Grow or groan

EURO ZONE RISKS WILL WEIGH ON CORPORATES UNLESS THEY CAN FIND GLOBAL GROWTH, SAYS **PAUL WATTERS**.

Under Standard & Poor's base-case shallow recession scenario for 2012, we see country risk, rather than more typical cyclical factors, as driving the credit fortunes of our European rated corporates. As sovereigns in the euro zone struggle to reduce debt while supporting growth, we anticipate that companies reliant on localised operations in countries hardest hit by weak consumer demand and austerity measures will be most exposed to negative rating developments. Internationally oriented multinational and exporting companies, on the other hand, benefit from the stronger international growth environment and are better positioned to maintain their rating levels.

The policy response to the euro zone sovereign crisis involving fiscal tightening and supply-side reforms will inevitably take time, with no guarantee of success. Business and consumer confidence is likely to continue to suffer and we consider it highly likely that the weakness in the so-called "peripheral" economies will increasingly spread to the core of Europe. In this environment, Standard & Poor's current base-case forecast is for a mild recession in the euro zone during the first half of the year, resulting in minimal growth for the year as a whole, with Germany acting as a locomotive providing 0.6% growth. We envisage some degree of negative rating pressure for local companies with significant exposure to the GIIPS economies (Greece, Italy, Ireland, Portugal, and Spain).

AUSTERITY ARRIVES We believe Europe is entering an atypical period in which downward rating pressure will be exerted from two main sources: government spending cutbacks and the knock-on impact of austerity measures on local consumers and businesses. Utilities and incumbent telecoms, which are highly local, could be hardest hit, given they provide essential services in their host countries.

Yet we also predict that some transport segments, such as regional airport businesses Aeroporti di Roma (BB/Negative/B) and Copenhagen Airports (BBB-/Negative/—), could feel the effects of consumer retrenchment, and will not be helped by higher passenger duties. European steel producers and oil refiners exposed to declining profitability could also experience harsher times as lower demand and capacity utilisation create downward price pressures while traded commodity input costs remain high because of demand from China.

By contrast, companies that trade goods and services globally should be better insulated from the euro zone turbulence, even in highly cyclical sectors. They should be able to rely on continued relatively strong growth in emerging markets.

For example, since the last downturn of 2008–09, we think European auto manufacturers have become more global players. They have taken strides to improve their operational efficiency, strengthen their balance sheets and diversify their sales and operations outside western Europe. Nonetheless, luxury-rated car makers BMW (A-/Positive/A-2) and Daimler (BBB+/Positive/A-2) are better placed, in view of the brand consciousness of the aspiring middle classes in developing markets, than volume producers Peugeot, Renault (both BB+/Stable/B) and Fiat (BB/Negative/B), which still have a higher percentage of their unit sales in Europe.

Mirroring our expectation of diverging fortunes between locally and globally operating companies in 2012, we currently have a relatively higher proportion of negative outlooks or CreditWatch

negative placements in utilities, telecoms, steel, oil and gas, and some transportation segments than at a similar point in the cycle in January 2008.

TIGHTER BANK LENDING MAY CURB BORROWING AND ADD TO DEFAULTS Further adding to corporate credit pressures, we expect the lending relationship between banks and corporates to remain in flux over the coming year. In the near term, the European Banking Authority-mandated rush for banks to increase Tier 1 core equity to 9% by June 2012 will dampen new money corporate lending as most affected banks seek to reduce risk-weighted assets, including through the sale of non-core assets. In the longer run, as banks' business models adapt to a lower leveraged and more capital-intensive regulatory environment, we expect them to increase pricing and be more selective about the provision of corporate credit.

In this volatile funding environment, we think it will be paramount that corporates maintain at least adequate liquidity. We anticipate they will extend committed facilities beyond 12 months and wherever possible seek to refinance bank debt at least 15–18 months in advance of maturity. This will be more palatable for banks' loan exposures in the speculative-grade arena, where the principal outstanding can be reduced through a repayment or refinanced in whole or in part via the bond market.

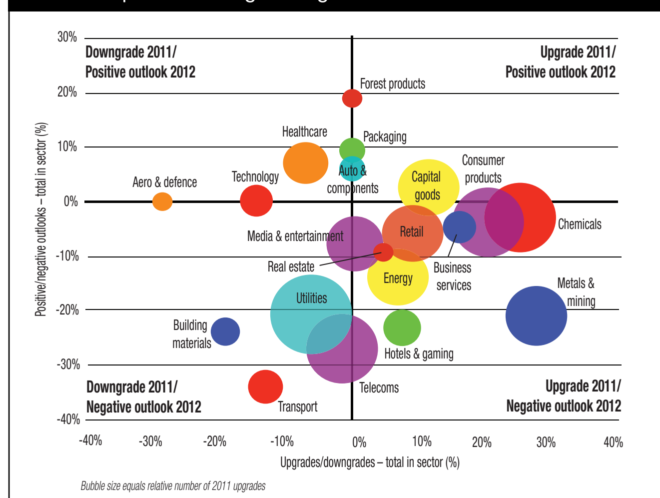
However, we believe that smaller companies and vulnerable leveraged buy-outs (LBOs) – both rated and unrated – with highly leveraged credit profiles will struggle to access external debt funding on terms they can afford. This includes many smaller firms in the supply chain, which are already under severe pressure from retailers and manufacturers to absorb higher costs. They could also be hit by a renewed credit crunch as debt financing becomes more restrictive.

In this context, we expect the rate of defaults to increase among highly leveraged companies. We forecast that the speculative-grade default rate will rise to 6.1% by the end of December 2012, from 4.8% at the end of December 2011. This is based on our pool of corporates in the 27 EU countries (plus Iceland, Norway, and Switzerland) that either have public ratings or for which we have provided private credit estimates. We see an upside risk of defaults rising to 8.4% by the end of this year. This is a modest upward revision to our previous forecast of 5.5–7.5% for 2012/13 made at the end of 2010.

DEFENSIVE FINANCIAL POLICIES PROVIDE A CREDIT BUFFER In spite of these adverse conditions, under our base-case scenario we maintain the majority of our corporate outlooks at stable, with any potential future rating actions likely to be limited to a rating outlook change or a one-notch downgrade. The reasons for this are that many companies appear to have capitalised on the stronger than expected recovery over the past two years to implement financial efficiency programmes, prioritising free operating cashflow, strengthening balance sheets and improving liquidity. This has led to some rating upgrades or provided good headroom for their credit ratios at current rating levels.

For instance, strongly improved operating performance and/or a supportive financial policy resulted in upgrades for a number of chemical companies early in 2011, including Evonik Industries (BBB/Stable/A-2), Rhodia (BBB+/Negative/A-2) and SPCM (BB/Stable/—). Capital goods companies such as Sandvik

EMEA corporate rating changes vs outlook bias 2011



(BBB+/Stable/A-2) and Assa Abloy (A-/Negative/A-2) were likewise upgraded.

Most rated companies have also taken advantage of improved financial market conditions prior to July 2011 to refinance debt due over the coming few years, strengthening their liquidity position in the process. Further underpinning the credit strength of multinational companies, we expect demand from developing and emerging markets in general to stay strong in 2012.

In China, for instance, we anticipate growth remaining high at about 8% in 2012. This is slower than over 2010–11 (about 9.5%) but more sustainable, in our view. We also anticipate inflation in the euro area falling below 2% in the coming months, which could give the European Central Bank (AAA/Stable/A-1+) some flexibility to ease monetary policy further. Together with the likely further weakness in the euro, this should improve the competitiveness of European exporters.

Any unexpected weakening of emerging markets, however, in particular in the BRIC economies, would likely have a material impact on the ratings outlook for European cyclical sectors. The continued strength of these markets underpins our assumption of relative stability for cyclical global sectors, such as auto, chemicals, oil and gas, metals and mining, and capital goods. Neither our base-case nor our downside scenarios for the coming months factor in any significant weakening in emerging market demand.

This is, nonetheless, one of the low-probability but high-impact tail risks that we keep under review. Others include a disorderly breakup of the euro zone and an unexpected acceleration of inflation induced by either excessive quantitative easing and/or sharp escalation in commodity and energy prices. We view all three scenarios as quite unlikely over our rating horizon.

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