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Summary:

Scania (publ.) AB

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Summary:

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: the operating margin in this segment should remain at 4%-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.

Scania's results for the first nine months of 2008 showed a continuation of the strong earnings performance observed over the past two years. The group's EBIT margin was 15.8%, compared with 13.8% for the corresponding period of 2007, 14.4% in full-year 2007, and 12.4% in 2006.

Scania has continued to benefit from solid capacity utilization as a result of higher production volumes, a favorable pricing environment, and increasing high-margin service revenues. The company's industrial operations' EBIT was 15.2% for third-quarter 2008, versus 13.5% for third-quarter 2007, 13.8% for full-year 2007, and 11.7% in 2006.

Truck order bookings in the second and third quarters of 2008 continued to show considerable declines, notably in Europe. Standard & Poor's Ratings Services expects order bookings to soften over the next few quarters, notably due to lower demand for construction vehicles in Southern Europe and lower overall demand from Central and Eastern Europe. Like many of its peers, Scania will decrease its build rates in the coming months and plans to reduce capacity to prevent an inventory buildup. In view of the uncertain economic environment, Scania did not provide an outlook for this year. For 2009, we expect a substantial market decline and moderate price declines. As a result, Scania's medium-term goal of a 12%-15% EBIT margin for 2007-2009 could prove challenging. The same is true for Scania's targeted average sales growth of about 10% for the same period.

Last July, Volkswagen AG (VW; A-/Stable/A-2) acquired an additional 30.62% of voting power in Scania under an agreement signed in March 2008, following which VW attained 68.60% of the voting rights. According to our ratings criteria, there is now a strong link between the ratings on VW and those on its subsidiary Scania, owing to the close affiliation between the two companies. Although VW's economic interest in Scania is low, it 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 complements 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 insufficient for us to conclude that Scania is completely autonomous. Consequently, we factor in the relationship with VW into our ratings assessment of Scania, although we have not equalized the ratings on both companies.

Liquidity

Standard & Poor's considers Scania's liquidity and financial flexibility to be strong, enhanced by two committed revolving credit facilities (RCF) of €1 billion each. In first-quarter 2008, Scania upsized its €500 million RCF to €1.0 billion. This new facility, due in January 2013, has a two-year renewal option. The second RCF is due in May 2012. In third-quarter 2008, Scania arranged a loan of Swedish krona (SEK) 3.0 billion (about $380 million) with the European Investment Bank, which will be used for research and development during 2008 to 2010. This loan has a maximum term of seven years and was unused as of Sept. 30, 2008, when Scania also reported access to unutilized credit facilities of SEK24.3 billion, some of which are uncommitted, however. Committed facilities were received from 18 different banks. For its financial services unit, Scania's policy is to have dedicated financing that covers the estimated funding needs for the subsequent year.

The bank lines are not subject to financial covenants or rating triggers. The company's liquidity position is underpinned by access to medium-term notes and commercial paper programs. In addition, Scania reported cash and short-term investments of SEK3.3 billion on Sept. 30, 2008. Positive free cash flows through the cycle and credit lines provide leeway for Scania to cover its 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 it to continue its predominantly organic growth strategy. We have not factored major acquisitions into the ratings.

In view of Scania's business risk, to maintain the rating, we would expect the industrial business to generate funds from operations of about 40%-45% of industrial debt, and industrial debt to EBITDA to be less than or equal to 1.8x. 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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