STANDARD & POOR'S

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Scania (publ.) AB

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Table Of Contents

Scania (publ.) AB

Major Rating Factors

Corporate Credit Rating
A-/Negative/A-2
South African National Scale *zaAA+/--/zaA-1*

Strengths:

- Leading market positions in Europe and South America in the manufacture of heavy trucks and buses.
- Up-to-date product range and the highest degree of component commonality in the global truck industry.
- A conservative financial policy and an intermediate financial risk profile, very strong profitability relative to peers', and good financial flexibility.

Weaknesses:

- Operations within industries characterized by high volatility and high capital intensity.
- Sizable operations in regions that might be susceptible to economic and political instability (such as Brazil).

Rationale

The ratings on Sweden-based truck and bus manufacturer Scania (publ.) AB reflect the group's satisfactory business profile and intermediate financial risk, according to Standard & Poor's Ratings Services' criteria. The ratings are supported by Scania's very strong profitability in the global truck industry. However, the ratings also take into account the strong cyclicality of operating earnings. 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.

We apply our parent-subsidiary criteria in our assessment of Scania's credit quality because of the relationship between Scania and its parent Germany-based Volkswagen AG (VW; A-/Negative/A-2). VW owns 71% of the voting rights in Scania and 46% of the capital, and VW consequently fully consolidates Scania. Although VW's economic interest in Scania is smaller than previously, its voting power is enough for it to exert a significant influence over Scania's business risk profile, strategy, and, more importantly, its financial risk profile. VW views Scania as a group brand within its portfolio. Furthermore, we regard other investors as less able to influence Scania, given the small proportion of voting rights in the hands of minority shareholders.

We assess Scania's stand-alone credit profile at 'BBB+'. The long-term corporate credit rating on Scania therefore includes a one-notch uplift, owing to the parent-subsidiary relationship between VW and Scania. The corporate credit ratings and outlook on Scania are capped at those on the parent.

Key business and profitability developments

Scania's results for the first half of 2010 showed an improvement in profitability following a 40% rise in unit sales. The EBIT margin of the industrial operations increased significantly to 15.1% from 1.8%. This is in line with peak-of-the-cycle margins in 2006-2008 (the industrial operations' EBIT margins were 13.6% in 2008, 13.8% in 2007, and 11.7% in 2006). The considerable margin expansion was mainly supported by better capacity utilization; cost reductions; and stronger sales in Brazil, partly because of tax incentives and interest rate subsidies. Overall, the 2010 first-half earnings stemmed largely from emerging markets, which contributed about one-half of the group's revenues.

The order intake in the second quarter of 2010 and the order backlog at the end of June indicate that Scania will have a solid third quarter in 2010. Consequently, Scania's capacity utilization in Europe should improve. Contrary to our earlier assessments, we now expect Scania's industrial operations to post an EBIT margin considerably higher than 10% for 2010.

Key cash flow and capital-structure developments

In first-half 2010, free operating cash flow (FOCF) in the industrial operations was positive at Swedish krona (SEK) 6.0 billion. The customer finance portfolio declined by about SEK1.6 billion over the same period. Consequently, together with the effect of a stronger krona against major currencies, Scania's debt decreased by about SEK9.0 billion compared with December 2009. Credit metrics, such as funds from operations (FFO) to debt and debt to EBITDA, improved markedly from the weaker levels in 2009. In view of the solid cash flow generation and our expectation of a continuation of solid operating results, we envisage a further improvement in Scania's credit-protection measures in 2010. According to our base-case scenario, fully-adjusted FFO to debt should considerably exceed 100% in 2010, and fully-adjusted debt to EBITDA should stay comfortably below 1.0x.

In line with our forecast of solid results for 2010, we expect Scania to increase its dividend payout in 2011 compared with that in 2010. If Scania were to increase dividends to the 2008 level (SEK4.0 billion), we believe its financial risk profile would not be affected because we see solid financial headroom for the current ratings.

Liquidity

The short-term rating is 'A-2'. We consider Scania's liquidity and financial flexibility to be "adequate". The company's industrial unit reported cash and short-term investments of SEK7.2 billion as of June 30, 2010 (of which we view SEK6.6 billion needed to maintain ongoing operations). Existing financial flexibility cover the industrial unit's short-term maturities.

We expect Scania to report positive FOCF in 2010. Scania's liquidity is enhanced by two committed revolving credit facilities (RCF) of €1 billion each. One facility is due in January 2013 and the other is due in May 2012. To our knowledge, the bank lines are not subject to financial covenants or rating triggers. However, the documentation for the RCFs contains a material adverse change clause. As of June 30, 2010, Scania had two additional committed lines totaling SEK9.0 billion available. In total, Scania had access to unused committed credit facilities of SEK26.7 billion as of June 30, 2010. The committed facilities are from a variety of banks. For its financial services unit, Scania pursues a policy of having dedicated financing that covers the estimated demand for funding during the subsequent year.

Outlook

The negative outlook on Scania reflects the negative outlook on VW, at which it is capped.

Scania's stand-alone credit profile could suffer from a negative rating action on VW, as well as from a further deterioration of truck makers' business characteristics if the economic recovery takes longer than we expect.

We might revise the outlook on Scania to stable if we revise the outlook on VW to stable.

Business Description

Scania, based in Södertälje, Sweden, is one of the world's leading heavy-truck and bus manufacturers. Although the group's divisions encompass buses, industrial and marine engines, and services, the truck operations dominate Scania's business. Despite strong growth in South America in 2010, Europe remains the group's major market.

Business Risk Profile: A Track Record Of Strong Profitability And Efficient Manufacturing Processes

The major supports for Scania's "satisfactory" business risk profile are:

- Leading market positions in Europe and Latin America in the manufacture of heavy trucks and buses. Scania ranks as the fourth-largest heavy-truck producer globally, behind Daimler AG (BBB+/Stable/A-2), Volvo (publ), AB (BBB-/Negative/A-3), and PACCAR Inc. (A+/Stable/A-1). It has a market-leading position in South America, notably Brazil. Scania's largest market is Western Europe, where it contributed about 45% of total heavy-truck deliveries in 2009 (after 51% in 2008, 52% in 2007, 57% in 2006, and 60% in 2005) and has had a relatively stable market share of about 13%-14% over the past six years. Scania is also No. 4 in the heavy bus segment, behind Daimler, Volvo, and Germany-based MAN SE (BBB+/Stable/A-2). The group leads the market in extending its modular concept to buses and has achieved high integration of the truck and bus segments;
- Up-to-date product range/lines. Scania offers a wide range of bus and coach products from chassis to fully built buses. However, the bus segment mainly produces bus chassis, and Scania subsequently outsources final assembly through independent bus body builders;
- Strong profitability. We don't expect the operating margin to fall to less than 4%-5% at the bottom of the cycle, reflecting Scania's focus on the owner-operator market (lower need for discounting) and the efficiency resulting from the modular concept. For the past 10 years, Scania's EBIT margin has been the highest in the global truck industry. Heavy-duty trucks dominate Scania's production and contribute to the group's superior margins because they are generally more profitable than light trucks, although they also increase the cyclicality of revenues. Industrywide profitability in bus production remains generally low, reflected in EBIT margins of 2%-4%;
- The most advanced modular production system in the truck industry, which means Scania uses the lowest number of individual parts for different vehicle specifications. This allows Scania to tailor vehicles to individual customers' needs, but still benefit from economies of scale;
- Successful turnaround of the bus operations by integrating bus chassis production into the truck operations and by restructuring the bus body building operations; and
- Production flexibility. In early 2008, Scania started to assemble its P-, G-, and R-series trucks in Latin America. As a result, the company now offers the same truck range in the 100 or so markets in which it operates, providing additional production flexibility.

These supports, however, may be challenged by:

- High volatility of operations and operating profits. Sales and earnings in the heavy truck industry are volatile and follow swings in demand that are linked to the macroeconomic climate;
- Sizable operations in regions that might be susceptible to economical and political instability (notably in Brazil);
- A structurally problematic bus industry, which has low profitability. The global bus industry has been confronted

with a number of challenges, including prolonged market downturns in Europe and America, price and competitive pressures, and industrywide overcapacity. However, all the industry players have taken steps to cope with these difficulties, notably by relocating labor-intensive assembly work to low-cost countries;
- Low utilization of truck customers' fleets, which continues to lead to investment deferrals and only gradual improvement of volume demand in Scania's important market region, Europe; and
- Strong cyclicality, resulting in varying reported EBITDA margins before depreciation (8.4% in 2009, compared with a high 18% in 2007 and a low 5% in 1993). This also stems from Scania's dominant focus on the more cyclical, but also more profitable, segment of long-distance haulage trucks. The group is less active in the less cyclical, but less profitable, truck segments of distribution and construction vehicles.

Financial Risk Profile: Conservative Financial Policies And Positive Free Cash Flow Through The Cycle

The main strengths of Scania's "intermediate" financial risk profile are:

- A conservative financial policy, in our view, shown by an organic growth strategy, conservative reserve policy, and prudent liquidity goals;
- Good financial flexibility. Scania has set sufficiently prudent liquidity goals for its industrial operations. It intends to hold a liquidity reserve (cash and unutilized credit facilities) that exceeds its funding needs for the next two years (excluding the financial services businesses). For its financial services unit, Scania intends to have dedicated financing to cover the estimated demand in funding for the subsequent 12 months;
- A historically organic growth strategy, with some minor bolt-on acquisitions mainly to complement the distribution network. We expect the group to continue its prudent, predominantly organic, growth policy in the future;
- Lower write-off rates than the industry average. This is helped by the group's absence from the North American market, which has much higher write-offs than is usual in Western Europe. However, Scania's average write-off ratio of 1.9% in 2009 was considerably higher than the 0.53% it posted in 2008;
- Mature portfolios, higher initial deposits, and better value on security because the majority of the group's financial services assets are concentrated in Western Europe;
- Conservative reserving to cover potential future losses on the existing financial services portfolio; and
- Ability to generate positive FOCF through the cycle. Scania's operating cash flow stream has been steady for a number of years. Positive FOCF generation through the cycle enabled the company to report low debt in 2004-2007. Also, in the trough year 2009, Scania managed to generate significantly positive FOCF, with the help of strong working capital management.

These strengths are moderated by:

- High capital intensity;
- Moderate financial leverage. The ratio of debt to EBITDA was 1.8x in 2009 compared with 0.9x in 2008;
- Significant underfunded benefit liabilities relative to the group's industrial indebtedness (including leases), at SEK4.2 billion after tax, which add to overall debt leverage. However, cash payments to retirees are manageable, in our view; and
- A high dividend payout ratio. Scania's dividend policy is based on the group's long-term performance. Payouts were in a range of 30%-50% of net earnings over the past few years, except for 2006 when Scania paid 64%. For

2009, the payout ratio was high at 71%.

Financial Statistics/Adjustments

Since 2005, Scania has prepared financial statements under International Financial Reporting Standards. When assessing Scania's credit profile, we make a number of adjustments to the reported financial information (see table 1).

We make the following debt-related adjustments:

- Operating leases/postretirement benefit obligations: Operating lease obligations are capitalized and treated as debt. Postretirement liabilities are added as a debt-like liability in adjusted financial ratio calculations;
- Surplus cash: Our total adjusted debt figure for the group includes our estimate of surplus cash, which is netted from the total debt figure. Our calculation of surplus cash factors in the level of cash we consider appropriate to remain available to meet the group's business needs and includes analysis of other consolidated cash balances that might not be immediately accessible by the group. The cash amount that was not credited against debt is SEK800 million;
- Deconsolidation (captive finance adjustments): We use our captive finance methodology as a tool to facilitate the analysis of industrial companies with captive financial service operations, such as truck makers, automakers, or capital goods companies. The debt of the captive finance company is usually assigned the same rating as that on the parent's debt because we view the captive finance company and its operating company parent as a single business enterprise. Although the ratings on the captive and the parent are equalized, we don't analyze the two on a consolidated basis. Rather, the analysis separates financing activities from manufacturing activities and analyzes each separately, reflecting the different types of assets they possess. Debt, equity, and earnings (EBIT) are allocated to the parent and captive so that both entities reflect a similar credit quality. For Scania, we determined a financial services debt leverage factor of 7-to-1 as appropriate for the rating category, based on the quality of the captive's receivables and lease assets. This implies that captive-finance assets of SEK40.4 billion at year-end 2009 are covered by SEK35.3 billion of financial debt and SEK5.1 billion of equity. Furthermore, when calculating the cash flow figures used to calculate key ratios, we do not include cash generated by the captive finance unit (SEK511 million). For an overview of our methodology for captive finance adjustments, see "Captive Finance Operations," published on April 17, 2007, on RatingsDirect.

We make the following earnings and cash-flow-related adjustments:

- Capitalized development costs: The adjustment eliminates the effects of capitalization and changes EBIT, EBITDA, and cash-flow numbers. This adjustment treats capitalized development costs as an ongoing expense. At the same time, the capitalization is reversed by a negative adjustment for capital expenditures.

Related Criteria And Research

- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Key Credit Factors: Business and Financial Risks In The Automaker Industry, Sept. 25, 2008
- Principles Of Corporate And Government Ratings, June 26, 2007
- Captive Finance Operations, April 17, 2007

Table 1

Reconciliation Of Scania (publ.) AB Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. SEK)*

	--Fiscal year ended Dec. 31, 2009--					
Scania (publ.) AB reported amounts						
	Debt	**Shareholders' equity**	**Operating income (before D&A)**	**Operating income (after D&A)**	**Interest expense**	**Cash flow from operations**
Reported	46,432	23,302	7,087	2,473	824	9,172
Standard & Poor's adjustments						
Operating leases	1,502	--	65	65	65	250
Postretirement benefit obligations	4,212	25	(5)	(5)	219	(166)
Surplus cash and near cash investments	(6,347)	--	--	--	--	--
Capitalized development costs	--	--	(287)	(23)	--	(287)
Deconsolidation/consolidation	(35,354)	(5,051)	(1,179)	(479)	--	(511)
Reclassification of nonoperating income (expenses)	--	--	--	320	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	(5,779)
Minority interests	--	1	--	--	--	--
Other	--	--	(5)	--	--	--
Total adjustments	(35,986)	(5,024)	(1,411)	(122)	284	(6,493)
Standard & Poor's adjusted amounts						
	Debt	**Equity**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**
Adjusted	10,446	18,278	5,676	2,351	1,108	2,679

*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts. SEK--Swedish krona.

Table 2

Scania (publ.) AB--Peer Comparison*

	Scania (publ.) AB	**Volvo (publ), AB**	**MAN SE**	**SKF, AB**
Corporate credit ratings as of Sept. 6, 2010	A-/Negative/A-2	BBB-/Negative/A-3	BBB+/Stable/A-2	A-/Stable/--
(Mil. €)	--Fiscal year ended Dec. 31, 2009--			
Revenues	6,059	20,172	12,026	5,489
Net income from cont. oper.	110	(1,437)	(396)	160
Funds from operations (FFO)	261	(620)	288	501
Capital expenditures	1,984	881	614	245
Debt	1,020	5,877	2,113	1,397
Equity	1,784	4,743	4,887	1,785
Adjusted ratios				
Operating income (before D&A)/revenues (%)	9.5	(1.7)	8.6	9.9
EBIT interest coverage (x)	2.1	(3.4)	(1.4)	4.1
EBITDA interest coverage (x)	5.1	(1.0)	5.0	5.6
Return on capital (%)	7.8	(12.8)	(3.6)	10.9
FFO/debt (%)	25.6	(10.5)	13.7	36.0

Table 2

Scania (publ.) AB--Peer Comparison* (cont.)				
Debt/EBITDA (x)	1.8	(14.1)	2.4	2.7

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt.

Table 3

Scania (publ.) AB--Financial Summary*					
	--Fiscal year ended Dec. 31--				
(Mil. SEK)	**2009**	**2008**	**2007**	**2006**	**2005**
Revenues	62,074	88,977	84,486	70,738	63,328
Net income from continuing operations	1,129	8,890	8,554	5,939	4,665
Funds from operations (FFO)	2,679	11,165	12,784	10,024	6,108
Capital expenditures	20,254	7,117	5,147	4,610	3,904
Debt	10,446	13,583	2,938	227	4,540
Equity	18,278	16,074	20,125	22,279	20,059
Adjusted ratios					
Operating income (before D&A)/revenues (%)	9.5	17.3	17.4	16.0	14.1
EBIT interest coverage (x)	2.1	15.9	20.7	14.7	11.9
EBITDA interest coverage (x)	5.1	19.0	24.4	18.2	15.1
Return on capital (%)	7.8	45.9	49.5	34.9	27.1
FFO/debt (%)	25.6	82.2	435.2	4,407.8	134.5
Debt/EBITDA (x)	1.8	0.9	0.2	0.0	0.5

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt. SEK--Swedish krona.

Ratings Detail (As Of September 6, 2010)*		
Scania (publ.) AB		
Corporate Credit Rating		A-/Negative/A-2
South African National Scale		zaAA+/--/zaA-1
Commercial Paper		
Nordic National Scale Rating		K-1
Senior Unsecured (4 Issues)		A-
Corporate Credit Ratings History		
31-Aug-2009		A-/Negative/A-2
08-May-2009		A-/Watch Neg/A-2
25-Jul-2007		A-/Stable/A-2
14-Sep-2006		A-/Watch Neg/A-2
23-Jul-2009	*South African National Scale*	zaAA+/--/zaA-1
23-Jul-2009		zaAA+/Watch Neg/zaA-1
03-Jun-2009		--/--/zaA-1
Business Risk Profile		Satisfactory
Financial Risk Profile		Intermediate

Ratings Detail (As Of September 6, 2010)***(cont.)**	
Debt Maturities	
(As of Dec. 31, 2009) 2010: SEK19.5 bil. 2011: SEK8.6 bil. 2012: SEK9.9 bil. 2013 and thereafter: SEK8.0 bil.	
Related Entities	
Scania CV AB	
Senior Unsecured (1 Issue)	A-

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.