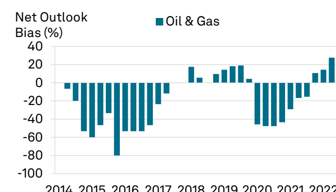


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	11	18	29
Downgrades	0	1	1
Upgrades	3	0	3

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



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S&P Global Ratings Raises Oil And Natural Gas Price Assumptions On Further Market Price Step-Ups, June 8, 2022

Real Estate (REITs)

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Inflation boosts revenue but rate rises a challenge

What's changed?

Debt investor sentiment is significantly weaker, which could weigh on REITs' funding costs and refinancing plans. Bonds' spreads have materially widened in the sector since March 2022, raising risks of access to debt capital markets.

Soaring interest rates could slow investment and push cap rates up. Higher rates should affect investors' expectations for returns and put some gradual pressure on asset revaluations, unless rental income rise or risk premiums reduce.

Higher inflation should drive greater revenue growth. Rents rise with inflation because most leases are indexed to CPI, to the extent tenants can afford this increase, and most costs are passed through to them. Supply also becomes rarer as building costs increase.

What to look out for?

REITs might use shorter debt or alternative funding. Weaker capital markets could prompt REITs to make more use of alternative sources, such as bank mortgages or insurance loans, Schuldschein, and private placements; or issue shorter-maturity debt.

Debt service and LTV metrics will see headwinds, while debt to EBITDA might improve. If cap rates and funding costs rise, the former ratios should weaken or stabilize. The latter could improve as revenue increases and investment moderates, although a recession would likely dampen EBITDA growth.

REITs might invest less and rely more on asset disposals to fund their growth. As both debt and raw materials become more expensive, we believe REITs will likely reduce acquisitions and new developments capital expenditure, and possibly become net sellers.

What if there's a recession?

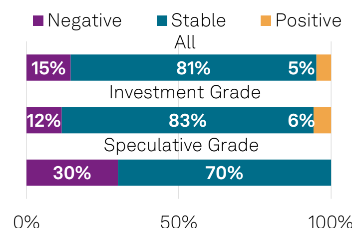
Revenue growth could erode because tenant demand would likely weaken. GDP contraction would likely hit tenants' capacity and willingness to expand their real estate footprints. Revenue growth might no longer be a catalyst in valuations.

The office segment could be more vulnerable. While the segment has been relatively resilient to the pandemic, it is more cyclical and sensitive to economic downturns. A recession would likely hit corporates' expansion plans and demand for office space.

Retail and hotel recovery post-pandemic could derail. Weaker consumer sentiment and reduced purchasing power would erode retailers and hotel operators' revenue, ultimately affecting their landlords.

Rating Trends

Outlook Distribution

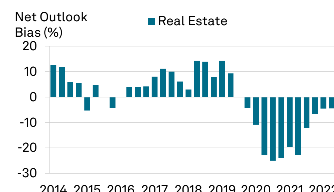


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	52	10	62
Downgrades	1	1	2
Upgrades	1	1	2

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



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When Rates Rise: European REITs' Funding Costs And Cap Rates Climb, So Does Revenue, June 16, 2022

[SLIDES] Russia-Ukraine Conflict: Implications For European Corporate And Infrastructure Sectors, March 16, 2022

Retail and Restaurants

Rising prices will lead to consumers pulling back

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What's changed?

The unrelenting rise in inflation has hit consumer confidence. Rapid--and, in some cases, very steep--rises in fuel, energy, and food prices, and continued tensions from Russia's invasion of Ukraine have severely dented consumer sentiment.

A slowdown in retail sales is in the cards. In the EU and U.K., retail sales have sustained their strong momentum through first-quarter 2022 on high household savings and pent-up demand, but signs of decreased spending are emerging.

Retailers need to maintain favorable price perception. Retailers have passed on higher input and operating costs and prices from their suppliers. However, with consumers looking to moderate their spending, retailers now face the challenge of becoming more price competitive, even as costs are escalating.

What to look out for?

Higher labor, energy, and order-fulfillment costs. Retailers will look to rationalize brick-and-mortar store costs and numbers further as the e-commerce channel remains robust. However, given the high operating leverage, many retailers will struggle to cut these costs to offset a meaningful portion of cost increases.

Already-low retail margins coming under further pressure. Higher input and operating costs will hit margins because sales volume could decline as consumers are hurt by continued high prices. The persistent supply chain and logistical bottlenecks also impede initiatives to gain efficiencies and limit operating costs.

The ability to defend free cash flow. Retailers will be tested on their ability to protect their free cash generation, particularly because working capital needs will be high as sales volumes and margins moderate and supply chain disruptions continue.

What if there's a recession?

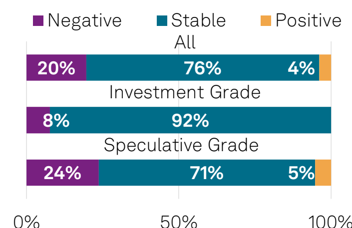
Consumer spending is likely to decelerate. Consumers will turn more cautious and begin to cut spending, especially on discretionary items. Some parts of apparel retail, or retailers that didn't fully regain their financial footing from the pandemic, could struggle the most.

Discounters and value retailers will gain market share. Consumers will favor private label over higher-priced branded products. Discount and value retailers will continue to gain market share as consumer look for ways to cut spending.

Highly leveraged retailers and restaurants will suffer the most downgrades. Weaker profitability and cash flow will lead to elevated leverage. The share of entities in EMEA rated 'B-' and below will rise to more than one-fourth (from below 20% currently). Many of these will see their capital structures becoming unsustainable and, inevitably, a few businesses will suffer financial distress.

Rating Trends

Outlook Distribution

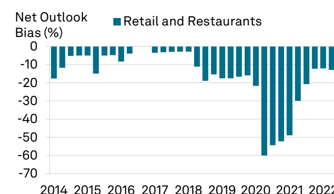


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	13	38	51
Downgrades	0	5	5
Upgrades	1	4	5

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



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European Retailers: Forced To Raise Prices While Wary Of Consumers Cutting Back Spending, June 9, 2022

Telecommunications

Stable outlook despite inflation and reduced market access

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What's changed?

Inflation is affecting cost structures. While less damaging than in other sectors, higher energy, labor, and material costs pose risks to margins and capital expenditure (capex) budgets. We expect efficiency programs, along with power purchase agreements and energy hedges, will contain the margin impact to low-single-digits before pricing responses. Delayed investments can push capex out, keeping a lid on annual investment budgets at 18% of revenue on average.

Transaction levels have dropped. Telecom refinancing needs are modest after years of extending maturity walls in a near-zero interest rate environment, but about a third of speculative-grade telecom debt is floating rate, and of over €21 billion in 2022-2023 maturities, a quarter is outstanding. These issuers are now facing higher borrowing costs to refinance (currently 7%-8% annual yields).

What to look out for?

The ability to pass through higher costs via price hikes might be uneven. We have seen significant price hikes by operators in Northern Europe markets. While positive for top lines and margin preservation (in some cases even outstripping cost inflation), higher churn could follow if any operators break from the herd. A split could emerge versus Southern Europe markets, which lack contractual escalators and where fierce competition makes price hikes more difficult.

Potential deals to watch include in-market consolidation in Spain, the sale of DT's towers, and the creation of a monopoly fixed-line infrastructure player in Italy. Outcomes could help clarify the extent governments have rebalanced their priority between incentivizing investment versus customer protection. However, major price hikes could temper the recalibration hinted at last year when wholesale regulation was loosened in several markets, including the U.K. and Spain.

What if there's a recession?

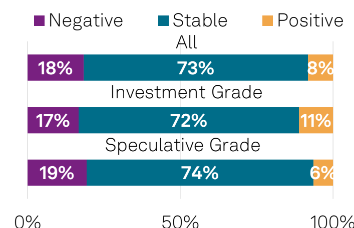
Telecoms are a relatively safe harbor. We expect modest, low-single-digit top-line growth, and the utility-like nature of telecoms should cushion against economic volatility. Even under a recession downside scenario, we expect adjusted debt to EBITDA will only rise by 1.2x for speculative-grade issuers, the second-lowest among 19 corporate sectors.

Asset sales could slow. Rising interest rates could erode the high valuation multiples, and the number of suitors for telecom infrastructure spins, curbing a monetization opportunity that operators have used to increase financial flexibility.

Inflationary price hikes should be handled with care. Operators can point to higher costs and the unmonetized economic value they provided through the pandemic to justify higher pricing. However, aggressive price hikes that push all the pain to customers might be viewed as overreach. If seen to be taking advantage of inflation, operators may inadvertently open the door to competition or regulatory pushback.

Rating Trends

Outlook Distribution

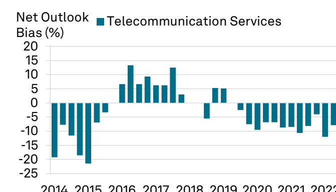


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	18	31	49
Downgrades	0	1	1
Upgrades	0	0	0

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



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EMEA Telecoms: Relative Strength Ranking 2022, March 29, 2022

Industry Top Trends 2022, Telecommunications, Jan. 25, 2022

Transportation

Air traffic booms, shipping strong, but macro risks loom

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What's changed?

Air traffic is booming. Europe's airline industry is experiencing a stronger summer than we envisioned now that travel restrictions are all but lifted. Pent-up demand, namely for short-haul leisure trips, is lifting air passenger numbers, and air capacity in third-quarter 2022 is nearing pre-pandemic levels.

Surging oil prices constrain airlines' profitability. Crude oil prices have continued to rise in recent months amid the Russia-Ukraine military conflict and the tightened global supply-and-demand conditions. We assume Brent will average $100 per barrel (/bbl) for the rest of 2022 and $85/bbl in 2023.

Port congestion remains severe and containership capacity is tight. We forecast that shipping freight rates might not start moderating (from current all-time highs) until late 2022. From 2023, as the supply chain bottlenecks ease, demand softens, and overall industry capacity increases with the ramp-up of ordered vessel deliveries, rates will decline but remain above 2020 levels.

What to look out for?

High leisure demand may dry up. Although demand for flights is rebounding, increasing headwinds suggest the recovery could decelerate toward end-2022, particularly once pent-up demand is mostly satisfied.

Airlines may charge more. We note markedly higher ticket prices for this summer travel season, with some carriers are reporting higher yields than pre-pandemic levels. Still, the airlines might have trouble raising prices later in the year if inflation causes consumers to cut back on travel. Also, the need to pass-through cost inflation to passengers will build since airlines' hedging contracts rolled into 2023 will likely be at higher prices.

Shipping freight rates could dip amid slowing demand. The intensifying headwinds to trade volumes due to China's stringent COVID-19 policy, the Russia-Ukraine conflict, and rising inflation are rapidly eroding purchasing power, as are potential setbacks from climbing interest rates.

What if there's a recession?

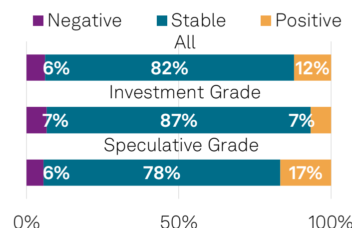
Air traffic recovery would stall. A recession could prevent households from using savings accumulated during the pandemic and might curb discretionary spending, thereby cooling the travel industry's prospects.

Airlines' deleveraging will be slower than expected. Airlines accumulated a lot of debt during the pandemic, and since they face mounting new aircraft investment, their ability to deleverage is limited. Disrupted EBITDA recovery would worsen the already-strained situation.

Supply tightness might ease. The heat from the cargo market and the expected drop in volumes would likely alleviate the supply chain disruptions and capacity shortages.

Rating Trends

Outlook Distribution

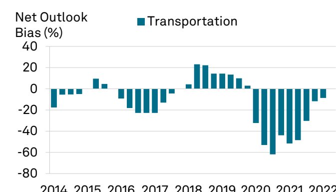


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	15	21	36
Downgrades	0	1	1
Upgrades	0	9	9

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



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Omicron Has Only Slowed European Airlines' Climb To Clearer Skies, Feb. 17, 2022

Transportation Infrastructure

Weakened economies and inflation may undo recovery

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What's changed?

Solid comeback following lifted restrictions. A strong summer season and pent-up demand for travel have ushered airports, railways, and toll roads onto a solid recovery path. Still, the speed of recovery will differ by asset class: Toll roads should reach pre-pandemic levels first, by end-2022, followed by rail by end-2023. Airports are unlikely to fully bounce back until 2025.

Prices on the rise. Escalating inflationary pressure, higher energy costs, and expected increases in capital expenditure could squeeze margins. In 2022, inflation for the eurozone and the U.K. could reach 7.0% and 8.7%, respectively, from about 2.0% before the Russia-Ukraine conflict started.

What to look out for?

Weaker economic prospects may constrain mobility. Despite a rebound in traffic in the first half of 2022, the prospects of low economic growth, less disposable incomes, and higher inflation could curb the momentum, especially after the summer. The rising cost of living could deter travel and passenger transport, and weaker consumption and imports/exports may hit the freight industry.

The ability to pass through real-cost inflation will vary. Depending on the regulatory framework for each asset class and country, the ability to pass through real-cost inflation in a timely manner via higher tariffs will mark each company's ability to withstand inflationary pressures. A strong competitive position to support higher prices without sacrificing volumes will be vital to sustain credit quality. Social pressure may lead governments to mitigate tariff increases on toll roads, despite generally solid contractual framework.

Cost controls and financial flexibility will be critical. Companies that have sustained cost-savings during the pandemic and still have flexibility in capital spending will likely have stronger liquidity buffers against rising costs.

What if there's a recession?

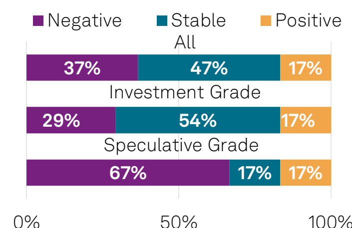
Airports are likely to be most vulnerable. Developments in 2023 will be key for the recovery of European airports, most of which are on negative outlooks. A recession could slower recovery and tighten margins more than anticipated as airports try to revive credit metrics from pandemic impacts.

Rail companies might rely further on the government. Often seen as an essential service and an instrument for climate change goals, railways have received extraordinary government support when needed. Without this help or the rail companies' own countermeasures, recessionary pressure could stunt profitability and cash flow metrics given their high fixed costs.

Toll roads would be more resilient. Despite the negative impact a recession would have on heavy vehicles' traffic, toll roads' strong balance sheets are likely to buffer their credit quality in a downturn. Higher tariffs may trigger discussions on the affordability of some assets.

Rating Trends

Outlook Distribution



Ratings Statistics (YTD)*

	IG	SG	All
Ratings	24	6	30
Downgrades	0	1	1
Upgrades	1	0	1

Ratings data as of end-June 2022. * Year-to-date. Only issuer-level ratings shown.

Related Research

European Railways Are On Track To A Fuller Recovery, July 4, 2022

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Utilities

Risks rise even if the lights stay on

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What's changed?

Increased sector volatility. The Russia-Ukraine conflict has aggravated heavy, preexisting imbalances in European gas markets. The additional physical supply risks have intensified storage concerns and prompted government actions to support affordability.

This makes the sector riskier. Increasingly divergent credit paths are emerging. Low-cost generators with high availability and regulated operations should prove resilient and regulated networks in the U.K. may benefit in the long term from rising inflation (unless their debt is inflation-linked). Gas importers, however, may face greater liquidity pressure, possibly partly offset by political or regulatory support.

That said, ratings on utilities across EMEA have held steady. So far in 2022, none of the upgrades or downgrades have exceeded one notch, confirming a ratings distribution concentrated in the 'BBB' to low 'A' range. However, the negative outlook bias has slightly increased since the Russia-Ukraine conflict tipped the balance of risks and government and industry responses.

What to look out for?

Record high and volatile prices. Dwindling Russian supplies while Europe plans how to accelerate the buildup of renewable energy mean a gas bridge is needed to make the energy transition. Because renewable capacity growth is very gradual and additional LNG supplies before 2025 are limited, power prices will stay high and volatile at least through next winter and into 2025.

Increased investments. The gas bridge and the shift to renewables require capital expenditure to increase at least 20% from the levels spent over the past three years. Although balance sheets will somewhat erode as a result, they are still generally solid, with de-risked portfolios, and typically good access to senior debt.

Green light for previously stalled projects. Nuclear and, temporarily, coal and gas may now be key to meeting the EU's decarbonization targets by providing short-term balance to the power system. But doubling the renewables capacity by 2030 entails high execution risks linked to supply bottlenecks and cost inflation.

Reduced ratings headroom. Higher debt costs, government measures to support affordability, and (notably outside regulated networks) inflation may constrain utilities' credit quality.

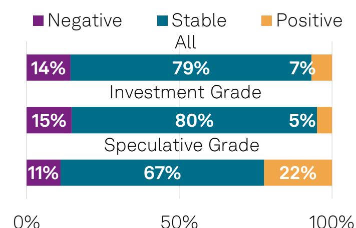
What if there's a recession?

A mild recession could ease pressure. Weakening economies consume less gas, tempering the upward pull on prices, and the sting of rising interest rates on utilities' balance sheets may be lighter. A severe recession, however, would put earnings and refinancing more at risk.

Additional factors to consider. Alongside economic growth, domestic, political, and regulatory risks around energy affordability drive utilities' credit quality. Geopolitical risks, notably from Russia, remain important considerations.

Rating Trends

Outlook Distribution

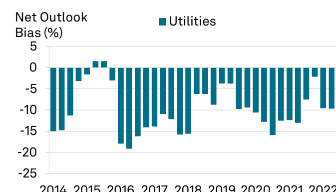


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	81	10	91
Downgrades	4	1	5
Upgrades	1	3	4

Ratings data as of end-June 2022. * Year-to-date. Only issuer-level ratings shown.

Ratings Outlook Net Bias



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