

Capital Goods

Short cyclical downturn with robust secular trends

This report does not constitute a rating action.

What's changed?

Destocking and macroeconomy weighs on short cycle business. Order intake has declined for short cyclical products in automation, warehouse equipment, and consumables over the last six months. This demonstrates a normalizing after considerable pre-buying in the last two years, when supply chains were constrained. Customers and distributors have reduced inventory levels, while the economic environment has remained soft. Despite this, diversified companies are experiencing revenue growth thanks to high order backlogs for longer cyclical businesses, like energy transition products and equipment. We expect a more supportive environment in the second half of 2024 for short cyclical products.

Easing inflation and normalized supply chains support profit margins. We expect slight margin expansion for the sector in 2024 as end-market demand remains robust providing sound utilization, fixed cost absorption, efficiency measures, and still good pricing. Simultaneously, inflationary dynamics have decreased for raw materials and transportation costs. Supply chains have broadly normalized, underpinning the recovery in profitability and leading to reduced inventory supporting cash flow generation.

The credit quality trend has been positively skewed across the capital goods portfolio. Over the past six months we raised the ratings for about 10% of the companies in the sector, most notably upgrading Siemens AG, Schneider Electric, and ABB. This reflects the sound strategic position of the businesses to secular trends, resulting in a higher margin and more stable cash flow profile but also reflecting a conservative financial policy. Upgrades in the speculative-grade space relate to addressing refinancing risks and less aggressive leverage. Most companies target a more conservative balance sheet to support their credit standing given the higher cost of debt.

What to look out for?

Tight labor market and supply constraints could lead to renewed cost escalation. Skilled labor availability challenges will put pressure on the production costs (directly and indirectly). Supply chains have broadly normalized but could be disrupted by geopolitical tensions or by renewed elevated demand for certain components and raw materials because of the time lag to expand capacity of supply networks.

We expect merger and acquisition activity to pick up because of lower inflation and gradually declining interest rates. The portfolio transformation for most companies is not yet complete and we anticipate sizable bolt-on acquisitions such as Nexans, Prysmian, or Knorr Bremse AG.

What are the key risks around the baseline?

Longer than expected order intake contraction for short cyclical businesses. This could lead to revenue declines after the order backlog is eaten up, and profit margins are likely to take a strong hit as operating leverage is high.

Demand and earnings could become depressed because of the lasting elevated interest environment. Higher interest rates are slowing demand, with a time lag for the late cyclical capital goods sector. Sticky core inflation in Europe is likely to result in higher-for-longer interest rates, which depresses demand in the medium term.

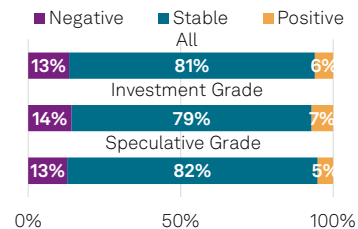
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Rating Trends

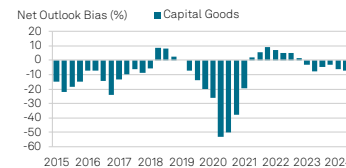
Outlook Distribution



Ratings Statistics (YTD)*

	IG	SG	All
Ratings	28	39	67
Downgrades	0	1	1
Upgrades	4	5	9

Ratings Outlook Net Bias



Sector Forecasts (Median)

2024	IG	SG
Revenue growth (Y/Y%)	0.5	4.3
EBITDA growth (Y/Y%)	1.6	13.3
EBITDA margin (%)	18.7	15.1
Capex growth (Y/Y%)	4.8	-6.1
Debt/EBITDA (x)	1.4	5.3
FFO/Debt (%)	51.1	10.5
FOCF/Debt (%)	40.2	3.8

All data as of end-June 2024.

* Year-to-date. Current ratings only.

Related Research

[Research Update: Siemens AG Upgraded To 'AA-' On Successful Portfolio Transformation And Conservative Financial Policy; Outlook Stable](#), Feb. 13, 2024

[Research Update: Schneider Electric Upgraded To ,A/A-1' On Resilient Business Model; Outlook Stable](#), April 26, 2024

[Research Update: ABB Ltd. Upgraded To 'A/A-1' On Strong Credit Metrics And More Supportive Financial Policy; Outlook Stable](#), March 28, 2024