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Research Update:

Swedish Truckmaker Scania Downgraded To 'BBB' On Expected Gradual Integration With TRATON; Outlook Stable

May 14, 2020

Rating Action Overview

- We believe that Scania's ties with its 100%-owner TRATON will continue to strengthen over the medium term, since the company is, in our view, pivotal to TRATON's strategic goal to integrate its main brands, and to the group's credit profile.
- At the same time, TRATON's lower profit margins, smaller free cash flow, and higher leverage ratios make our estimate of the wider group's credit profile weaker than Scania's.
- As a result, we are lowering our long-term issuer credit rating on Scania to 'BBB' from 'BBB+' and the short-term Nordic regional scale rating to 'K-2' from 'K-1'. At the same time, we are affirming the 'A-2' short-term issuer credit rating and the 'zaAAA/zaA-1+' South Africa national scale ratings on Scania.
- The outlook is stable, reflecting our expectation that TRATON will likely restore its financial performance once the COVID-19-related economic and operating challenges subside, with funds from operations (FFO) to debt of at least 60% for 2021.

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Rating Action Rationale

Scania is essential to TRATON's strategy, in our view, and will likely integrate further into the group gradually. We view Scania's superior EBITDA margins, as adjusted by S&P Global Ratings, and its valuable premium brand and technologies as essential for TRATON, German original equipment manufacturer (OEM). We assume the group will slowly advance its integration plans to increase synergies thanks to a now larger scale and market span. A gradual consolidation of group functions, over the medium term, would create a more harmonized group structure, with integrated shared services and support functions, including treasury, research and development, and purchasing functions, among others.

That said, we recognize that, on a consolidated basis, TRATON's credit profile is somewhat weaker than Scania's. Compared with Scania, TRATON has narrower profit margins and lower free cash flow prospects, as well as higher leverage ratios. Scania reached a net cash position in 2019 against Swedish krona (SEK) 9.3 billion adjusted debt under the industrial business in 2018. We expect Scania to maintain a strong balance sheet over 2020, notwithstanding COVID-19 fallout. We continue to assess the stand-alone credit profile of Scania at 'bbb+'. The ongoing integration into the group, however--considering TRATON's credit weaknesses relative to Scania--leads us to cap our assessment of Scania's credit quality at the level of TRATON's group credit profile, as reflected in the current 'BBB' rating on Scania, versus 'BBB+' previously.

Scania outperformed our expectations for 2019, and we think the company on a stand-alone basis is well equipped to face COVID-19 challenges in 2020. Scania's industrial business over 2019 reported strong adjusted profit margins of 13.5%, up from 10.5% in 2018. We expect Scania's margins to drop to around 7.0% in 2020--since the COVID-19 pandemic will likely dampen significantly the demand for trucks--before improving to about 11.5%-12.5% in 2021. The company sustained good operating profits in 2019 on the termination of the parallel production after the deployment of its new commercial vehicles offer. Additionally, the company's free operating cash flow (FOCF) under the industrial business jumped to SEK11.0 billion in 2019 from SEK4.3 billion the prior year. This helped the group reach a debt-free balance sheet in 2019, compared with FFO to debt of more than 100% at end-2018. For 2020 we expect the Scania to have enough financial flexibility to sustain its industrial business while maintaining a virtually leverage-free adjusted industrial balance sheet, even amid the economic and credit distresses stemming from the COVID-19 pandemic.

The COVID-19 pandemic will likely cause a pronounced drop in volumes this year, leading to operating profit margins under the industrial business of about 7%, before rising to historical highs from 2021 on. Over 2019 the group units sold increased 3% to 99,457, reflecting an anticipated slowdown in the truck market order intake, which decreased 9% to 88,739 in 2019 from 97,446 in 2018. First-quarter 2020 deliveries were down 23% to 18,184 from 23,576 over the same period last year, indicating some resilience and outperforming the market average. Order intake for first-quarter 2020 fell 23% to 20,671 from 26,703 in first-quarter 2019. Due to COVID-19-related shutdowns over the first quarter, Scania, similar to all other OEMs, halted production globally. Over the end of April and the beginning of May, the group has gradually restarted its plants and production. We expect units sold for 2020 to decrease by about 30% from 2019 levels, absent a second wave of COVID-19 infection or prolonged lockdowns to curb contagion. We understand the group has taken numerous measures to protect its balance sheet and that it is carefully evaluating which investment projects to pursue or postpone in order to protect its liquidity in anticipation of potentially challenging and cash-draining second and third quarters, before an expected stabilization in the final quarter of the year.

We expect Scania to continue providing its clients financing services thanks to its well-established portfolio. As of end-2019, Scania's financial services customer finance portfolio amounted to SEK103.8 billion, up 16.4% from 2018. The penetration rate in the markets where financial services are active reached 42%, broadly in line with 2018. Operating income in financial services increased to a record SEK1,511 million in 2019, from SEK1,440 million in 2018. Bad debt expenses were SEK314 million, representing 0.33% of its portfolio. Due to COVID-19-related risks, we expect the loss ratio could increase, since provisions over first-quarter 2020 started to surge, which resulted in its operating margin dropping to SEK277 million from SEK345 million in first-quarter 2019. Most of Scania's portfolio consists of customers in European markets. The financing portfolio is well diversified in terms of customer geography and type, as well as their size, economic sector, and vehicle applications. We estimate that about 30% of the portfolio is represented by assets under operating leases, however the obligation of the buyback assets sits at the industrial business, which poses risks for the industrial business cash flow. Scania also has a well-established financial policy to maintain the debt equity ratio below 10x, we think it less stringent in relative terms against other truck OEMs.

Outlook

The stable outlook on Scania reflects our view that TRATON will adhere to a financial policy that sustains credit metrics over 2020, with FFO to debt at about 30% this year, before improving to well above 60% from 2021 on.

Downside scenario

We could downgrade Scania if we were to downgrade Volkswagen AG, the majority owner of TRATON, and if, at the same time, we anticipate that TRATON is not able restore its credit metrics over the next 18 months, including achieving on a consolidated basis an FFO-to-debt ratio of at least 60%.

Upside scenario

Given the unprecedented circumstances that the commercial vehicle industry faces due to the COVID-19 pandemic, we believe rating upside is remote over the next 12-24 months. However, an upgrade could occur only if Volkswagen retains a 'BBB+' rating and TRATON, under its industrial business, progresses the integration of its brands gradually leading to FFO to debt above 60%, FOCF to debt above 25%, and EBITDA margins sustainably above 10%.

Company Description

Based in Södertälje, Sweden, Scania is one of the world's leading heavy truck and bus manufacturers. Although it also produces buses, truck operations dominate the business. German original equipment manufacturer TRATON, the 96%-owned truck subsidiary of Volkswagen AG, controls in full Scania's share capital.

Over 2019 Scania's revenues under the industrial business reached about SEK148 billion and sold 91,680 trucks and 7,777 buses. In 2019 Scania's adjusted EBITDA margin under the industrial business rose to 13.5% from 10.5% in 2018, when excluding the depreciation of assets under operating lease. Scania under the industrial business enjoys a debt-free capital structure, and we calculate that its financial service business has about 9.3x reported debt equity ratio, in line with its financial policy remaining below 10x.

Our Base-Case Scenario

Assumptions

- Real GDP growth in the eurozone to contract by 7.3% for 2020, then improving by 6.2%

year-on-year in 2021, compared with 1.2% in 2019. Brazil real GDP to shrink by 4.3% in 2020, improving by 3.3% year-on-year in 2021, from 1.1% in 2019. Despite signs of recovery in China, under our revised macroeconomic assumption, we think it is likely that real GDP for Asia-Pacific will grow by just 0.7% in 2020, then 6.3% in 2021, after 4.8% growth recorded for 2019.

- Heavy-duty truck sales in Europe are likely to decline by between 30% and 40% this year, depending on the speed of recovery in the second half of 2020. For 2021, we expect pronounced growth ranging between 15% and 25%, but not enough to fully cover 2020 volume losses. For South America we expect heavy-duty trucks units sold to fall by 10%-20% from about 18% growth in 2019, while for 2021 we see growth consolidating by 20%-30%. For Asia-Pacific we expect a decline in commercial vehicle sales by about 10%-20% this year. Additionally, we still forecast another sales contraction for heavy-duty trucks in Asia-Pacific in 2021 of up to 10% mainly because of the recent fleet expansion after regulation changes and the scheduled implementation of higher emission standard in 2021.
- For Scania we therefore see units sold to decrease to about 70,000 units, resulting in about 30% drop from 2019 level, which stood at 99,457. For 2021, we currently expect units sold for Scania to surge by about 15%-20% to about 80,000 units.
- Our expectations for the global commercial vehicle market will likely evolve throughout second-quarter 2020 as more information becomes available.
- Substantial strain on Scania's operating performance from COVID-19 fallout. Industrial adjusted EBITDA margins at around 7% in 2020, to improve to about 11.5%-12.5% for 2021. This compares with 13.5% reported by the company over 2019. This would translate in industrial adjusted EBITDA between SEK7.5 billion and SEK 8.5 billion for 2020, strengthening to about SEK15.0 billion-SEK16 billion for 2021, against SEK20 billion in 2019.
- Corporate tax rate of about 25% for 2020 and 2021 after about 24.8% in 2019.
- Negative working capital changes, including changes in leased asserts of about SEK1 billion for 2020. For 2021 we expect working capital to be negative by about SEK4 billion.
- Capital expenditure (capex) in the industrial business, including capitalized development costs of about SEK6.4 billion for 2020, lower than SEK7.5 billion for 2019. For 2021 we expect a level of capex of about SEK7.1 billion.
- We understand that COVID-19-related risks could prompt Scania to withdraw its dividend proposal to TRATON, amounting to SEK6.2 billion. For 2021 we expect the dividend to now range between SEK1.0 billion and SEK1.5 billion representing a 50% dividend payout from prior year profits.

Key metrics

- EBITDA margin between 7% in 2020, improving to around 11.5%-12.5% in 2022.
- We still expect the industrial business to be in a net cash position over 2020 and 2021.
- We expect adjusted FOCF under the industrial business to reach SEK4 billion for 2020, decreasing to SEK2 billion over 2021.

Liquidity

We assess the company's liquidity as strong. We estimate that Scania's ratio of sources to uses of liquidity will be 2.5x over the 12 months started April 1, 2020, and 2.3x over the 24 months from that date. Although Scania's liquidity could be eligible for a higher liquidity assessment, we do not perceive the company as having a strong commitment to maintaining an exceptional liquidity overtime. Additionally, we believe that the company would not withstand a sovereign crisis without the need of refinancing. Finally, we understand that the available revolving credit facilities (RCFs) can be used by both its industrial business and the financial services. There are no financial covenants or rating triggers in the RCFs.

We expect principal liquidity sources for the 12 months from April 1, 2020, will include:

- Cash and equivalents of about SEK20 billion when excluding our assessment of cash not immediately available and cash that we estimate at captive.
- Our assessment of available undrawn committed credit line of SEK15 billion with maturity horizon beyond the next 12 months. We have excluded from the committed credit lines our assessment of peak commercial paper drawings at the captive business compared with SEK7.4 billion, which are coming due in the next 12 months.
- Unadjusted cash FFO at industrial business of about SEK16.7 billion for 2020, improving to SEK13.2 billion for 2021, including the payment of operating leases over the next 12 months.

We expect principal liquidity uses for the same period will include:

- Negligible debt maturities for Scania over 2020 amounting to SEK1.6 billion and SEK3.9 billion for 2021.
- Our assumption of working capital outflow including working capital intra-year swings of up to about SEK6.8 billion for both 2020 and 2021.
- Capex of about SEK6.6 billion for 2020, increasing to SEK7.1 in 2021.
- Dividends of SEK6.2 billion in 2020, declining to SEK1.2 billion in 2021. We note an increasing the likelihood of the 2020 dividend not being paid.

Group Influence

We consider Scania to be a core subsidiary for TRATON, reflecting the 100% ownership of Scania's share capital. This also points to Scania's pivotal role for TRATON in developing the group's long-term growth strategy, aimed at strengthening its market reach, operating profit margins, and consolidated leverage metrics following the recent IPO.

Although still in the early stages, TRATON's integration process of its businesses and brands over the coming 12-18 months will likely continue as per its strategy to become a global truck champion. This, over the medium term, would result in a more harmonized group structure with integrated shared services and support functions, included but not limited for example to treasury, research and development, purchasing functions.

At the same time, we expect the group to cast a rigorous approach to brand management, increasing Scania's brand awareness. As such, we continue to expect Scania will retain its access to debt capital markets to fund its financial service business, essential to support the commercial vehicle sales over the intermediate terms.

Issue Ratings--Subordination Risk Analysis

Capital structure

Scania's capital structure consists of senior unsecured debt issued at its financing subsidiary, Scania CV AB.

Analytical conclusions

The debt is rated 'BBB', in line with the long-term issuer credit rating on Scania, since there are no significant elements of subordination risk in the capital structure. This is also supported by the company's low leverage.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/A-2

Business risk: Satisfactory

- Country risk: Low
- Industry risk: Moderately high
- Competitive position: Strong

Financial risk: Minimal

- Cash flow/Leverage: Minimal

Anchor: a-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Negative (-1 notch)
- Captive finance: Neutral (no impact)

Stand-alone credit profile: bbb+

- Estimated group credit profile: bbb
- Entity status within group: Core

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology: The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers, Dec. 14, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Auto And Commercial Vehicle Manufacturing Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Understanding S&P Global Ratings' Rating Definitions, June 3, 2009

Related Research

- Europe Braces For A Deeper Recession In 2020, April 20, 2020
- Truckmaker Scania Outlook Revised To Negative On Possible Integration With Traton; Ratings Affirmed At 'BBB+/A-2', Sept. 19, 2019

Ratings List

Downgraded; Outlook Action; Ratings Affirmed

	To	From
Scania AB (publ.)		
Issuer Credit Rating	BBB/Stable/A-2	BBB+/Negative/A-2
Nordic Regional Scale	--/--/K-2	K-1
Scania CV AB		
Senior Unsecured	BBB	BBB+

Commercial Paper	K-2	K-1
Ratings Affirmed		
Scania AB (publ.)		
Issuer Credit Rating		
South Africa National Scale	zaAAA/--/zaA-1+	