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Summary: Scania (publ.) AB

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Scania (publ.) AB

Credit Rating: A-/Stable/A-2

Rationale

The ratings on Sweden-based truck and bus manufacturer Scania (publ.) AB (Scania) reflect the group's strong business profile and modest financial risk. The ratings are supported by Scania's outstanding profitability in the global truck industry, which is not expected to fall below an operating margin of 4% to 5% at the bottom of the cycle. The group's truck and bus businesses benefit from leading market positions, up-to-date product lines, and the highest degree of component commonality in the global truck industry.

In July 2008, Volkswagen AG (VW; A-/Stable/A-2) acquired an additional 30.62% of voting power in Scania in accordance with an agreement signed in March 2008. VW's stake in Scania is now 68.60% in terms of voting rights. According to our ratings criteria, there is now a close link between the ratings of the parent (VW) and subsidiary (Scania). This is because the degree of affiliation between the two parties is high. Even though VW's economic share in Scania is low, VW has enough voting power to influence Scania's business risk profile and, more importantly, its financial risk profile. Our view that Scania has effectively become a subsidiary under VW's control is supported by VW's statements about the long-term nature of its investment and its long history as an investor in Scania. What's more, other investors are less able to wield control over Scania given the low proportion of voting shares in the hands of minorities.

Scania is complementary to VW's existing products and brands. Therefore, VW's statements that Scania will operate its business independently with no changes at the helm of the company are not sufficient indicators for us to conclude that Scania is completely independent from VW. As a consequence, we factor in the relationship with VW into the ratings assessment of Scania, even though the ratings on VW and Scania are not automatically equated.

Scania's results for the first half of 2008 showed a continuation of the strong earnings performance observed over the past two years. The group's EBIT margin in the first half was 16.6%, compared with 14.7% in the first half of 2007, 14.4% in full-year 2007, and 12.4% in the year 2006.

Scania continues to benefit from high capacity utilization as a result of increased production volumes, a favorable pricing environment, and increasing high-margin service revenues. EBIT in industrial operations was 16.6% in the first half of 2008, versus 14.7% in the comparable period, 13.8% in the year 2007, and 11.7% in the year 2006.

The company has affirmed its medium-term margin goal of achieving a 12%-15% EBIT margin between 2007 and 2009, while at same time achieving an average sales growth of about 10% over the same period.

Truck order bookings in the second quarter of 2008 continued to show considerable declines, notably in Europe. However, given the strong comparable figure from the second quarter of 2007, a negative growth rate in order bookings is not unexpected. We expect order bookings to soften over the next few quarters, notably due to lower demand for construction vehicles in southern European countries. Overall, the outlook for the European truck market for 2008 remains solid but we expect slight declines in 2009.

Liquidity

Standard & Poor's Ratings Services considers Scania's liquidity and financial flexibility to be strong. It is enhanced by two committed revolving credit facilities (RCF) of €1 billion each. In early 2008, Scania upsized its old €500 RCF to €1.0 billion. This new facility is due in January 2013 with a two-year renewal option. The second RCF is due in May 2012.

The bank lines are not subject to financial covenants or rating triggers. The company's liquidity position is underpinned by access to medium-term note and commercial paper programs. In addition, the company reported cash and short-term investments of Swedish krona (SEK)3.9 billion at June 30, 2008. Positive free cash flows through the cycle and credit lines should provide ample leeway for Scania to cover short-term debt maturities.

Outlook

The stable outlook reflects Scania's industry-leading profitability and ability to generate free cash flows through the cycle, which limits downside risk. In line with Scania's historical practice, we expect that it will continue its predominantly organic growth strategy. Major acquisitions are not factored into the ratings. In view of Scania's business risk, we would expect FFO in the industrial business to be about 40%-45% of industrial debt, and industrial debt to EBITDA not to exceed 1.8x, to maintain the rating level. Currently, Scania's financial ratios are significantly above these targets. The industry's tough competitive environment and cyclical demand restrict upside ratings potential.

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