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Research Update:

Swedish Truck Maker Scania 'BBB+/A-2' Ratings Affirmed; Outlook Stable

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Overview

- Following good demand for trucks, notably in Europe, we expect Scania to deliver strong operating results in 2018, with an adjusted EBITDA margin of about 12.5% and adjusted free operating cash flow (FOCF) of about Swedish krona (SEK) 6 billion (€0.6 billion).
- We also expect Scania's balance sheet to remain strong, with only a limited amount of adjusted debt, despite a cash dividend of SEK4.3 billion to Volkswagen Truck & Bus AG in the second quarter of this year.
- We are affirming our 'BBB+/A-2' ratings on Scania.
- The stable outlook on Scania reflects that on Scania's ultimate parent, Volkswagen AG (VW), and our expectation that Scania will maintain low debt and positive FOCF (excluding the captive finance operations) in 2018-2020.

Rating Action

On July 19, 2018, S&P Global Ratings affirmed its 'BBB+/A-2' long- and short-term issuer credit ratings ratings on Sweden-based heavy vehicle manufacturer Scania AB (publ.). The outlook is stable.

We also affirmed our 'K-1' Nordic regional scale rating and 'zaAAA/zaA-1+' South Africa national scale ratings on Scania.

At the same time, we affirmed our 'BBB+' issue ratings on Scania's senior unsecured bonds.

Rationale

We expect that Scania will continue to demonstrate very strong leverage metrics over the next few years, with zero or very low S&P Global Ratings-adjusted debt. This is although Scania started to pay regular dividends this year, in line with its financial policy, which targets a dividend payment of 50% of net income. We therefore believe Scania is unlikely to pay dividends in arrears, as it did in 2015 when it booked a SEK9.6 billion dividend to VW. We also perceive that VW's financial situation has stabilized, as shown by the outlook revision to stable in 2017 (see "German Automaker Volkswagen Outlook Revised To Stable From Negative; 'BBB+/A-2' Ratings Affirmed ," published Nov. 6, 2017, on RatingsDirect). As a result, we see less

uncertainty regarding Scania's future debt. For 2018 and 2019, we forecast funds from operations (FFO) to debt at 100%-150% and debt to EBITDA at below 1.0x. Nevertheless, in our view, the company's absolute discretionary cash flow generation and margin profile are not yet compatible with a credit profile in the 'a' category on a stand-alone basis, in light of the truck industry's high cyclicality.

Our assessment of Scania's business risk reflects the company's position as the third largest heavy truck manufacturer in Europe, with a 16% market share, after Daimler AG and AB Volvo. Scania also leads the South American market, notably in Brazil with a share of about 18%. A key operational strength is the company's advanced modular production system in the truck industry, which means that it uses the lowest number of individual parts for different vehicle specifications, resulting in superior efficiency gains in the manufacturing process. This also allows Scania to tailor vehicles to individual customers' needs, but still benefit from economies of scale.

Compared with competitors such as Volvo and Daimler, we believe Scania still lacks product diversity despite recent efforts to enlarge its product range, which includes long haulage trucks and a new generation of construction trucks, in addition to buses and engines. That said, although--compared with peers--Scania focuses more on the production of heavy trucks, a typically volatile segment, its operating performance has been very stable, and we don't foresee any major changes in our base case. Over the past six years, Scania's adjusted EBITDA margin has averaged 11%-12%, and 8.7% in 2009 during the financial crisis.

For 2018, we forecast a gradual improvement of the EBITDA margin to around 12.5%, thanks to strong cyclical demand, new product offerings, and moderately lower research and development investments. The stable profitability also stems from Scania's control of its services business, whose aftermarket sales and service generate around 20% of sales revenue, implying a lower need for discounts on vehicles. The increasing cost of new product development over the past few years and recent supply chain constraints have somewhat weakened Scania's profitability metrics and operating efficiency compared with historical levels. Following Scania's launch of a new truck in 2017, we however expect a gradual improvement in profitability in the near term.

Our assessment of Scania's financial risk profile is supported by our expectation that the group will continue to demonstrate very strong leverage metrics over the next two years, with close to zero or very low adjusted debt and significant headroom within the ratings. Scania has generated positive, albeit moderate absolute adjusted FOCF through the cycle, averaging about SEK3 billion over the past five years. We consider Scania to have a supportive financial policy framework, which includes limited or no spending on acquisitions and maintenance of a strong balance sheet with significant cash holdings and available committed revolving credit facilities (RCFs).

At the same time, sizable capital expenditures (capex) and relatively large dividend payments constrain adjusted discretionary cash flow generation at

SEK2.0 billion-SEK3 billion in 2018-2020 (or about 20%-30% relative to adjusted debt), down from SEK4.4 billion (or 69%) in 2017. As a result, we now view the company's financial risk profile as modest compared with minimal previously.

Although we believe investments have peaked, we expect that Scania will continue to make large investments over the cycle. We therefore consider it unlikely that investments will be lower than SEK6.0 billion annually in the near term. In 2016, Scania launched a new truck model and, in 2017, a new Euro 6 V8 engine. Capex has therefore been high at SEK6.5 billion-SEK7.4 billion annually over the past three years, compared with SEK4.3 billion-SEK5.0 billion in 2012-2014. The rollout follows several years of substantial investments, including to rebuild manufacturing lines. This implies that, for some time, Scania has been operating with duplicate product ranges, which weighed on the group's profitability. The new truck appears to have been well received in the market, among other things due to its driveline performance and low fuel consumption. We view Scania as well positioned to take advantage of the heavy truck industry's transition toward more energy-efficient engines, including electrical engines, that reduce emissions. We believe this will stimulate growth and further strengthen the company's position in the market.

Scania has substantial debt related to its financial services business, which is a central part of the group's business model and supports vehicle sales. On Dec. 31, 2017, the group's captive finance receivables and operating lease assets totaled about SEK77.0 billion. We regard the asset quality of the SEK16.7 billion of finance receivables (primarily vehicle-financing term loans) to be excellent, based on annual net credit losses being less than 1% in recent years.

We exclude the reported gross debt of the financial services division from the group's reported debt to calculate our adjusted debt figures. On this basis, the group's adjusted debt was zero as of Dec. 31, 2017. The main analytical adjustments to reported gross debt of SEK62.0 billion were to deduct SEK62.0 billion of financial services debt and SEK6.4 billion of surplus cash. We added SEK7.5 billion in pension obligations, SEK2.0 billion of operating leases, and a SEK3.8 billion provision for an EU fine. We note, however, that the fine is approximately €880 million, and that the timing and final amount remain uncertain.

We believe Scania will likely remain integral to the VW group's identity and future strategy. While we understand that Scania's ultimate owner could consider divesting parts of Volkswagen Truck & Bus AG, the entity that owns all of Scania's shares, we continue to consider Scania a highly strategic entity within the VW group.

In our base case, we assume:

- Moderate GDP growth of close to 2% in 2018 in the eurozone, where the group generates more than 60% of its revenues. Typically, over the cycle we expect truck sales to correlate closely with economic growth, and slower-than-expected growth will likely depress sales volumes.

- A revenue increase of 5%-6% in 2018, down from 14.5% in 2017, underpinned by increased truck orders in first-quarter 2018 in Europe, Russia, Brazil, Argentina, and Iran, and stronger services revenue. We believe volume growth is at the top of the cycle and project it at 1%-4% in 2019.
- A modest improvement in the EBITDA margin to about 12.5% in 2018 and 2019 from 12.0% in 2017, owing to higher volumes, including from the new truck model, although supply chain constraints will likely continue to weigh on margins in the short term.
- Capex of SEK6 billion-SEK7 billion annually (excluding the customer finance operations) in 2018-2019, broadly in line with that in 2017 but lower than the SEK7.3 billion peak in 2016 resulting from the shift to the new-generation truck.
- Moderate working capital outflow of SEK1.5 billion-SEK 2.5 billion per year in 2018 and 2019, driven by volume growth, compared with an outflow of SEK3.2 billion in 2017.
- Annual cash dividend payment of 50% of net income, in accordance with Scania's financial policy.
- No material acquisitions or disposals.

Based on these assumptions, we arrive at the following credit measures for 2018 and 2019:

- Adjusted FFO to debt staying well above 100%.
- Adjusted debt to EBITDA below 1x, compared with 0.4x in 2017.
- Adjusted discretionary cash flow of SEK2 billion–SEK3 billion, down from SEK4.4 billion in 2017.

Liquidity

We expect Scania to maintain strong liquidity, with the ratio of sources to uses in the next 12 months for the industrial division staying at about 2.8x, and about 2.7x for the subsequent 12 months, mainly due to low debt at that division. Other supportive factors include Scania's generally high standing in credit markets and well-established bank relationships. There are no financial covenants or rating triggers in Scania's undrawn SEK31 billion of RCFs.

On a consolidated basis, the group had substantial cash and marketable securities of SEK6.5 billion on March 31, 2018, as well as short-term financial liabilities totaling about SEK18 billion relating to the captive finance operations. Captive finance debt is matched with underlying assets. The group continues to have resilient capital market access via diverse funding sources, such as medium-term notes and commercial paper programs.

As of March 31, 2018, the industrial division's liquidity sources included:

- Cash and marketable securities of about SEK6.1 billion at the vehicle and services division.
- SEK31 billion of undrawn RCFs, of which €1.55 billion matures in 2021 and

€1.25 billion in 2023. We deduct from the available RCF amount about SEK3.4 billion of outstanding commercial paper.

- Cash FFO of around SEK12 billion.

On the same date, the liquidity uses comprised:

- No short-term debt at the vehicle and services division.
- Dividend payment of 50% of the previous year's net income in line with the company's financial policy, amounting to SEK4.3 billion paid in second-quarter 2018.
- Industrial capex of SEK7.0 billion-SEK8.0 billion annually (including capitalized development costs) over 2018-2019.
- Limited working capital needs.

Outlook

The stable outlook on Scania reflects that on VW and our expectation that Scania will maintain low debt and positive FOCF (excluding the captive finance operations) in 2018-2020.

Downside scenario

Downside rating potential is predominantly tied to the rating on VW. We could also lower our rating if Scania's EBITDA margin deteriorated to below 10% over a prolonged period, or if dividends to VW were larger than expected, resulting in FFO to debt declining to below 60%.

Upside scenario

We believe rating upside is currently limited for Scania, since it relies on an upgrade of VW and, simultaneously, a track record of the EBITDA margin staying above 13% and strong cash flow generation over the cycle, including discretionary cash flow above SEK3 billion.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/A-2

Business risk: Satisfactory

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

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb+
- Group credit profile: bbb+
- Entity status within group: Highly strategic

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+', the same as the long-term issuer credit rating, since there are no significant elements of subordination risk in the capital structure. This is also supported by the company's low leverage.

Related Criteria

- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Auto And Commercial Vehicle Manufacturing Industry, Nov. 19, 2013

- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Scania AB (publ.)	
Issuer Credit Rating	BBB+/Stable/A-2
Nordic Regional Scale	--/--/K-1
South Africa National Scale	zaAAA/--/zaA-1+

Scania CV AB	
Senior Unsecured	BBB+
Commercial Paper	K-1

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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