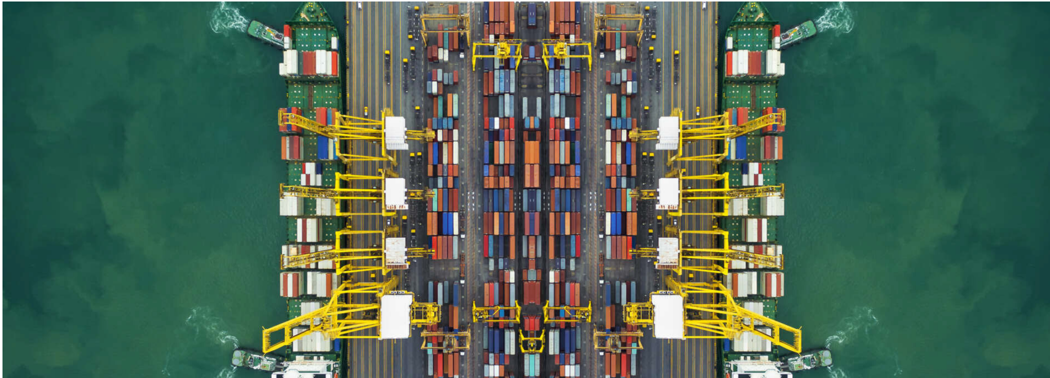
S&P Global Ratings

Transportation

Recession risks rise for global transportation companies

January 23, 2023

This report does not constitute a rating action



What's changed?

A slowing global economy will weigh on demand. Freight transportation, which boomed from H2 2020 through H1 2022, is seeing lower pricing--from record levels--and softer demand.

Airlines should weather a softer economy but are not immune. Lifted COVID-19 restrictions and pent-up demand keep fares high. Although demand could cool, air travel recovery continues.

Much higher interest rates will squeeze some companies. Low-rated companies that need to refinance will face more costly and limited options.

What are the key assumptions for 2023?

The U.S. and much of Europe will enter a shallow recession. Higher interest rates and energy costs will depress demand, but services, including transportation, should hold up.

Oil prices should ease from 2022 peaks but remain high for a recession. Disruptions from the Russia-Ukraine conflict raised oil prices and volatility. Uncertainty remains high.

Labor inflation will further pressure costs. Recruitment issues and wage negotiations will likely persist for companies that cut staff and reduced salaries during the pandemic.

What are the key risks around the baseline?

A shallow recession could evolve into something worse. Excessive tightening from central banks or an energy shock in Europe could trigger a deeper economic downturn.

Geopolitical crises could send energy prices back up. Airlines are most exposed to higher prices, but most transportation companies would suffer from the resulting weaker economy.

COVID-19 could still upset recovery. China's easing of pandemic restrictions led to a surge in cases and testing requirements. New viruses or strains anywhere could set back air travel again.

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Ratings Trends: Transportation

Chart 1

Ratings distribution by region

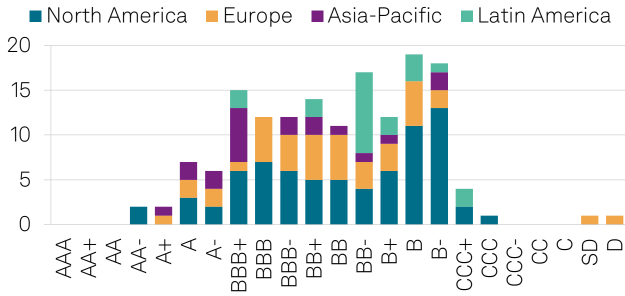


Chart 2

Ratings distribution by subsector

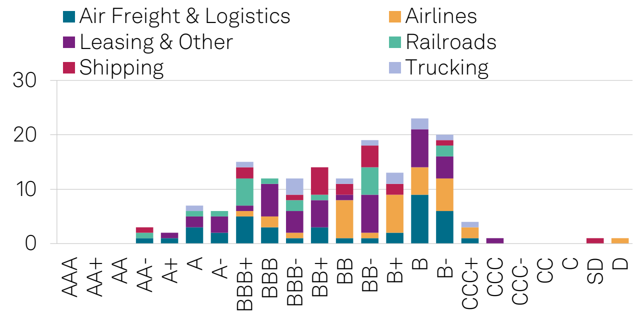


Chart 3

Ratings outlooks by region

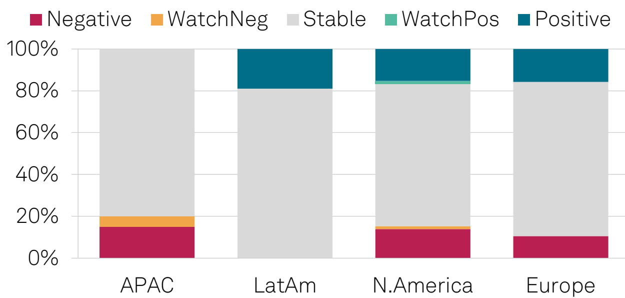


Chart 4

Ratings outlooks by subsector

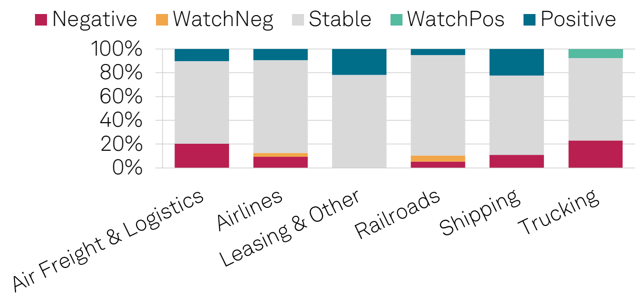


Chart 5

Ratings outlook net bias by region

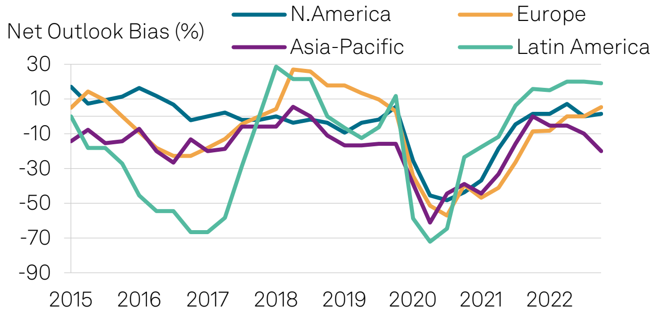


Chart 6

Ratings net outlook bias by subsector

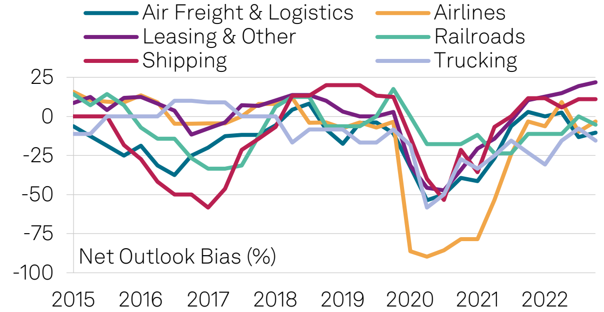


Chart 7

Ratings outlooks

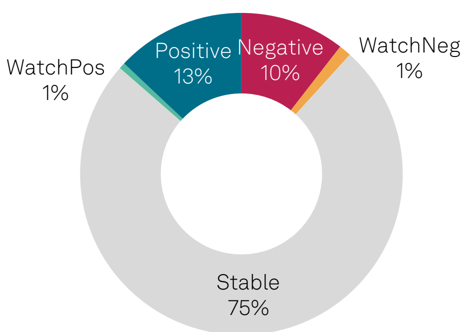
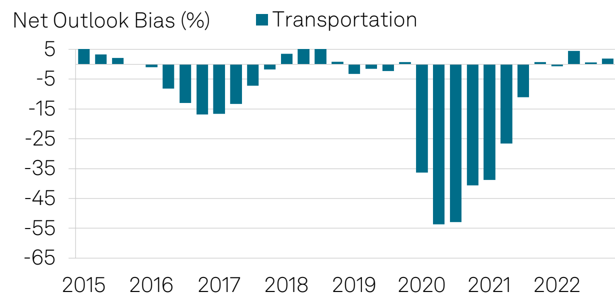


Chart 8

Ratings net outlook bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook: Airlines

Ratings trends and outlook

Airline ratings bottomed out in 2020, and the strong though uneven recovery of air travel since then has mostly stabilized ratings and allowed for selected upgrades. However, further progress is facing global headwinds. The strong U.S. dollar and higher interest rates are squeezing some developing-world airlines, such as those in Latin America. China's abrupt move away from its lengthy zero-COVID-19 strategy has led to a rise in cases, and some countries announced testing requirements for flights arriving from China. The resurgence--or appearance--of a more dangerous variant in any part of the world could set back normalization of air travel. That said, there is also opportunity for growth given the huge pent-up demand for international travel from China, particularly for visiting friends and family, following years of stringent COVID-19 rules.

Main assumptions about 2023 and beyond

1. Revenues increase, but at a slower rate

Although there is considerable uncertainty, air travel trends appear to have sufficient momentum to support some year-over-year gains (aided by weak comparisons against the omicron-affected first quarter of 2022), even in a shallow recession. Airlines will deploy more capacity and ticket prices may soften as they seek to fill seats.

2. Oil prices moderate

We expect global oil prices to pull back somewhat from 2022 peaks but remain higher than normal for a recession, with continued, wide crack spreads for jet fuel. Whether airlines give back some of the lower prices will depend on the strength of demand and competitive dynamics in each market.

3. Labor costs trend upwards

Many labor contracts remained unresolved through the pandemic, but airline unions want a share of airlines' improving earnings and compensation for the difficult working conditions of the past few years. Whether new and costlier contracts affect an airline's competitive cost position will depend partly on if airline labor talks in a country or region follow "pattern bargaining," with resulting similar pay scales across comparable airlines.

The outlook for 2023 is uncertain. First quarter year-over-year revenue and earnings comparisons should be easy, as the omicron outbreak heavily influenced January and February of 2022 (this comparison assumes any COVID-19 increase for the remainder of this winter will be less severe). With our assumed recession underway in the U.S. and some European countries, year-over-year comparisons for the rest of 2023 will be more difficult. However, it's worthwhile to remember that some international markets opened partway through 2022 and business travel trended up through the year, helping year-over-year comparisons.

Demand for passenger transportation remained strong as 2022 ended. In the U.S., planes were packed over the late-November Thanksgiving holiday, and airlines reported solid forward bookings. In Europe, leading airlines claim customer bookings are following a normal seasonal pattern. However, there is mounting evidence that (particularly large) corporations are beginning to trim travel spend in response to the impending economic downturn, and visibility (over bookings) is low.

We expect U.S. airlines to add some capacity (since they did not fly as much during the summer as they would have liked) as they receive new aircraft deliveries and deploy more pilots. European airlines have scaled back and are still not deploying their full pre-pandemic capacity in many cases. Latin American airlines will likely add capacity during 2023 as both corporate and international travel was well below pre-pandemic levels during 2022 (with omicron affecting the first quarter and high season). Asia-Pacific (APAC) airlines will continue closing the recovery gap with other regions in 2023, especially since most Northeast Asian countries have gradually eased border restrictions. We expect some airlines in Southeast Asia that suffered bankruptcies to emerge in stronger financial positions following a restructure.

As macroeconomic uncertainty remains high, we also expect uneven capacity additions across markets and airlines, and financing constraints and strong liquidity management could prevent faster capacity deployment. Ticket prices could remain relatively high where there are capacity constraints, particularly if new aircraft deliveries continue to be delayed, and high inflation (particularly for fuel and labor) that operators will hope to pass on to customers. That said, we may see prices soften in certain regions given the weak macroeconomic outlook, particularly for tickets aimed at more price-sensitive leisure travelers.

Overall, we forecast somewhat higher revenues for global airlines in 2023, and they should also benefit from a slight pullback in crude oil (and thus jet fuel) prices. Our energy team assumes a full-year average price of $85 per barrel for West Texas Intermediate (WTI) and $90 per barrel for Brent crude oil. That is lower than the 2022 average but higher than normal in a recession, reflecting disruptions caused by the Russia-Ukraine conflict and capacity constraints by OPEC and other major producers.

A more gradual but lasting cost pressure is rising labor costs. Major U.S. airlines are close to new contracts with their pilot unions, with impending substantial pay raises. This will filter down as other labor groups negotiate with airlines. Most European airlines are also under pressure to rebuild both staff and salaries to avoid the operational issues they experienced over the summer of 2022. China's reopening may further strain staffing, especially within APAC, if airlines are not prepared for a surge in Chinese travelers. South American airlines have also experienced strikes by pilots and flight attendants in the past couple of months and agreed on increased pay and benefits. To some extent, airlines should be able to pass these higher costs through to passengers, but a soft economy may limit this ability somewhat.

Environmental regulations are picking up pace, particularly in Europe, where France is in the process of banning certain short-haul domestic flights where there is a suitable rail alternative. Initially this will only impact three routes, but it is expected to expand. Furthermore, the proposed EU regulation "Fit For 55" targets a 55% reduction in carbon emissions by 2030, from 1990 levels. The proposals plan to phase out free allowances for airlines under the EU Emissions Trading System (ETS) to zero by 2026, introduce a minimum amount of Sustainable Aviation Fuel usage for flights departing from EU airports, and may even introduce a tax on jet fuel. This could put further pressure on ticket prices--and eventually demand--over the medium term.

Airlines in Europe, as well as Latin America, and APAC, face an added risk in the form of the strong U.S. dollar. This pushes up lease rentals and fuel costs, both usually denominated in dollars. The extent of the vulnerability depends on how much of these airlines' revenues are denominated in dollars or other hard currencies that do not deviate markedly from the dollar (though the yen, euro, and pound sterling have all weakened appreciably against the dollar in 2022).

Credit metrics and financial policy

We lowered our ratings on all airlines by at least one notch (and often more) during 2020. Even at this low point, our ratings factored in a forecast recovery, as a continuation of losses at that rate would have bankrupted almost all. Since then, recovery of demand and, in many cases, substantial government support have enabled airlines to gradually restore credit measures, at least to some degree. In most cases, ratios entering 2022 supported current ratings, but some permitted selected upgrades or positive outlooks. The weakening global economy and high oil prices have somewhat stalled the positive credit trend, so further rating progress may require more clarity on the economic downturn in 2023. **We expect most airlines' liquidity and improved operating results should enable them to weather the effects of the recession, unless it is materially worse than we currently anticipate.**

Airlines preserved liquidity during 2020 and 2021 using government grants and massive borrowing to raise cash. With improving industry prospects and internal cash flow, many airlines have begun to pay down debt while still maintaining cash and borrowing capacity well above pre-COVID-19 levels. Others needing to invest in new aircraft, following several years of reduced capital expenditure (capex) during the pandemic, may be unable to meaningfully reduce debt for several years. Airline management teams are looking toward longer-term liquidity targets that are likely more cautious than previously, but lower than current levels. **Rising interest rates are not a major concern, as most airline debt is fixed rate and long term. However, these higher rates will gradually raise interest expense as airlines finance new aircraft deliveries or refinance debt**. This is particularly an issue for Brazilian airlines as we forecast cash flow deficits during 2023 (amid larger leasing payments following deferrals during the pandemic) and higher capex needs (following postponed maintenance and fleet renewals). Higher dividends or new share buybacks are off the table for almost all airlines because of competing liquidity and balance sheet needs, and, in some cases, outright government restrictions or a desire to avoid a political backlash to such moves.

Key risks or opportunities around the baseline

1. The economic downturn is worse than we expect

From an operational perspective, airlines appear mostly better positioned to weather this economic storm than going into past recessions. However, that depends crucially on how severe the recession or slower growth is as many balance sheets are more debt leveraged than normal. A further question is if consumers' pivot from goods to services will continue, allowing the travel industry to hold up better than other sectors.

2. Oil prices could be a risk or opportunity

We expect oil prices to pull back somewhat from 2022 levels but remain higher than normal for a recession. Disruptions from the Russia-Ukraine conflict or a rapid recovery in Chinese economic growth as it repeals COVID-19 restrictions could send prices higher. Conversely, a worse-than-expected global slowdown could push prices below our current forecasts, helping cushion the effect of likely weaker air travel.

3. Don't forget COVID-19

The virus appears to have evolved to more transmissible but less deadly variants. Most countries have at varying paces, relaxed COVID-19 restrictions to reflect this and allay popular weariness against such constraints. However, China's recent relaxation of rules has led many countries to increase testing requirements for flights arriving from China. A more dangerous variant anywhere in the world could set back the recovery in air travel, though we do not expect a return to the widespread stringent lockdowns, outside an extreme downside scenario.

Airlines operate in a notoriously highly cyclical industry, so any expectation of improving operating results in 2023 requires justification:

- **First, our current forecast is for a shallow recession in the U.S. and some European countries** (though we also see only a tepid recovery). Reduced consumer spending will likely fall more heavily on goods than services, continuing a recent trend.
- **The momentum behind recovering air travel demand as COVID-19 restrictions ease has likely not run its full course.** During the peak 2022 summer travel season, limited airline capacity because of labor and aircraft shortages could not satisfy all consumer demand as those who flew did so in crowded planes and at expensive fares. Total annual traffic was still below 2019 levels in most cases, despite larger economies in some countries (such as the U.S.) as compared with 2019.
- **Airlines should be able to deploy more flights this year**, and likely lower fuel prices and consumer price sensitivity mean passengers may fly at somewhat lower fares. Many airlines hired employees and added fixed costs to support greater capacity than they could deploy in 2022, so these costs should be spread over more flying this year.
- **Lastly, airlines have become more capable of varying their cost structure in response to weaker demand**, having faced the ultimate test to do so in 2020. Despite downside risks to this outlook, as we identify above, airlines have a chance to fare better than in past downturns, particularly in North America.

Industry Outlook: Container Shipping

Ratings trends and outlook

The global container shipping industry boomed starting in the second half of 2020 through the first half of 2022, with container liners and containership tonnage providers alike posting record results, leading to several upgrades. This was principally driven by elevated freight and charter rates on the back of strong demand for tangible goods due to the pandemic-related restrictions (as demand for services dipped). Congestion in major maritime ports and supply chain disruptions further drove the boom as they tied up containership capacity. Although we had anticipated shipping rates to normalize from late 2022, **the correction has been faster and steeper than we expected**. As worldwide trade volumes shrunk and supply chain pressures eased, shipping rates plummeted abruptly in September-October 2022, albeit from record highs. Despite this, following a few years of extraordinary results, **credit metrics remain much stronger than before the-pandemic**.

Main assumptions about 2023 and beyond

1. Hefty vessel orderbooks strain shipping rates

Accelerating containership supply growth on the back of the current massive orderbook (accounting for 29% of the total global fleet as compared with an all-time low of 8% in October 2020, according to Clarkson Research) will likely surpass demand growth in the coming quarters. Macroeconomic headwinds and the expected sluggish global container trade will aggravate the overcapacity situation.

2. Container freight rates stabilize at profitable levels

After plunging from all-time highs during late 2022, average freight rates in 2023 might stabilize at levels above the pre-pandemic base, allowing container liners to (at least) recover operating costs that have escalated since 2019. Our base case accounts for industry players implementing timely and sufficient capacity-containing measures.

3. High operating costs burden profits as inflation lingers

Container liners have reported up to a 30% rise in average (excluding fuel) operating expenses in 2022, significant compared with 2019. Given the inflationary environment, we expect operating costs per container shipped to stay elevated the next quarters.

The most recent industry indicators and financial reporting by leading container liners indicate a sharper-than-expected demand erosion weighing on freight rates. As such, we revised our base case to incorporate negative industry trends that continued in fourth-quarter 2022. According to Clarkson Research forecasts, year-on-year trade volumes (as measured in containers shipped) fell about 3% in 2022 and might expand less than 1% this year. That said, there could be variations in trading patterns and freight rates across different destinations for various reasons, as we observed during 2022 with transpacific and Asia-Europe destinations more significantly affected than intraregional traffic and other global routes. There are certainly downside risks to this outlook in light of lingering macroeconomic and geopolitical uncertainties.

On the supply side, maritime port congestion has eased substantially, freeing up ship capacity in the market. A spike in containership deliveries means that the likely demand-and-supply imbalance (supply growth surpassing demand growth) expected in 2023 will weigh on freight rates. That said, we believe the industry will be more disciplined in managing excess supply, with

tested tools such as blank sailings, slow steaming, rerouting, and swift capacity reallocation, and perhaps some potential deferral of new vessel deliveries.

Container freight rates have tumbled across most trade lanes in late 2022. According to Clarkson Research, the Shanghai Containerized Freight Index (SCFI) reached only close to 1,100 points as of Dec. 30, 2022, which is 3.0x-3.5x lower than the elevated averages of 3,410 in 2022 and 3,750 points in 2020, but still above the pre-pandemic full-year average of 810 points for 2019. At the same time, the weekly weighted freight rate per 40-foot container, according to the World Container Index (assessed by Drewry Supply Chain Advisors), crashed to near-pre-pandemic levels of $2,100 from a high of $10,400 in September 2021. Asia-Europe and transpacific main lanes drag on indices while transatlantic and Europe-South America routes hold up relatively well, so far. Meanwhile, period tonnage markets followed suit, with one-year time charter rates dropping significantly and abruptly across all vessel classes in late 2022.

Sharply corrected freight rates will hamper this year's operating profits. What's more, we expect operating costs to stay inflated at 2022 rates, with any potential efficiency improvements largely wiped away by general cost inflation. Although the bunker price might ease from mid-2022 highs, we forecast future bunker cost changes (typically linked to crude oil price movements) are either passed through or returned to customers through respectively adjusted freight rates with a time lag of a few months. In general, we think that the significant consolidation of the container shipping industry over the past several years and larger contribution from longer-term contracts with shippers could soften the impact of plunging rates on top-line revenue in 2023.

Credit metrics and financial policy

Container liners and containership tonnage providers have been subject to multiple upgrades and positive outlook revisions in 2021-2022, as record-high shipping rates translated into strong financial performance and exceptional levels of free cash flow generation. Although some companies used that cash for mergers and acquisitions and shareholder returns, **most have significantly reduced debt leverage and built headroom under the ratings** for unexpected adverse developments. However, in many cases, a lack of track records or affirmed commitment to maintaining this low level of debt leverage prevents further upgrades.

Key risks or opportunities around the baseline

1. The economic downturn is worse than we expect

Lower-than-expected global trade volumes, a key engine of shipping growth, would damage the container shipping industry as it struggles to balance demand and supply.

2. Freight rates fall more severely absent capacity cuts or surprise in a positive way

Sluggish demand and a surge in new-build deliveries threaten capacity utilization, calling the industry for swift corrective measures. Compared with previous downturns, container liners mostly appear in a much better shape (from a debt-leverage and liquidity perspective) to weather this overcapacity, but if liners prioritize market share wins ahead of profit protection, they risk further destabilizing fragile demand-and-supply conditions. Conversely, stringent industrywide capacity withdrawals could push rates above our current forecasts, softening the impact of likely weak consumer activity.

3. Counterparties fail to deliver on charter agreements

Significantly longer time-charter profiles at attractive rates prompted our most recent upgrades of containership tonnage providers, assuming counterparties (mainly container liners) are able and willing to honor their multiyear commitments. Unexpected amendments or nonpayment under the charter agreements could materially weaken ship lessors' credit measures and liquidity.

Global container shipping demand will remain subdued in 2023 on the back of macroeconomic challenges, such as energy and other cost inflation, hikes to interest rates, and dwindling disposable incomes. Geopolitical risks and uncertainties remain given the ongoing conflict in Ukraine and the surge in COVID-19 cases in China following an abrupt end to its zero-COVID-19 policies. Sluggish commodity imports and consumption from China could cause additional harm to capacity utilization rates.

Buoyant container shipping industry conditions in 2020-2021 pushed charter rates and durations higher, benefiting ship owners that prioritized gaining visibility and secure cash flows. A shift towards multiyear contracts has contributed to our positive rating actions on containership tonnage providers. Long- to medium-term time-charter profiles comprising noncancellable and fixed-price contracts at attractive rates normally help to mitigate inherent industry volatility. This works if charterers (typically container liners) deliver on their commitments, which we incorporated in our base-case scenarios. The **counterparty risk rises when the industry cools off and rates fall far below those in existing contracts**; if container liners' credit quality weakens, this increases the possibility of amendments to existing contracts, delayed payments, or nonpayment under the charter agreements. Some rated shipping companies were forced to amend charter terms or faced defaults under charters during the last cyclical downturns.

Industry Outlook: Railroads

Ratings trends and outlook

Our ratings and outlooks on large North American railroads remain mostly stable. Weakening economic conditions pose some risk to demand over the next year. However, the large North American railroads haul a diverse mixture of goods, some of which are less exposed to macroeconomic volatility, such as grain, or are difficult to move by alternative means, such as chemicals. Additionally, recovering service quality should allow U.S. railroads to meet demand that went unfulfilled in 2022 and support improved operating efficiency. We anticipate debt-financed share repurchases will remain high, offsetting any improvement to credit metrics, but anticipate a decrease in buybacks if economic conditions decline more than we currently expect.

Main assumptions about 2023 and beyond

1. Larger workforce supports improved service quality

Following a protracted bargaining process with labor unions, we expect recent agreements will support U.S. railroads' continued hiring efforts. We also expect the productivity of recent hires will increase as they complete mandatory training. In turn, higher train and engine headcount should allow railroads to optimize their available capacity, leading to more efficient operations and greater ability to meet customer demand.

2. Intermodal volumes remain challenged

Weaker consumer spending, lower container imports, and elevated retail inventory levels will likely contribute to lower demand for goods that railroads transport via intermodal shipments. Additionally, truck pricing continues to normalize following record-high levels over the past two years, which will make rail less price competitive on certain routes, pressuring volumes.

3. Pricing gains should help offset potentially lower volumes for package express companies

We expect 2023 volumes to be more representative of overall economic conditions, after the surge of e-commerce activity in 2020-2021 during the pandemic. Announced parcel rate increases should enable revenue growth to outpace GDP, with the potential of further consumer spending rebalancing as inflation provides a moderate headwind to volumes.

U.S. railroads continued to experience service disruptions in 2022 due to an insufficient workforce within train- and engine-related positions. This prompted railroads to impose embargoes on certain shipments and divert resources to prioritize critical shipments, such as fertilizer. As a result, railroads could not meet customer demand, and some customers chose other means of transportation, especially with shipments that compete closely with truck, such as intermodal. Headcount has improved in recent months but remains below pre-pandemic levels. Therefore, **we expect railroads will continue to hire new employees and work to increase the productivity of new hires**. A worse-than-expected recession could lead railroads to curtail some hiring. However, given the difficulty in hiring and retaining new workers following the pandemic, we believe railroads may be more hesitant to furlough workers or reduce staffing levels than in past downturns.

Higher headcount should allow railroads to take advantage of available capacity and improve operating efficiency in 2023. Although a weaker macroeconomic environment will lead to lower demand for transportation of certain goods, we believe railroads have opportunities to grow carload volumes. Industrial production, particularly related to automobiles, will likely improve

somewhat as supply chain conditions ease and semiconductor availability increases. These factors should support higher volumes related to input materials as well as finished goods, particularly cars. Improved service quality will also allow customers to return some shipments to rail that they had diverted to other transportation modes.

Service quality should also improve for intermodal shipments. U.S. ports have largely worked through container backlogs amassed during the pandemic, thanks to generally lower demand for goods and improved labor availability. Moreover, higher overall headcount at railroads, as well as improved chassis and drayage availability (which are involved in the trucking of shipping containers to and from rail facilities), should lead to more reliable intermodal shipments and allow railroads to increase capacity on key routes, such as Southern California to Chicago. Nonetheless, we believe intermodal faces near-term challenges from moderating consumer spending, reduced restocking activity, and lower spot-market pricing for truck capacity. Over the longer term, however, we believe intermodal represents a growth opportunity for railroads and offers diversification away from declining coal shipments. Therefore, we expect continued investment in equipment and terminals.

We believe parcel volumes could stay relatively flat in 2023, having somewhat normalized in 2022, though this would depend on how inflation is addressed along with the length and depth of a possible recession. Parcel volumes in 2022 compared with 2021 and 2020 are down, as the prior periods set all-time highs because of associated robust e-commerce activity emerging during the pandemic. Nevertheless, parcel volumes in calendar-year 2022 were still strong, and we expect both UPS and FedEx to be above pre-pandemic levels. The 2022 volume declines were largely in line with our expectations as consumer spending began to normalize, with customers returning to stores and spending more on services, such as travel. However, the currently high inflation environment exacerbated normalization in 2022, reducing consumer discretionary spending while China's zero-COVID-19 policies hindered supply chains.

UPS and FedEx announced parcel rate increases across various delivery segments starting in 2023, which should mitigate inflationary and recessionary risks to volumes. On an aggregated basis, we expect revenue for package express providers to increase 3%-5% in 2023, with expected FFO growth at both companies. We also expect e-commerce trends will continue to enable revenue growth slightly above long-term GDP levels for parcel providers. This should support the current ratings despite higher possible net debt arising from shrinking cash balances. Both UPS and FedEx are sitting on larger-than-usual cash balances due to the strong e-commerce activity over the past several years. We expect cash balances to decline from increased levels of share repurchases. Regardless, we believe both companies have more-than-sufficient cushion at their current ratings to absorb larger-than-anticipated macroeconomic shocks.

Credit metrics and financial policy

Credit metrics will likely remain stable in 2023. Railroads face higher labor-related costs following the conclusion of union negotiations, but we believe they can absorb most of these increases through higher pricing. Railroads also face some cost inflation for materials used in maintaining track and equipment, likely leading to higher capital spending in absolute terms. On the other hand, improved network efficiency resulting from higher headcount should allow for lower costs related to leased equipment and purchased services. We continue to expect financial policy will prioritize share repurchases in 2023, assuming a shallow recession, and incremental debt will offset any improvement in credit metrics that would come from higher earnings or cash flow.

Logistics providers and trucking companies enter 2023 with the prospects of significantly lower spot-market pricing and weaker demand conditions. Following two years of favorable conditions, the market now faces lower volumes and added incremental trucking capacity compared with the beginning of the pandemic. Smaller logistics companies with capital structures largely consisting of floating-rate debt also face rising interest rates, which could weaken cash flows and credit metrics. Companies that provide less-than-truckload (LTL) shipping will likely benefit from the less-fragmented nature of the sector and its more-stable pricing compared to truckload (TL). Nonetheless, lower retail and industrial demand will likely pressure volumes and could weaken credit measures for some LTL providers. Niche-focused logistics companies and truckers, such as those involved in flatbed and hazardous goods transportation, should fare better than those participating in more commoditized spaces, given more limited competition and more specialized requirements.

Key risks or opportunities around the baseline

1. Workforce levels do not adequately improve

Railroads encountered difficulty in hiring new workers following the pandemic. Contentious contract negotiations, the intervention of the federal government, and the loss of paid sick leave could make railroad jobs less attractive to prospective workers, making hiring more difficult or leading to higher-than-expected attrition. The protracted negotiations could also deteriorate the relationship between railroads and unions.

2. Regulatory scrutiny increases

In response to reduced service quality, the railroad industry's main federal regulator, the Surface Transportation Board (STB), stepped up its oversight by instituting additional disclosure requirements and held hearings on measures to improve service. These efforts could increase if service takes longer to improve. The STB is also set to rule on other issues aimed at increasing rail competition, including the merger between Canadian Pacific and Kansas City Southern.

3. A deeper recession leads to lower industrial production and more shifts in consumer spending

We believe improving supply chain conditions within the manufacturing sector and order backlogs could help support rail transportation demand in 2023, even if overall macroeconomic demand falters. However, if higher interest rates cause companies to cancel equipment orders, demand for freight transportation could weaken more than we currently expect. Similarly, we also believe if consumer spending shifts further than expected towards services from goods, volume levels for package express companies could underperform our expectations.

Negotiations between labor unions and railroads ended in 2022 only after Congress and the president imposed an agreement after months of contentious bargaining. While the end of negotiations provides more visibility to companies and better pay and benefits to workers, the difficult process or the lack of certain worker-friendly provisions (i.e., paid sick leave) could hamper railroads' efforts to increase headcount or lead existing employees to resign. While we view this as somewhat unlikely, **continued labor disruptions would likely delay sustained improvement in service and operating results.**

The STB used its oversight powers in 2022 to mandate additional reporting and hold public hearings related to railroads' efforts to improve service quality. Slower-than-expected improvement in service, lagging headcount, or continued shipper complaints could prompt the

STB to take additional, more-forceful actions. We also expect the STB will continue to evaluate whether to mandate reciprocal switching in areas where limited rail competition exists, which could lead to reduced network efficiency, decreased train speeds, and more competitive pricing on affected routes. Lastly, a final decision on the merger of Canadian Pacific and Kansas City Southern is due in the first quarter of 2023. Approval is unlikely to lead to additional large mergers in our view, given the stringent regulatory hurdles larger railroads would face.

Finally, a greater-than-expected reduction in industrial demand would likely lead to lower demand and weaker operating performance, especially for railroads. Weaker-than-expected consumer spending on goods would likely greatly hurt package express companies. However, financial policy remains a key factor in our ratings for companies in both sectors. We expect railroads to reduce debt-funded share repurchases in a significant downturn, in line with actions taken during the pandemic and in the 2008-2009 recession. Likewise, parcel providers would also look to curtail share repurchases. However, we could consider negative rating actions if debt-financed repurchases outpace improved operating efficiency or cash flow generation.

Industry Outlook: Transportation Equipment Leasing

Ratings trends and outlook

Transportation equipment lessors' ratings mostly remained stable in 2022, a trend we expect to continue in 2023, despite weaker economic conditions and rising interest rates. Free cash flow generated by these companies tends to be countercyclical; when demand weakens, they typically reduce capital spending but continue to generate strong cash flow due to the long-term nature of their contracts with customers (typically 5-7 years, but 10-12 in some cases). This means less need for borrowing, and lessors often use free cash flow to pay down debt. We have already seen some reduced capital spending in the second half of 2022 due to reduced demand, particularly for marine cargo container lessors. Although demand remains strong for new planes, aircraft lessors' capital spending has been below previous expectations because of the continued delays in receiving new aircraft from manufacturers. We expect these trends to continue well into 2023.

Main assumptions about 2023 and beyond

1. Volume and pricing weaken for freight transportation equipment lessors

Transportation equipment lessors benefited significantly from the supply chain shortages that began in mid-2020 and lasted through mid-2022. With equipment shortages, especially at ports, these companies experienced record use and pricing. However, as the shortages ease, we expect these companies to have excess capacity and lower pricing on new contracts.

2. Demand for leased aircraft remains strong

For the most part, global airline traffic has rebounded since early 2022, particularly in short-haul leisure markets. This, alongside continued delays new aircraft deliveries from manufacturers, has resulted in a shortage of capacity. Most large aircraft lessors have order books for new deliveries that stretch out many years, so we expect they will continue to be one of the few sources of available aircraft for the foreseeable future.

3. Rising interest rates unevenly influence the cost of and availability of capital

Many transportation equipment lessors have large percentages of floating-rate debt in their capital structures. As a result, their interest costs could increase sharply as rates rise. In addition, some companies might have less access to capital, a particular concern for those with large refinancing requirements.

Transportation equipment lessors are a diverse group that includes leasing aircraft, railcars, short-term car rentals, trucks, marine cargo containers, chassis, and portable storage units. Lessors involved with the freight sector experienced record use and pricing from mid-2020 through mid-2022 due to well-known supply chain issues. By contrast, the steep decline in airline travel during the pandemic resulted in aircraft lessors having to restructure aircraft leases, defer payments, and repossess aircraft from hard-pressed airline customers. However, that trend has since reversed; airline traffic has rebounded, especially for short-haul leisure traffic, and demand for goods has receded as consumers pivot to spending on services rather than goods. We expect these trends to continue even in a weaker economy, as pent-up demand for travel continues, particularly in Asia-Pacific and China now that COVID-19 restrictions have been virtually eliminated. Aircraft lessors have seen increased demand, especially for narrowbody aircraft used on shorter haul flights. Demand for widebody aircraft has only recently started to recover as

long-haul international traffic recovers, particularly on transatlantic routes. Even before the pandemic, aircraft manufacturers saw constrained capacity from delivery delays, and the trend will likely continue, albeit at a lesser rate. We don't expect production to ramp up sufficiently to fully meet demand over the foreseeable future, especially for aircraft with newer fuel-efficient technology that meet increasingly stringent environmental requirements.

Car renters also benefited from demand and supply imbalances due to manufacturing constraints on new vehicle production while travel demand was high. As a result, overall operating performance for car renters has been at record highs due to historically elevated rental rates and historically low vehicle costs (based on lower depreciation rates). However, used car prices have pulled back in recent months as manufacturers produce more new vehicles, and we expect rental rates to return to normal levels.

Many of these companies, particularly aircraft lessors, took advantage of the strong capital markets since mid-2020 to issue new debt and refinance maturities at record-low rates. The aircraft lessors' average cost of capital is still relatively low, and they maintain strong liquidity with access to credit facilities and term loans from banks while carrying mostly fixed-rate debt. However, substantial debt maturities and capital spending (even with manufacturer delays) will require refinancing in 2023, and their blended cost of capital will increase somewhat. Additionally, many speculative-grade issuers have large amounts of floating-rate debt in their capital structures; we expect their interest costs to increase, at times significantly. Within this group, we expect interest expense for car renters and chassis-and-portable-storage lessors to increase the most.

Credit metrics and financial policy

Strong operating performance since mid-2020 has largely offset capital spending and its associated debt. As such, credit metrics for freight transportation equipment lessors have been relatively flat. These companies will likely reduce capital spending, and we therefore anticipate credit metrics to remain relatively consistent for those with mostly fixed-rate debt. In contrast, higher interest expense could weaken metrics and reduce liquidity for lessors with high levels of floating-rate debt.

Car renters' credit metrics improved significantly over this period, primarily due to strong operating performance, which included record gains on used-vehicle sales. Correspondingly, most renters also significantly increased share repurchases. Although gains on sale are declining, so is capital spending, and we expect renters to continue directing free cash flow to dividends and share repurchases.

Credit metrics for the aircraft lessors have been depressed, first due to reduced revenues from lease restructurings and payment deferrals, and then to large charges taken on from aircraft stranded in Russia. Even so, we maintained ratings at pre-pandemic levels for most and revised rating outlooks back to stable in 2021. We expect credit metrics to improve somewhat as lease rates increase to cover higher interest expense and demand continues to exceed supply for new aircraft.

Key risks or opportunities around the baseline

1. The economic downturn is worse than we expect

Poorer conditions will likely result in lower demand, utilization, pricing, revenues, and cash flow. However, for most of these sectors (except for aircraft), the lead time to order new equipment is relatively short, so companies can reduce capital spending fairly quickly to meet weaker demand without incurring incremental debt to finance investment.

2. Access to liquidity becomes constrained

For the most part, investment-grade transportation equipment lessors have strong liquidity with access to credit facilities and term loans. They also have mostly unencumbered assets, which could be used for secured financing, if necessary. However, weaker credits could constrain access to capital if operating performance softens while refinancing.

3. The recovery in airline travel stalls

A global recession, a COVID-19 resurgence, or a geopolitical event such as the Russia-Ukraine conflict could stall the recovery in airline traffic. If so, the airline sector could face another stressful period, resulting in airlines requesting lease restructurings, lease payment deferrals, or repossessions, hindering aircraft lessors' revenues and operating performance.

If the global economic downturn is worse than we expect, demand, pricing, utilization, revenues, and cash flow would also correspondingly weaken. However, we would also expect lower capital spending, resulting in less need for incremental debt to finance these investments, which would then offset lower levels of earnings and cash flow. Therefore, while this combination could weaken credit metrics, we do not expect it the deteriorate enough to significantly hurt ratings for many transportation equipment lessors.

On the other hand, the environment could constrain liquidity for lower-rated (non-investment grade) credits, especially if their operating performance weakens or their interest costs increase. This could make it more difficult and costly for lower-rated companies to refinance maturities or access credit facilities limited by covenant restrictions.

Finally, while we still expect airline travel to continue to recover, a global economic downturn could significantly constrain discretionary spending on travel, as could a new or more-dangerous strain of COVID-19, or geopolitical events such as the Russia-Ukraine conflict. These events could hinder demand for aircraft.

Related Research

- Europe's Remarkable Air Passenger Traffic Recovery Faces A Trickier 2023, Nov. 21, 2022

We would like to recognize **Philip Baggaley** for his significant contributions to this report.

Industry Forecasts: Transportation

Chart 9

Revenue growth (local currency)

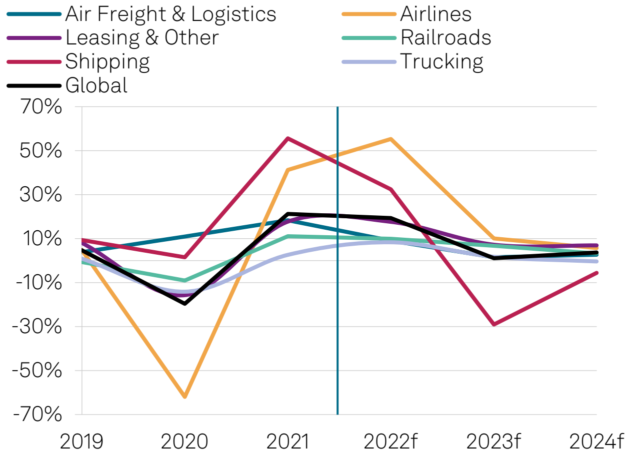


Chart 10

EBITDA margin (adjusted)

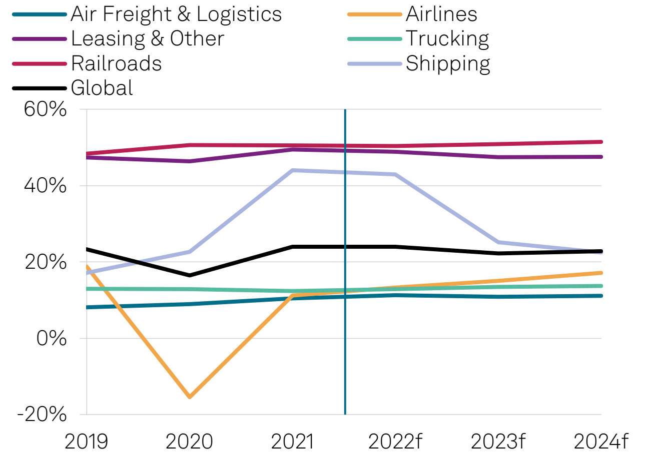


Chart 11

Debt / EBITDA (median, adjusted)

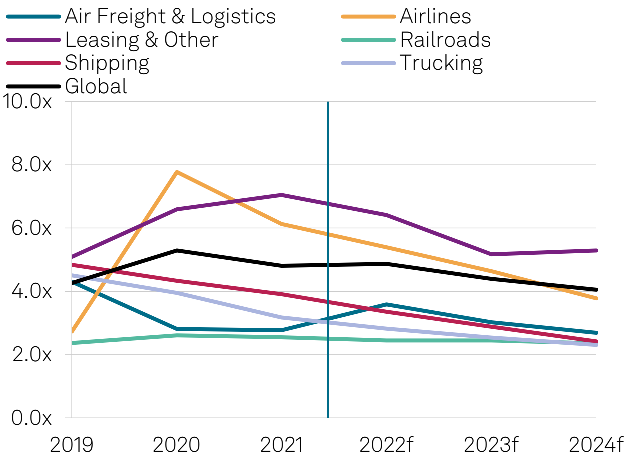
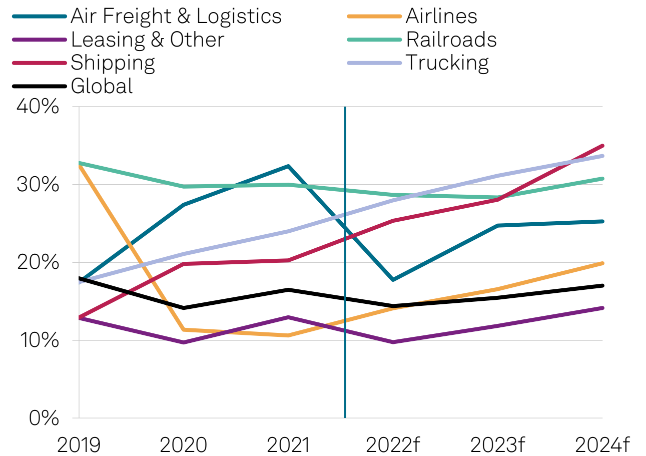


Chart 12

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Transportation

Chart 13
Cash flow and primary uses

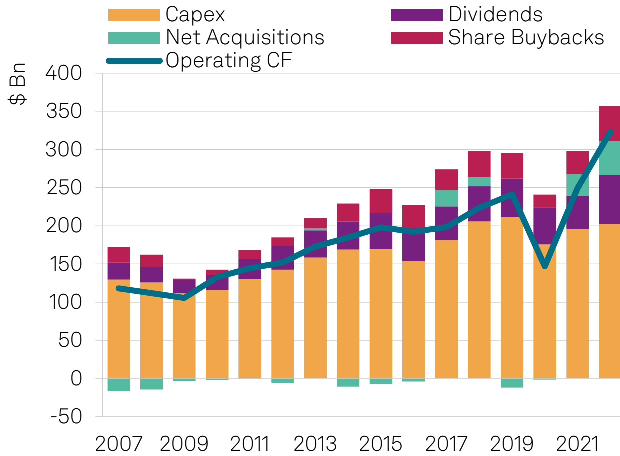


Chart 14
Return on capital employed

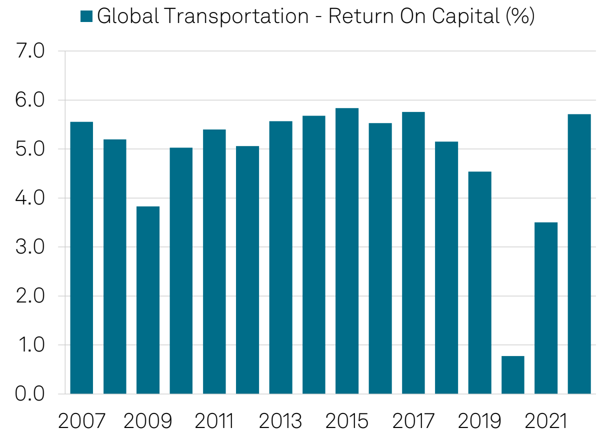


Chart 15
Fixed- versus variable-rate exposure

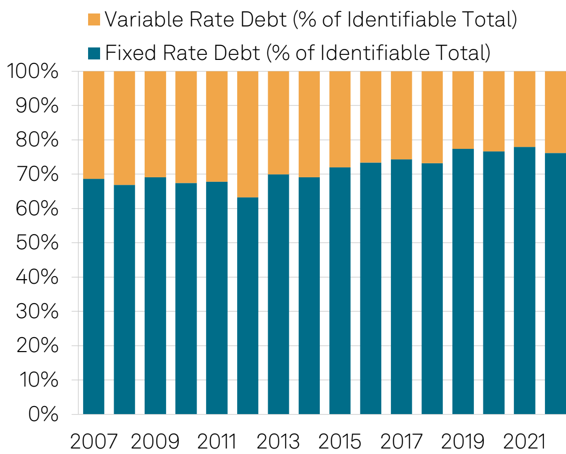


Chart 16
Long-term debt term structure

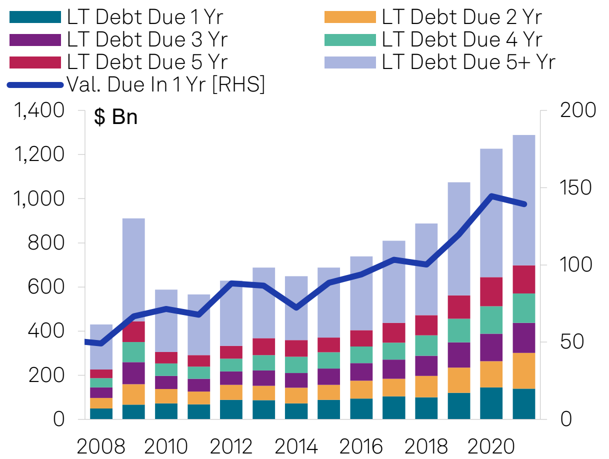


Chart 17
Cash and equivalents / Total assets

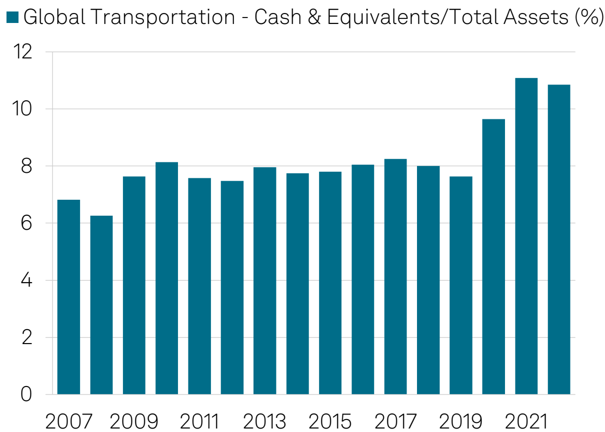
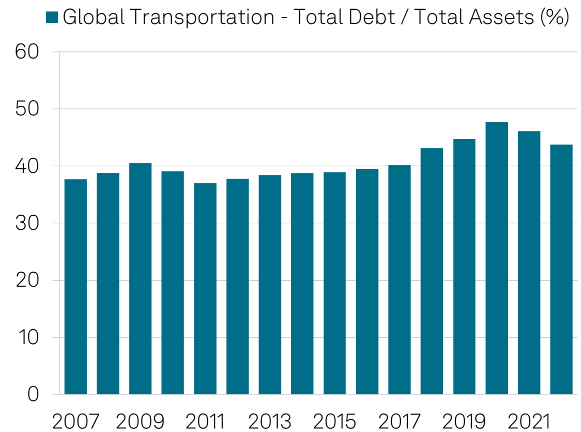


Chart 18
Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2022) figures use the last 12 months' data.

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