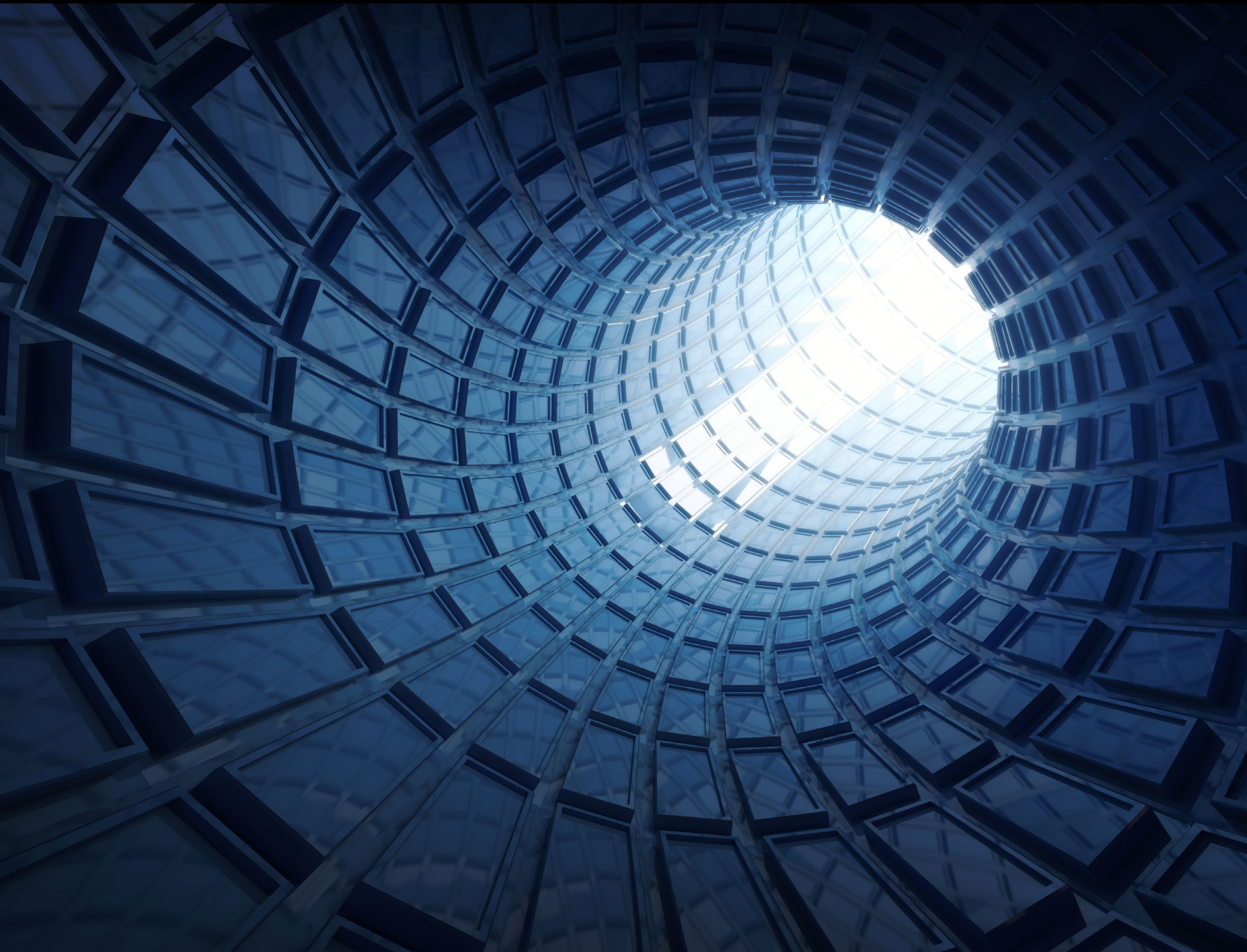
S&P Global
Ratings

10TH EDITION

Industry Credit Outlook 2025

February 4, 2025

This report does not constitute a rating action.



Foreword

Dear reader,

We recently published our Industry Credit Outlook 2025 reports for corporate and infrastructure industries, the 10th annual edition of this series. We designed these reports to communicate our credit views on rated companies and the industries in which they operate. They draw on the assessments of more than 5,500 corporate and infrastructure entities that we rate globally. This publication brings the 25 individual reports together into a single volume, along with our assessment of the common themes that emerge.

The global corporate sector is in a relatively healthy position. Despite the difficulties posed by interest rates moving structurally higher, a minor earnings recession, resurgent inflation, supply chain disruptions, and a significant debt hangover resulting from the pandemic period, we enter the year with many positives. The global economy appears to have achieved a remarkable and historically rare soft landing. Inflationary pressures have eased, and rates are consequently falling. Buoyant global financial markets have lowered financial risk premia and eased the significant burden of refinancing debt.

Our analysts expect positive revenue and EBITDA growth for all industries, margins are still expanding, leverage declining, and interest coverage recovering. Even so, this is an outlook fraught with anxiety. The new U.S. administration is expected to be forceful in relation to tariff and trade policy, with the potential for damaging trade wars. The health of the corporate sector brings risks that companies begin to lose financial discipline and increase leverage to undertake M&A or boost shareholder returns. Prospects for weaker credits are inherently subject to economic and financial volatility. AI and climate transition bring both risks and opportunities.

Best wishes

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Infrastructure

Industry Credit Outlook 2025

Key Themes

- The corporate outlook appears fundamentally healthy with broad-based growth, margins expanding, leverage falling, and interest coverage recovering.
- Anxiety around the potential for trade and tariff conflict is widespread, given the potential risks for demand, inflation, financial market volatility, and supply chains.
- AI, climate risks, and energy transition are the broader themes with most tangible credit risk and opportunity, given uncertain outcomes and substantial financial requirements.

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Growth and anxiety

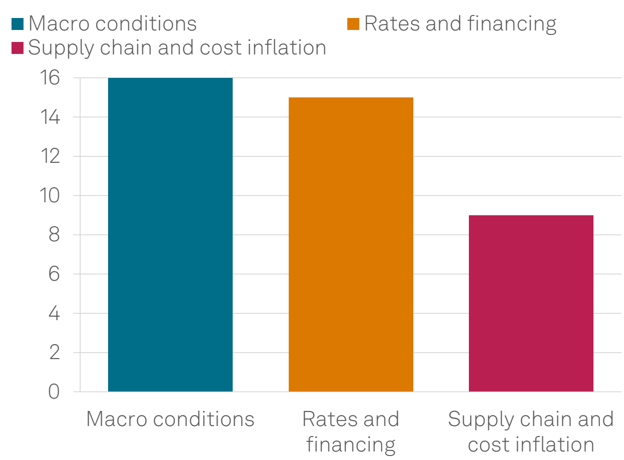
The fundamental credit outlook appears healthy but clouded by anxiety. Last year's concerns around the global economy, interest rates, and refinancing have faded, supplanted by worry as to what the new U.S. administration's focus on tariffs and trade might mean for costs, supply chains, labor supply, and the assumption that dwindling inflationary pressures will allow interest rates to continue falling. Our analysts also highlight concerns that improved operating and financing conditions might start to encourage a greater focus on M&A and shareholder returns, which could undermine the significant recovery in credit metrics seen since the pandemic.

Chart 1

Chart 2

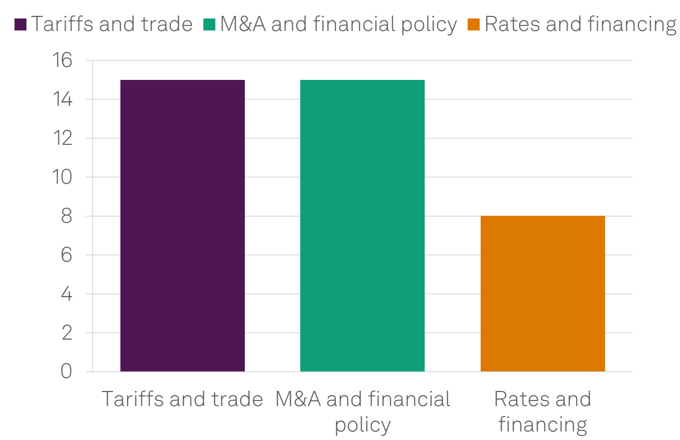
Tariffs, trade, M&A, and financial policy are the main risks for 2025, with macroeconomic anxieties less pronounced

Most frequently cited risks to sector outlook for 2024



Source: S&P Global Ratings

Most frequently cited risks to sector outlook for 2025



Source: S&P Global Ratings

Trade policy is the great unknown. It is not yet clear how far the second Trump administration will go in implementing a forewarned shift to higher tariffs and forceful bilateral trade actions, how long such actions might stay in place, nor the scale of retaliatory measures. The potential consequences for demand, costs, and supply chains loom large, along with any resultant financial market volatility creating a more difficulty financing environment. A surging U.S. dollar and more rapid inflation could make it more difficult for central banks to cut interest rates, rekindling financing pressures and worsening an already poor demand environment in Europe and Asia-Pacific. This risk is the most frequently cited negative risk to our baseline views.

The corporate growth outlook is overwhelmingly positive. We expect positive median revenue and EBITDA growth in 2025 for almost all industries, both investment grade and speculative grade. The pattern of fastest and slowest growing sectors is expected to echo 2024. Growth is likely weakest for commodity sectors (metals and mining, oil and gas), telecoms, autos, and consumer products. Aerospace and defense, technology, and homebuilders are sectors seen likely to deliver strong revenue and EBITDA growth, reflecting continuing theme around global rearmament, the AI-led technology investment cycle, and long-term demand for housing.

Chart 3

Global median revenue and EBITDA growth in 2025 for investment grade issuers by industry

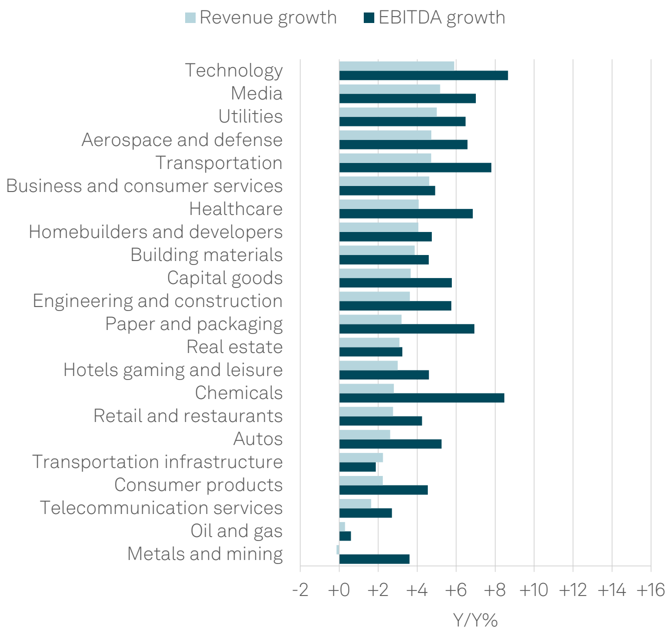
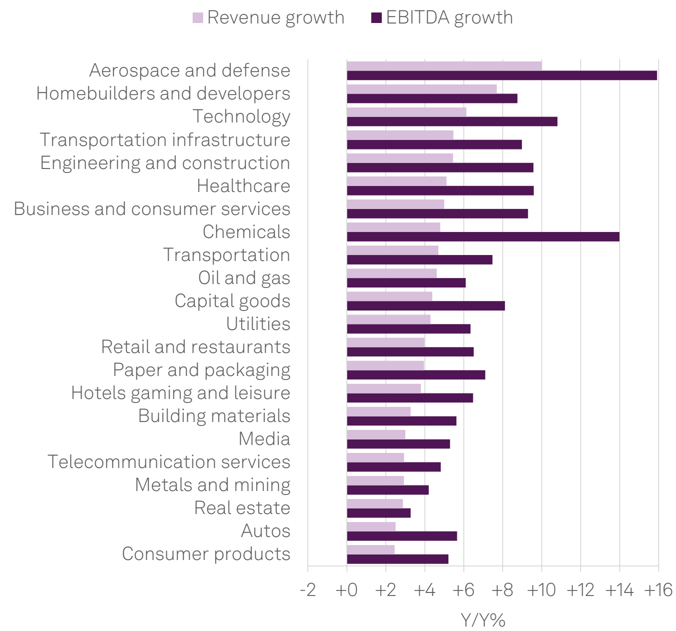


Chart 4

Global median revenue and EBITDA growth in 2025 for speculative grade issuers by industry



Source: S&P Global Ratings. Calculated as of Jan. 29, 2025. All units are USD. Charts are ranked in descending order of estimated median revenue growth.

Margins should expand further, particularly for speculative-grade entities. We forecast higher median nonfinancial corporate profit margins across all ratings categories this year, particularly for 'CCC'- and 'B'-rated entities (see chart 6), where a degree of catch up from the earnings slowdown is at play. This broad margin strength is echoed in industry forecasts too, with a most sectors likely to see margins rise this year, both for investment and speculative-grade companies (see chart 7).

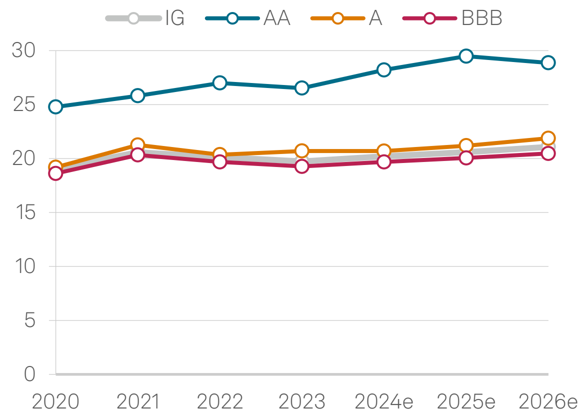
Structurally higher labor costs remain a concern for labor-intensive sectors. In health care, labor costs remain elevated, and we expect they will remain so long term, given continued shortage of health care professionals. For retailers, input costs are expected to remain manageable but high labor costs are sticky and likely to necessitate store closures, particularly in markets like the U.K., where labor taxes are set to rise. In the transportation sector, structurally higher labor costs are projected given still tight labor markets and wage agreements ratified in 2024. A further risk exists for U.S. entities such as homebuilders, which have been heavily reliant on immigrant labor, likely to become less readily available as U.S. policy shifts. In contrast, the application of AI and other emergent technologies may offer companies the ability to reduce labor costs. In the consumer products sector, for example, digital tools will likely help optimize processes and supply chains and partly offset higher labor costs.

Chart 5

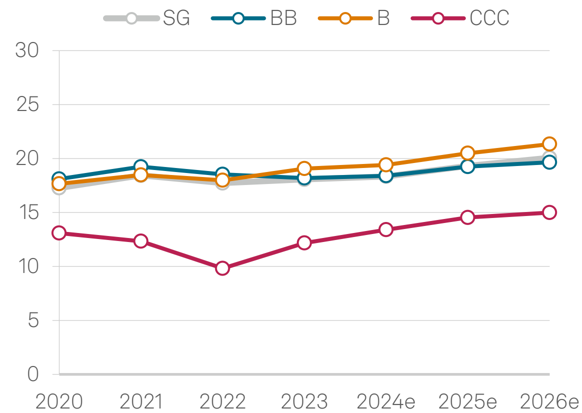
Chart 6

Margins are expected to rise further in 2025, particularly for 'AA'-rated issuers and more generally for speculative grade

Global nonfinancial investment-grade corporate issuers
Median EBITDA margin by rating



Global nonfinancial speculative-grade corporate issuers
Median EBITDA margin by rating

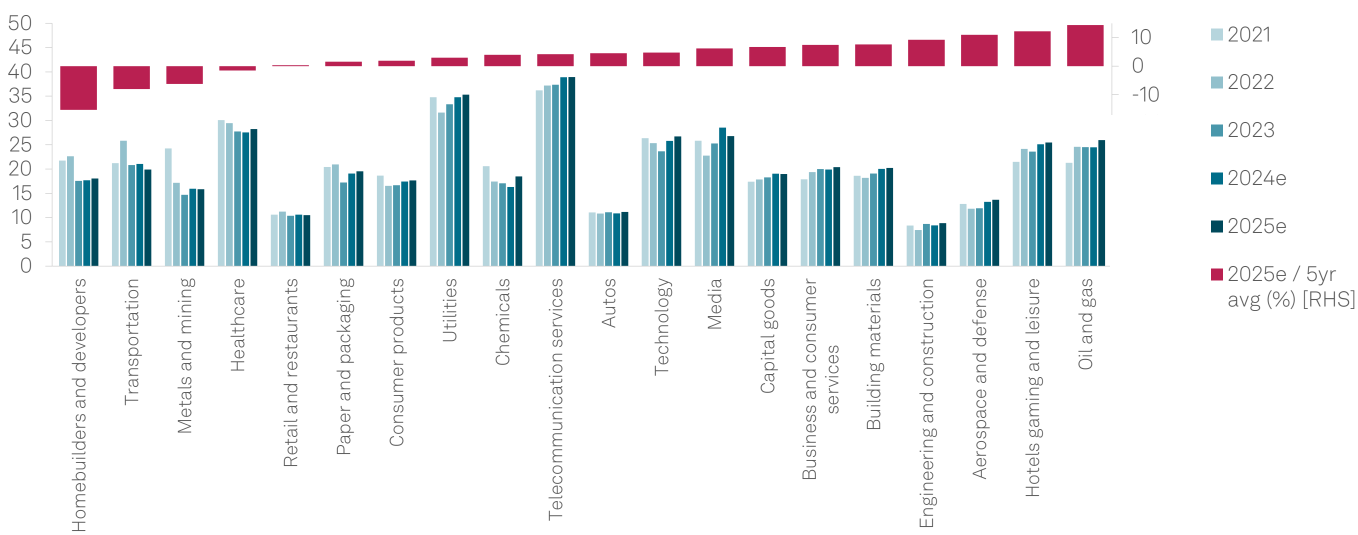


Source: S&P Global Ratings. Calculated as of Jan. 29, 2025. All units are USD. Global and regional aggregates exclude utility and real estate entities.

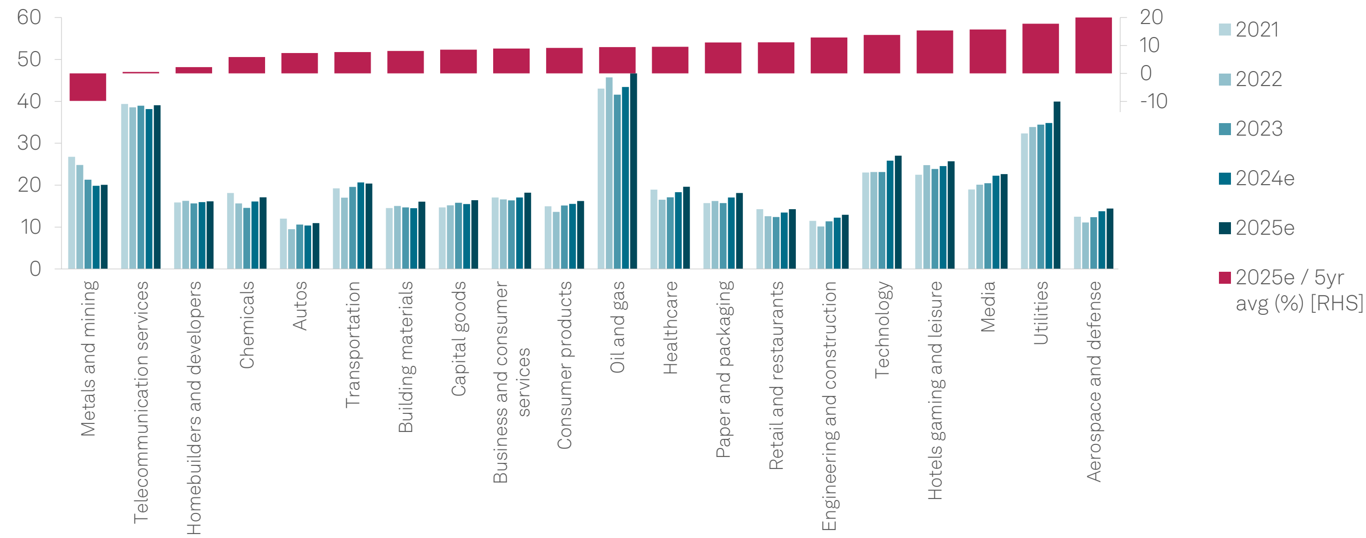
Chart 7

Nearly all industry sectors should see EBITDA margins expand above their five-year average

Global nonfinancial investment-grade corporate issuers median EBITDA margins by industry



Global nonfinancial speculative-grade corporate issuers median EBITDA margins by industry



Source: S&P Global Ratings. Calculated as of Jan. 29, 2025. Ranked right to left by prospective 2025 margin relative to five-year average margin (%).

Supply chain pressures have dissipated for the most part. The aerospace and defense sectors are where problems remain most acute, with many issuers building as fast as their supply chain will permit them to, and supply chain challenges are likely to persist through 2025 and into 2026. Other sectors report progress: in autos, supply chain issues and widespread component shortages eased further in 2024, for big box retailers, supply chain issues have largely diminished, and medical device and product companies will see margin improvement because supply chain pressures and shipping costs have eased. Although tariff and trade conflict could lead to resurgent supply chain problems, tariff measures in the first Trump administration and the COVID-19 pandemic have already led to significant efforts to limit supply chain risk. For example, there has been a long-term trend across the toy industry to make fewer toys and games in China by relocating factories and diversifying supply chains, and the technology industry is working to diversify its supply chain away from China.

With EBITDA growth likely to outpace debt issuance, leverage multiples will fall. We expect the median debt/EBITDA for 'B-' issuers to fall to 6.8x in North America and 7.2x in Europe (see charts 8 and 9). This is lower than or close to 2019 leverage for North America and Europe, respectively, and a reduction in leverage of about a turn and a half from the pandemic-era peak. However, not all industries have been able to deleverage. Median speculative-grade leverage for North American real estate, and European paper, packaging, aerospace and defense are all still significantly higher than in 2019, for instance (see charts 10 and 11), although this is not the case for a majority of sectors in both regions.

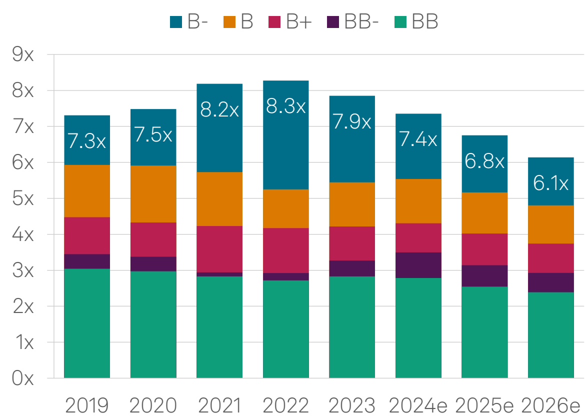
Capital investment needs, M&A activity, and private-equity distributions are key factors seen most likely to curb deleveraging. For example, for North America regulated utilities, our expectation of continued increasing capital spending over the next decade means that we expect financial performance and credit quality will continue to be pressured. Global automakers and suppliers are having to juggle capital investment needs related to electric vehicles, with uncertain demand and the aggressive expansion of Chinese OEMs. AI investment and energy transition are amongst factors requiring a sustained period of elevated capex. For Asia-Pacific power operators, debt-funded capital capex for renewables expansion will stay high and add to their debt burden. AI We estimate capital spending by large data center players Microsoft, Alphabet, and Meta Platforms increased about 50% in 2024, and will grow by more than 20% in 2025. This marks an incremental $30 billion expansion in 2025 on top of nearly $50 billion growth in 2024.

Chart 8

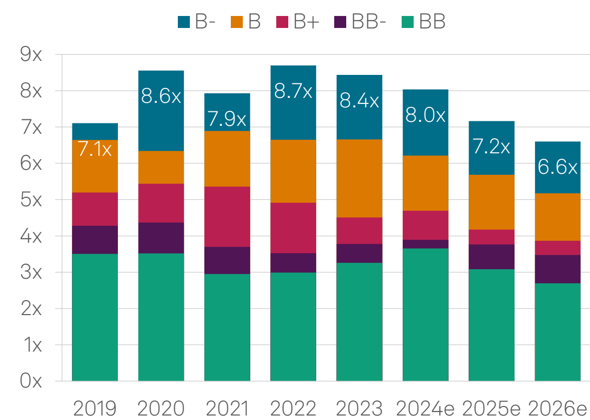
Chart 9

Median 'B-'-rated debt/EBITDA multiples fall to their 2019 level by the end of 2025 reflecting recovering growth and margins

North American nonfinancial corporate issuers
Median debt/EBITDA by rating



European nonfinancial corporate issuers
Median debt/EBITDA by rating



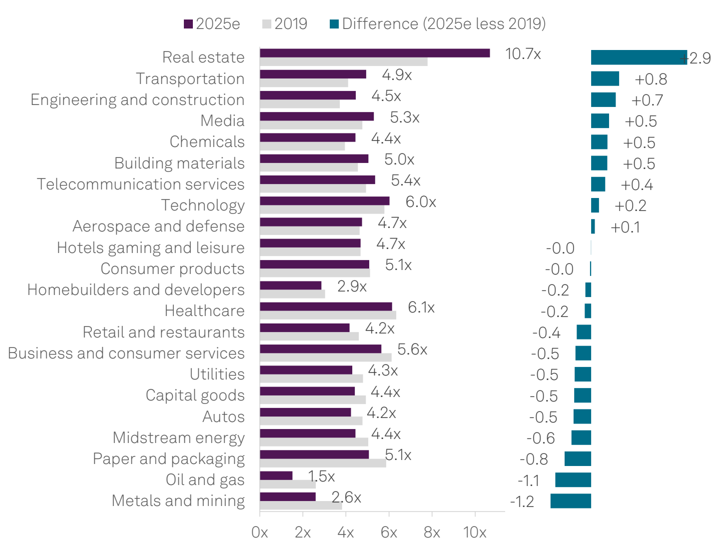
Source: S&P Global Ratings. Calculated as of Jan. 29, 2025. All units are USD. Global and regional aggregates exclude utility and real estate entities.

Chart 10

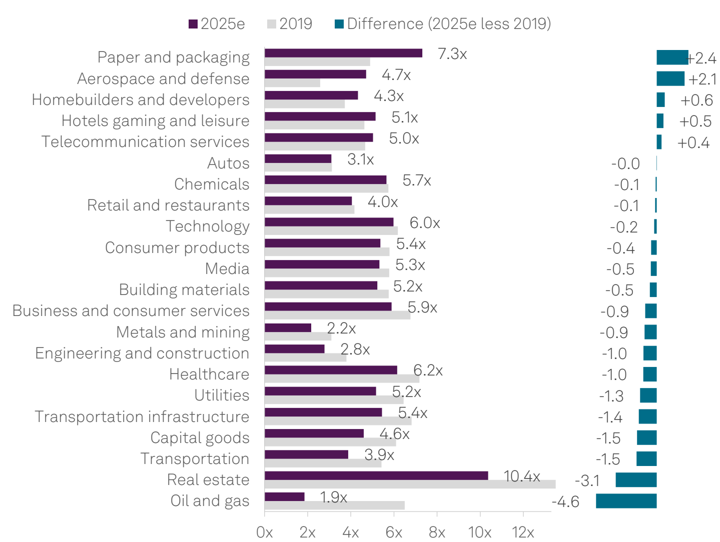
Chart 11

Most speculative-grade sectors have reduced leverage below 2019 levels

North American speculative-grade nonfinancial corporates
Median debt/EBITDA by industry



European speculative-grade nonfinancial corporates
Median debt/EBITDA by industry



Source: S&P Global Ratings. Calculated as of Jan. 29, 2025. Ranked by descending order of difference between 2025 estimated leverage and 2019.

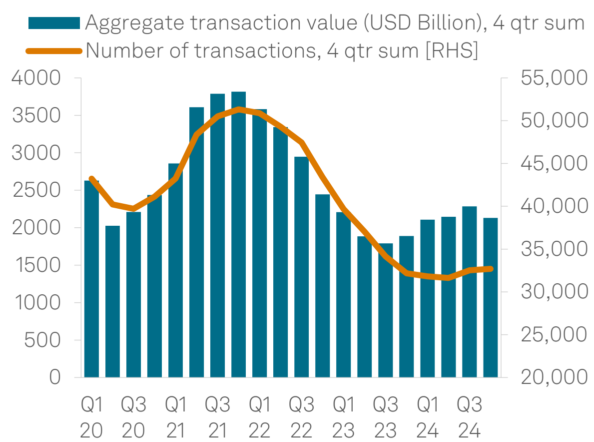
M&A activity will likely continue to recover at a modest rate. While there is some concern for the implications for credit metrics, there is little sense of a breakdown in capital discipline. Inevitably the political and regulatory environment will also have a significant bearing on acquisition activity levels, with industries such as aerospace, defense, media, and technology anticipating that the new U.S. administration might be more favorably disposed to M&A. For sectors such as telecoms which are already subject to significant regulatory oversight globally, the direction of travel of government policy remains critical. For instance, in Spain and the U.K., recently approved consolidations with relatively light regulatory remedies may indicate a recalibration of competition concerns and a more open regulatory environment for M&A. Sectors where we expect M&A to pick up notably include:

- Building materials: The building materials industry is heavily controlled by private investment and has seen significant M&A deals in recent years. We expect this trend to continue in 2025.
- Health care: We expect M&A to increase, even among the heavily private-equity owned, highly leveraged, speculative-grade service providers.
- Media: Significant M&A is challenging and needed, although there are significant impediments to this in terms of regulation, capital availability, valuations, and cultural fits. We saw limited M&A activity in 2024 as companies focused primarily on balance sheet repair.
- Oil and gas: After extremely robust M&A activity last year, particularly in North America, the pace is slower but still relatively high. The main reason is to replace inventory and diversify production.
- Transportation infrastructure: Issuers will likely increase M&A, as outlooks bode well and interest rates decrease.

Chart 12

M&A activity is gradually recovery

Global nonfinancial M&A by value and count

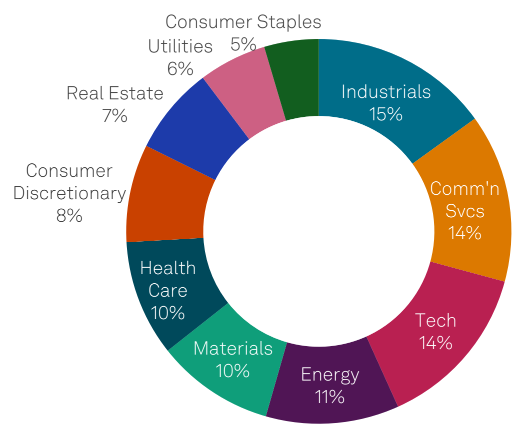


Source: S&P Global Market Intelligence, S&P Global Ratings

Chart 13

Industrials, communications, and tech led 2024 M&A

Share of 2024 global nonfinancial M&A by industry



Source: S&P Global Market Intelligence, S&P Global Ratings

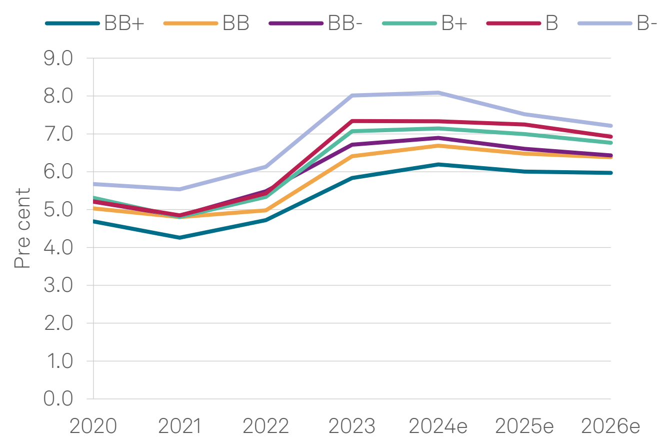
Interest rate pressures have abated, with policy rates declining, low risk premia supporting refinancing, and interest coverage being rebuilt as EBITDA expands. While we expect to see median effective interest rates – cash interest paid divided by total debt – start to decline (see chart 14), they will nevertheless remain structurally higher, and any resurgence of inflationary pressures or financial market volatility could bring a more challenging environment for weaker issuers. Interest coverage ratios are recovering from their 2023 lows, although median levels are still below where they were in 2019 for many speculative grade industries (see charts 16 and 17).

Chart 14

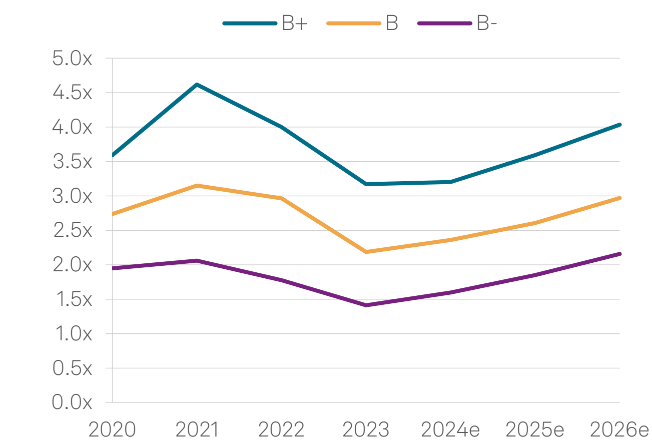
Chart 15

Effective interest rates have likely peaked and should start to decline, helping rebuild interest coverage for weaker issuers

Global speculative-grade nonfinancial corporates
Median cash interest paid/total debt (%) by rating



Global speculative-grade nonfinancial corporates
Median EBITDA interest coverage for 'B' rated issuers



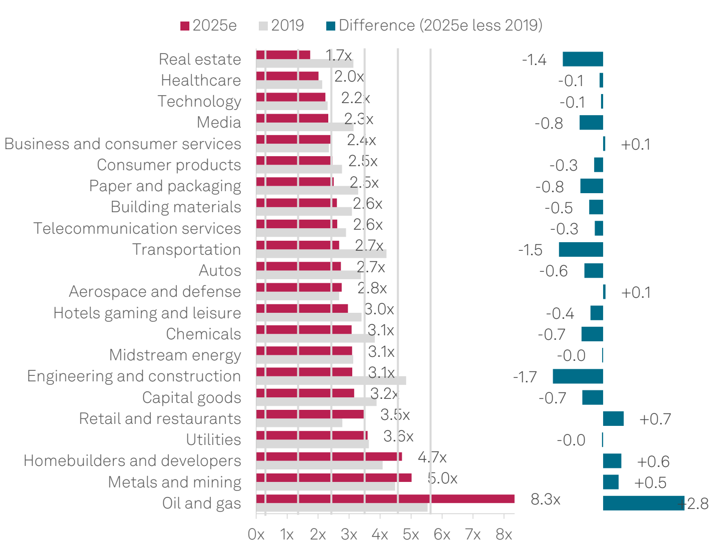
Source: S&P Global Ratings. Calculated as of Jan. 29, 2025. All units are USD. Global and regional aggregates exclude utility and real estate entities.

Chart 16

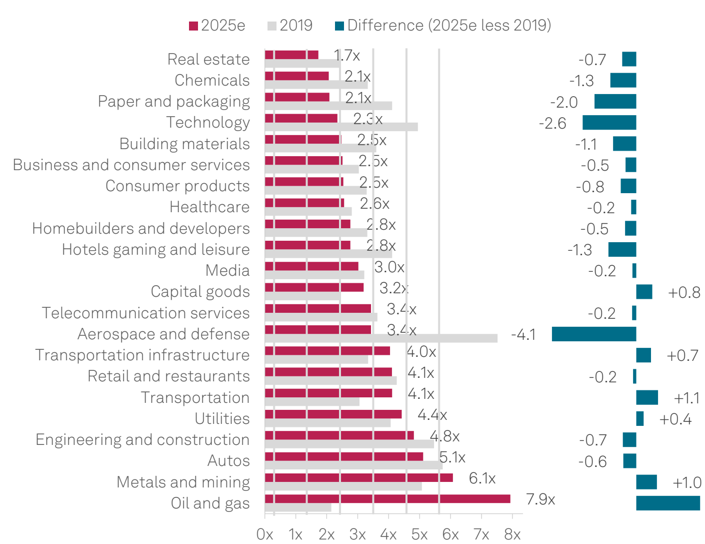
Chart 17

EBITDA interest coverage is recovering but still expected to remain below 2019 levels for many industries

North American speculative-grade nonfinancial corporates
Median EBITDA interest coverage by industry



European speculative-grade nonfinancial corporates
Median EBITDA interest coverage by industry



Source: S&P Global Ratings. Calculated as of Jan. 29, 2025. Ranked by ascending order of estimated EBITDA interest coverage for 2025.

AI is seen both as opportunity and threat. For some sectors, it has brought a welcome increase in demand. The technology industry is on the cusp of a massive wave of spending on AI, with companies poised to spend over $230 billion in 2024, primarily from the largest technology companies globally. Data center growth has been exponential amid the digitization of the global economy, boosted by cloud migration and further propelled by the broad adoption AI. Utilities, engineering and construction, capital goods, and technology issuers have benefitted from the spillover from data center buildouts, power generation, electricity distribution and transmission, and connectivity requirements. For the media sector, there are challenges as well as cost opportunities. AI is accelerating the shrinking quality difference between certain professionally produced and user-generated content. How AI can be used to create content is still being determined and may be fraught with legal and regulatory risk. More broadly, credit risks lie mainly in the significant capex involved in AI, the risk of business model disruption, and the potential for an "AI winter" if the current level of enthusiasm proves to be oversold. Longer term opportunities lie in cutting costs, enhancing productivity, and accelerating speed to market for products.

Climate-risk related trends are similarly mixed. The growing frequency of devastating physical events, including hurricanes, storms, and wildfires, is elevating the North American utility sector's credit risks, and long-term climate progress would mitigate this. There are, however, high costs linked with climate transition. Absent sufficient support from public bodies, it can be difficult for companies and households to invest to comply with local decarbonization regulation. For example, climate transition risk is at the core of cement companies' capital allocation. Cement companies assign an increasing share of their maintenance capex to improve plants' thermal efficiency and cut carbon dioxide emissions. Growing environmental requirements could also weigh on REITs' balance sheets. European REITs are progressing toward their decarbonization targets for this decade, but longer-term goals remain challenging and will involve significant investments. Buildings are responsible for about 40% of energy use in the EU, which aims to fully decarbonize buildings by 2050.

Related Research

- S&P Global Ratings Publishes Updated Regional Corporate Rating Component Score Reports, Jan. 31, 2025
- Global Nonfinancial Corporate Medians History And Outlook 2025: A positive outlook for corporate credit fundamentals, Dec. 4, 2024
- Global Credit Outlook 2025 Promise And Peril, Dec. 4, 2024
- Corporates: Can Monetary Easing Bring Enough Relief To Justify Current Market Optimism?, Dec. 4, 2024
- Corporate Results Roundup Q3 2024: Ex-commodity EBITDA growth accelerates, but still driven by margins not revenues, Nov. 25, 2024

Table 1

Corporate sector risk and opportunity map

Sector	Subsector/region	Risk/opportunity '1'	Risk/opportunity '2'	Risk/opportunity '3'
Aerospace and defense	Commercial aerospace	Boeing disruptions	Airbus new models	Tariffs
	U.S. defense	Profitability	New U.S. administration	M&A
	European defense	New U.S. administration	Conflict and supply chains	Financial policy
Autos		Tariffs	Chinese economy recovers	Regulatory pragmatism
Building materials	North America	Interest rates and costs	Tariffs and margins	Financial policy
	EMEA	Weak demand, higher costs	Financial policy	Climate transition costs
	Latin America	Trade policy and growth	Physical climate risk	Lack of CO_2 regulation
	Asia-Pacific	China's property market	Cement carbon regulation	Korean city property
Capital goods		Costs (tariffs, labor, rates)	Maturity wall	Investment cycle
Chemicals		Tariffs and trade conflict	U.S. port strikes	Higher financing costs
Consumer products		Weak consumer spending	AI and tech lower costs	Physical climate risk
Engineering and construction		Materials costs and tariffs	Skilled labor shortages	China payment delays
Health care		Margin pressure	M&A	New U.S. administration
Homebuilders	U.S.	Labor supply	Tariffs and material costs	Higher home inventories
	EMEA	Conflict and supply chains	Government stimulus	Environmental regulation
	Asia-Pacific	Tariffs and China demand	HK mortgage rates	Indonesia tax cuts
	Latin America	Volatile economies	Brazilian regulations	Access to funding
Hotels, gaming, leisure	Gaming	Economic headwinds	Increased leverage	Rapid European regulation
	Hotels and timeshare	M&A and leverage	Labor cost pressure	Economic slowdown
	Cruise and recreation	Slowing economy	Rates higher for longer	Tariffs
Media	Content	Consolidating M&A	AI is risk and opportunity	
	Distribution	Streaming profitability	Declining linear audience	M&A
	Advertising	Weak economy	AI efficiencies	
Metals and mining		Weaker profitability	High capital requirements	Energy transition
Oil and gas		Tariffs	Refining margins weaken	Financial policy relaxation
Real estate	U.S. REITs	Rates higher for longer	Office recovery	M&A increases leverage
	European REITs	M&A and dividends	Geopolitical risks	Environmental regulation
	Asia-Pacific REITs	Slower deleveraging	Elevated funding costs	Return-to-office mandates
	Latin America	U.S. tariffs	Reflation	Reshoring
Retail and restaurants		Tariffs and inflation	Strong consumer spending	Refinancing and defaults
Technology		Trade restrictions	AI transformation	Interest rate uncertainty
Telecommunications	Global	M&A (if permitted)	Competition risk	Capex and investor returns
	North America	Consolidation	Fiber demand	Starlink and Amazon
	EMEA	Infrastructure asset sales	Intensified competition	Consolidation
	Latin America	Competition	Currency risk	M&A
	Asia-Pacific	Economic uncertainty	M&A	5G Spectrum purchases
Transportation	Airlines	Fuel prices	Cost inflation	Weaker ticket prices
	Container shipping	Red Sea disruption eases	Tariffs	Capex requirements
	Rail roads	Trucking capacity reduces	Coal production increases	Tariffs
Most prevalent themes		Tariffs and trade tensions	M&A and financial policy	Rates and financing

Source: S&P Global Ratings. Risks and opportunities have been simplified and standardized relative to the originals for cross-sectional clarity. No rank ordering is implied between the risks/opportunities.

Table 2

Infrastructure sector risk and opportunity map

Sector	Sub-sector/region	Risk/opportunity '1'	Risk/opportunity '2'	Risk/opportunity '3'
Midstream energy		OPEC increases production	Faster growth of renewables	Opposition to hydrocarbons
Utilities	APAC	Grid instability	Technology bottlenecks	Volatile fuel cost
	EMEA	Price volatility/event risks	Political/regulatory risks	Low-carbon project economics
	Latin America	Higher energy prices	Curtailment risks	Sovereign rating limitations
	North America competitive power	Higher tariffs	Partial repeal of IRA	Ability to meet surging demand
	North America regulated power	Rising wildfire risks	Changes in tax legislation	Low common equity issuance
Transportation infrastructure	Airports	Lower traffic growth	Geopolitical tensions	Aggressive financial policies
	Ports	Trade/geopolitical tensions	Modernization	Continued disruptions
	Roads	Regulation risk in China	Aggressive financial policies	Affordability concerns
	Rail and Mass Transit	APAC: weaker leverage profile	Competition	

Source: S&P Global Ratings. Risks and opportunities have been simplified and standardized relative to the originals for cross-sectional clarity. No rank ordering is implied between the risks/opportunities.

Aerospace and Defense

Manufacturing as fast as the supply chain will allow

January 14, 2025

This report does not constitute a rating action.

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What's changed?

Boeing's setbacks delayed its aircraft production recovery and put significant pressure on its finances and ratings.

Many issuers are building as fast as their supply chain will permit them to. Soaring demand is still being weighed upon by persistent supply chain/production turbulence.

Trump 2.0 brings uncertainty to the defense world. Trump might pursue a defense policy that leaves European countries having to fill a military void.

What are the key assumptions for 2025?

Domestic and international flying hours will continue to hit record highs, bolstering already high demand for new aircraft and aftermarket services, except perhaps in APAC.

Airframers boost build rates. Boeing ramps up 737 MAX production and deliveries, while Airbus increases production of its A320 models.

Defense demand will remain elevated for some time as many governments realize that 20-30 years of peacetime has left their armed forces too small and antiquated.

What are the key risks around the baseline?

Delay in Boeing's production recovery would hurt suppliers and airline customers and leave an opening for Airbus.

Supply or labor constraints could hinder increased production, eroding profitability.

Some problems are expensive to fix, and the next one is always around the corner. Boeing, for example, is still recovering from widespread quality problems uncovered in the January 2024 blowout.

Ratings Trends: Aerospace and Defense

Chart 1

Ratings distribution

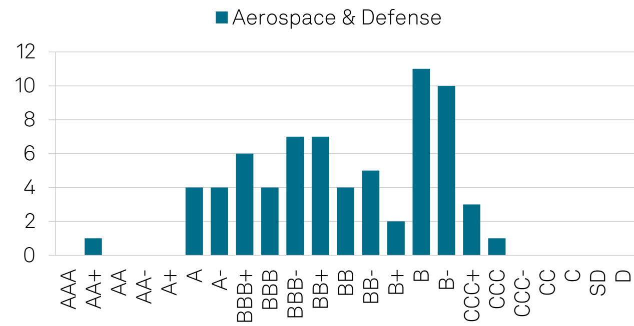


Chart 2

Ratings distribution by region

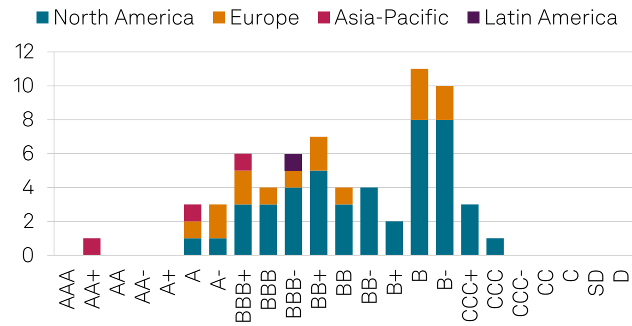


Chart 3

Ratings outlooks

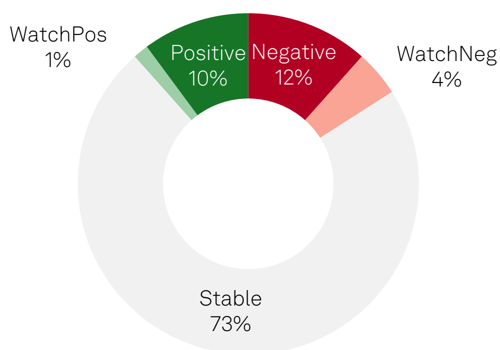


Chart 4

Ratings outlooks by region

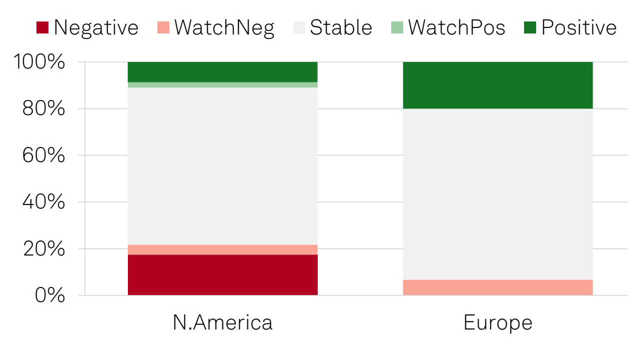


Chart 5

Ratings outlook net bias

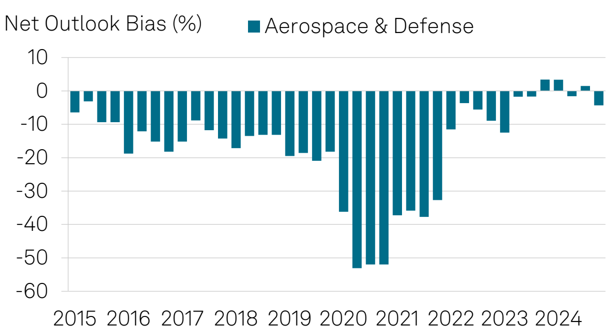
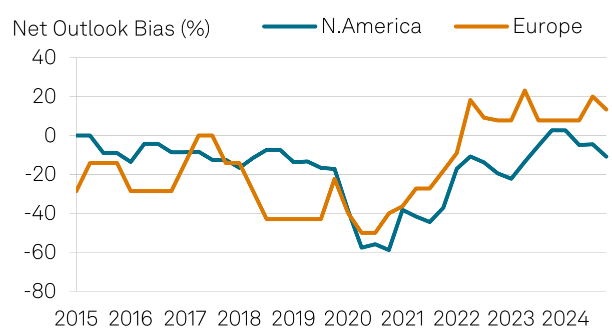


Chart 6

Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook: Commercial Aerospace

Ratings trends and outlook

Ratings are largely stable and globally are balanced between positives and negatives for outlooks that are not stable. The positive outlooks include aircraft component makers benefiting from strong demand for new aircraft and support for in-service planes. They also include companies taking advantage of strong cash flows to reduce debt, especially with higher interest rates making refinancing less attractive. The negative outlooks include aerospace suppliers dealing with the effects of manufacturing flaws, labor disruptions, supply chain inefficiencies, as well as aggressive financial policies. The larger number of negative outlooks in North America, compared with Europe, reflects the prevalence of suppliers to Boeing and financial sponsor-owned U.S. issuers, which typically have high debt levels and are very sensitive to rising interest rates.

Main assumptions about 2025 and beyond

1. New aircraft production remains below demand.

Both Airbus and Boeing are sold out for years and will continue to ramp up production as best they can. Supply chain challenges are likely to persist through 2025 and into 2026.

2. Demand for air travel stays strong.

Revenue passenger kilometers (RPKs) are likely to continue hitting record highs, fueling solid demand for aftermarket services.

3. Global risks and regional conflicts motivate strong defense spending.

Many manufacturers have both commercial aerospace exposure and defense exposure, so will benefit from robust demand from both sides.

Boeing aims to recover from quality control problems and a strike by its largest union. The company reached a contract agreement with its machinists on Nov. 4th, ending a 53-day strike. The work stoppage came as Boeing was poised to raise production and deliveries of its 737 MAX aircraft from subdued levels where the company held them for most of the year. The company had been overhauling its MAX manufacturing process following a mid-air fuselage panel blowout in January. Ramp-up of MAX production has been pushed out more than a year because of it. We expect MAX deliveries of approximately 250 planes in 2024, down from around 500 before the January incident. The company is targeting 38 planes per month by mid-2025, which we view as key to generating positive free cash flow. Output of widebody 787 aircraft, which was not directly affected by the overhaul and strike, is on track to average five planes per month.

In addition to restarting MAX production, the company has a new CEO tackling senior management changes, cutting its workforce by 10%, returning the defense business to profitability, and potentially paring its portfolio. It is seeking FAA approval for two 737 MAX model variations and working to ensure its long-delayed 777X widebody will start deliveries in 2026. Boeing is also scheduled to close the acquisition of Spirit Aerosystems, maker of fuselages for the MAX, in mid-2025. The original equipment manufacturer (OEM) sets the pace for component makers in its supply chain, and they are hesitant to outpace the OEMs until they demonstrate stability.

The new U.S. administration's tariff plans may complicate Boeing's efforts to deliver its remaining inventory of planes built before the pandemic for Chinese airline customers, especially if China retaliates. Tariffs on imports from Mexico and Canada would also make some components used in new planes significantly more expensive.

Airbus produces what the supply chain will allow, and our rated EMEA-based suppliers will continue to reap the upside. Following a flurry of deliveries in Q2 2024 and a record 123 deliveries in December, Airbus finished the year with 766 commercial aircraft deliveries--to 86 customers--in calendar 2024. This means that the group almost met its target of 770 aircraft that it had set itself in June 2024 (at the time revised down by 30 aircraft from 800 for the year, due to continued supply chain disruptions, particularly in engines, cabin, and equipment, and aerostructures). Airbus relies on thousands of suppliers for on-time delivery and, ultimately, revenue growth and cash generation. For large commercial aircraft engines, key suppliers are Pratt & Whitney (PW1500 G for the A220 and PW1000 GTF for the A320 family), Safran's and General Electric's CFM (LEAP-1A for the A320neo [new engine option] family), and Rolls-Royce (Trent 7000 for the A330 and Trent XWB for the A350). We note that engine makers improved delays as 2024 progressed and this helped Airbus towards its delivery target for the year. Despite this, we expect that supply chain challenges will persist in 2025, which might weigh on Airbus's efforts to raise production rates. Airbus targets production rates of 75 A320s per month by 2027, 14 A220s per month by 2026, and 12 A350s per month by 2028.

Problems with new engine models have extended the reliance on older equipment. In 2023 RTX subsidiary Pratt & Whitney disclosed a flaw in its new PW1100 Geared Turbofan (GTF) engines that required remediation, and we estimate it is only about a third of the way through the process of fixing it. GTF engines power a significant portion of Airbus A320 and A220 planes that are in high demand. RTX has had to compensate airline customers for the loss of use of grounded aircraft during the remediation process. The pace has been somewhat constrained by limited facility and labor capacity.

GE Aerospace's new LEAP engine has also (albeit to a much lesser extent) faced durability issues that have limited time-on-wing. The company expects to fix these shortcomings with updated components that are currently being introduced.

Engine makers also point to forged metal castings as a limiting factor to ramping up production, though P&W and GE are both reporting double-digit output growth.

New aircraft engine model introductions typically result in losses for the engine makers early in equipment life cycle and long tail of solid profits while the engines are maintained. We now expect planes with the new-generation engines will displace installed engines more slowly than previously expected. And these delays will in turn delay the delivery of new planes, resulting in extended use of older ones and driving demand for aftermarket services and parts. And maintaining in-service equipment has better margins than supplying OEM parts does.

Rolls-Royce Plc's civil aerospace operating profit should continue growing, up to 18% in the first half of 2024 (from 12.3% in the first half of 2023), with higher contribution of aftermarket services, with higher margins on long-term service agreements and better business jet performance. The continued increasing engine flying hours support growing cash flow generation and higher maintenance, repair, and overhaul (MRO) activity. However, the group has experienced delays in shop visit servicing times, which impacted cash flow by around £150 million-£200 million in 2024, and the effect could be greater in 2025 if supply chain challenges persist. Nonetheless, we expect Rolls-Royce's credit quality to improve as its balance sheet continues to strengthen.

Strong business jet sales to continue, with private buyers leading demand. New aircraft model introductions in 2024, including General Dynamics's Gulfstream G700 and Textron's Citation Ascend, spurred interest across segment classes. We expect demand for larger business jets with longer ranges to remain a key driver of interest in new planes. Preference for advanced technology and fuel-efficient aircraft reflects a return to pre-pandemic travel patterns for corporate and wealthy fliers, emphasizing the benefits of on-demand flights and unique point-to-point routes. Additionally, access to business jets is broadening, with fractional ownership and jet card programs gaining popularity. Healthy demand bodes well for suppliers. Supply chain bottlenecks, however, continue to challenge production rates and are expected to persist in the near term. As a result, the slower delivery of new aircraft is likely to give a boost to MRO providers in the short term.

Credit metrics and financial policy

Credit measures should continue to improve for most commercial aerospace issuers. Favorable demand and improving OEM build-rates support revenue growth and margin expansion across the sector. Both major airframers face supply-chain constraints and labor inefficiencies that will likely persist to some extent, but we estimate higher average earnings and cash flow for civil aerospace companies. For higher-rated companies in that segment, we anticipate that financial policy will set the pace of financial measure improvement. Return of capital to shareholders through share repurchases will remain the primary use of free operating cash flow. Merger and acquisition (M&A) activity, while subdued of late in the commercial aerospace supply chain, may be more likely with the change in regulatory orientation under a new administration.

Credit measures for lower-rated companies are sensitive to modest earnings and cash flow growth and likely to benefit from higher build rates. Moderating interest rates should also favor issuers with high debt burdens and are sensitive to liquidity pressures.

Key risks or opportunities around the baseline

1. Further Boeing disruptions.

These could delay the restart of the 737 MAX and other aircraft model production.

2. Unexpected challenges in the A321LXR and A350F.

Our base case is for a smooth take-off for these two new Airbus models.

3. Tariffs and increased obstacles to trade.

U.S. tariffs could make planes more expensive.

For Boeing, unforeseen quality control or component supply constraints could delay restart of the 737 MAX and other aircraft model production.

Any unexpected challenges with the introduction of the A321LXR and A350F. The entry of any new aircraft model to service is always important, but our base case is for a smooth take-off for these two Airbus models.

Trump 2.0 tariffs and increased obstacles to trade. U.S. tariffs on China, could be met with retaliation, making Boeing planes more expensive in an important market. Tariffs on imports from Canada and Mexico would make certain components more expensive for the OEM.

Industry Outlook: U.S. Defense

Ratings trends and outlook

Our ratings on U.S. defense companies should remain mostly stable amid continued robust government spending. While real dollar outlays could decline slightly in 2025, overall spending remains high and far-reaching after years of material growth. Strong earnings and cash flow performance should continue, particularly for the larger, higher-rated issuers. However, these companies tend to prioritize shareholder returns as a use of discretionary cash flows, and we expect this will continue, thereby limiting improvements in credit measures and ratings. While smaller, lower-rated companies could face additional challenges if new programs are delayed, they could benefit from a decline in interest rates.

Main assumptions about 2025 and beyond

1. Defense spending will remain strong, though it could decline in real dollar terms.

We expect budgets will continue to support defense spending in the face of various threats.

2. Near-peer threats will drive spending priorities.

Conflicts in the Middle East and Ukraine and continued tensions with China underpin U.S. strategic and defense priorities. As such, we expect limited material downside risk to defense spending in the U.S.

3. Companies will emphasize shareholder returns.

Cash flows are likely to remain high, especially for the larger firms, who are likely to prioritize share repurchases or dividends, limiting improvements to credit metrics.

Defense spending could decline in real dollar terms but will remain strong. After significant growth in recent years, a flattening is likely, with a small increase in nominal spending potentially resulting in a small decrease in real dollar spending. For example, the proposed 2025 U.S. defense budget of $850 million would be up 1% from last year. This amount is down slightly in real dollar terms after adjusting for inflation but is still an increase from where the budget stood a few years ago and signals that the appetite for defense spending remains strong.

Specific threats drive spending priorities. The proposed defense budget focuses on enhanced readiness and modernization efforts, space, missiles and missile defense, artificial intelligence research and development (R&D), and nuclear deterrence in response to recent conflicts in the Middle East and Ukraine, as well as continued perceived threats from China. In terms of specific programs, funding is focused on Virginia- and Columbia-class submarines built by Huntington Ingalls and General Dynamics, and aircraft carriers and Arleigh Burke class destroyers built by Huntington Ingalls. Major aircraft programs including F-35 fighter made by Lockheed Martin, the B-21 strategic bomber made by Northrop Grumman, and unmanned aircraft systems are likely to remain well funded, though future block sizes may come under pressure. International sales growth is supported by allies' commitments to increase spending in response to heightened security concerns. Foreign sales comprise less than 20% of the largest defense contractor’s revenue but generally contribute higher margins than domestic sales.

Companies will emphasize shareholder returns. Cash flows are likely to remain high, especially for the larger firms, despite the variety of factors creating uncertainty. Large firms may perceive greater opportunities for M&A under the new administration but are likely to continue to prioritize share repurchases or dividends, limiting improvements to credit metrics.

Credit metrics and financial policy

While U.S. defense budget growth has flattened in recent years, spending remains robust and we expect most companies in the sector to generate ample free cash flow. Large strategic acquisitions that increase industry consolidation are unlikely, though the change in administration could open the door somewhat after the Biden administration's active stance regarding maintaining competition.

Prioritization of cash flow, whether for debt reduction or shareholder returns through dividends and share repurchases, will drive the direction of credit ratios for larger U.S. defense companies. Smaller companies with higher debt burdens will focus on rebuilding financial strength as they face likely declining, but still high borrowing costs and upcoming debt maturities.

Key risks or opportunities around the baseline

1. Profitability risks.

Supply chain and labor inefficiencies, among other things, could pressure margins and cash flows, particularly on legacy fixed-price contracts.

2. The new administration's investment priorities.

Uncertainty regarding the new administration's spending priorities, timing, and DOGE add risk, particularly around the award of new contracts.

3. M&A activity may increase.

A more accommodating approach under the new administration could make deals more likely to pass regulatory review.

Supply chain and labor inefficiencies and fixed-price contracts pose risks to profitability. Fixed-price contracts were generally agreed to in a period of low inflation and higher labor productivity and do not accommodate current conditions. For example, Northrop Grumman took a sizable charge against its B-21 program, and Huntington Ingalls reduced expectations for Virginia-class submarine profitability as a result of these pressures. We anticipate that performance will improve as companies invest in workforce efficiency and supply chain capacity and older contracts roll off and are replaced with agreements that reflect current conditions.

The next defense budget. The industry is currently operating under a budget continuing resolution (CR) and the change in administration raises the likelihood that it will extend further, given the new administration will not take over until more than halfway through the current fiscal year and opt for a full-year CR and push to achieve its goals in the next year's budget. The inability to pass the 2025 budget in a timely manner will create delays for new contract awards. In addition, the new administration's advisory Department of Government Efficiency (DOGE) creates uncertainty that may cause companies to delay investment decisions.

It is not clear how much spending the administration can cut within the existing political and legal framework, and on what timeline. At this stage, wholesale spending cuts seem unlikely, especially in the defense space. However, we see the risk that the procurement process might be affected with new awards potentially delayed as a result. This could push some spending into the future, creating cash flow volatility, particularly for smaller firms.

Industry Outlook: European Defense

Ratings trends and outlook

For many European defense manufacturers, the trends for 2025 will be similar to those in 2024, but with added tailwinds. The wars between Russia and Ukraine and between Israel and its neighbors, coupled with uncertainty about the incoming Trump administration's approach to these conflicts and to the U.S.'s role in NATO continue to sharpen political minds and drive rising defense budgets in Europe. We note reports that European NATO members are currently discussing a potential 3% target (of defense spending versus GDP) and also the potential formation of a joint project fund of EUR500 billion or more for shared defense projects.

Backlogs, revenues, and EBITDA continue to rise for our rated issuers, and robust cash flows are almost a given through 2025. Our rated issuers will continue to benefit from solid industry prospects over the medium to long term, with high demand for their products and services. We expect few rating actions in 2025 as issuers will maintain strong balance sheets despite tolerance for opportunistic M&A and share buybacks.

Main assumptions about 2025 and beyond

1. Defensive urgency continues to fuel strong operating performance.

Demand for some battlefield products and services remains at a record high, and our issuers have been winning some very large orders, specifically in the air defense segment.

2. Rated issuers seem well placed for the next Trump administration.

Many of our rated issuers, especially the primes, are well diversified with good exposure to the U.S. defense industry. Were Trump to step back from NATO, our issuers are also well placed to capture higher demand from European governments were they to hike spending to fill the void.

3. Demand will remain focused on short term battlefield needs.

We expect any issuers with exposure to munitions, radar, communication equipment and air defense technologies will benefit from current the geopolitical climate.

European NATO members' defense budgets will increase and defense expenditure as a percentage of national GDP will continue rising for many members. The Russia-Ukraine and Israel-Hamas wars have added further momentum to many European governments' appetite for such spending. NATO's European members are reportedly discussing a 3% target (of defense spending to GDP). The existing target is 2% and we expect 23 of NATO's 32 members to meet that target in 2024. However, several European members continue to lag and some face a challenge in hiking their defense spending at such a rate, given the state of their economies and existing budget pressures.

Continued benefit from soaring demand and uncertainties around Trump. European defense manufacturers, who tend to be more globally oriented than U.S. peers, are winning large contracts and several of our issuers have revised up their financial guidance (e.g. BAE Systems, Babcock, Israel Aerospace, Leonardo, Rafael, SAAB, and Thales). We also see benefits for Rolls-Royce and Safran.

The immediate need for battlefield equipment—radar, communications, and munitions—has resulted in large spikes in demand for certain products and services for some issuers. And many of our rated issuers, especially the primes, are well diversified, so were the incoming Trump administration to step back from NATO, our issuers would be well placed to capture higher demand from European governments to fill the void.

Defense contracts tend to be long term and so are likely to provide support for revenues and profitability for many years to come. Any previously anticipated pressure on defense budgets due to post-pandemic bean-counting has abated.

Credit metrics and financial policy

Pure-play defense issuers should continue to experience good backlog, revenue, and cash flow visibility, with stable credit metrics. Gradually improving credit metrics will likely be at least partly offset by increased M&A, dividends, and share buybacks, particularly among large defense contractors. Smaller, weaker contractors will continue to focus on rebuilding financial strength, although many are owned by private equity, which tends to emphasize immediate returns.

Key risks or opportunities around the baseline

1. Trump takes an unexpected approach to existing conflicts or alliances.

Trump has promised changes in course toward certain geographies. This could also involve platforms and contracts.

2. Conflicts escalating/spilling over and impacting production.

Escalating conflicts or the spilling over of wars to pull countries like Iran into an all-out confrontation could mean some production facilities having more chance of being damaged. This is especially germane for rated issuers based in Israel.

3. Adventurous financial policies.

Investment-grade issuers that already pay for dividends and share buybacks could venture into opportunistic M&A.

The Trump administration takes an unexpected approach to existing conflicts or alliances. Following several years of stable defense policy, the U.S. could change tack once Trump takes office, ultimately changing course toward certain geographies, platforms, and contracts. However, in our view many rated defense issuers—the primes especially—are well diversified in their exposure to both the U.S. and Europe, meaning they should be able to capture new/changing demand regardless of political developments.

Conflicts escalating/spilling over and impacting production. Especially for our rated issuers based in Israel, escalating conflicts or the spilling over of wars to pull countries like Iran into an all-out confrontation could mean some production facilities having a heightened chance of being damaged. However, this is not currently in our base case.

Adventurous financial policies. Some investment-grade issuers that are already paying for dividends and share buybacks could venture into opportunistic M&A. However, we don't think opportunistic M&A or shifts in financial policy will lead to material ratings downside, as many players have healthy balance sheets and cash to deploy. Instead, any downside might come from financial underperformance or operational challenges.

Related Research

- Boeing Co. Ratings Affirmed On Greater-Than-Expected Equity Issuance; Remains On CreditWatch, Nov 1, 2024
- Thales, Oct. 10, 2024
- End Of Boeing Dispute Is Credit Neutral For Embraer, Sept. 16, 2024
- Aerospace And Defense Company Thales Affirmed At 'A-' On Solid Operating Performance; Outlook Stable, Aug. 30, 2024
- Leonardo SpA Outlook Revised To Positive On Deleveraging Prospects And Business Momentum; 'BBB-/A-3' Ratings Affirmed, Aug. 16, 2024
- Airbus Can Accommodate Announced Operating Setbacks, June 26, 2024
- Aernnova's Proposed Upsize And Extension Of Its Term Loan B Is Leverage Neutral, June 11, 2024

Industry Forecasts: Aerospace and Defense

Chart 7

Revenue growth (local currency)

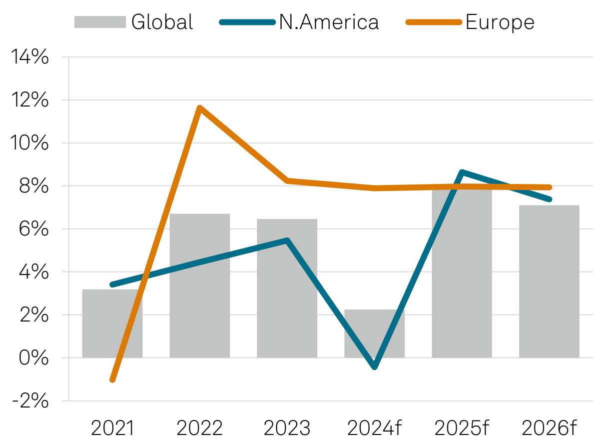


Chart 8

EBITDA margin (adjusted)

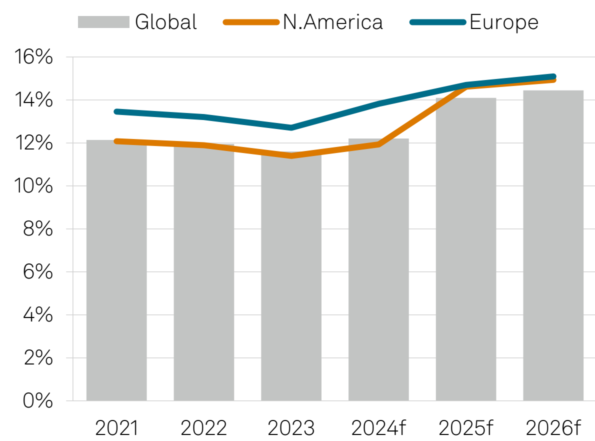


Chart 9

Debt / EBITDA (median, adjusted)

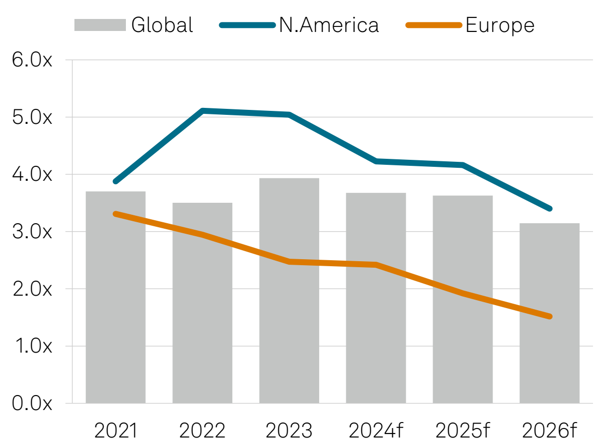
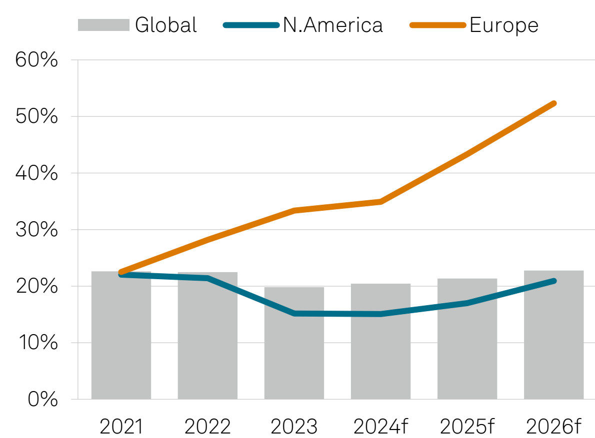


Chart 10

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Aerospace and Defense

Chart 11

Cash flow and primary uses

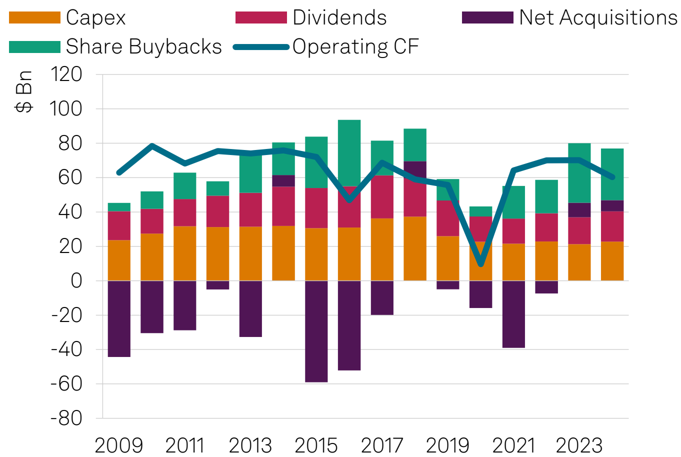


Chart 12

Return on capital employed

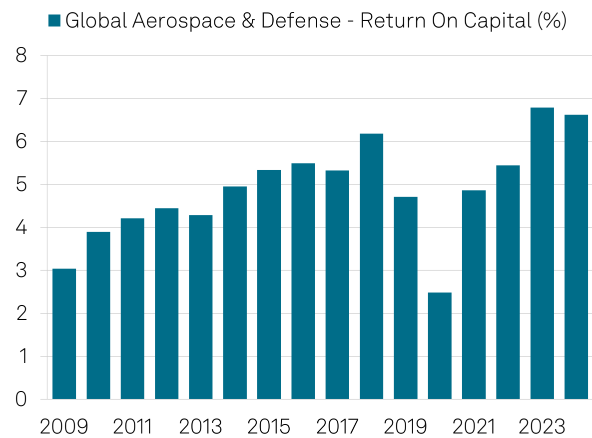


Chart 13

Fixed- versus variable-rate exposure

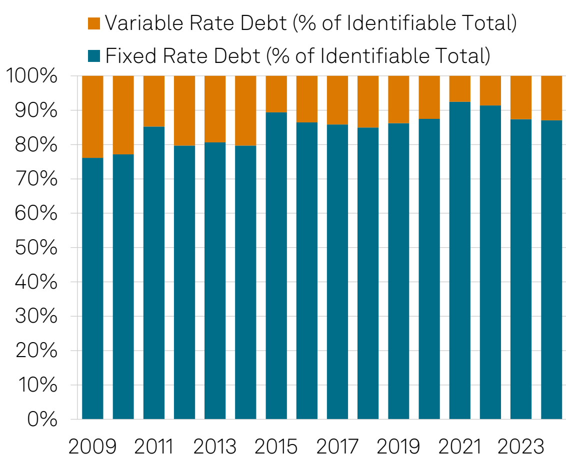


Chart 14

Long-term debt term structure

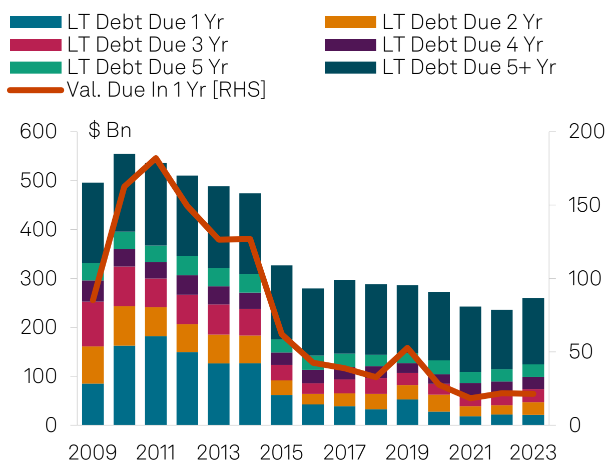


Chart 15

Cash and equivalents / Total assets

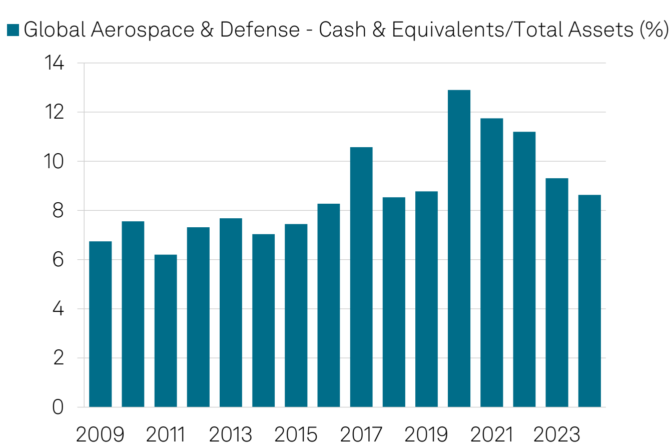
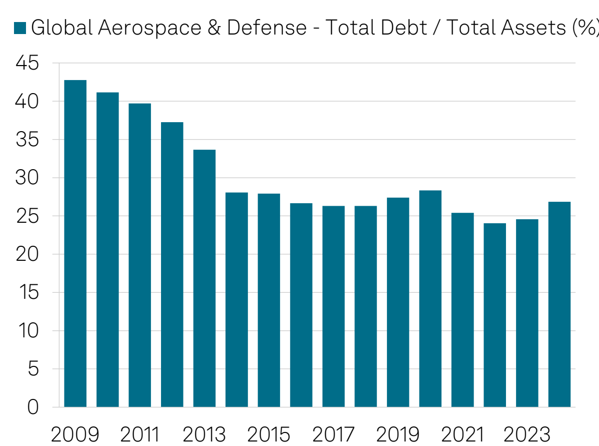


Chart 16

Total debt / Total assets



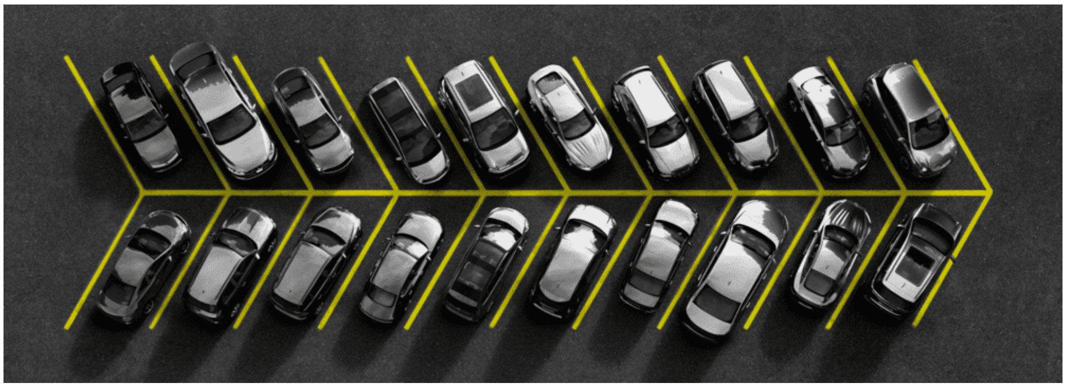
Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Autos

Cloudy skies loom over the auto industry

January 14, 2025

This report does not constitute a rating action



What's changed?

Foreign carmakers are losing market share in China more quickly, while suppliers face pressure to diversify with domestic OEMs, which may reduce returns as they compete with local leaders.

Trump's second term as U.S. president revives fears of new trade tariffs on imported vehicles from Europe, Mexico, and Canada, complicating the challenging market for OEMs and suppliers.

Europe's slowing EV adoption raises the risk of weaker margins for automakers due to uncertainty about government support for the transition through incentive schemes**.**

What are the key assumptions for 2025?

Global demand for light vehicles remains stable, although market shares are shifting to Chinese original equipment manufacturers (OEMs).

Pricing is more resilient than expected, helped by production discipline, but will likely weaken in the U.S. and Europe due to a very competitive market and price-sensitive consumers.

Supplier ratings will be less resilient than OEMs since ongoing restructuring has not significantly improved deleveraging or profitability.

What are the key risks around the baseline?

Tariffs on U.S. imports of light vehicles and parts would require price adjustments, changes to product strategy, and selective relocation, likely negatively affecting profitability and cash flow.

A stronger-than-expected economic slowdown fueled by low consumer confidence in the U.S. and Europe, decelerating growth in China and the risk of OEMs overproducing relative to demand.

Delaying 2025 regulatory targets in Europe would ease pressure on OEMs to push electric vehicles (EVs), helping to stabilize prices and lower the risk of fines at least temporarily.

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Ratings Trends: Autos

Chart 1

Ratings distribution

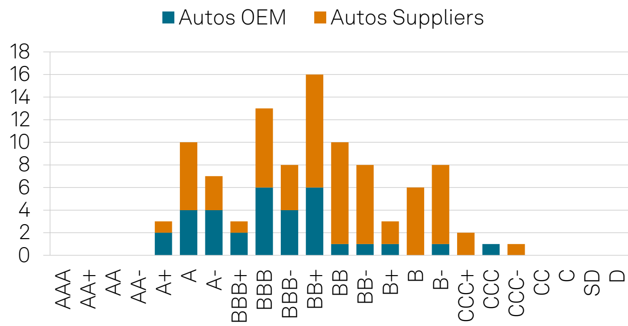


Chart 2

Ratings distribution by region

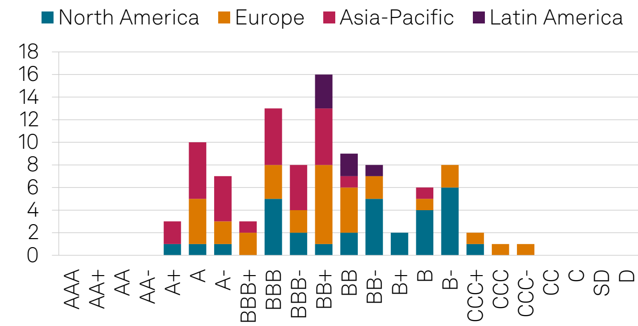


Chart 3

Ratings outlooks

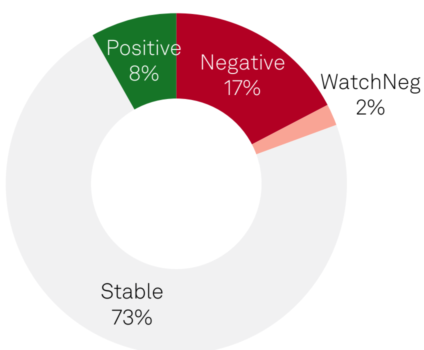


Chart 4

Ratings outlooks by region

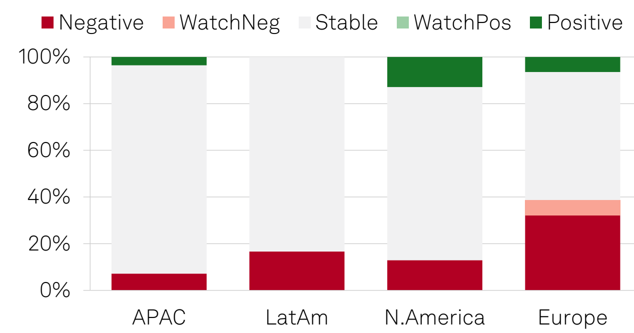


Chart 5

Ratings outlook net bias

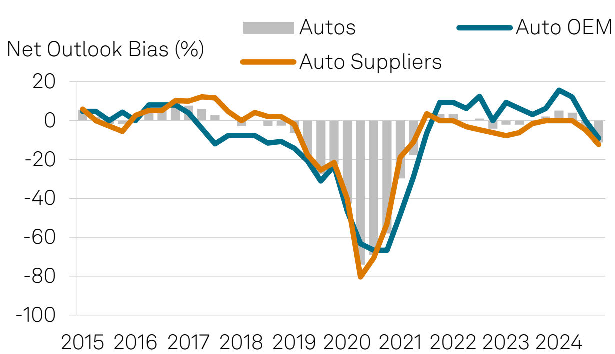
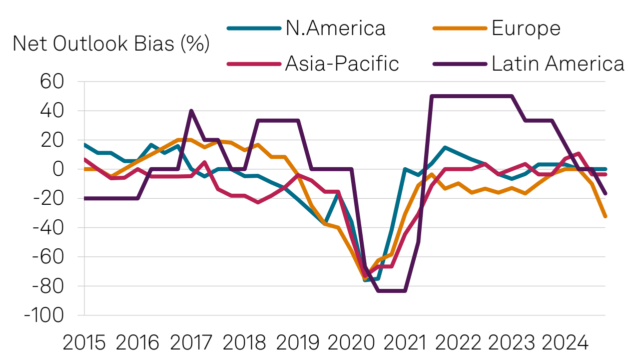


Chart 6

Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

A downside rating risk is emerging in the auto industry, primarily affecting suppliers, since the sector faces a profound transformation in the competitive landscape coupled with low volume growth. For OEMs, volume, pricing, and mix will play a less supportive role for earnings compared to previous years. We identify three main risks for 2025: Chinese OEMs' aggressive domestic and international expansion, the high likelihood of new import trade tariffs into the U.S., and tightening regulation in Europe, and further down the road, in China.

We deem Chinese OEMs' aggressive expansion to be a game changer for the industry. China's weak economy relative to its industrial overcapacity is set to further intensify competition in the country and in international markets targeted for Chinese vehicle exports. This raises geopolitical tensions that have already triggered protectionist reactions. Protectionism distorts markets and at best delays necessary adjustments by foreign automakers to narrow competitive gaps, but it does not change the fundamental competitive advantage of Chinese OEMs and suppliers, which is their significantly lower cost base.

In the global race to lower total costs, auto suppliers will have to support OEMs in realigning production capacity to address market share losses to emerging Chinese manufactures, as well as in adjusting to the slower global transition to EVs. Unless there is a wave of market consolidation, residual headroom for cost reductions and deleveraging seems limited after the significant adjustments made post-pandemic, as well as the low likelihood of further compensation from OEMs. Even the Chinese EV champion BYD is seeking to negotiate with auto suppliers for an annual 10% price reduction, highlighting the challenge suppliers face to improve profitability. The momentum in negative outlooks for our global supplier portfolio in 2024 has risen to slightly below 20% from 10%, reflecting the accelerated loss of rating headroom for these issuers.

Weak market conditions, upcoming tougher carbon dioxide regulatory limits in Europe starting in 2025, and tighter fuel efficiency standards in China likely from 2026, will constrain light vehicle OEMs' options to manage the powertrain mix as they try to maintain profitability in a slower-than-expected EV adoption scenario. The prolonged use of internal combustion engine (ICE) vehicles will come with costs. In Europe, we expect the impact of lower EV margins will fully affect profits and cash flows in 2025.

The positive credit trends for OEMs such as Renault, GM, Hyundai, and Tesla over 2024 will be tested against these risks, making upward rating transitions less common. For all other light vehicle automakers, maintaining their ratings will depend on their capacity to reduce costs, manage regulatory risks, and stabilize their market shares (or eventually tie up with a better rated competitor).

Our rated portfolio of truck companies shows overall rating stability, even with more negative volume forecasts compared to light vehicles, especially in Europe. Rating headroom remains satisfactory thanks to lower exposure to Chinese companies in key profit areas, especially in Europe and North America, and because the transition toward lower-emission vehicles is still in its early stages. Currently, the non-ICE share represents less than 1% of units sold.

Main assumptions about 2025 and beyond

1. Low volumes, low pricing power.

Global light vehicle sales growth will slow to 1%-3% per year in 2024-2026. Increased OEM incentives and lower dealer prices will reduce margins. There will also be weak demand for heavy-duty trucks, but the rating headroom can absorb it.

2. Market share erosion to Chinese automakers.

Intense competition rages on in the Chinese volume segment and is rapidly extending into the premium segment, posing displacement risks for traditional manufacturers and forcing suppliers to restructure operations in the region.

3. Moderate EV adoption growth globally.

EV losses and regulatory fines will offset the advantages of continued ICE use.

Light vehicles

Low volume growth and weaker pricing. Most global OEMs will struggle to expand their profit margins over the next few years since the combination of low volume growth and weaker pricing will fail to support the earnings momentum observed over 2021-2023. We anticipate very moderate growth in light vehicle demand over the next two years (see table 1). We expect OEMs to maintain tight production levels and adjust capacity downward now that the prospect of volume growth is moving further away, in order to limit pricing downside and reduce fixed costs. We think the product mix could negatively impact revenues and earnings because consumers are more interested in affordable options than in recent years, as well as due to the higher share of EVs. Meanwhile, new OEMs will challenge legacy producers' previously successful value-over-volume strategies, likely leading to declining pricing power, which may manifest as either higher discounts or lower retail prices. This will increase the need for traditional OEMs to support profitability through ongoing, and perhaps additional, cost reductions.

Table 1

Global light vehicle (LV) forecast (as of October 2024)

	Actual		New projections (as of October 2024)			Previous projections (as of April 2024)		
	2023	2023	2024e	2025e	2026e	2022e	2023e	2024e
	Mil. units	YOY%	YOY%	YOY%	YOY%	YOY%	YOY%	YOY%
Global LV sales	86.7	9.8	1-2	2-3	1-2	1-3	2-4	1-3
China (mainland)	25.5	5.6	0-2	0-2	1-3	2-4	2-3	1-3
U.S.	15.6	12.4	(1)-0	1-2	1-2	(1)-0	1-2	0-1
Europe	17.9	19.5	0-2	1-3	1-2	0-2	1-3	0-2
South Korea	1.7	3.3	(4)-(2)	0-2	0	0-2	0-1	0
Japan	4.7	13.7	(4)-(2)	1-3	0	(4)-(2)	0-2	0
Rest of the world	21.2	5.0	4-6	4-6	1-2	4-6	4-6	4-
Global LV production	90.5	9.9	(3)-(1)	0-1	0-1	0-1	0-2	0-2

e—Estimate. YOY—Year-on-year. All percentages are year-on-year changes. Sources: Actuals from S&P Global Mobility, forecasts by S&P Global Ratings.

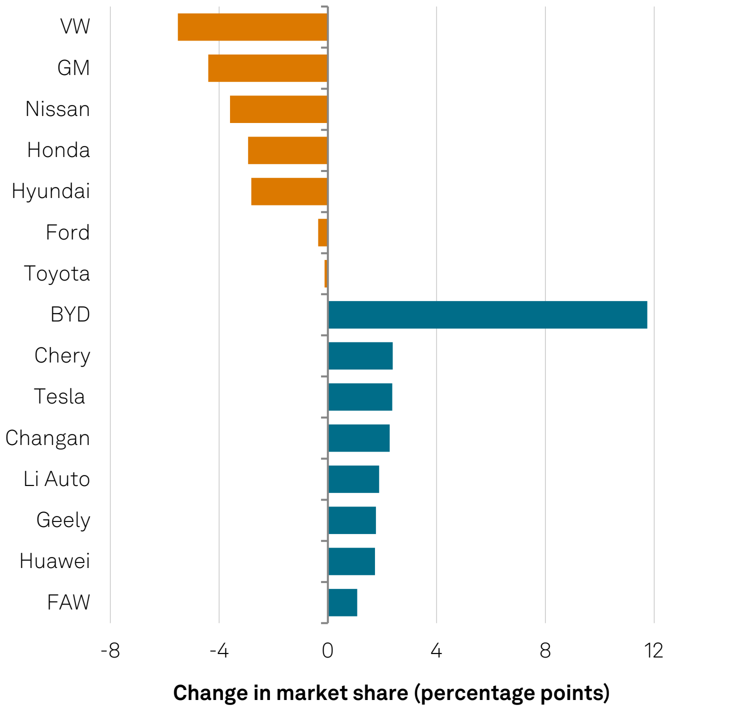
Foreign automakers are losing market share in China at an accelerated pace. The decline in foreign OEMs' market share in China since the pandemic was initially a phenomenon mainly limited to the volume market (see chart 7). However, Chinese OEMs have also been expanding into the premium segment, and this trend gained momentum in 2024 (see chart 8). Emerging

Chinese OEMs will challenge traditional premium brands with vehicles that compete on technology, design, and price.

Chart 7

Foreign brands ceded market share in China's volume segments

Change in volume market share in China (YTD 2024 vs. 2019)

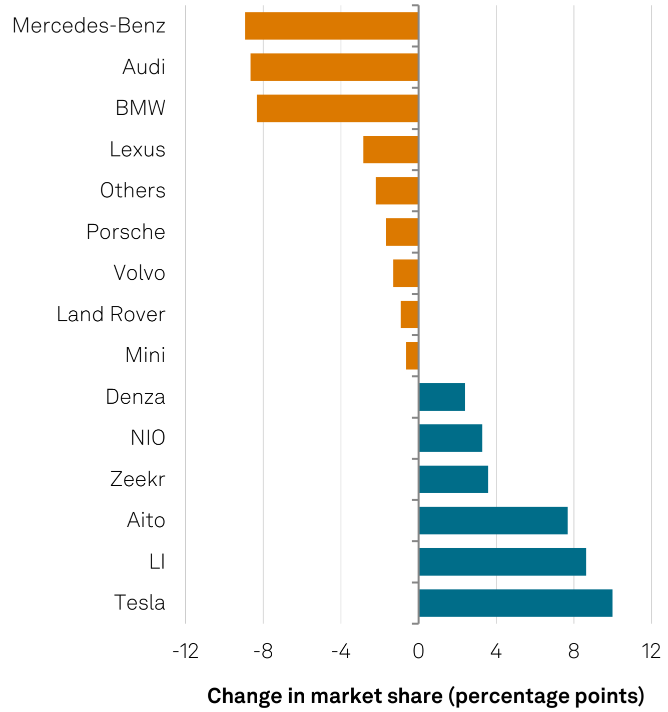


YTD—Jan.-Sept. 2024. Sources: S&P Global Mobility, S&P Global Ratings.

Chart 8

...as well as in premium segments

Change in premium market share in China (YTD 2024 vs. 2019)



YTD—Jan.-Sept. 2024. Sources: S&P Global Mobility, S&P Global Ratings.

In the premium market, foreign OEMs often lag their Chinese competitors in terms of technology. Despite significant investment in product innovation, European and Japanese brands have so far failed to persuade Chinese consumers with respect to infotainment and autonomous driving assistant features. That said, in the high-end premium space—i.e., vehicles priced over Renminbi (RMB) 1 million—a lack of confidence in electric vehicle technology is discouraging battery electric vehicle (BEV) adoption in favor of ICEs. However, the captive market for ICE-powered vehicles is declining in China and may shrink further with the new corporate average fuel consumption regulations starting in 2026.

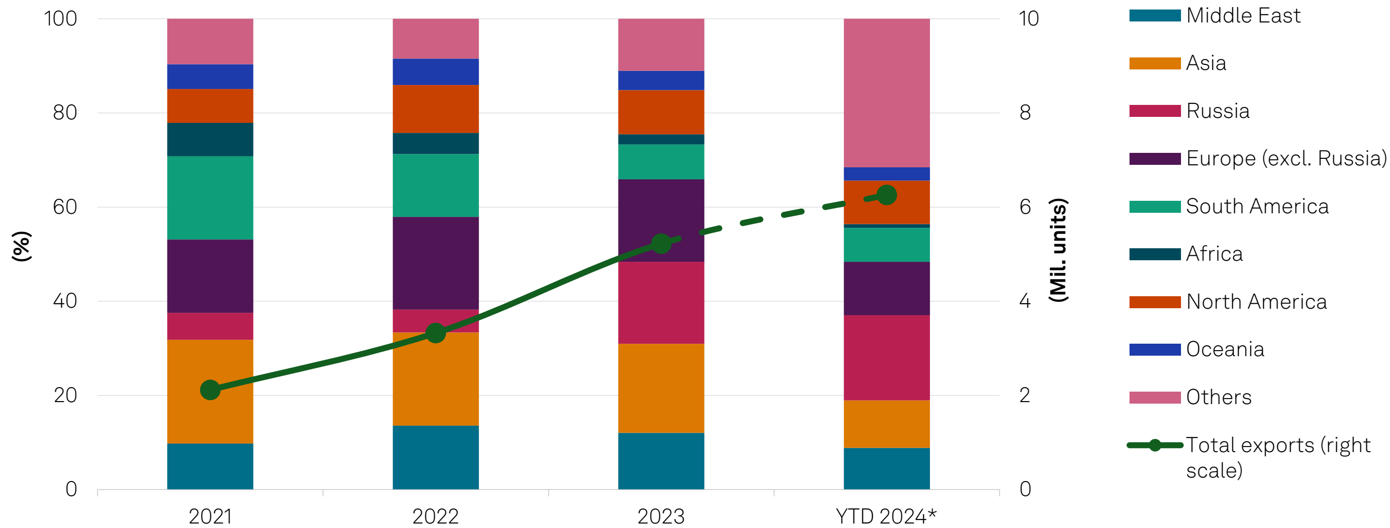
We deem the loss of market share a key risk for foreign OEMs in China in the coming years. In the premium segment, so far most of this market share loss is explained by the segment's growth as a share of the total market, which has been captured by local OEMs. While foreign OEMs' sales have been more stable in absolute terms, this may change in the context of an expanding and very competitive premium offering from local peers. We expect foreign OEMs to limit further significant share erosion in the medium term given their ongoing investments in technology, platforms, and partnerships (mostly through joint-ventures), and likely changes in strategy related to product segments, pricing and exports.

If foreign OEMs succeed in bridging the cost competitiveness gap in China, they will be better equipped to counter Chinese OEMs' aggressive expansion in Europe, Asia-Pacific (APAC) excluding China, Africa, and South America (see chart 9).

Chart 9

China's light vehicle exports have nearly tripled in the last three years

China's auto exports by destination (2019 – YTD 2024)



*YTD-2024—Jan.-Sept. 2024. Total exports for YTD-2024 has been annualized.
Sources: China Passenger Car Association, China Customs, S&P Global Ratings.

A less predictable EV transition. The transition to electrified mobility is highly likely, but the process is exposed to political influence. China is leading the shift away from traditional gasoline and diesel engines, with the share of EVs (BEVs + PHEVs) exceeding 40% of new vehicle sales in the 12 months to October 2024. We think this transition will keep momentum since the government plans to tighten fuel consumption thresholds starting in 2026, further discouraging sales of traditional engines.

In Europe, low visibility on a stable incentive scheme, coupled with unclear total cost of ownership advantages, has slowed EV adoption in 2024 (see chart 10). Political uncertainty in two of Europe's largest auto markets—Germany and France—does not favor any bold political initiatives supporting EV transition in 2025. This leaves OEMs in Europe exposed to margin dilution because they will have to sell EVs at low margins, purchase carbon dioxide credits, and face regulatory fines next year, or any combination of these.

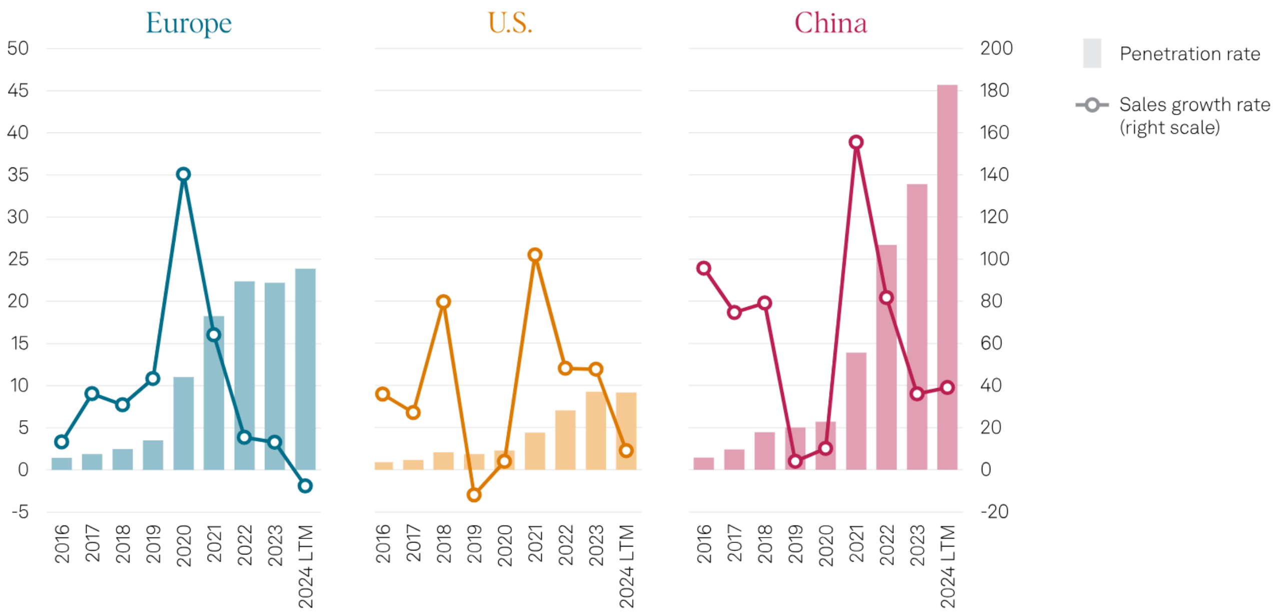
The newly appointed European Commission will need to assess whether regulatory ambitions should be realigned to accommodate a hesitant market. The consensus is not in favor of postponing near-term company-specific carbon dioxide limits, but instead of mitigating regulatory penalties, which represent a burden on already strained 2025 earnings forecasts. This is, however, not included in our base case for 2025. To meet the carbon dioxide emissions targets for 2025, approximately 20%-22% of vehicles sold in the overall market would need to be EVs. As of October 2024, EVs represented a 20.2% market share, down from 21.6% in the previous year (source: European Automobile Manufacturers' Association; ACEA).

The combination of pushing margin-dilutive EVs into the market, along with the pooling costs among car manufacturers currently weighs on the earnings forecasts of most traditional automakers with sizeable operations in the EU. Furthermore, additional costs may arise from adjusting investments in new battery technology and managing contracted battery volumes. Even if there is a possibility of reduced regulatory fines in the short term, we do not expect major changes in the level of EV penetration in Europe by the end of this decade.

Chart 10

EV penetration is pausing in Europe and the U.S., while still rising in China

EV penetration rate and sales growth rate (%)



LTM—Last 12 months. Source: S&P Global Ratings.

The outlook for EV demand in the U.S. could face some downside pressure during Donald Trump's second presidential term. This will depend on the timing and magnitude of changes to consumer and production tax credits under the Inflation Reduction Act, as well as investments in charging infrastructure under the Bipartisan Infrastructure Law. We expect significant competitive pressure for all automakers in 2025 and 2026. Following a slowdown in market share gains for EVs and rising inventories for several models, we think the next wave of buyers will be more price-sensitive and depend on significant battery range improvements, charging infrastructure, and technology. This is evident from the 7% year-over-year growth for EVs in 2024, which is much slower compared to a 37% growth in hybrids. Therefore, any removal of tax subsidies or charging infrastructure will skew estimates toward the lower end of the range in our base case (see table 2) and take longer to close the U.S. EV market share gap with Europe and China. For now, our global electrification scenario remains unchanged.

Table 2

Global electrification scenario

Share of BEVs + PHEVs as a percentage of total sales

	2021	2022	2023	2024e	2025e	2026e	2030e*
Europe 10	18%	22.4%	22.2%	<20%	20%-25%	20%-25%	55-60%
China (Mainland)	14.0%	27.0%	32.9%	Approx. 40%	44%-48%	48%-52%	70%-75%
U.S.	4.50%	7.1%	9.2%	10%-11%	13%-16%	16%-22%	30%-35%
Global	8.3%	13.0%	16.5%	18%-19%	19%-20%	20%-22%	45%-50%

Europe 10—Germany, France, U.K., Italy, Spain, Belgium, Austria, Netherlands, Sweden, and Norway. e—Estimate. BEVs—Battery electric vehicles. PHEVs—Plug-in hybrid electric vehicle. *2030 production projections by S&P Global Mobility. Source: 2019-2023 EV Volumes, 2025 estimates by S&P Global Ratings.

Heavy duty commercial vehicles

We forecast that global sales of heavy-duty trucks (HDTs) will increase by low single digits to about 1.95 million units in 2025, up from 1.93 million units expected in 2024 (see table 3). In Europe, the market continues to normalize but with a declining trend, recovering moderately in North America and APAC. Supply chain issues and widespread component shortages have eased further in 2024, but intensifying U.S.-China trade tensions, and the extent of President-elect Trump's proposed trade tariffs could lead to a deterioration over 2025-2026, impacting both units sold and profit margins. In Europe, we expect up to a 5% decline owing to weak macroeconomic conditions, political uncertainty in its largest markets (Germany and France), and little hope that the neighboring Russia-Ukraine and Middle East conflicts will de-escalate. For further details, see "2025 Global Outlook For Heavy-Duty Trucks Isn't Rosy," published Dec. 11, 2024.

Table 3

HDT growth forecast – unit sales

(%)	2019	2020	2021	2022	2023	2024e	2025e	Units sold in 2023
EU27+3	(0.1)	(28.7)	20.5	6	15.5	(15.0) - (10.0)	(5.0) - 0.0	350,213
APAC	0.3	18.1	(2)	(48.2)	19.9	(7.5) - (2.5)	0.0 - 5.0	1,091,549
North America	7.3	(25.1)	13.4	7.8	7.8	(15.0) - (10.0)	0.0 - 5.0	295,385
South America	18.4	(9.4)	49	(0.5)	(15.7)	7.5 - 12.5	0.0 - 5.0	116,419
Total	1.8	3.5	5.1	(31.4)	16.3	(10.0) - (5.0)	0.0 - 5.0	2,074,678

HDT—Heavy-duty truck. e—Estimate. Sources: S&P Global Mobility, S&P Global Ratings.

Credit metrics and financial policy

Light vehicles

Over the next two years, we expect moderate revenue growth for OEMs in line with the weak momentum of light vehicle sales and increasing pricing pressure. Cost reduction will remain crucial to accommodate headwinds generated by trade tensions, inflation, regulatory commitments, intense competition in China and other markets, and expenses linked to new model launches. In addition, the widespread need to reduce idle capacity to cut fixed costs will likely add to ongoing restructuring measures that will weigh on margins and cash flows. In a very competitive market, investments—such as capitalized research and development (R&D) and capital expenditure (capex)—may offer little flexibility to improve free cash flow generation. Slower adoption of EVs will not provide significant support because the benefits of longer lifespans for ICE worldwide may not sufficiently balance decreasing margins on EV sales.

Given that most OEMs have strong balance sheets, they will likely maintain financial policies that benefit shareholders to support equity valuations. With sales and pricing facing challenges, some OEMs might lower their underwriting standards at their proprietary captive finance businesses to compete, which could increase credit risk.

Auto suppliers will face increasing pressure from OEMs to share their cost reduction efforts in the event demand remains flat. Volume shortfall could have been somewhat mitigated by the anticipated rise in product content and value for suppliers; however, this is likely to be undermined by the slower EV transition and more cost-conscious consumers. These factors will make it harder for suppliers to deleverage through EBITDA growth, leaving them with limited options, such as selling assets, tightening financial policies, and cutting capex spending.

Heavy duty commercial vehicles

We publicly rate four truck OEMs that primarily operate in Europe, the U.S., and South America. For 2025, we anticipate overall muted revenue growth and margins in line with 2024 levels. Capex will remain sustained as truck makers prepare for the energy transition that may now take longer than expected. Tariffs represent a short-term risk that could lead to lower demand and increased supply chain issues. However, most of the companies we rate have strong balance sheets, which could help sustain less favorable free operating cash flow generation in their industrial businesses. We also anticipate the loss ratio for captive finance businesses could increase over 2024-2025 as logistic companies struggle with their cost base.

Key risks or opportunities around the baseline

1. New tariffs on U. S. imports of vehicles and parts.

The risk of tariffs is high, but their impact remains uncertain and depends on tariff levels, whether (and which) parts are included, and sourcing locations. Thus, specific tariff scenarios are not included in our issuers' 2025 base cases but are noted as potential additional headwinds. Mitigation strategies will differ among OEMs, and should be evaluated individually.

2. The recovery of the Chinese economy could benefit the auto industry.

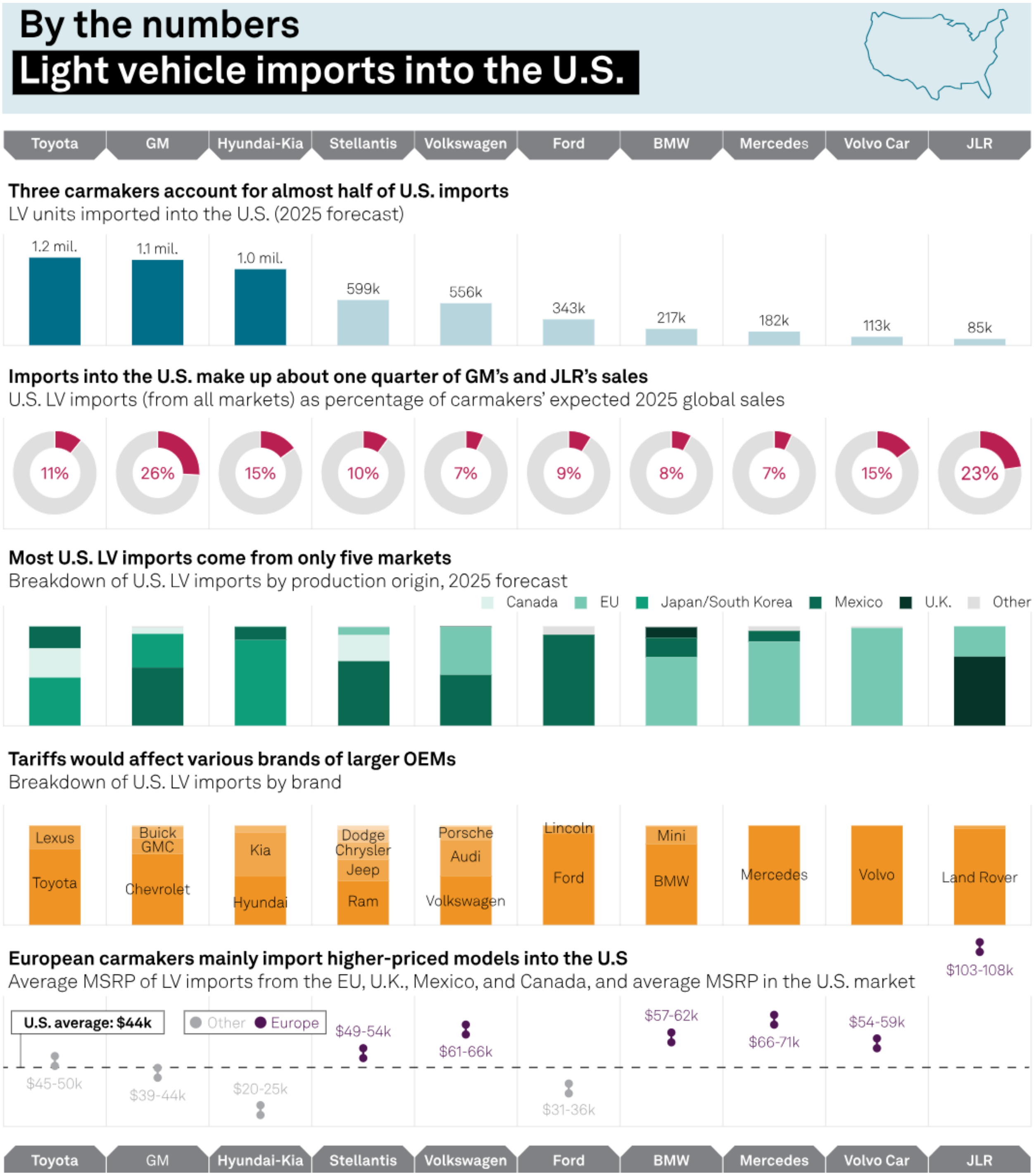
The hypercompetitive environment is magnified by a low-growth economy and weak consumer confidence, such that an earlier-than-expected recovery (2026-2027) could offer some relief for sales and pricing.

3. Regulatory pragmatism in Europe could create opportunities.

Near-term risks involve selling EVs at low margins, and costs for credit purchases, and penalties for not meeting 2025 carbon dioxide targets. If the new European Commission eases these risks, such as averaging fleet emissions over a longer period, OEMs with significant operations in Europe would see this source of earnings risk partly reduced.

Tariffs on imports of vehicles and parts into the US. The debate surrounding tariffs on the import value of parts and finished vehicles into the U.S. is a focal point in the global auto industry. To assess the maximum EBITDA at risk for OEMs, we developed a scenario analysis based on assumptions regarding tariff levels and the potentially affected sourcing area (see chart 11 and "Auto Industry Buckles Up for Trump's Proposed Tariffs on Car Imports," published Nov. 29, 2024). European premium carmakers Volvo Car and Jaguar-Land Rover are particularly exposed to tariffs on European imports, whereas General Motors and Stellantis would face the greatest risk in case of tariffs on imports from Mexico and Canada. Toyota and Hyundai-Kia have low exposure if no additional duties are applied to imports from Japan and Korea.

Chart 11



Note: Volumes represent the October 2024 forecast by S&P Global Mobility. MSRPs are from October 2024. GM—General Motors. JLR—Jaguar Land Rover. LV—Light vehicle. Mercedes—Mercedes-Benz. MSRP—Manufacturer Suggested Retail Price. Sources: S&P Global Ratings, S&P Global Mobility.

The heavy-duty truck market is typically less exposed to exports from Europe to the U.S. This is due to its more regional production. At the same time, the threat of tariffs imposed by President-elect Donald Trump's administration could challenge the profit margins of truck OEMs that rely on Mexican exports for U.S. domestic sales. According to S&P Global Mobility data, U.S. production accounted for about 55% of the total heavy-duty unit truck sales in the U.S. in 2023. Demand is primarily met by imports from Mexico, which represented about 98% of truck imports in the U.S. in 2023. We understand global truck OEMs have used Mexico as a production hub to varying degrees. S&P Global Mobility data indicates that the companies most exposed to Mexican production for export to the U.S. are Daimler Truck, which represents about 70% of heavy-duty truck exports from Mexico to the U.S. (slightly more than 80,000 units), followed by Traton at about 30%, (slightly more than 34,000 units). Under a scenario of 25% tariffs on imports from Mexico, we anticipate these companies' profit margins could be challenged, particularly because it will be difficult to reallocate the production elsewhere in a timely manner.

The light vehicle market in China could experience a revival. A marked recovery of the Chinese auto market is not in our base case for 2025 or 2026 due to persistently weak consumer sentiment (despite an improvement observed towards the end of 2024). The prolonged property market downturn has negatively weighed on consumer confidence and dampened spending on non-essential high-cost items. The government's attempt to revive the market through a trade-in program stimulated passenger vehicle retail sales in the fourth quarter, potentially pulling forward demand for 2025.

However, a more consistent intervention next year should not be excluded. Our economists have already factored in a lift in U.S. tariffs on Chinese imports to 25% from the second quarter of 2025 onwards (from about 14%), which would hit the Chinese economy. To counter challenging macroeconomic conditions, further stimulus seems inevitable, though its magnitude remains uncertain. For the auto sector, in addition to extending the trade-in policy, some industry participants are advocating for a cut in purchase tax (10% for ICE vehicles), which has historically been the most effective measure to support auto purchases. If successful, this could create stronger market momentum and potentially alleviate pressure on volume and profitability.

That said, we remain cautious about the road ahead for auto OEMs. While stimulus policies could promote auto sales, the market is highly competitive, with continuous new model and brand launches. Cost leaders seeking market share may prolong the price war, especially if they can pass cost pressures onto suppliers. Market followers will need to adapt or risk losing volume. This also applies to premium OEMs, particularly in the entry-level premium segment.

The rating headroom for rated auto makers remains divergent but has generally decreased. For Geely entities, despite strong volume growth in 2024 due to improved product offerings, margin recovery could be complicated by the EV transition and trade tariffs. For latecomers to electrification, such as Beijing Automotive and China FAW, competitive pressures are increasing because of the lack of competitive EV models. The success of their EV strategy will determine their market position and rating trajectory in the next two to three years.

Regulatory pragmatism in Europe could ease earnings pressure for affected OEMs. Manufacturers are integrating their regulatory commitments in Europe into their planning for 2025. This includes planning their mix of models and engine types—gasoline, hybrids, and EVs—as well as tweaking pricing, including potentially raising prices for ICE-powered vehicles, and preparing to buy credits from other manufacturers to meet company-specific targets or pay penalties. Meanwhile, the European People's Party is starting to acknowledge the challenges automakers face in the EU, which extend beyond light vehicles to include trucks and buses. The regulations mandate a 15% reduction in the average carbon dioxide emissions emitted per kilometer compared to 2021 levels. In the first 10 months of 2024, the market share of EVs in the EU fell to 20.2% from 21.6% last year. ACEA is calling for a two-year delay in the tightened carbon dioxide targets for 2025 to avoid fines of up to €15 billion, which represents approximately 25% of annual R&D spending in Europe. If successful, relaxing the 2025 targets and fines could alleviate one important earnings risk for 2025 for the affected OEMs in the region.

Related Research

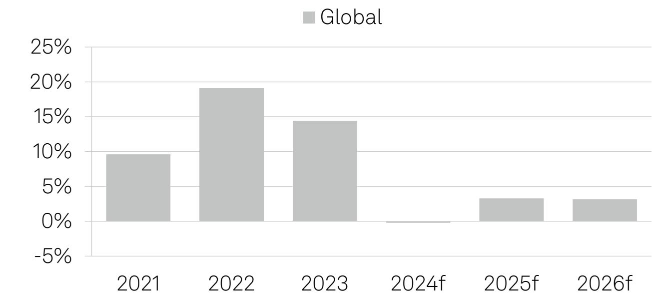
- Auto Industry Buckles Up for Trump's Proposed Tariffs on Car Imports, Nov. 29, 2024
- EV Makers To Bet $20 Billion On South And Southeast Asia, Oct 29, 2024
- China Auto: Survival Of The Fittest, Oct. 17, 2024
- Idling Auto Sales Limit Upside For U.S. Auto Sector Ratings, Oct 10, 2024
- Global Auto Outlook: More Players, Less Profit, Oct. 9, 2024
- Credit FAQ: Inflation, China, And EV Transition Risks Casts Long Shadow On North American Auto Suppliers, July 22, 2024
- Industry Credit Outlook Update Asia-Pacific: Autos, July 18, 2024
- Industry Credit Outlook Update Europe: Autos, July 18. 2024
- Industry Credit Outlook Update North America: Autos, July 18. 2024
- Autoflash EMEA: Suppliers Feel The Heat Of Low Volumes And Earnings Pressure, July 1, 2024
- Rated China Carmakers Can Take The Heat From European Tariff Hikes On EVs, June 17, 2024
- Credit FAQ: Why China Is At The Center Of Global Auto Conversations, June 11, 2024
- CreditWeek: Who Will Emerge As The Winners And Losers Of The Electric Vehicle Adoption Race?, May 30, 2024
- China EV Startups Struggling To Stay Afloat, May 28, 2024
- Asian Auto: Resiliency Over Adversity, May 23, 2024
- Hybrids Prop Up Japanese Automakers, April 24, 2024

Industry Forecasts

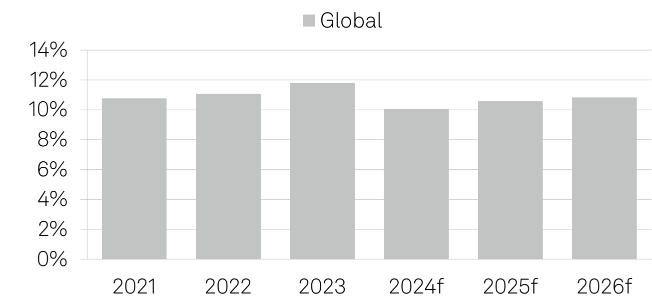
Auto OEMs

Chart 12

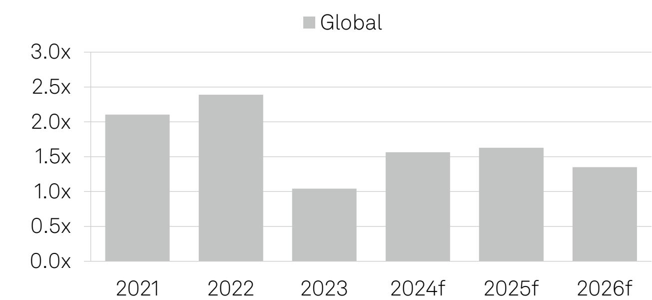
a) Revenue growth (local currency)



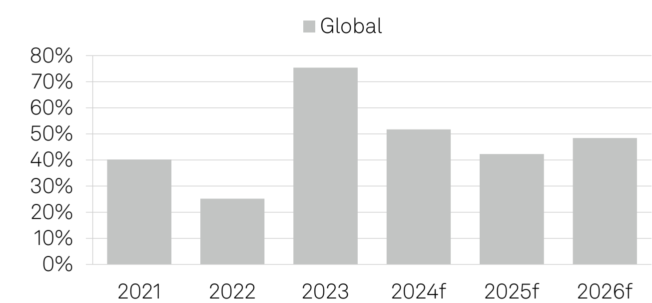
b) EBITDA margin (adjusted)



c) Debt / EBITDA (median, adjusted)



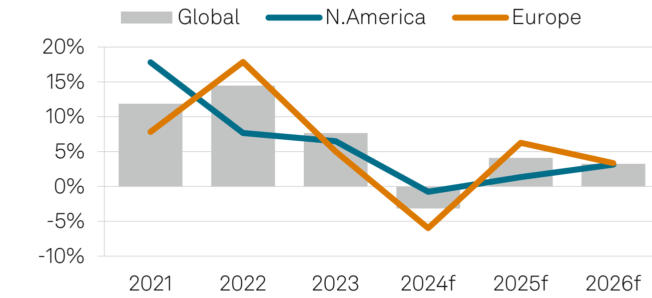
d) FFO / Debt (median, adjusted)



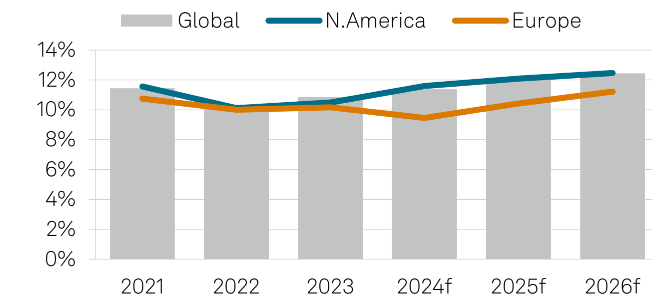
Auto Suppliers

Chart 13

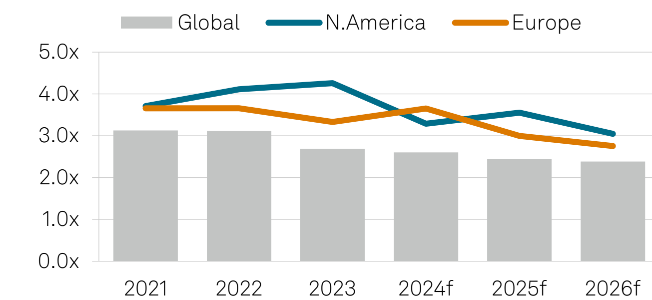
a) Revenue growth (local currency)



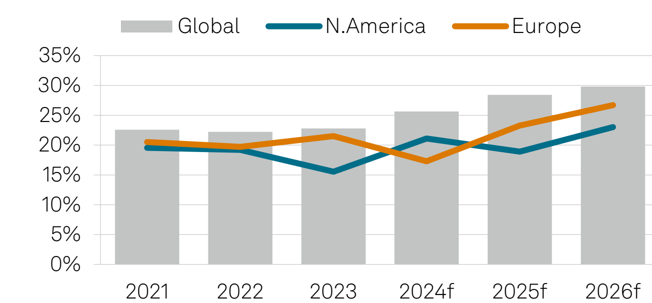
b) EBITDA margin (adjusted)



c) Debt / EBITDA (median, adjusted)



d) FFO / Debt (median, adjusted)



Source: S&P Global Ratings.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. OEMs--Original equipment manufacturers. FFO--Funds from operations.

Cash, Debt, And Returns: Autos

Chart 14

Cash flow and primary uses

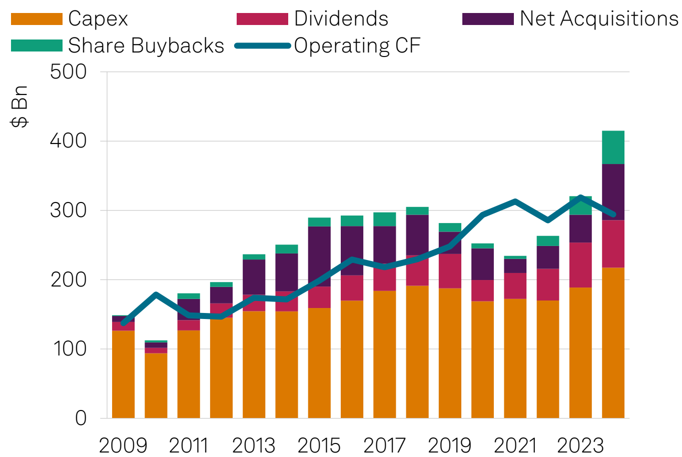


Chart 15

Return on capital employed

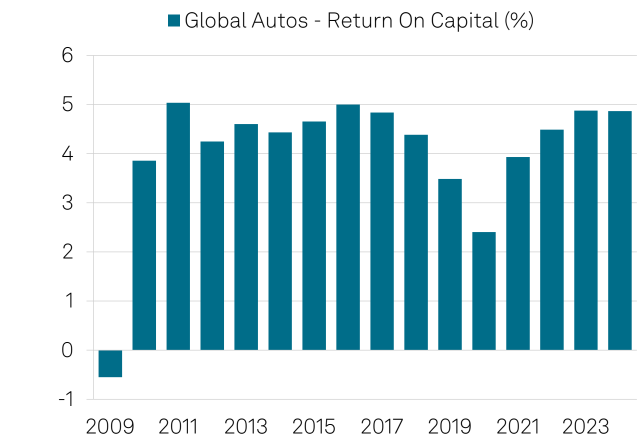


Chart 16

Fixed- versus variable-rate exposure

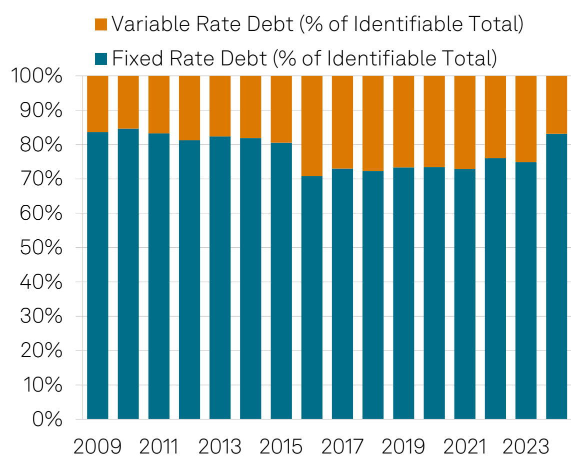


Chart 17

Long-term debt term structure

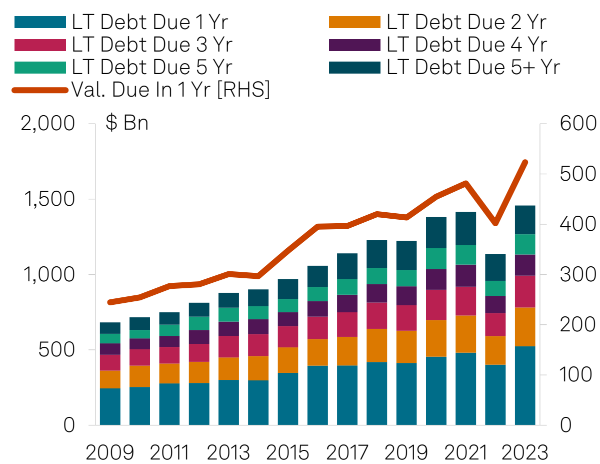


Chart 18

Cash and equivalents / Total assets

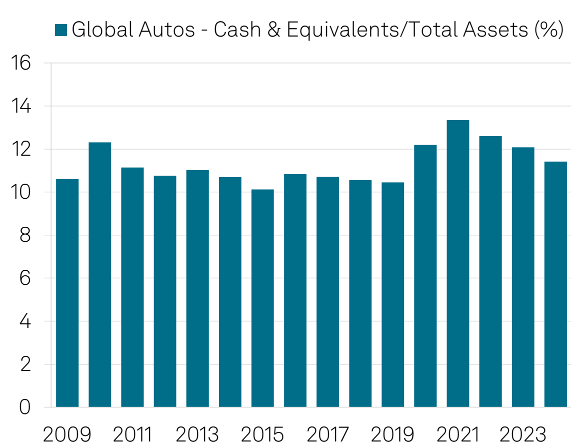
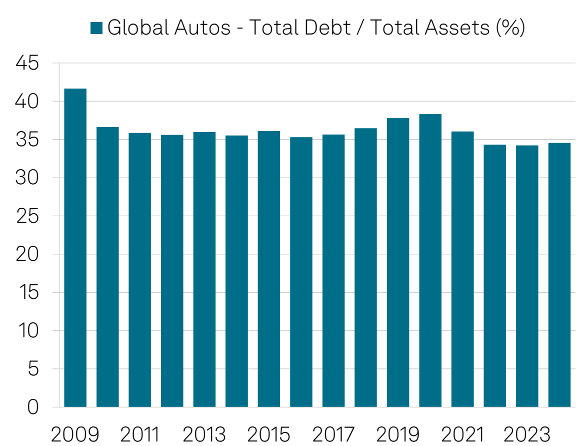


Chart 19

Total debt / Total assets



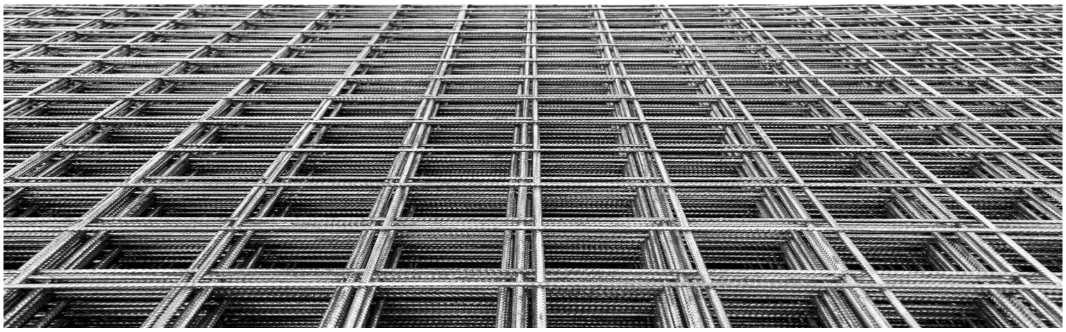
Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Building Materials

Stable credit quality on a weaker foundation

January 14, 2025

This report does not constitute a rating action.



What's changed?

Heightened geopolitical and trade tensions could indirectly affect the sector. Most building products are produced and sold locally. However, increasing trade tensions and continued geopolitical risk may indirectly affect sales by hampering business and consumer confidence.

Rating pressure is confined in the 'B' category. Elsewhere, we expect credit quality to remain largely stable in 2025 despite the prolonged effects of challenging market conditions.

M&A activity has resumed. After renewed activity in 2024, we anticipate further acquisitions, particularly large companies expanding in regions or segments that benefit from higher growth.

What are the key assumptions for 2025?

Volume recovery will be very gradual. In most regions, the residential sector is still struggling, and growth is confined to infrastructure construction fueled by public funds.

Largely stable profitability. Limited volume recovery by the end of 2025 may support operating leverage, but high commodity, labor, and delivery costs could put pressure on margins.

Capital expenditure (capex) is sustained. Investments in high growth business segments, climate transition, and digitalization continue to drive capital allocation.

What are the key risks around the baseline?

Prolonged business downturn. Weak demand could persist as property and building product prices stay high. Also, geopolitical and trade tensions could affect household confidence.

Financial policies are more aggressive. Given both increased acquisition spending and longer than anticipated market softness, the debt leverage cushion has deteriorated for many issuers.

High costs linked with climate transition. Absent sufficient support from public bodies, it can be difficult for companies and households to invest to comply with local decarbonization regulation.

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Ratings Trends: Building Materials

Chart 1
Ratings distribution

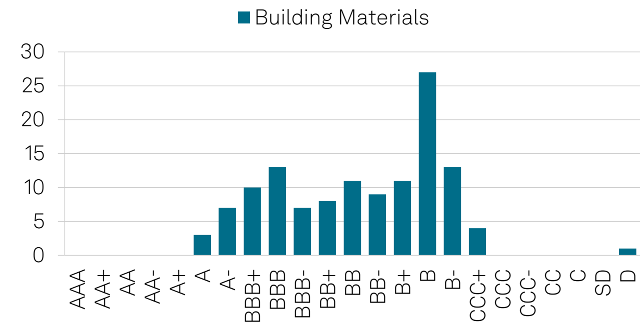


Chart 2
Ratings distribution by region

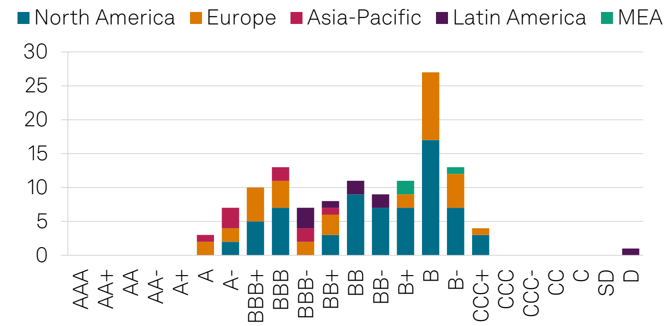


Chart 3
Ratings outlooks

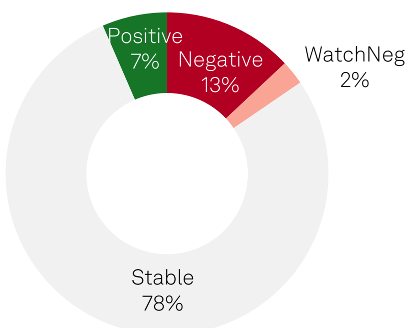


Chart 4
Ratings outlooks by region

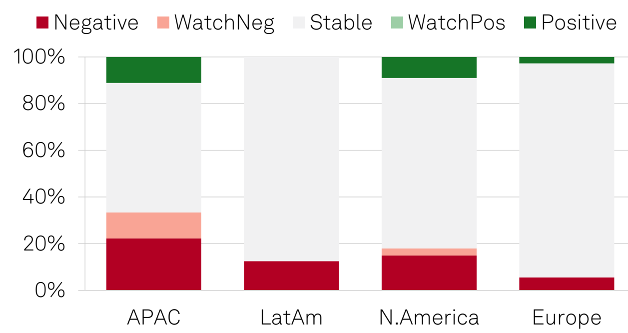


Chart 5
Ratings outlook net bias

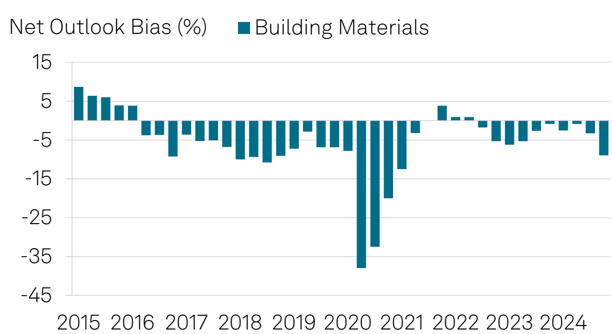
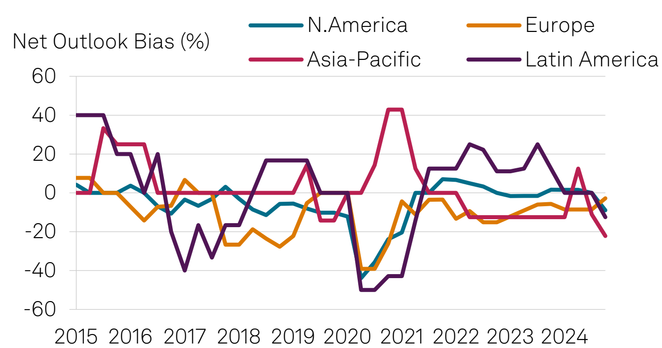


Chart 6
Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook: North America

Ratings trends and outlook

We expect credit quality to remain largely stable in 2025 despite the prolonged effects of challenging market conditions, offset by the considerable benefit from nondiscretionary product resiliency and some opportunity for declining interest rates. The ratings on about 80% of issuers have a stable outlook with the remaining companies marginally biased toward negative outlooks compared with positive. Therefore, we anticipate that most issuers are prepared to navigate uncertain conditions through 2025. We anticipate that any ratings deterioration will be concentrated on the lower-rated issuers.

Building materials companies could still experience some margin pressure from higher commodity, labor, and freight costs, while the potential for tariff implementation could result in materially higher prices that could dampen demand. We expect margins will be pressured if the ability to pass through cost increases is limited. Generally, building materials companies are successfully implementing cost-saving and efficiency initiatives, which we think will anchor margins above pre-pandemic levels. Companies that can maintain pricing power with lower cost inventory despite declining demand volume will be better positioned to meet our profit and leverage forecasts for 2025.

Main assumptions about 2025 and beyond

1. Interest rate cuts are not enough to reverse low repair and remodel spending or delayed projects.

While we expect further interest rates cuts will eventually lead to an increase in renovation and other spending, the pace and speed of the improvement is expected to lag several quarters. The Federal Reserve (Fed)'s 100 basis points (bps) of rate cuts in 2024 are also not likely to improve affordability enough to incentivize completion of larger discretionary projects.

2. Margins will likely stay under pressure; however, public infrastructure spending may mitigate pressure for some issuers.

We expect margins will remain under pressure in 2025 because of high commodity, labor, and delivery costs. Aging housing stock and federal investments in infrastructure should increase demand but issuers will likely continue to rely on pricing power to maintain margins.

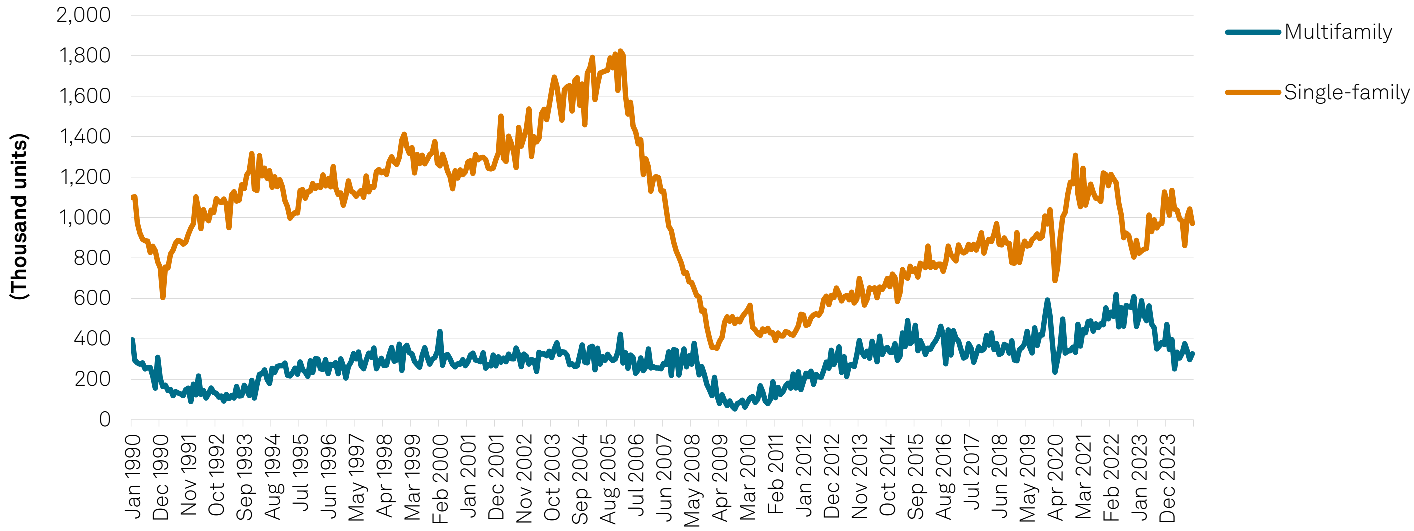
3. Delayed construction market recovery may mean persistently pressured earnings.

Fundamentals for the building materials sector remain subject to slowing economic growth and consumer spending. We previously anticipated the second half of 2024 would reflect more significant earnings recovery than what occurred. We expect consumer spending to remain pressured through the first half of 2025, some issuers may experience persistently low volumes.

Interest rate cuts may also be materially delayed. This is because the Fed may react to the higher inflation expectation from tariffs. Inflation will erode purchasing power, which will disproportionately affect demand for discretionary products such as cabinetry and bath fixtures. In recent years, revenue across the portfolio has been generally strong but we expect flat to low-single-digit declines for the sector with commodity-based companies falling more sharply. We expect housing starts will remain stable at about 1.36 million in 2025 (see chart 7).

Chart 7

U.S. housing starts

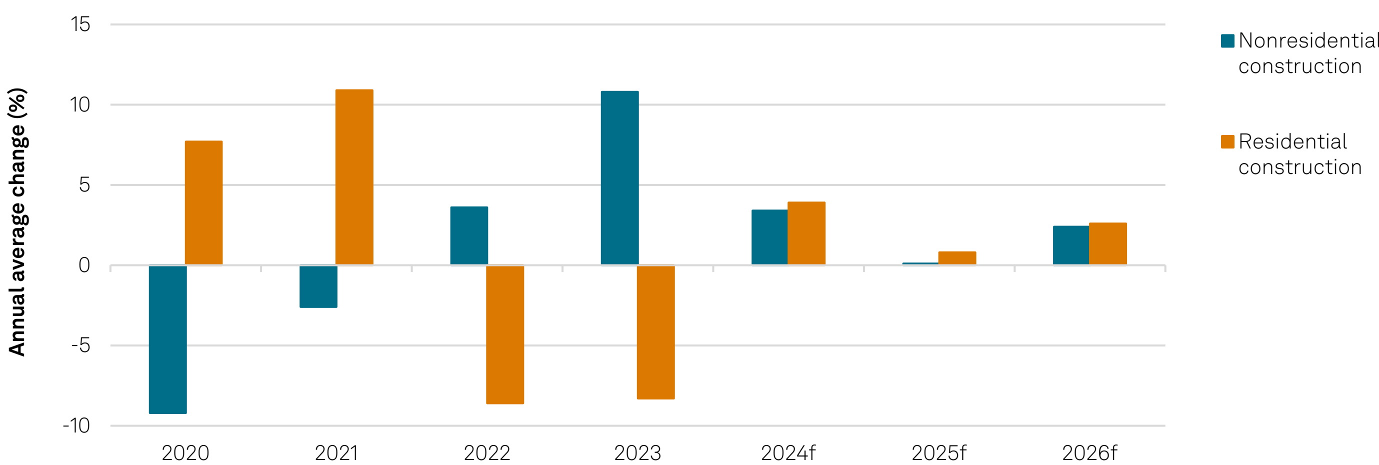


Note: Multifamily starts are housing starts of 5-unit structure. Data as of Oct. 2024. Source: Federal Reserve Economic Data.

Nonresidential and residential construction is forecast to contract in 2025. Better-than-expected performance for both end markets throughout 2024 (see chart 8), despite challenging conditions and higher borrowing costs. We expect market fundamentals to remain strained in 2025 as we think that current interest rates remain restrictive of housing affordability. Similarly, we anticipate weak nonresidential construction in 2025. Public construction outlay is likely to continue offsetting private construction contraction, however, we think that recent indicators may foreshadow exhausted growth sources for infrastructure investments.

Chart 8

U.S. nonresidential and residential construction forecast



f—Forecast.
Source: S&P Global Ratings Economics, Economic Outlook U.S. Q1 2025: Steady Growth, Significant Policy Uncertainty.

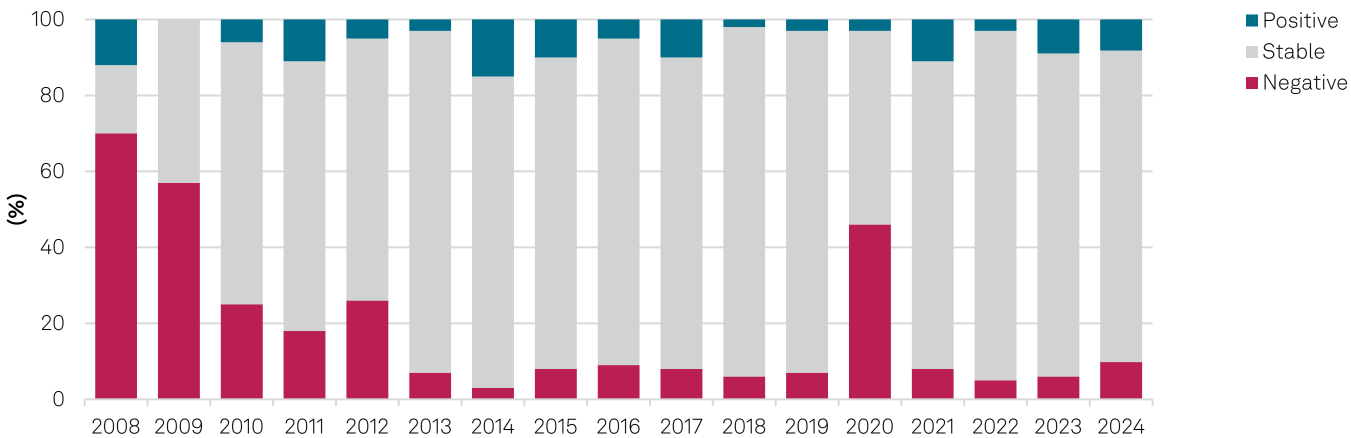
Credit metrics and financial policy

With an uptick in merger and acquisition (M&A) activity in the first half of 2024 and many companies refinancing, completing add-ons, or raising new debt in 2024, the credit cushion has largely depleted from pandemic-era highs. We viewed the capital structure rebalancing as largely credit neutral; however, the combination of elevated debt and market uncertainty may contribute to negative bias within the sector. We have taken negative rating actions on companies like Cornerstone Building Brands Inc. and Mannington Mills Inc. whose performance was weaker than expected and coupled with newly raised debt levels resulted in materially weaker metrics. Well capitalized companies demonstrating strong cash flow, profitability, and the ability to pass on cost increases are likely to see stable or improving credit metrics.

The outlook bias is more negative than in 2023 (see chart 9) reflecting some issuers' inability to maintain stable key credit metrics through the cycle.

Chart 9

U.S. building materials companies' outlook distribution



Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Interest rates and cost inflation could strain consumer spending and reduce earnings.

Construction has remained soft as interest rates remain restrictive despite a 100 bps cut by the Fed in 2024. We anticipate affordability will remain an issue across repairs and remodeling, and new residential construction markets due to cost pressures. The recent flattening in infrastructure spending also indicates exhausted growth in infrastructure-driven nonresidential construction.

2. Successful implementation of tariffs may affect margins.

Suggested tariffs by the new U.S. presidential administration may lead to higher material costs, disrupt supply chains, and potentially slow construction projects. Margin performance will likely depend on a company's ability to pass on increases costs, a disproportionately challenging task for smaller companies or those in highly competitive markets.

3. Aggressive financial policy will remain a key risk to rating actions.

Given the rise in debt issuances, M&A transactions, and longer-than-anticipated market softness, the debt leverage cushion has deteriorated for many issuers. Continuation of the trend, coupled with market volatility, may result in a more negative biased for the sector.

Increased inflation is a risk to our base-case assumption. S&P Global Ratings expects inflation to remain above the 2.0% target longer than previously anticipated, likely to reach 3.5%-3.75% by end-2025. President-elect Donald Trump's proposed economic plan could push inflation even higher and dent GDP growth. This could result in negative rating actions, especially for companies with significant exposure to discretionary consumer spending or whose earnings are highly sensitive to cost-price adjustments.

We think an increase in tariffs could pressure revenue and margins. This is if price inflation dampens demand or the ability to pass through cost increases is constrained. While supply chains have evolved in the last several years, with issuers optimizing supply chains and reducing exposure to China (following the first Trump administration and the pandemic), this remains a risk. We think that a universal tariff and significantly higher tariffs on Chinese imports could mean an increase in U.S. inflation, and a drag on GDP growth. A 10% universal tariff on all core goods imported into the U.S. could add as much as 1.8 percentage points to the Consumer Price Index (based on share of exposure), triggering a resurgence in inflation in the first year—although that would be a one-off shift in prices rather than having an ongoing inflationary effect.

Aggressive financial policies remain among the main risks to ratings. The building materials industry is heavily controlled by private investment and has seen significant M&A deals in recent years. We expect this trend to continue in 2025. Larger companies may benefit from economies of scale, improving their credit profiles, while smaller players may face financial pressure and potentially reduce their access to credit. Some companies may face financial restructuring or take on more debt to fund expansion, which could affect their credit outlooks.

Industry Outlook: EMEA

Ratings trends and outlook

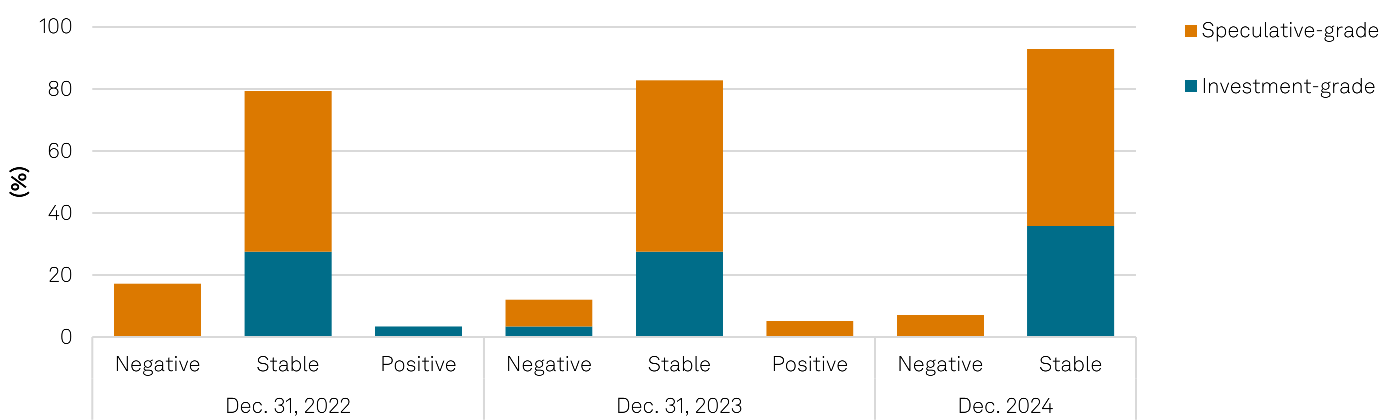
The European building materials sector is still experiencing a pronounced downturn in residential construction, particularly of new buildings. While mortgage rates are progressively adapting to an easier monetary policy driven by reduced inflation, construction costs and property prices remain high, constraining substantial demand recovery. We anticipate the rebound to be very gradual, starting in the second half of 2025. At the same time, civil engineering remains solid on the back of large infrastructure fundings and projects, and nonresidential construction displays more resilient trend, particularly those segments with carbon reduction targets that benefit from public grants. Median EBITDA margins are almost unchanged, but this masks significant differences: Large building materials companies have been able to further increase margins thanks to a positive price-cost gap that more than offset lower volume and the benefit of geographic diversification outside of Europe, while regional and small companies are suffering from margin decline due to lower operating leverage ahead of significant volume drop in Europe.

The rating headroom built after the pandemic has significantly reduced reflecting both the 2023-2024 business downturn (particularly in the speculative-grade category) and renewed capital spending for both acquisitions and shareholder remuneration (particularly in the investment-grade category). Rating pressure has intensified on speculative-grade companies focused on Europe. We took negative rating actions on companies in the 'B' category, particularly distributors, and with a business focus in weak performing countries such as Germany, the Nordics, and the U.K. Currently, about 93% of rated companies display a stable outlook (see chart 10). Negative outlooks reduced to 7% in December 2024, from 12% in December 2023 reflecting some downgrades we took over 2024. Even so, the negative outlook bias persists in the B rating category, indicating that negative rating actions should exceed positive ones in 2025.

We think that speculative-grade companies remain more exposed to downgrades, given their weaker business diversity and limited financial flexibility. Rating headroom for investment-grade companies has reduced, but it still provides some flexibility for additional capital spending in 2025. We think that financial policies will continue to determine companies' creditworthiness and our ratings, both in the investment-grade and the speculative-grade category.

Chart 10

European building materials companies' outlook distribution



Source: S&P Global Ratings.

Main assumptions about 2025 and beyond

1. The volume recovery should be very gradual, only starting in the second half of 2025.

The European construction outlook remains downcast in 2025, especially in Germany and Italy. Growth should only resume in the second half of 2025, when we anticipate a progressive volume recovery in residential construction, mainly driven by renovation. Nonresidential building construction should post a modest growth. In contrast, the positive volumes trend in civil engineering persists, thanks to new public funded investments.

2. Profitability margins should modestly improve as the recovery progresses.

If in 2024 the still positive price-cost gap drove most of the margin resilience, in 2025 we anticipate that somewhat better operating leverage should lead to a modest margin improvement. This is coupled with the benefit of business restructuring undertaken in 2024 in those segments mostly affected by business drop, such as distribution.

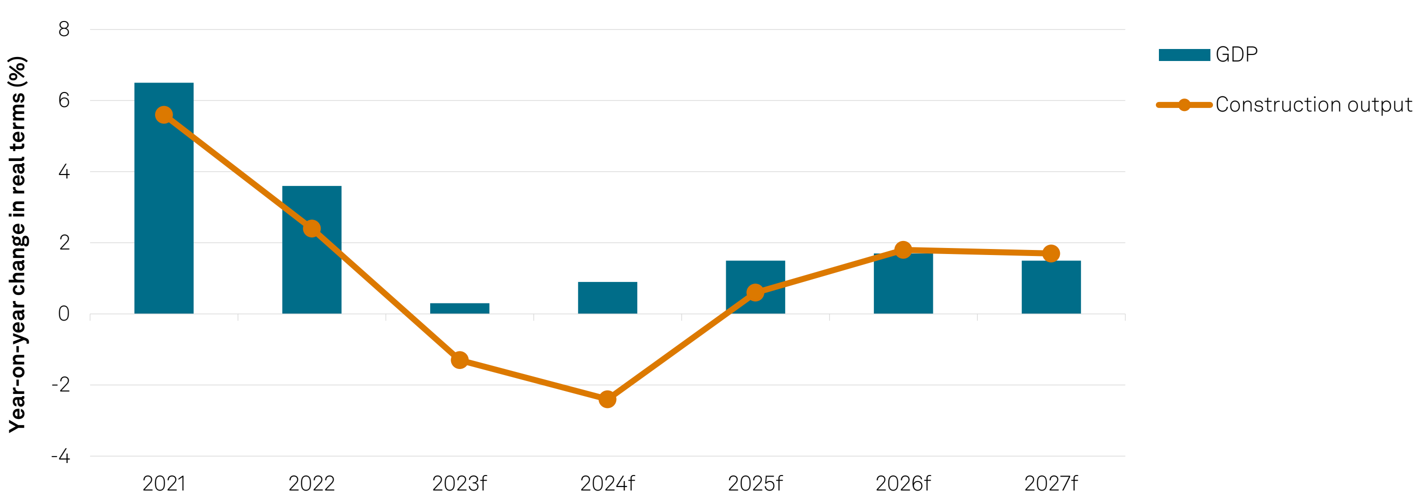
3. M&A has resumed, and we anticipate further acquisitions in 2025.

Across the sector there were increasing debt-funded acquisitions, particularly from large and diversified companies that expanded in regions outside Europe, such as North America and Australia; and in adjacent segments that benefit from climate transition, such as the construction chemicals segment. We anticipate that this trend will continue in 2025, as companies aim to take on business growth linked with digitalization and energy transition.

Uncertainty remains around the economic and operating environment in 2025. Growth should only resume in the second half of 2025 in the European construction sector, when we anticipate a modest volume recovery in residential construction, mainly driven by renovation. While mortgage rates are adapting to an easier monetary policy ahead of reduced inflation, both construction costs and property prices remain high, constraining a substantial demand rebound. Significant uncertainties linked to geopolitical risks also undermine consumer spending and business confidence. According to Euroconstruct, construction output should have contracted by 2.4% in 2024, after a decrease of 1.3% in 2023, and it should rebound by a modest 0.6% in 2025. Construction growth should only align with GDP in 2026 (see chart 11).

Chart 11

GDP and construction output in Europe (EC-19, % change)



f—Forecast. Source: Euroconstruct.

Business conditions will remain tough in the new residential sector. This is because housing permits will remain depressed. According to Euroconstruct, new residential construction should stabilize in 2025, with growth only returning in the following years. The residential building renovation sector, which contracted in 2023-2024, should post a modest recovery by the end of 2025.

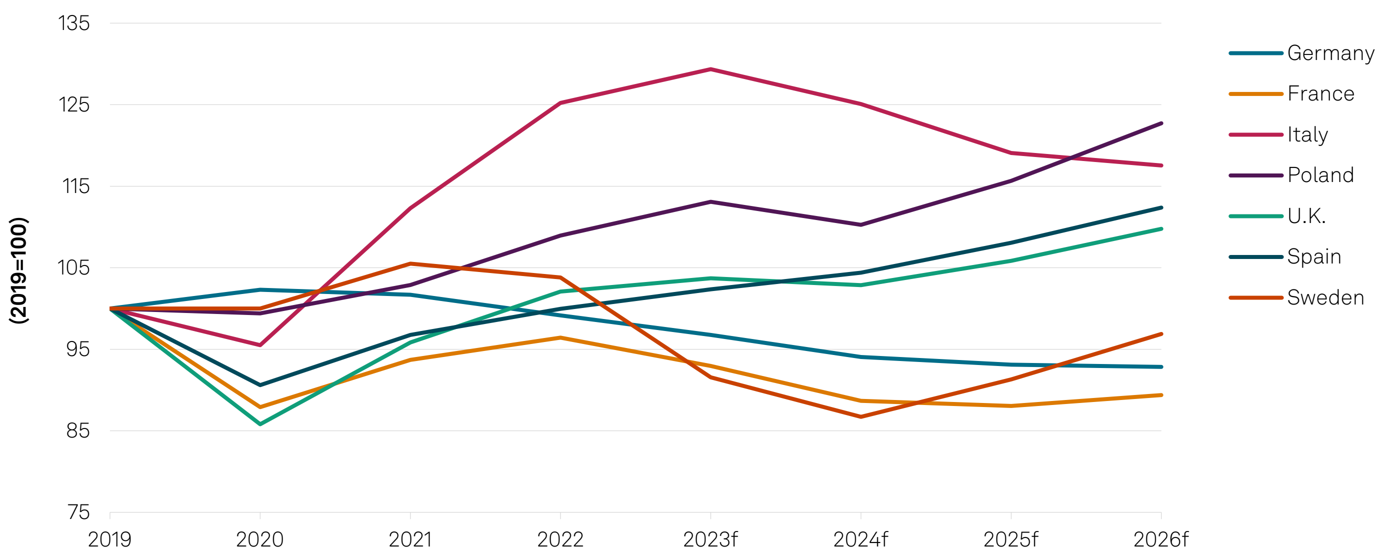
Civil engineering and industrial construction should benefit from investments. Particularly in low-carbon energy production, energy distribution, and transport networks. This follows the implementation of the NextGenerationEU strategy.

Companies offering light products in heating, ventilation, air conditioning, and electricity (including cables and installation materials, lighting, automation, data, and safety products) should benefit first from the volume rebound compared with companies that offer heavy-side building materials.

Business conditions remain challenging in core countries. These include Germany and Italy, while conditions should improve in the Nordics and the U.K. According to Euroconstruct, most European countries posted a volume drop in 2024, particularly the Nordics, Germany, and France where the drop should have averaged 5% (see chart 12). In 2025, there should be a moderate volume recovery in the Nordics. However, Germany and Italy should post a further, though modest, volume drop. In Germany, political instability at home and abroad, and high construction costs remain a barrier to household investments. In Italy, the residential sector performed best in 2021-2022, with a cumulative growth of about 30%, thanks to generous tax incentives to the residential renovation segment. However, as result of the current Italian government decision to significantly scale down tax incentives starting year 2025, we anticipate a depressed outlook in 2025-2026.

Chart 12

Construction output by country (EC-19, index, 2019=100)



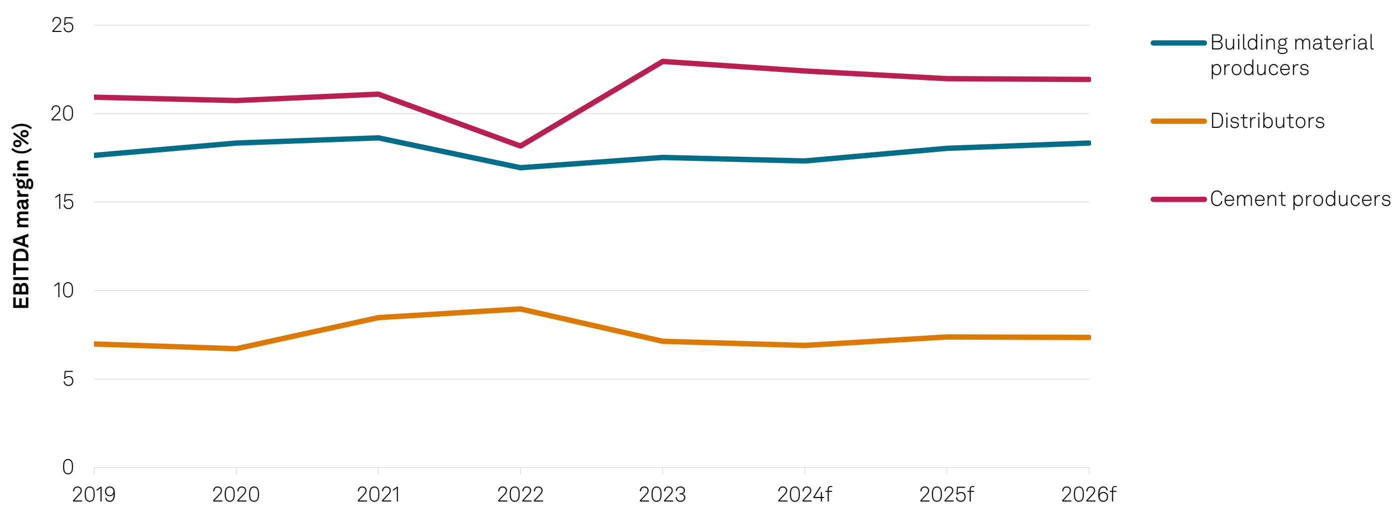
f—Forecast. Source: Euroconstruct.

The EU Energy Performance of Building Directive offers opportunities to the sector. This is because it aims to accelerate building renovation rates, reduce carbon emissions and energy consumption, and promote the uptake of renewable energy in buildings in the medium term. The directive is part of the “Fit for 55” program, which aligns the EU’s policies with its commitment to reduce net greenhouse gas emissions by at least 55% by 2030 compared with 1990 levels, and to achieve climate neutrality by 2050. The directive would provide a significant boost to companies whose products target building energy efficiency, such as insulation panels, heat pumps, and windows. However, since 2022, most critical building products prices have significantly increased, reflecting both cost inflation and solid price discipline in the market. As such, the significant costs associated with the large-scale implementation of the directive, particularly for low-income households, could delay single country enactment and disperse the benefits beyond the current decade, unless there are consistent and more favorable subsidy schemes for housing renovation in key countries in Europe.

We anticipate that EBITDA margins on average will be broadly stable in 2024. Margins will then improve modestly in 2025 (see chart 13). However, there are significant differences by business segment and company. Small distributors' margin dropped significantly in 2024, reflecting significantly lower volumes. Margins should only modestly recover in 2025, reflecting some volume rebound and the benefit of business restructuring undertaken in 2024 when small distributors suffered from significant costs associated with the restructuring. Large players in the heavy-side segment have, however, been able to improve or keep margins despite the volume drop, reflecting a more favorable price-cost gap and diversification outside Europe and they should keep their margins largely unchanged in 2025. Persisting wage inflation and limited volume rebound should limit the extent of margin improvement in 2025, on average.

Chart 13

Median adjusted EBITDA margin



f—Forecast. Source: S&P Global Ratings.

We anticipate pricing discipline will persist in the market. This is a key difference compared with previous business downturns. Building materials companies, particularly heavy side, were able to pass on cost inflation to clients over 2022-2023, reflecting both supportive demand and strong pricing discipline. In 2024, companies kept their prices unchanged, on average, which helped margins in front of disinflation in raw materials and energy prices.

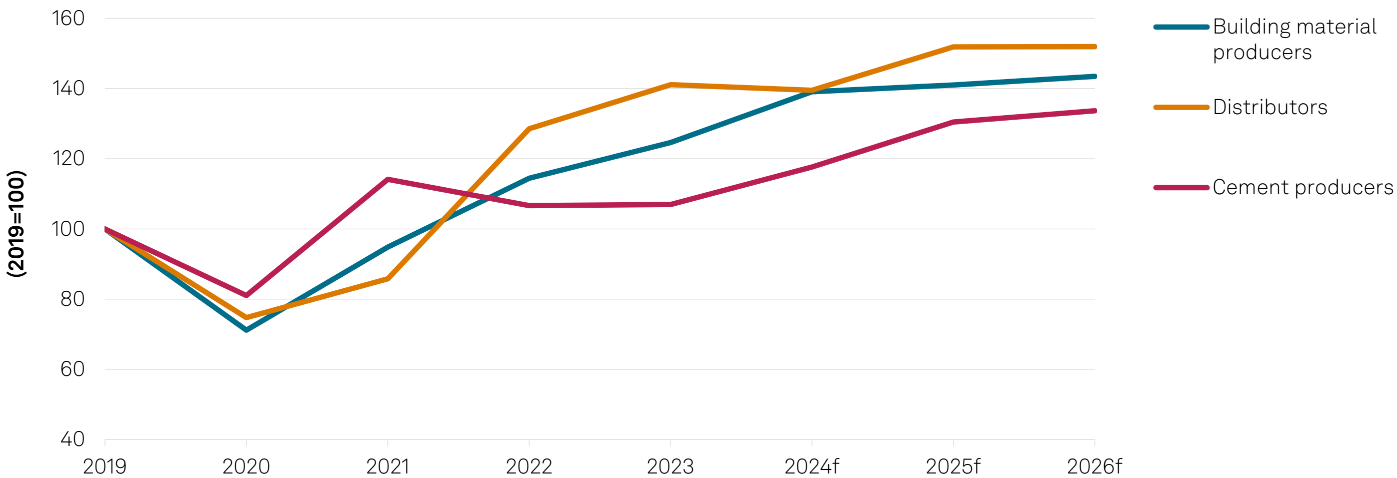
We assume that raw material and energy costs will be mostly unchanged in 2025. Spot prices on the Title Transfer Facility of natural gas, a key energy source in some building materials segments, has averaged between €30 and €40 in 2024. This is well below the peak reached in 2022. Natural gas prices, however, remain about 2.0x higher than they were before the pandemic. The price of electricity, another key energy source in the building materials segment, has displayed a downward trend since 2023, but there are significant price differences by country, reflecting the different energy mix used to produce electricity. On average, the electricity price is higher in countries such as Italy and Germany that rely more on natural gas to produce electricity.

Among other relevant raw materials in the sector, copper, steel, and aluminum wholesale purchase prices have normalized since the peak in 2022. However, they remain above pre-pandemic levels because of additional demand resulting from infrastructure renovations, energy efficiency renovations, and digitalization.

Despite weakened business confidence, most companies' capex further increased. We anticipate an increase in capex of about 5% in 2025, on average (see chart 14). Climate transition continues to drive capital allocation. This is the case for cement manufacturers, who invest to reduce their carbon footprint and meet their 2030 carbon reduction targets; light-side companies that enlarge their product offering to meet the demand for energy efficient improvements; and distributors that invest to improve their logistic and digital resources.

Chart 14

Capex evolution (index, 2019=100)



f—Forecast. Source: S&P Global Ratings.

Climate transition risk is at the core of cement companies' capital allocation. Cement companies assign an increasing share of their maintenance capex to improve plants' thermal efficiency and cut carbon dioxide emissions. Investments relate to increasing the use of alternative fuels or biomass, decreasing clinker content, and accelerating process innovation. Some companies switch to other building products, which helps reduce their consolidated carbon intensity. The most tangible example is Holcim Ltd., whose growth strategy focuses on increasing its share of value-added products and strengthening its environmental credentials by reducing the carbon footprint in its core cement business.

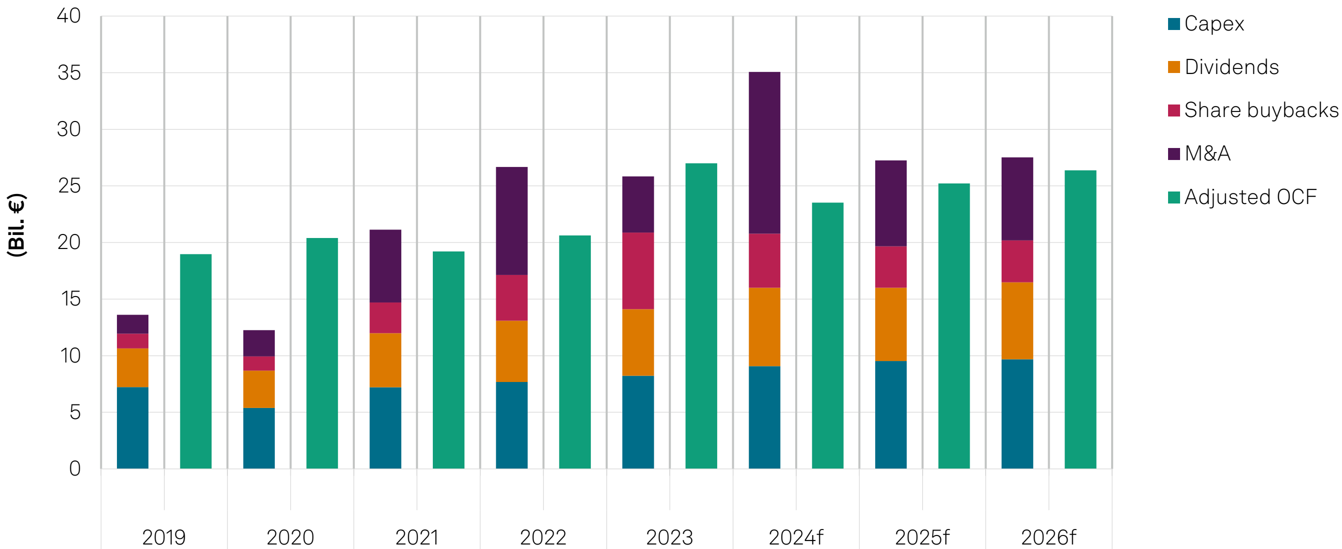
Credit metrics and financial policy.

Companies in the investment-grade category display solid balance sheets. This is thanks to the resilient performance achieved during the current downturn, which follows the strong results in the 2021-2022 after recovering from the pandemic.

Most companies have significantly increased their capital allocation to M&A in 2024 (see chart 15). Companies have also kept a generous shareholder remuneration, which translated into higher adjusted debt and lower credit metrics. We anticipate that this trend will continue in 2025, as companies aim to take on business growth linked with digitalization and energy transition and investing in those developed countries with most attractive growth rates, such as the U.S.

Chart 15

Large building materials companies' capital allocation (2019-2026f)

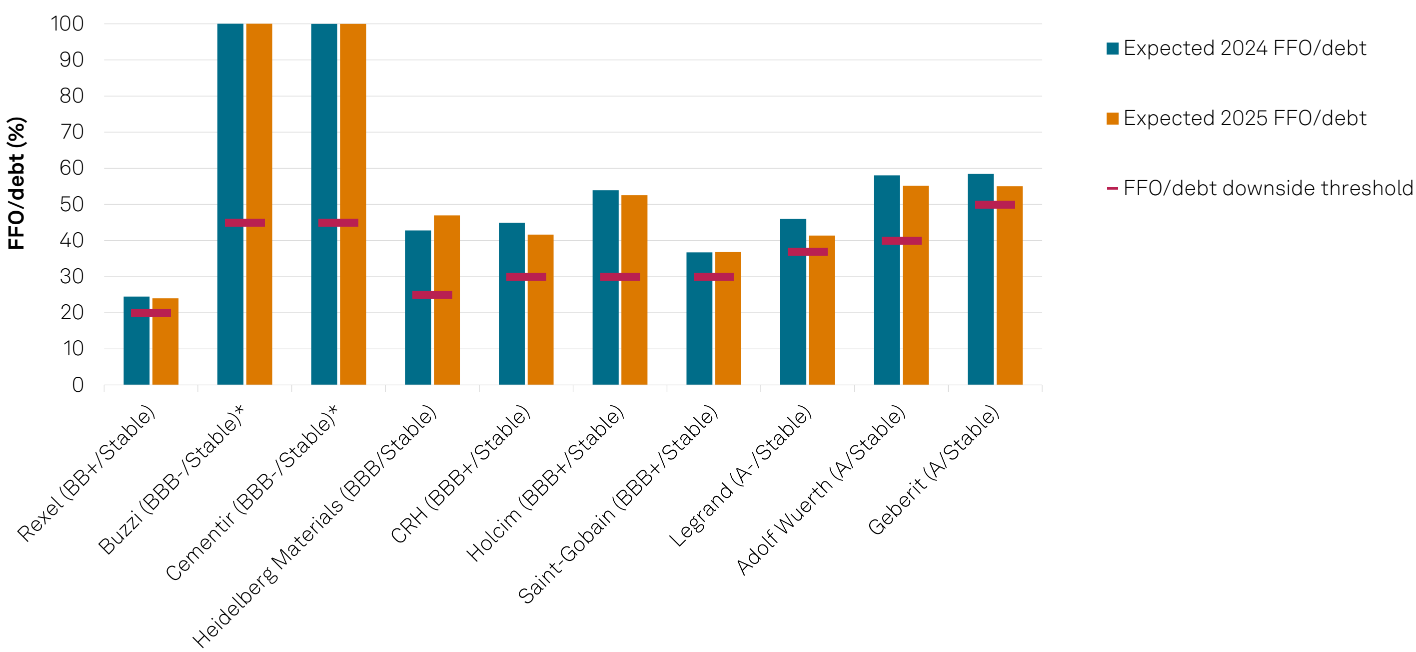


f—Forecast. OCF—Operating cash flow. Companies include Adolf Wuerth, Buzzi, Cementir, Saint-Gobain, CRH, Heidelberg Materials, Holcim, Legrand, and Rexel. Source: S&P Global Ratings.

Most investment-grade issuers' have sufficient rating headroom (see chart 16). This translates into a stable outlook on their ratings. However, companies' shareholder remuneration remains generous on average. Share buybacks decreased in 2024, but total shareholder remuneration remains elevated in the context of the business cycle. We think that financial policy stands as the main driver of potential rating changes, though we observe that our rated companies are committed to keep their current rating.

Chart 16

Rating headroom of main rated investment-grade issuers



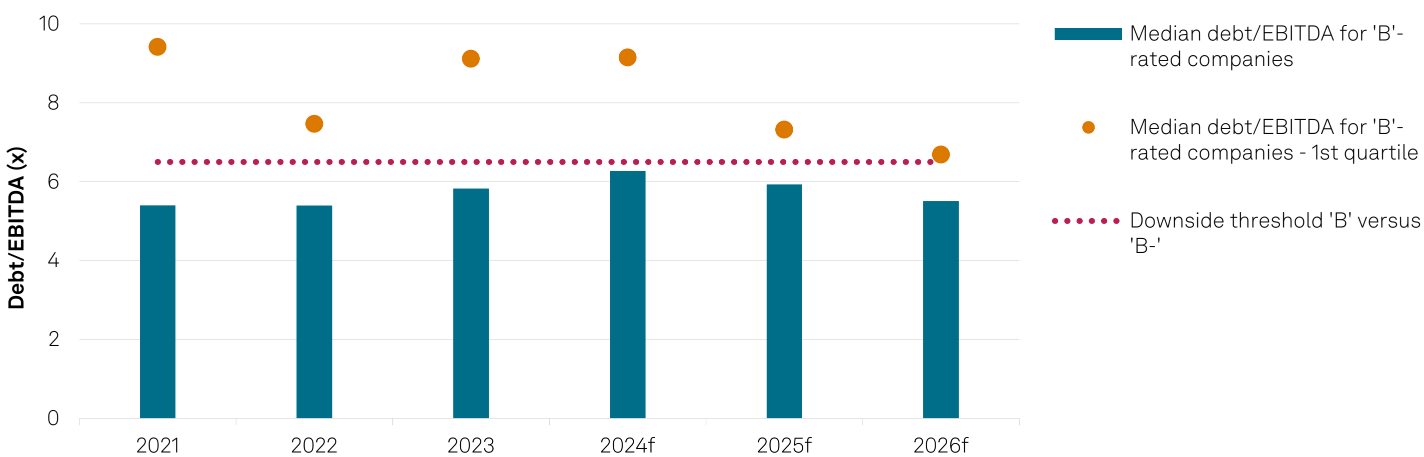
* FFO/debt of Buzzi and Cementir is expected to be above 100%. Source: S&P Global Ratings.

Speculative-grade companies are more exposed to downgrades. This is because of their weaker business diversity and limited financial flexibility. We took negative rating actions on companies in the 'B' category that entered the business downturn with limited rating headroom and that suffered from lower business volume and cash flow generation, particularly regional distributors, with a business focus in weaker-performing countries such as Germany, the Nordics, and the U.K.

We forecast median S&P Global Ratings-adjusted leverage will improve. This is for issuers with a rating in the 'B' category, leverage will improve modestly to 5.9x in 2025, from 6.3x in 2024 (see chart 17). This reflects some volume rebound, and the benefit of business restructuring undertaken in 2024 along with the associated significant costs. However, the worst quartile still displays an adjusted leverage above 7.0x in 2025, which make it vulnerable to negative rating actions. Companies' ability to keep or turn their free operating cash flow (FOCF) positive will be key to ease rating pressure. We understand that most private equity-owned companies will focus on deleveraging in 2025. Therefore, we think that an increase in financial leverage because of acquisitions or shareholder remuneration will be unlikely over next few quarters.

Chart 17

'B'-rated companies' median leverage trend



f—Forecast. Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Prolonged downturn and reduction in demand in Europe could impair credit metrics.

Weak demand could persist in Europe, especially for the new-build end-market, as housing materials stay expensive. Geopolitical and trade tensions could indirectly affect the sector. Early signs of raw materials and labor costs inflation could also drag on profitability in 2025, and issuers may not be able to pass through price increases in a weak demand environment.

2. More aggressive financial policies could lead to negative rating actions.

Rating pressure may arise if shareholder remuneration remains high, especially in a context of weak demand and declining volumes. Debt-funded acquisitions could also constrain credit metrics. Private equity-owned issuers remain exposed to highly leveraged capital structures, particularly among 'B' rated companies.

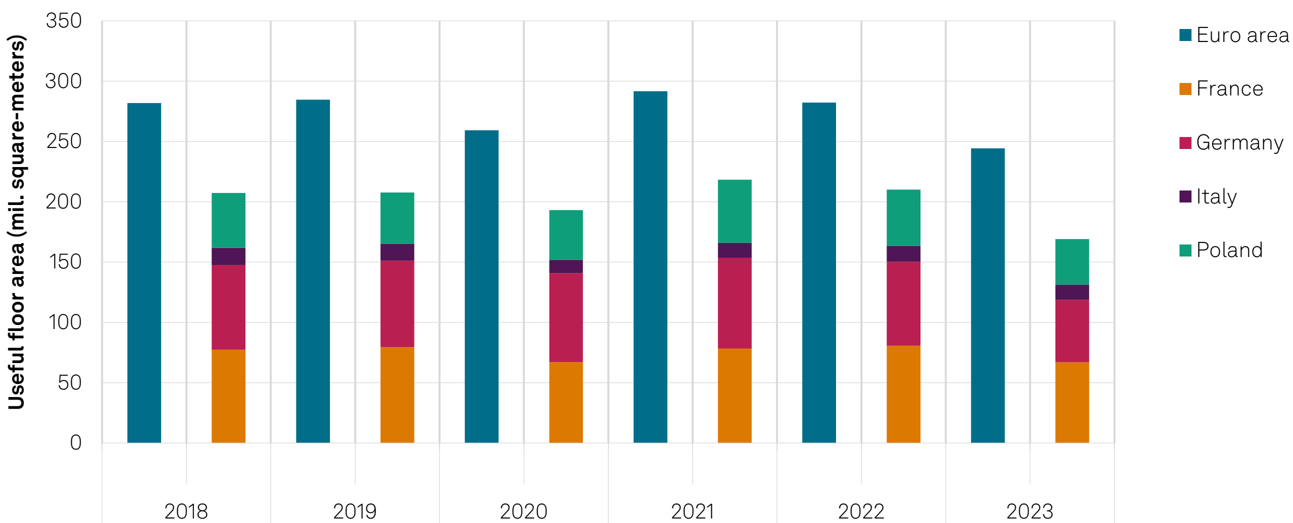
3. Costs linked with climate transition could weigh on companies and households.

Companies need to invest materially to meet their decarbonization targets, especially in the heavy building materials segment. Absent financings or incentives from public bodies, we think that carbon costs and capex could materially dent companies' credit metrics, potentially delaying their decarbonization agenda. Similarly, tax incentives are important to mitigate the burden of energy-saving building materials costs, particularly for low-income households; without them, a significant volume rebound is unlikely in the next few years.

It will take some time for companies to recover. Companies will eventually rebuild their order books, resume new building projects, and their financial results will recover. Depending on the sector submarkets, we estimate that there could be a time lag of six to nine months between the start of the trend reversal and the actual pick up of the companies' profit and loss and cash flows. The number of building permits have been at historical lows for the past decade (see chart 18). If building permits, business confidence, and housing starts do not recover in the coming quarters, companies are unlikely to see an improvement in activity and revenues in 2025.

Chart 18

Building permits in the EU



Source: Eurostat.

Geopolitical and trade tensions could indirectly affect the sector. Most building products are produced and sold locally. However, increasing trade tensions and geopolitical risks may indirectly affect sales by hampering business and consumer confidence.

The increase in raw materials costs could affect companies. This includes companies' price-cost spreads narrowing, and profitability decreasing in 2025. Few companies such as CRH PLC, Heidelberg Materials AG [?], and Compagnie de Saint-Gobain [?] already hinted at some potential raw material inflation in 2025. In a context of weak demand in Europe, issuers may struggle to pass through additional price increases and profitability may reduce. In addition, wage inflation could continue into 2025. Therefore, the ability to adapt the cost base to a prolonged downturn would be key for issuers. We think that it could be harder for speculative-grade companies to further adjust their cost-base without harming their businesses, as they have already made meaningful efforts in 2023-2024.

Shareholder-friendly financial policies could continue to consume rating headroom. This could also lead to a greater deterioration of credit metrics than we anticipate. Shareholder remuneration has significantly increased between 2021 and 2023 and remained sustained in

2024. While dividends of building materials issuers in the investment-grade category have increased by an annual average of about 15% since 2019, share buybacks tripled over the same period. If issuers do not scale down shareholder remunerations, they could face tighter rating headroom. We recently lowered our rating on Geberit AG to (A/Stable/--) from (A+/Negative/--) due to weakened credit metrics ahead of persistently high shareholder remuneration in a tough market environment. Private equity-owned issuers' financial leverage has worsened, reflecting the current downturn (see chart 17), and current ratings would be significantly pressured in the case of debt-funded dividends.

Rating pressure could also stem from debt-funded M&As. This is because these usually weaken companies' financial leverage. M&A activity has been exceptionally high in 2024, namely in the investment-grade rating category, and it involved both large transactions (such as those made by Compagnie de Saint-Gobain and CRH) as well as several bolt-on acquisitions (see table 1). We estimate that M&A spending for our investment-grade rated issuers will exceed €14 billion in 2024, from about €5 billion in 2023. We forecast that total M&A cash outflows will decrease in 2025, mainly because several issuers have consumed most of their rating headroom (see the "Credit metrics and financial policy" section), although M&A will remain elevated at more than €7 billion. Any additional debt-funded M&A cash outflows beyond our base case could weigh on companies' credit metrics and ratings. We think that speculative-grade companies have reduced capacity for M&A in 2025, absent any capital injection, because of their deteriorated financial leverage in 2023-2024.

Table 1

European building materials companies' large acquisitions announced or completed in 2024

Issuer	Acquired company	Description	Enterprise value	Completion date
Compagnie de Saint-Gobain	OVNIVER Group	Leading construction chemicals player in Mexico and Central America	$815 million (about €740 million)	First half 2025 (expected)
Compagnie de Saint-Gobain	CSR Ltd.	Leading building products company in Australia for residential and nonresidential construction	A$4.5 billion (about €2.7 billion)	July 2024
Compagnie de Saint-Gobain	FOSROC	Construction chemicals player with a strong geographic footprint in India, the Middle East, and Asia-Pacific	$1,025 million (about €960 million)	First half 2025 (expected)
Compagnie de Saint-Gobain	Bailey Group Companies	Manufacturer of metal building solutions for light construction in Canada	C$880 million (about €600 million)	June 2024
CRH PLC	Adbri Ltd.	Leading building materials business in Australia	A$2.1 billion ($1.4 billion) on a 100% basis	July 2024
CRH PLC	Assets from Martin Marietta Materials Inc.	Portfolio of cement and ready-mixed concrete assets in Texas	$2.1 billion	February 2024
Heidelberg Materials AG	Giant Cement Holding Inc.	Cement producer on the U.S. East Coast with a focus on using waste-derived fuels	$600 million	First quarter 2025 (expected)
Holcim Ltd.	OX Engineered Products, LLC	Leading U.S. provider of advanced insulation systems	Not communicated	End 2024 (expected)
Legrand S.A.	Davenham	Irish specialist in low-voltage power distribution systems for datacenters, including hyperscalers	Not communicated	June 2024
Rexel S.A.	Talley Inc.	Leading distributor of wireless infrastructure products and solutions in the U.S.	€431.5 million	June 2024

A$—Australian dollar. C$—Canadian dollar. Source: S&P Global Ratings.

We expect that M&A transactions will follow the same trends in 2025 as 2024. We anticipate that M&A transactions will continue to address geographic diversification, global long-term megatrends, and sector consolidation. Acquisition activity in 2024 has focused on the U.S., where the market is still fragmented and where we see higher growth linked with the reshoring of manufacturing capacities and significant infrastructure plans (see table 2). Acquisition activity has also focused on Australia where the market is also fragmented, and demographic trends are more favorable than in Europe. Most acquisitions addressed long-term megatrends such as decarbonization, digitalization, electrification, and energy-efficiency to meet sustainability targets in both the U.S. and Europe. However, announced divestments are focused on Europe and emerging markets, and on energy intensive businesses.

Table 2

Aggregate M&A spendings by issuers in 2024

Issuer	S&P Global Ratings' M&A spendings assumptions	Target size	Region	Transaction rationale
Adolf Wuerth GmbH & Co. KG	€500 million	Bolt-on	Europe	• Electrification
Buzzi SpA	€300 millions	Bolt-on	Latin America	• Geographic diversification
Compagnie de Saint-Gobain	€5 billion	Bolt-on and large deals	North America Asia-Pacific	• Geographic diversification • Sustainable housing • Decarbonization
CRH PLC	€5 billion	Bolt-on and large deals	North America Asia-Pacific	• Geographic diversification
Heidelberg Materials AG	€800 million	Bolt-on	North America	• Geographic diversification
Holcim Ltd.	€1.4 billion	Bolt-on	Europe North America Latin America	• Geographic diversification • Decarbonization
Legrand S.A.	€1.3 billion	Bolt-on	North America Europe Asia-Pacific	• Digitalization • Electrification • Geographic diversification
Rexel S.A.	€500 million	Bolt-on	North America Europe	• Electrification • Geographic diversification

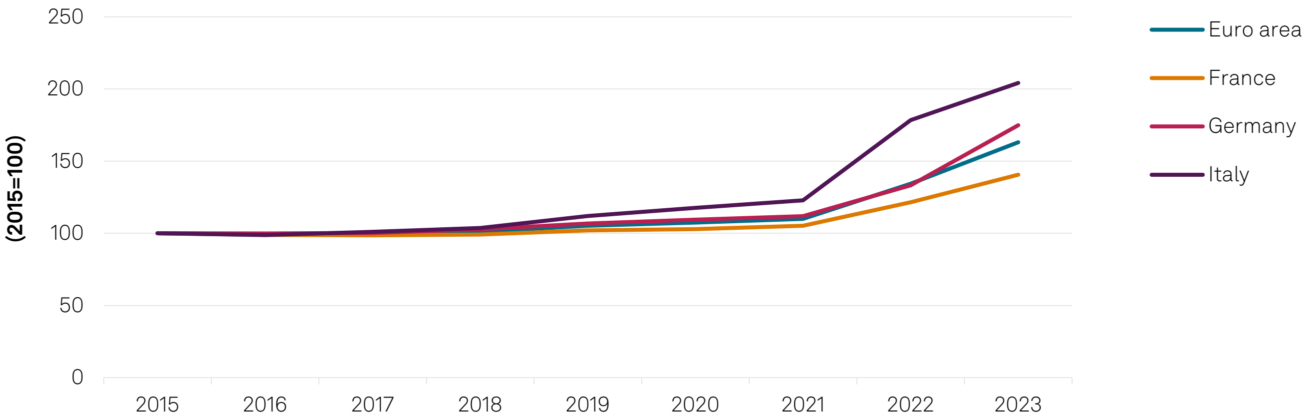
Source: S&P Global Ratings.

We continue to see decarbonization primarily as a risk for ratings. The building materials sector, particularly cement companies, accounts for about 7% of global carbon dioxide emissions. Building materials producers may face cost pressures in the EU because the EU's "Fit for 55" program will likely translate into a significant increase of carbon costs.

Annual carbon costs could account for 75% of EU cement companies' EBITDA on average. This is assuming a complete phase-out of allowances. However, this would not necessarily imply a permanent weakening of their profitability. This is because cement substitution alternatives are limited, and companies' pricing discipline in the market has significantly strengthened after the COVID-19 pandemic. For example, cement companies were able to significantly increase prices in most European countries in 2022-2023 to balance the surge of energy costs ahead of the Russia-Ukraine conflict (see chart 19). We think that large cement companies would be able to pass on much of the higher carbon costs that we anticipate in next few years, though with some time-lag. However, small issuers that display higher carbon emissions may suffer more.

Chart 19

European cement price trend 2015-2023 (index 2015=100)



Source: Eurostat.

Cement issuers' CCUS-related capex could materially increase. Companies could also be persuaded to delay their decarbonization agenda, in the absence of significant cofinancing from public bodies. A significant drop in emissions beyond 2030 can only be achieved by accelerating new carbon capture technologies. Only the leading cement manufacturers are currently at the forefront of carbon capture, utilization, and storage (CCUS) projects. We estimate that building a CCUS plant would cost about €500 million, but this may change depending on the technology used. In Europe, most companies' CCUS projects have been cofinanced by the EU or by single countries. Heidelberg's Brevik CCS project in Norway is the most advanced, and it reached mechanical completion in 2024; this project is part of the Norwegian government's Longship initiative and has been awarded €131 million from the European Commission. Other CCUS projects in the EU are underway, such as Cementir Holding N.V.'s project in Denmark, which has been selected to receive €220 million in project support under the EU Innovation Fund. Holcim also has several ongoing CCUS projects in Belgium, Croatia, and France, among others. European cement players are also pursuing decarbonization projects in the U.S., where there is not a federal carbon regulation, and instead public bodies seem to prefer facilitating the decarbonization of cement and other hard-to-abate sectors though granting subsidies. For example, Heidelberg expects to receive up to $500 million of funding from the U.S. Department of Energy for its largest CCUS project in Indiana, U.S. by 2030. We think that the public financial support remains essential to meet companies' decarbonization agenda, at least until new carbon abatement technologies prove financially viable to companies.

The residential construction market's recovery could be delayed. This is because of a lack of fiscal grants to households. In our view, the large-scale implementation of country and European legislations that address energy savings in buildings will request significant financial support to households, particularly low-income households. This is because most building materials and products' prices have considerably increased since the pandemic. According to Eurostat, cement prices in the eurozone area have increased by over 60% after the pandemic on average, and prices of many other products, such as roof tiles and windows, have increased by more than 50%. This contributed to keeping prices for residential homes high, notwithstanding the sector downturn, which raises concerns about affordability. Absent consistent and prolonged tax incentives in major European countries, we think that recovery could take much longer than expected.

Industry Outlook: Latin America

Ratings trends and outlook

S&P Global Ratings expects ratings stability for most Latin America (LatAm) building materials rated entities in 2025. Only one entity in Peru is under negative outlook due to tighter liquidity management. At the end of 2024, a third of the portfolio is rated at investment-grade (at 'BBB-' or above), while 56% of the portfolio relates to speculative-grade ratings, all of which are in the 'BB' rating category, and one entity is currently in default.

Our baseline assumptions suggest tougher business conditions in 2025 for the building materials sector in LatAm due to our expectation of softer economic growth in the region's largest countries, a high comparison base from 2024 in several markets, and still significant downside risks to our forecast. These factors will likely result in mixed results for LatAm building materials companies. We expect the Brazilian building materials sector will continue to grow, although at a softer pace than in 2024. In Mexico, we anticipate the sector to face a mild contraction due to a slowdown in nonresidential infrastructure projects. In other markets like Peru, Colombia, and Argentina, we forecast a modest uptick in construction activities thanks to the ongoing economic recovery. Our baseline assumptions also include steady remittances and stabilized inflation in most LatAm countries which should contribute to the informal housing sector. Finally, we anticipate profit margins to remain broadly stable in LatAm in 2025, as long as input costs inflation are controlled, because rated entities have lesser capacity to hike their prices significantly following recent years of inflation on most building materials products.

However, we remain cautious, and we will likely revise our forecast through the year because several local and global downside risks surround our sector baseline assumptions in the region. Uncertainty regarding the effect of several domestic and global trade policies could undermine investor sentiment, weaken private fixed investments, and worsen financing conditions in LatAm. Additional downside risks include global geopolitical conflicts that could cause disruption in supply chains and increase energy and transportations costs globally, and the risk of climate change and more frequent natural disasters, among others. Those risks could affect rated entities earnings, profit margins, cash flows, and credit metrics beyond our current estimate, if they materialize or intensify.

Main assumptions about 2025 and beyond

1. Modest, although uneven, growth expected across countries.

We expect soft and mixed results for building materials companies in LatAm because macroeconomic conditions and political landscapes vary across countries.

2. EBITDA margins should remain broadly stable in 2025.

We anticipate a stabilization of EBITDA margins due to limited revenue management capacity beyond inflation and a still fierce competitive environment in most markets.

3. Overcapacity in the region suggests limited need for large investments.

We forecast capex to remain at 4%-5% of revenues.

Our baseline assumptions for the building materials sector in LatAm suggest modest growth. Although this will be uneven across countries. We expect the LatAm region to grow at 2.1% in 2025 and 2.2% in 2026, from 1.5% in 2024, although with several disparities across the region. Inflation should be controlled, and credit conditions should remain resilient.

- **In Brazil**, we forecast GDP growth of 1.9% in 2025, from 3.1% expected in 2024. We anticipate the building materials sector to keep growing although at a softer pace than in 2024. Supporting factors include the government housing program that increases demand in the low- to mid-income segment and a large backlog of infrastructure projects under the New Growth Acceleration Program. The program's progress has been below expectation so far. In early 2025, we expect another hike in the interest rate from the central bank to contain inflation, which we think could negatively weigh on the high-income residential sector, and therefore on the sector's growth. We also think that the competitive environment in Brazil will remain fierce, limiting price increase at inflation.
- **In Mexico**, we anticipate a mild contraction in the building materials sector, before potentially rebounding in the medium to long term (2026-2028). In our view, the sector will face several challenges in 2025. These include a high 2024 comparison base, softer GDP growth at 1.2% from the 1.5% expected in 2024, and lower fixed investments most likely due to the uncertainty from the trade relationship with the U.S. and the lack of clarity on the implications from several domestic policies such as the changes to the judicial system, as well as lower public spendings as the government targets to control the fiscal deficit. Still, our base case suggests a hike in housing starts due to the government's new housing policy, and steady remittances coming from the U.S. that support the informal housing sector, although not enough to offset the expected decline in infrastructure projects.
- **In Peru**, the building materials sector has shown a gradual recovery in the second half of 2024, and we expect this trend to continue in 2025 thanks to better economic activities. We anticipate GDP growth of 2.8% in 2025, from 2.9% expected in 2024, supported by pension fund withdrawals and a rebound in primary exports. Thus, we expect private investments in residential and nonresidential sectors to recover as the economy increases and new infrastructure projects begin.
- **In Colombia**, the building materials sector faced a complex 2024 in both residential and nonresidential construction activities. We expect investments to continue to slowly recover in coming quarters, however, we are cautiously prudent about the sector's growth in 2025. We think that construction activities have bottomed out in 2024 and anticipate that the sector will only increase slightly in 2025.
- **In Argentina**, the economy returned to sequential growth in the third quarter of 2024, and we expect some momentum to flow into year-end 2024 and into 2025. We forecast GDP growth of 3.8% in 2025, after an anticipated contraction of 3.5% in 2024. We still expect challenging business conditions for the building materials sector in 2025, but with some uptick potential in the second half of the year if public policies favor fixed investments and new infrastructure projects. However, we expect the housing sector to modestly rebound thanks to lower interest rates and mortgage financing availability.

EBITDA margins should remain broadly stable in 2025. LatAm building materials companies' EBITDA margin stabilized in 2023-2024, following the decrease from 2022, thanks to their price pass through ability and resilient demand. However, we think that the level of price increase seen in the past two years is unsustainable because of lower disposable income in the region, a still high interest rate environment, and a fierce competitive environment in major LatAm countries. As a result, we expect rated building materials entities to act prudently in terms of pricing strategies to protect volumes and market shares. Thus, for 2025 onward, we expect margins to remain broadly stable due to limited additional price increase capacity above inflation.

Overcapacity in the region suggests limited need for large investments. We estimate that capex will remain at about 4%-5% of revenues on average in LatAm. The low capex needs reflect our view that companies will operate with moderate utilization rates given the current macroeconomic environment and high level of uncertainty on global trade activity and local political reforms.

Credit metrics and financial policy

We expect a broad continuity in terms of financial policies for rated building materials entities, particularly in terms of capital deployments (investments and shareholders' rewards). We think that most of LatAm's rated companies have the financial flexibility to absorb high-impact, low probability events while maintaining resilient credit quality, in most cases. This is possible because most rated entities start 2025 with strong balance sheets, including leverage within 2.0x-3.0x on average, or below in some cases, and with ample liquidity positions and limited financing needs in 2025, as capex growth plans and debt maturities are limited. Shareholders' rewards, in the form of dividends or share buybacks, will remain subject to leverage tolerance and FOCF generation.

In 2024, some LatAm players reconfigured their geographic footprint through noncore asset divestments (like Cemex S.A.B. de C.V. and Votorantim Cimentos S.A.), while others took the opportunity to consolidate their presence in the region like Cementos Progreso S.A., Holcim, Sika AG, Martin Marietta Materials Inc. In 2025, we expect a few more divestments and M&A transactions in LatAm, although neutral from a credit standpoint.

Key risks or opportunities around the baseline

1. Domestic and global trade policies threaten growth.

Political, economic, and trade tension risks remain high in LatAm. The risks could undermine building materials companies' growth trajectories and credit quality if investors' sentiments and fixed investments weaken beyond our expectation, despite the large housing deficit and infrastructure needs in all LatAm countries.

2. Adverse weather conditions and geopolitical risks are elevated.

Building materials entities are exposed to more frequent and higher intensity adverse weather conditions that could affect the sector's growth outlook. LatAm economies and the building materials sector could also indirectly be vulnerable to an escalation of geopolitical conflicts.

3. Persistent lack of carbon dioxide regulation in LatAm, although rated companies are moving forward.

Most rated building materials entities are progressing according to their 2030 targets, with limited investments requirements. The path to carbon neutrality will be long and likely more expensive beyond 2030.

The building materials sector's growth outlook could be challenged. Including by several domestic reforms; tougher macroeconomic conditions; and, to a lesser extent, by increasing trade protectionism maneuvers. While still uncertain and difficult to quantify at this point, we think that domestic policies and global trade uncertainties pose significant downside risks to the region's economic growth, and to our forecast for the sector. In our view, political and economic risks could lead to weaker fixed investments, higher inflation, and tighter financing conditions. Ultimately, this could result into a contraction in nonresidential and residential construction activities in the region, despite the large housing deficit and infrastructure needs in all LatAm countries. In such a scenario, we would expect a deterioration of building materials companies' operating and financial performances beyond our current estimates, and into a likely erosion of credit quality.

- **In Mexico**, the threat of changes to the United States-Mexico-Canada Agreement, scheduled for review in mid-2026, could delay fixed investments decisions. Second, U.S. immigration policy toward Mexico is also likely to be contentious under the incoming U.S. administration, which could influence proposed changes in trade policy and weaken investments, as well as remittances. This would have direct negative effects on Mexico's building materials sector. And third, recently approved Mexican reforms—such as changes to the judicial system—could also delay investment decisions until there is more clarity on the implications of those bills.
- **In Brazil**, if macroeconomic conditions deteriorate amid a higher interest rate environment to control inflation, then we think this could take a toll on construction activities, as it would directly affect household disposable incomes and mortgage rates, while infrastructure projects could progress at an even slower pace than expected.
- **In Peru**, the political environment has been extremely volatile in recent years, and any heightened political turmoil and/or economic shift from the expected ongoing economic recovery could results io weaker-than-expected investments in infrastructure projects and housing activities, undermining building materials companies' operations.
- **In Colombia and Argentina**, downside risks to our growth outlook remain elevated. The construction sector remains exposed to political and economic risks amid uncertainty over several reforms proposed by President Gustavo Petro in Colombia, while foreign reserves remain very low, and exchange rate policy is highly uncertain in Argentina.

We are also monitoring the risk of potential upward tariffs for exported goods to the U.S. The vast majority of LatAm building materials are produced and sold locally, thus we think that consequences of direct upward tariffs is limited and contained in the building materials sector. Only a small portion of revenues, if any, are oriented to exports activities as companies tends to be vertically integrated in countries they operate in. Broader macroeconomic effects and a potential erosion of financing conditions, from disruptive trade policies could inevitably affect the state of play for building materials companies in LatAm.

The LatAm building materials sector is exposed to more frequent climate-related events. Including events related to climate change and more frequent natural disasters. There have been an increasing number of climate disasters in the region, including hurricanes, droughts, and floods, among others. We think that these extreme events could resurge with higher frequency and intensity, resulting in delays in construction activities in the LatAm region, ultimately affecting building materials companies' top-line growth.

Secondary effects from global geopolitical tensions could affect performance. The LatAm building materials sector's operating and financial performance could be indirectly affected by the Israel-Hamas and Russia-Ukraine conflicts that will likely linger into 2025. Escalations in the conflicts could cause disruption in supply chains and the production of important commodities. In our view, energy prices and transportation costs, which are important input costs for building materials companies, could increase if the Israel-Hamas was intensifies and spreads across oil-producing countries in the Middle East. These input costs could hamper a continuous stabilization in operating margins, cash flows, and credit protection measures.

Carbon dioxide regulations remain limited in LatAm. However, most rated entities are moving to decarbonize their operations to prevent longer-term operating and financial risks. In LatAm, we see limited progress from governments on carbon dioxide regulations due to the reality of local economies and social state of play, and consequently political agendas. Although the timing is still hard to predict, we think that it may change in the longer run. Nonetheless, most rated companies, particularly those that have a footprint in mature markets are proactively reducing their carbon dioxide emissions with production plants by plants roadmaps. For 2025, we think that budgeted investments for decarbonizing operations will remain manageable and will not deteriorate key credit metrics. Instead, these investment initiatives could become a crucial competitive advantage. Smaller players that make relatively slow progress in reducing emissions could suffer in the longer term, particularly if regulations are enforced and become stricter.

Industry Outlook: Asia-Pacific

Ratings trends and outlook

The outlook on the ratings of most of our rated building materials companies in Asia-Pacific are stable. Our rated companies' leading competitive position in their respective countries and sufficient financial headroom should help them manage industry headwinds and keep their creditworthiness steady.

We have put the outlook of one building materials company in China on negative in 2024. This is mainly due to the higher financial burden of the rated company's parent. The rating on our rated issuer is linked to our assessment of the parent's credit profile. All other rated companies' ratings remain unchanged supported by their financial discipline to offset demand uncertainty and profitability pressure.

Considering the slow recovery of China's property market, China-based producers will likely endure another tough year. Demand for building materials will remain subdued after a sluggish 2024. Demand for building materials in South Korea will remain under pressure. The overall construction sector sentiment remains weak with sluggish demand.

Main assumptions about 2025 and beyond

1. Stagnant downstream demand will continue to pressure demand recovery for building materials in China.

There will not likely be a meaningful recovery in demand in 2025 due to weak homebuyer confidence. We expect a further decline of property sales in 2025. The sector may only stabilize toward the second half of 2025. This means the number of new constructions will remain low and demand for building materials will remain sluggish. In addition, China's infrastructure investment growth will continue to moderate over the next 12 months with the government's focus on debt risk resolution.

2. The Korean market will likely see weak momentum due to slow construction demand.

The weak construction demand trend will continue into 2025, due to slow construction starts year-to-date in 2024, higher costs, and the weak property market. Despite some tailwinds such as interest rate cuts and property market strengths in Seoul metropolitan areas, the broader property market is likely to remain under pressure.

China-based building materials producers may endure another sluggish year in 2025 due to ongoing weakness in downstream demand, after a challenging 2024. We do not expect a meaningful recovery for the sector in 2025 as it continues to suffer from the fragile recovery of the Chinese property sector.

China's property sales could only stabilize toward the second half of 2025. However, that will depend on the government's continued support for funding conditions for developers and efforts to reduce inventories. S&P Global Ratings' property team estimates national property sales will further decline to Chinese renminbi (RMB) 8 trillion-RMB8.5 trillion in 2025, after declining to about RMB8.5 trillion-RMB9 trillion in 2024.

Structural obstacles still hinder major recovery in China's property market. The change in market structure with an increasing share of secondary-market sales and declining presale model will pressure new construction starts. China's new housing construction area decreased by 23% year on year in the first 10 months of 2024. Fewer new construction activities will translate into an extended low demand for building materials and keep prices under pressure.

Due to weak demand, the average price of cement experienced a year-on-year decline of 7.2% over the first three quarters of 2024. The cement output decreased by 11%, the lowest in the same period since 2010. Even under moderating coal prices, the total profit of the cement industry dropped by 65% over the same period.

China's infrastructure investment growth will moderate over the next 12 months. We expect infrastructure spending will stay substantial, to meet national strategies on strengthening the transportation system, energy transition, disaster prevention, and reconstruction after disasters. That said, the central government is increasingly selective in approving new projects. Also, authorities have mandated highly indebted local governments to focus on debt risk resolution.

We expect the demand for building materials in South Korea will remain soft. This is due to the weak property market. That weakness will extend to the construction market in 2025, with low construction starts and poor consumer sentiment. While there was some property market strengthening in Seoul metropolitan areas, in terms of both pricing and transaction volume in 2024, it was specific to certain areas. The broader regions and regional cities are still under meaningful pressure with limited improvement. Ongoing interest rate cuts by the Bank of Korea are a tailwind to the property market, but the government's tighter lending regulations will likely temper the effect to some degree.

Credit metrics and financial policy

We forecast that the credit metrics of our three rated companies will remain resilient in 2025. The satisfactory competitive position and sufficient financial headroom of most rated building materials companies in Asia-Pacific will help them manage demand and keep financial performance steady.

There is a diverging outlook for the two building materials companies we rate in China.

Anhui Conch Cement Co. Ltd. (Conch, A/Stable/--) has a solid balance sheet. It also has ample cash on hand to protect it against a potential extended weakness in the demand for building materials. The company's leading position in China's highly competitive cement market with effective cost control allows it to maintain more resilient performance compared with peers.

BNBM (A-/Negative/--) will maintain a minimal leverage. This is supported by its healthy earnings and cash flow attributed to the company's dominant market position in the gypsum board market, with strong pricing power and the ability to pass-through costs. The recovery of demand for gypsum board may fare better than that of cement, with support from rising renovation needs stemming from increasing secondary market sales.

Our outlook on Beijing New Building Materials Public Ltd. Co. (BNBM) is negative. This is due to the weakening credit profile of its parent China National Building Material Group Co. Ltd. (CNBM). The prolonged industry downcycle will strain CNBM's earnings and profitability. CNBM is a diversified building materials producer but focuses on cement. BNBM is a core subsidiary of CNBM and the rating on the company is linked to our assessment of the parent's credit profile.

We expect margin recovery for the China-based players could be gradual. Even under moderating coal prices. We expect domestic coal prices to decline over the next two years on loosening supply and weakening demand due to rising substitution from renewable energy. Yet, sluggish demand in China could continue to weigh on building materials prices.

Chinese rated companies will be disciplined in spending amid weak industry conditions. We expect that companies' financial policy will remain prudent and will refrain from aggressive expansions. A major deterioration in these companies' credit metrics is unlikely as both companies have a solid balance sheet with ample cash on hand.

We expect KCC Corp. (BB+/Stable/--) will likely maintain a steady operating performance. Even under a weaker market situation in 2025. This is largely thanks to the company's strong pricing power in the building materials sector, which helps them sustain profitability amid modest revenue growth. KCC holds a leading position in South Korea's domestic building materials market and has the largest domestic market shares in coating and gypsum boards.

Healthy growth of the coating materials business and recovery of silicone earnings should also support KCC's steady performance in 2025. We expect a gradual improvement in the company's leverage burden in terms of debt to EBITDA in 2025-2026, compared with 2024.

Key risks or opportunities around the baseline

1. A fragile path to stabilization of the property market in China hinders demand recovery.

The Chinese building materials sector's largest downside risks result from the property sector. A further slump in the property sector will hit the resumption of construction activities. This could exacerbate the already challenging operating conditions in the building materials sector, which struggles with low demand and a limited ability to pass on costs.

2. Upcoming inclusion of cement production in China's national carbon emission trading scheme will benefit industry leaders.

Our rated entities are industry leaders and should fare better compared with peers when the scheme is officially launched. This is due to their lower carbon emissions and more sufficient financial capacity to comply with environmental upgrades and transformation. An elimination of peers with high emission could accelerate further shrinkage of production capacity and may ease oversupply.

3. Weak property markets in the regional cities is a risk to the Korean building materials sector.

Korean domestic construction markets remain sluggish, and the polarizing trend in the property markets between the Seoul metropolitan area and regional cities continue. These could drive down the domestic construction project starts further, which, in turn, will weaken the demand for the building materials market, especially in the private sector.

The fragile path to stabilization for China's property sector remains the biggest risk. This sector accounts for over one-third of the nation's cement usage. Our base case assumes the property market could stabilize toward the second half of 2025 if the government further supports developers' funding conditions and continues to help destock inventories. However, failure to boost homebuyers' and developers' confidence could result in an ongoing weakness with low land acquisition and new construction activities.

China plans to include cement production in the national carbon emissions trading market. This would be beneficial for industry leaders. While the quotas will be delivered to cement makers cost-free at the initial stage before 2026, we think that Conch's good cost structure will be better positioned than its peers to absorb additional cost when the carbon quota starts trading at cost at a later stage. Building materials industry leaders are also more likely to benefit from the introduction of carbon pricing based on their lower emission and an associated acceleration of industry consolidation. Those that cannot meet national standards will likely shut down or be acquired by stronger players who can meet the standards.

Conch's solid balance sheet means the company has ample financial resources to invest further in technological upgrades and research and development for lowering emission and energy saving. The company could also promote replacement of alternative raw materials and fuels, such as solid waste, and increase the utilization of new energy.

We expect the new policy would pressure weaker player as they already struggle with an extended period with weak profitability. Weaker peers may be eliminated, aiding China in achieving its plan of reducing total cement production capacity to 1.8 billion tons by 2025 from 2.1 billion tons. An acceleration of eliminating excess capacity could help to ease oversupply and improve industry dynamics.

We forecast the key risk in the Korean market to be property market weakness. The polarizing trend in the property market in the Seoul metropolitan area and regional cities will likely continue into 2025, as we see limited recovery in the regional areas. This could lead to a weaker demand from regional construction companies, especially in the private sector. Prolonged property market weakness, which leads to lower number of new constructions starts, will pose downside risks to the building materials demand. Also, potential risks associated with project financing loans and the weaker credit quality of small and midsize construction companies could represent additional downside risks.

Related Research

- S&P Global Ratings Metal Price Assumptions: Prices Hold Steady Despite Headwinds, Oct. 16, 2024
- Beijing New Building Materials Outlook Revised To Negative On Weakening Industry Dynamics; 'A-' Rating Affirmed, July 8, 2024
- Decarbonizing Cement Part One: How EU Cement Makers Are Reducing Emissions While Building Business Resilience, Oct. 27, 2022
- Decarbonizing Cement Part Two: Companies Could See Pressure On Ratings As The EU Firms Up Carbon Rules, Oct. 27, 2022

Industry Forecasts: Building Materials

Chart 20

Revenue growth (local currency)

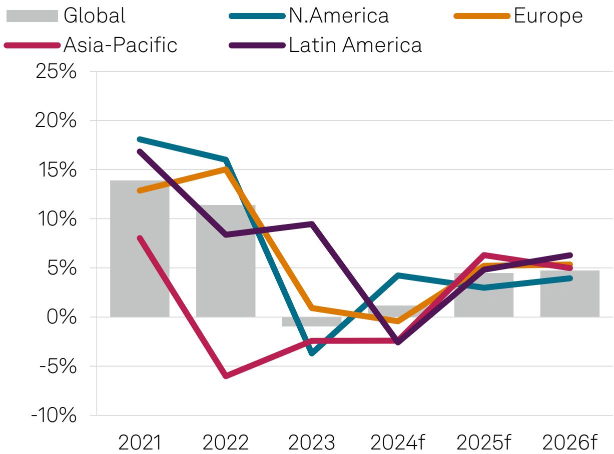


Chart 21

EBITDA margin (adjusted)

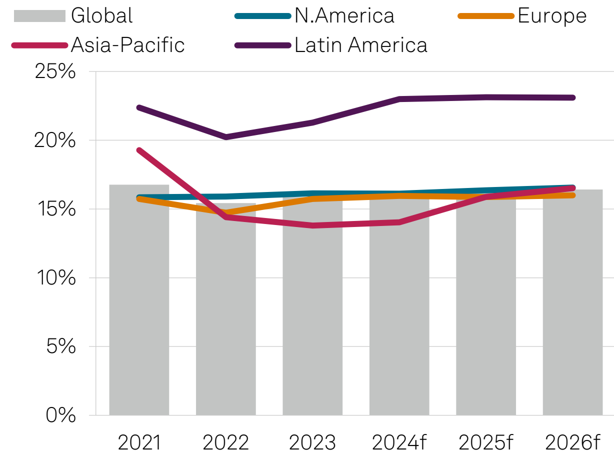


Chart 22

Debt / EBITDA (median, adjusted)

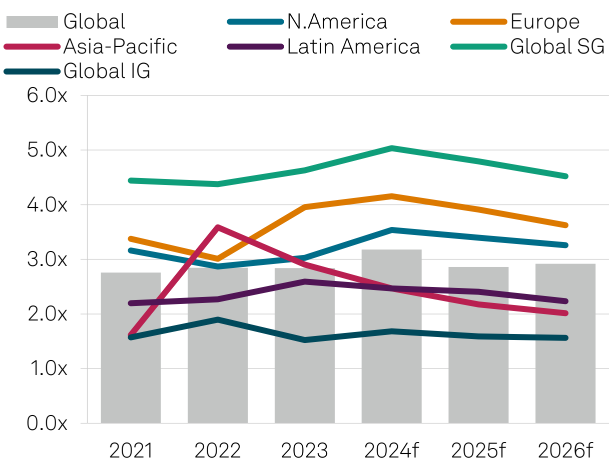
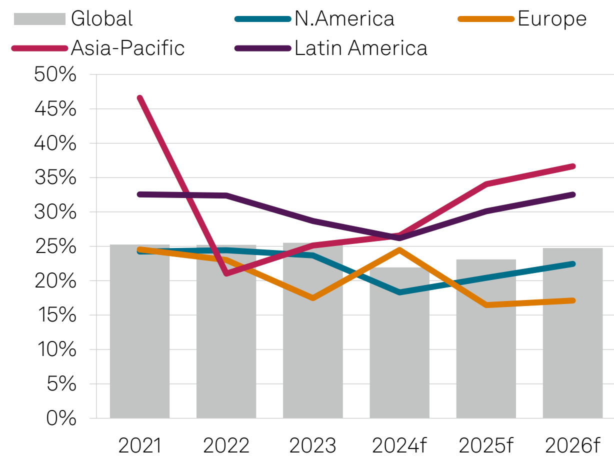


Chart 23

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Building Materials

Chart 24

Cash flow and primary uses

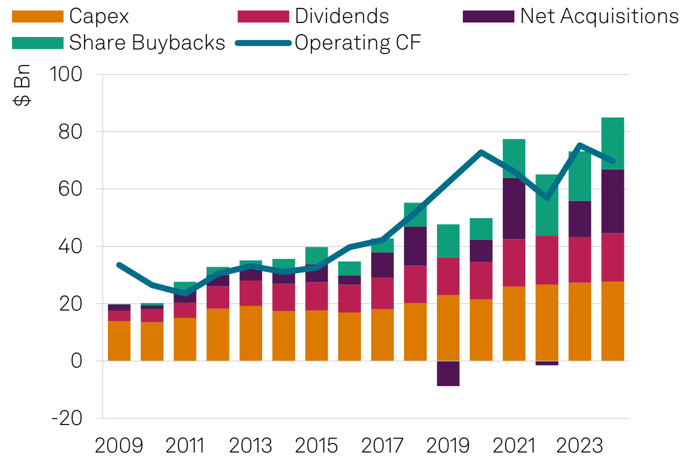


Chart 25

Return on capital employed

Chart 26

Fixed- versus variable-rate exposure

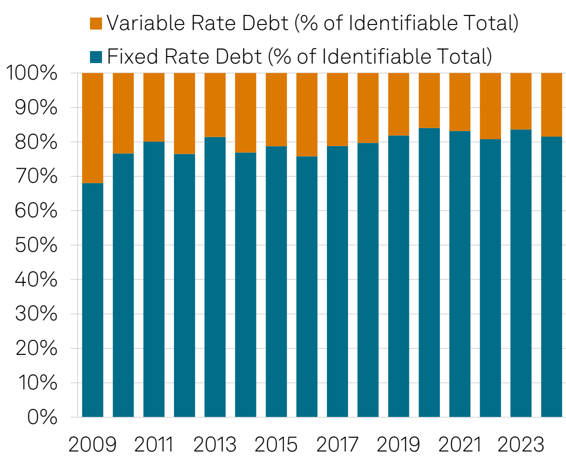


Chart 27

Long-term debt term structure

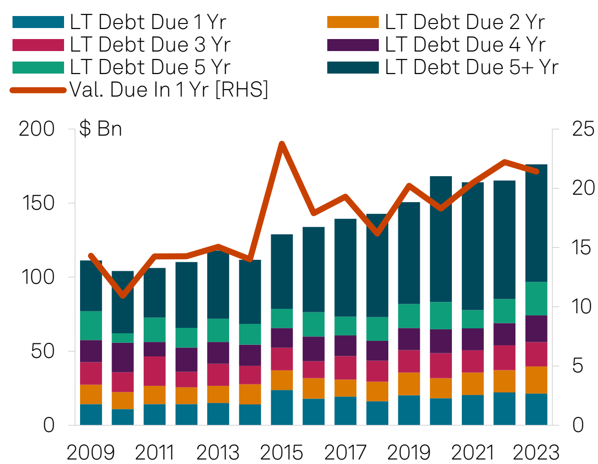


Chart 28

Cash and equivalents / Total assets

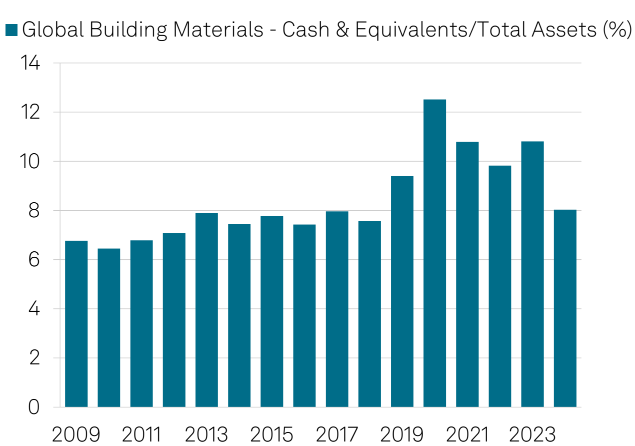
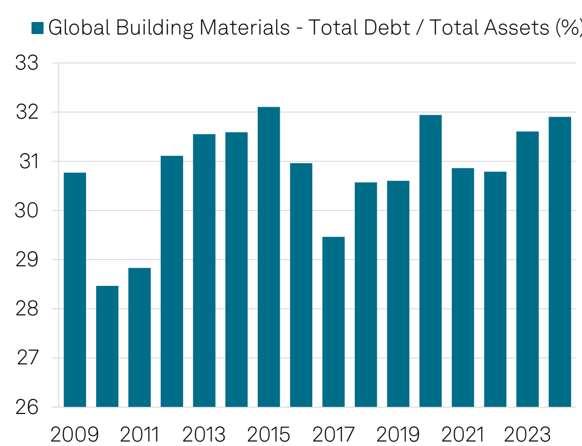


Chart 29

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Capital Goods

Global friction could grind down growth in 2025

January 14, 2025

This report does not constitute a rating action.

What's changed?

U.S. spending priorities set to shift. Up to two-thirds of U.S. Inflation Reduction Act (IRA) and CHIPS Act funds could be spent/committed before the new administration is in place, so capital goods industry growth looks good for 2025. But some investment plans are being reconsidered.

Energy transition remains a key support in EMEA. Investments in energy infrastructure gained momentum, supported by the data center boom and orders from grid operators, which have an estimated investment need of more than 600 billion euro in grid infrastructure by 2030.

Shifts in economic policies weigh on issuers in Asia. A new U.S. administration could affect business sentiment in Asia, where demand is already slow. U.S.-China friction, including potentially more tariffs, could weigh on the profits of rated exporters and deter investment.

What are the key assumptions for 2025?

Revenue rebounds after 12-18 months of destocking. Modest global capital expenditure (capex) growth could help boost industry revenue growth into the mid-single digits.

Steady costs and margins support robust ratios. Three years of good industry conditions support credit stability, but debt load is higher after a cautious few years.

What are the key risks around the baseline?

Higher-for-longer interest rates push off spending and hamper refinancing. Rates remain elevated despite recent central bank cuts, which could affect the economic rationale or funding for large investments or cause distress for smaller, highly leveraged issuers.

Tariffs or supply chain turmoil increase costs or disrupt demand. Capital goods companies around the world showed good cost pass-through under tariffs in 2018 and supply chain disruptions 2021-22, but pricing power will likely weaken if demand slows.

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Ratings Trends: Capital Goods

Chart 1
Ratings distribution

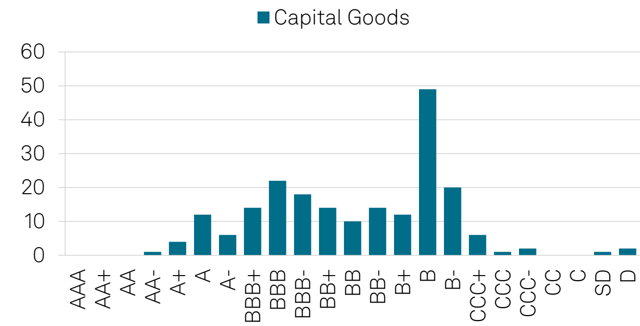


Chart 2
Ratings distribution by region

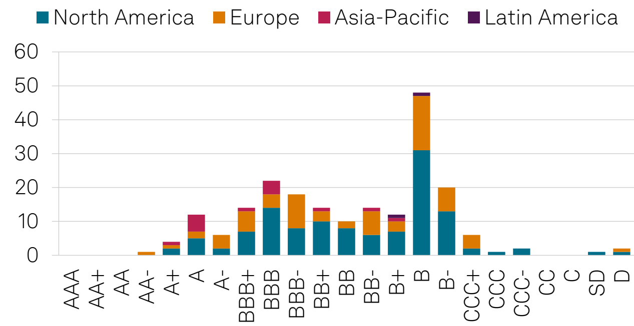


Chart 3
Ratings outlooks

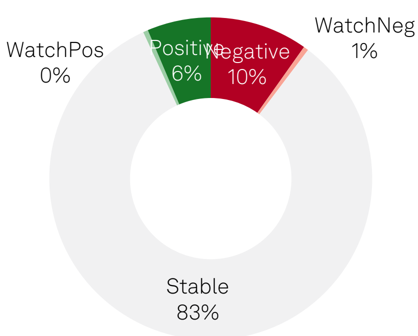


Chart 4
Ratings outlooks by region

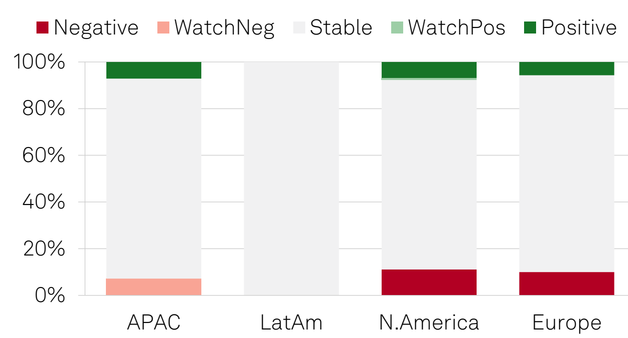


Chart 5
Ratings outlook net bias

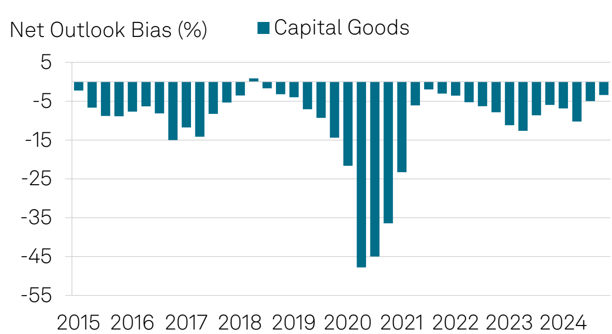
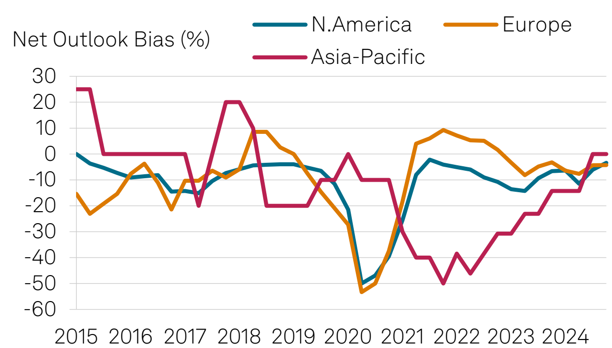


Chart 6
Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

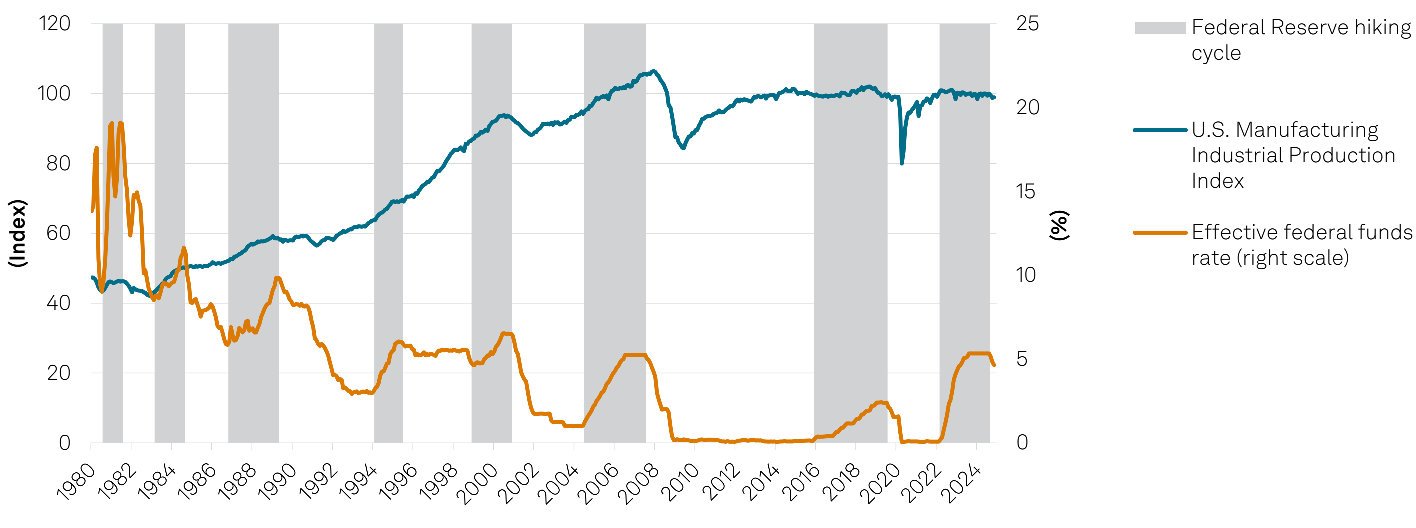
Credit quality in global capital goods looks steady and robust heading into 2025. Upgrades outstripped downgrades around the world in 2024, and the negative outlook bias is nearing a decade low of only 5%. Overall, less than 10% of ratings have a negative outlook and only about 5% have a positive outlook, indicating that only 2%-3% of ratings might change in 2025. Our credit outlooks around the world have converged to a 5% negative bias, as negative pressure in Asia-Pacific (APAC) eased, while North America and Europe, the Middle East, and Africa (EMEA) held steady through 2024. Most of that negative bias, however, remains among the smaller, highly leveraged issuers, which only represent about 20% of the rated debt in the portfolio. We use outlooks to signal at least a one-in-three chance of a rating change with 12 months for speculative-grade issuers and up to 24 months for investment grade.

Destocking has run longer than expected, and it continues. Revenue growth slowed to almost 0% in 2024 compared to our 2% forecast in last year's Industry Credit Outlook, as destocking persisted throughout the year, so earnings basically held steady year-over-year. Low credit spreads contributed to a $40 billion jump in investment-grade debt levels in the second half of 2024, which increased the industry's debt leverage heading into 2025. That said, we forecast those debt levels to drop by $30 billion in 2025, indicating that much of the new debt is being used to refinance near-term maturities.

Interest rates have started chilling demand, but backlogs still look good. Companies cited the impact of interest rates on investment decisions in late 2024, although we believe any spending caution is also motivated by the U.S. administration change and geopolitical instability. Multiyear investments from decisions in 2022 and 2023 supported growing revenues and earnings, offsetting typical headwinds we'd expect by now from the sharp rise in interest rates. It takes time for firms to adjust capex budgets, so any capital goods demand weakness could lag the interest rate cycle peak in 2023 and 2024 by a year or two, which could be 2025 or 2026. In most cases since 1980, manufacturing was flat or declined in real terms within a year or two of finishing a rising rate cycle (see chart 7).

Chart 7

Tighter monetary policy typically cools U.S. manufacturing production with a lag



Data through November 2024. Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis.

Credit buffer holds steady heading into 2025. Steady EBITDA in 2024 and cautious decisions around shareholder returns and mergers and acquisitions (M&A) leave most capital goods companies around the world with good buffer in credit ratios for a cyclical downturn. We forecast a bounce in revenue in 2025, supported by long-dated spending decisions. Considering current ratio buffer and growing credit strength since 2021 for issuers rated 'BB' and higher, a cyclical downturn would need to coincide with more aggressive debt usage to affect many ratings in the next year or two. Issuers rated 'B' and lower likely need continued good financial performance to ensure a smooth path to refinancing.

Defaults remain low, but refinancing risk looms for leveraged issuers. Four capital goods issuers defaulted around the world in 2024, which is only about 1.5% of the global portfolio. These companies were all sponsor-owned leveraged buyout (LBO) firms with high leverage. That default rate is lower than the overall trailing 12-month speculative-grade corporate default rate of about 4% as of September 2024. On the other hand, two-thirds of the negative outlooks in the industry are among companies we rate 'B' or lower, highlighting refinancing risk in 2025 and 2026 if they miss their profit targets or if interest rates remain elevated.

The outlook bias is positive among investment-grade and crossover credits. Large global companies like Mitsubishi Heavy Industries, Trane Technologies, Carrier Global, and Packaging Corp. of America all have positive outlooks, which could portend some rare upgrades among 'BBB' and 'BBB+' rated issuers. In contrast, 3M is the largest issuer in the capital goods portfolio with a negative outlook, after incurring large settlements and spinning off its health care division. In addition, a cluster of potential fallen angels (KION Group AG, Prysmian, and Leggett & Platt) are rated 'BBB-' with negative outlooks.

Main assumptions about 2025 and beyond

1. Global business spending and capex support higher revenue in 2025.

Destocking flattened global capital goods revenue growth to below 1% in 2024. Capital spending across all industries in the U.S. looks robust, potentially growing 4%-5% in 2025, a bit slower in EMEA at 3%-4%, and only 1%-2% in APAC. That said, issuers remain cautious in early 2025 owing mostly to uncertainty around U.S. trade and investment policies, which could have a significant impact on revenue and costs.

2. Solid demand enables cost pass-through, even if tariffs rise.

Revenue tailwinds and steady operating costs could enable about 40 basis points (bps) of EBITDA margin expansion to a decade-high 17.7%. The tariff impact of various proposals could pressure input costs again, but we assume good pass-through that mostly neutralizes the effect. In a scenario of steady costs and slow-growing revenue, manufacturing free cash flow still needs to fund growing working capital before seeing more free cash flow.

3. Ratio buffer is solid for midcycle conditions.

Many capital goods companies around the world have been on a cautious footing since 2023 when interest rates started rising. Industry conditions have been better than expected while debt usage for corporate development has been moderate. Debt levels rose in 2024 to prefund maturities, so global median debt leverage rose to 3.1x from 2.9x year-over-year. Some debt paydown and rising EBITDA should bring that back to 3x in 2025.

Demand looks good heading into 2025. We expect the completion of large projects will drive equipment purchases that support revenue growth for capital goods companies. The 12-18 month phase of destocking could be closing, and S&P Global Market Intelligence's Purchasing Managers' Index (PMI) surveys indicated global business activity expanded for a thirteenth straight month in November. At the same time, the PMI indicates U.S. manufacturing remained in contraction most of 2024, but the global PMI has been aligned with 2% GDP growth most of the year. Consequently, capacity utilization in U.S. manufacturing continued to drift lower in late 2024, according to the Fed's Industrial Production and Capacity Utilization measure. Also, the service PMI has been running ahead of the manufacturing PMI, which highlights the trend of cautious new investment we've seen most of 2024, supported by good parts and service demand. That said, manufacturing is bouncing back with a lift from replenishment in the U.S., linked in part to stocking up ahead of possible tariffs. S&P Global Market Intelligence's PMI also shows that inflation pressures remained near a four-year low because of softer labor markets, lower input costs, slow growth in goods prices, and few supply shortages.

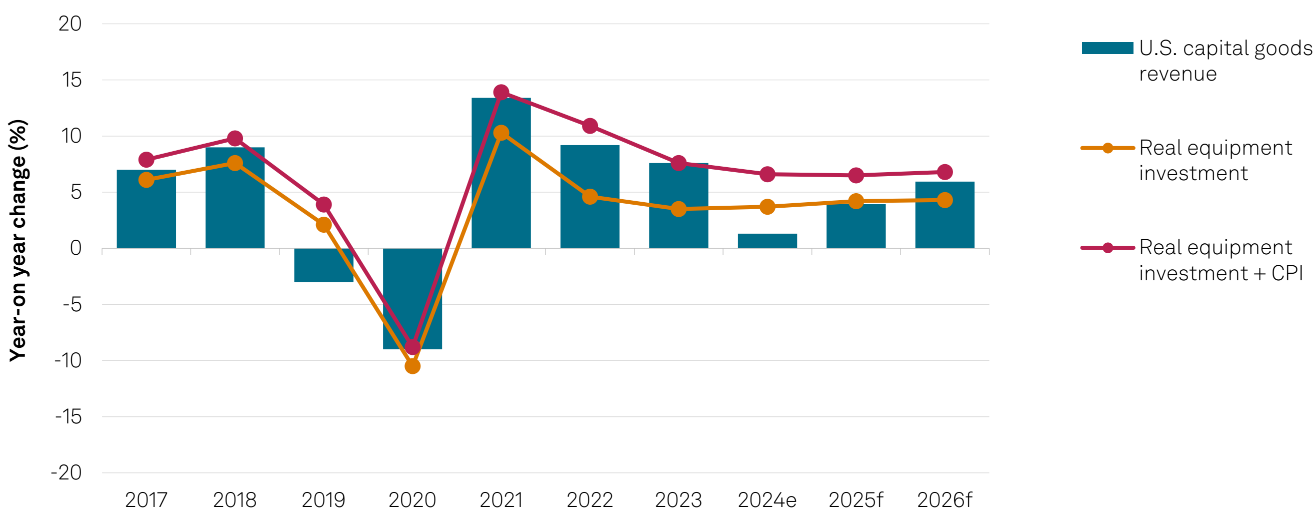
Our economists forecast U.S. GDP growth to slow gradually to 2% or below starting next year. The eurozone will continue its gradual recovery in 2025 to reach its potential growth rate, while China's growth will slow toward 4% as the U.S. tariffs weaken exports and investment. Our economists forecast at least 4% U.S. real equipment growth in 2025 and 2026, which should enable mid-single-digit revenue growth if companies can pass through small price increases.

Key U.S. economic indicators all turn positive for the first time in several years. Our economists' forecasts for revenue drivers like nonresidential construction, equipment investment, and residential construction are all positive in 2024 and 2025, in contrast with a mix of positive and negative growth in recent years (see chart 8). Nonresidential construction boomed in 2023 after the IRA and CHIPS Acts were enacted. The computer/electronic/electrical category (spending on plants producing electric vehicle batteries and microprocessors) fell 8.8% (annual rate) in Q3 2024, suggesting this category may have seen its peak in growth. Spending on data centers, on the other hand, has increased in all but one of the last 16 months with more growth in the pipeline for data centers and power. The growth in public infrastructure spending appears to have flattened. Housing starts have steadied after declining in 2022 and 2023, so aggregate residential spending should grow slowly in 2025 (0.8%) and accelerate in 2026 (2.6%).

Chart 8

Demand and pricing power

Equipment investment and inflation drive capital goods revenue



e—Estimate. f—Forecast. Source: S&P Global Ratings.

EMEA economic outlook remains muted for 2025. Our economists forecast about 1.6% GDP growth compared to 2024 (expected about 1.2%), behind the expected economic expansion for North America (2.2%) and Asia Pacific (4.3%). Reflecting their late-cyclical nature, we expect some slowdown to hit less globally diversified companies towards the middle of 2025 when order backlogs have been eaten up. PMI Manufacturing for the eurozone is staying at about 45, which is below the level that is indicating expansion (above 50). The eurozone manufacturing index indicates a 29th consecutive month of contraction. Notably, Germany, France, and Italy remain below the average, which indicates that destocking and normalization of inventories is taking longer than expected, and likely portends the continuation of subdued order intake through the first half of 2025. We note that order backlogs for most are approaching normalized levels, leaving little buffer in case of continued weaker demand.

On the other hand, companies exposed to energy transition or data centers continue to enjoy strong order intake and growing order books. Overall, we believe growth will further moderate in 2025 compared to 2024 as the manufacturing sector continues to bottom out.

APAC economic outlook will be more volatile in 2025. Our economists forecast the region's economic and credit conditions will become more volatile amid uncertain trade and foreign policies by the incoming U.S. administration. More tariffs against Chinese exports are likely to be imposed. Our economists' base case factors in a rise in the effective U.S. tariff rate on Chinese imports to 25% from 14% from the second quarter of 2025, and retaliation by China in kind. China's GDP growth could slow to 4.1% in 2025 and to 3.8% in 2026, amid limited stimulus to bolster consumption. China's slower economic growth, soft consumption sentiment, and weak property sector will continue to weigh on overall demand on capital goods. Countries with a large trade surplus with the U.S. such as Vietnam, Thailand, Malaysia, and India could be vulnerable to universal tariffs. Chinese producers may cut prices to stay competitive, while increasing exports to outside the U.S. The global trade slowdown could curb growth and squeeze Asia-Pacific currencies and exporters' revenues. We expect the region's growth to slip to 4.2% in 2025 and 4.1% in 2026, even as domestic consumption in emerging APAC remains supportive.

Large infrastructure investments in APAC support heavy industries. China's government policies support demand growth in certain markets, such as thermal and nuclear power generation equipment. Demand for railway equipment in China is also expanding amid higher passenger ridership and higher maintenance needs. We expect Japan's heavy industries will benefit from increased demand for electricity, increased defense spending, and commercial aircraft. We revised the outlook of Mitsubishi Heavy Industries to positive in July 2024 because we see a stronger likelihood of steady improvement in companywide profitability. This is due mainly to favorable orders and improved profitability in the company's power generation and defense businesses. The outlook revision also reflects our view that improved performance around these core businesses and its disciplined financial management will maintain the company's key cash flow metrics at stronger levels than we previously assumed. This is even as growth investments, including for decarbonization, increase.

For power generation equipment in China, we see solid demand for thermal power equipment on the back of supportive government policies. New orders for wind power equipment continue to grow and reached a five-year high thanks to continued support from government policy and accelerated project approval, though pricing still remained low. Key manufacturers entered into an agreement in late 2024 to promote disciplined pricing strategy, although it remains to be seen whether prices can improve amid fierce industry competition. We expect demand for conventional power generation equipment as a stable power source will likely remain solid amid a data center boom. This will benefit companies like Mitsubishi Heavy Industries and Shanghai Electric.

By comparison, issuers handling short cyclical mass products might perform less favorably, amid a stagnant factory automation market in China and slower demand for construction machinery and air conditioning equipment in Europe, despite a gradual recovery in demand for some of these products.

Construction in the U.S. flattens after a couple of good years, but infrastructure grows. S&P Global Ratings' economists believe U.S. nonresidential structures investment growth will be 0.1% in 2025 versus 3.4% in 2024 and a strong 10.8% in 2023. The computer/electronic/electrical category (spending on plants producing electric vehicle batteries and microprocessors) has been driving nonresidential construction growth for the past three years, but a decline in late 2024 suggests this category may have already seen its peak in growth. Data center construction has increased in all but one of the last 16 months, with more growth in the pipeline and added construction in the power sector. Infrastructure spending remains a bright spot, as $1.8 trillion in federal grants, loans, incentives, tax credits, and other financial assistance works its way through the U.S. economy. Infrastructure construction spending is on track to grow by 7.5% in 2024, according to S&P Global Market Intelligence (U.S. Infrastructure Focus Report, Dec. 2, 2024), down from growth of 11.6% in 2023. The strongest segments to date this year have been water and sewer and power. At the same time, we expect the availability of skilled construction labor will remain tight, pushing up wages and construction costs.

Low grain prices weigh on demand for agriculture equipment. The cyclical agriculture equipment market will be among the more challenging end markets for industrial companies, in our view; its peak to trough sales will fall by 30% through the end of 2025, greater than our previous expectations of 25%. Farmer cash income held up better than we anticipated in the U.S., as the United States Department of Agriculture (USDA) only forecasts cash income will be down 1.1% to $158.8 billion. Still, it is a significant fall since 2022, when it was $225 billion. Cash receipts for farmers have declined significantly due to lower commodity prices. Production expenses, meanwhile, have fallen, but remain relatively high. We assume the agriculture equipment rebound will not take place until 2026. Furthermore, we believe the new U.S. administration and potential tariff wars could weigh heavily on farmers and that immigration policy could weigh on farm labor.

During the last round of trade friction that affected U.S. agricultural exports to China, the U.S. government provided support to affected farmers, and tariffs yielded agreements to buy U.S. agricultural products to resolve the trade dispute. With a view to considerable end-market volatility, the leading equipment manufacturers in the space—Deere & Co. (A/Stable/A-1), CNH Industrial N.V. (BBB+/Stable/A-2), and AGCO Corp. (BBB-/Positive/--)—maintain relatively strong balance sheets for the rating, with S&P Global Ratings-adjusted debt to EBITDA under 1x, 2x, and 3x, respectively, as of Sept. 30, 2024 (Oct. year end for Deere & Co.).

We're expecting a soft year in 2025 for U.S. heavy equipment manufacturers, which we attribute to caution in construction spending. In the U.S., higher interest rates and affordability issues continue to weigh on residential construction spending, which we expect to grow just 0.1%. Falling electrical construction spending, which went through a post-pandemic boom, should weigh on nonresidential structures investment. We believe the data center boom and spending associated with power generation will offset this decline, resulting in 0.8% growth. We also believe infrastructure spending will continue to be positive for demand, with roughly 40% of the projects associated with the $1.2 trillion Infrastructure Investment and Jobs Act (IIJA). Construction spending should show a modest rebound in 2025 in Western Europe, with growth from infrastructure leading the way.

Other end markets within heavy equipment will be mixed, in our view. We believe mining companies will continue to exhibit capital discipline, while power generation equipment will continue to benefit from the data center buildout. In APAC, we continue to expect low demand for construction machinery, particularly in China. The property sector in that country is still struggling and confidence remains subdued, despite being partly compensated by moderate growth in infrastructure investment. We also anticipate sluggish demand for construction machineries in ASEAN (Association of Southeast Asian Nations) countries as persistently high interest rates slow the progress of construction projects. We believe demand for the mining sector in APAC will gradually decline due to lower commodity prices, although it should remain higher than in previous downturns.

U.S. equipment rentals are poised for continued healthy demand in 2025, allowing them to maintain stable performance. We expect megaproject spending to continue to benefit demand for equipment rentals, supported by spending tied to the IIJA and CHIPS Act, along with a sector-wide focus on reshoring to de-risk supply chains. However, near-term demand could be affected by shifts in project timing or disbursement of federal funds.

As interest rates cuts take hold, we expect a recovery in demand for smaller, local, and regional projects, which are typically highly sensitive to interest rates. Following multiple years of rental rate increases, we believe they will largely stabilize due to normalized supply conditions in the original equipment market and modest rate dilution from megaproject revenues, which tend to carry higher volumes and lower rates due to competitive bidding. We view national equipment rental peers as well-positioned to benefit from megaprojects given their large fleet sizes and wide-reaching branch networks. The gradual shift in customers' preference toward asset-light, rental-focused operating models remains a longer-term driver of growth in equipment rental demand. Over the past decade, equipment rental penetration has increased, and we expect it will continue, fueled in part by high-growth specialty equipment product lines. Overall, we believe organic rental revenue for large equipment players will continue to increase in 2025 as fleet utilization remains solid.

European equipment rentals keep growing despite weak construction. In Europe, the European construction sector continues to be marked by negative output growth in 2024 owing to the high interest rates and persistent inflation which undermine consumer confidence. In 2025, we still believe in a weak European construction sector outlook with about 1.5% market growth. However, we expect the largest European rental equipment peers to continue to outpace the construction output in 2025-2026 as supporting long term trends, such as improved cost efficiencies of renting versus owning and lower carbon footprint from newest rented equipment should result in higher rental penetration rates in most of the European countries.

As with the broader capital goods sector, the disruption of macroeconomic expansion due to developments around geopolitics or U.S. trade policy pose a risk to our forecast. However, if end market conditions unexpectedly deteriorate, we believe equipment rental companies can rapidly reduce capex to preserve cash generation.

Automation landscape looks steady with potential for some upside in 2025, after some destocking that had worked its way through in 2024. We expect 2025 to be generally favorable for companies with investments related to these key megatrends.

While M&A continues to support inorganic growth, the fundamentals and longer term prospects should continue to provide healthy profitability and favorable operating trends for most companies aligned with automation. We continue to expect backlogs and order rates to continue to moderate in 2025 from historical highs, but we believe the overall demand trends should support longer term growth and overall credit quality. Our view hinges on the ongoing challenges around labor availability—particularly skilled labor—which have increased the urgency for many companies to automate their operations and increase the efficiency of their plants. Costs to automate have decreased over time and companies continue to balance their return on investments relative to labor constraints and safety considerations.

Despite these medium-term megatrends, earnings for APAC issuers engaged in automation as a core business will likely recover slower in some end markets, such as EVs and batteries, amid economic slowdown in China.

Electrification and energy transition demand appear entrenched. The dynamics in the residential end markets over the longer term continue to drive the increased need for electrification. With a shortage of housing stock and the existing housing being older, the need for improved energy efficiency, more strict safety requirements, and to some extent regulation is supporting the increased need for electrification. We also expect the longer-term adoption of electric vehicles and trends toward energy storage and of heat pumps should align with the overall demand trends of electrification.

Amid the intensifying global trend toward decarbonization, Japanese heavy capital goods companies such as Mitsubishi Heavy Industries have seen a significant increase in new orders for gas-fired power generation equipment in the last couple of years; as in much of APAC, meeting growing electricity needs is prioritized over decarbonization targets for now. Demand for new gas-fired power plants will remain high compared with other regions in our view. Japanese capital goods companies will likely continue to benefit from growing demand for gas-fired power assets in the next three to five years.

But decarbonization brings new challenges for the industry. Renewable power projects are more complex and face more severe competition, and future development of greener technologies for power generation may shift the competitive landscape in the long term.

Credit metrics and financial policy

Good performance and steady policies among U.S. issuers. The North American business landscape is more stable than it's been the last few years, with supply chains moderately improving and cost inflation normalizing. Also, we note continued adherence to long-established financial policies for most issuers rated 'BB' and higher, with little indication of loosening targets for debt usage. We believe that general industrial companies should fare well and should be stable for the most part, driven by decent economic activity, pricing power, healthy backlogs and order rates compared to pre-pandemic levels, and overall decent consumer consumption expected in 2025. While the uncertainty about tariffs is still an overhang, we believe many of the rated companies have implemented changes in supply chains through relocating facilities, onshoring operations, and producing in-country. While the magnitude and actual implementation of tariffs could become pronounced, the impact should be manageable, particularly given some the risk management and mitigating factors that were implemented in the last period.

For example, many companies have automated parts of their business to rely less on labor; have alternative sources for key inputs to offset potential shortages; and have alternative shipping and transportation methods where they did not exist before. From a cost inflation perspective, many companies have successfully passed on price increases particularly for mission-critical products.

EMEA capital goods companies look to buy more growth. For investment-grade issuers we expect stable to slightly improving credit metrics. We estimate gradual improvement in profitability should yield sound free cash flow generation. We expect continued M&A spending to further support the portfolio transformation, as recently displayed by the acquisition of Altair by Siemens AG. However, we believe investment-grade issuers remain committed to their financial policy and are carefully matching free operating cash with spending on M&A or shareholder returns. For speculative-grade issuers, we might see some deterioration of credit metrics due to some end-market weaknesses, but overall most companies are targeting a more conservative balance sheet to support the higher cost of debt.

APAC issuers maintain their financial discipline. The creditworthiness of APAC capital goods companies is generally stable, even if interest rates and sluggish economies slow APAC growth. We estimate revenues and margins will recover in 2025, mainly supported by increased orders for heavy machinery and power grids. We expect that most issuers will maintain their high technological capabilities and solid business foundations, while improving profitability should absorb the financial burden from increased growth investments.

Construction machinery, which is relatively susceptible to economic fluctuations, will likely see revenues and margins decline from 2024 to 2025, but heavy machinery will benefit from increased orders, and Hitachi and others will benefit from increased investments in IT and digital transformation. We expect continued headwinds with interest rates remaining high and the economy slowing, as well as the expected impact of tariffs. Growth investments and shareholder returns are also likely to increase. Where orders increase, the burden of working capital will also increase. However, APAC issuers are generally managing costs and working capital with financial discipline and in some sectors with improved cash flow, and will absorb these burdens to the extent necessary to control key financial indicators.

In China, growing demand in key end-markets and leading market positions should support moderate earnings growth of our rated companies. We expect financial headroom to remain adequate over the next one to two years, amid profit expansion and disciplined investment.

Key risks or opportunities around the baseline

1. Get comfortable being uncomfortable with uncertainty.

A wide range of risks could affect our base-case for a small improvement in revenue and EBITDA in 2025, including tariffs, interest rates, labor, and new spending policies after a boom in manufacturing construction.

2. The maturity wall approaches and triggers more distress for the riskiest credits.

Strains began to show in 2024 with a few defaults, many from liability management exercises, which re-tranche the capital structure of a distressed issuer when a healthy refinancing appears unlikely.

3. Investment juggernaut transcends politics and interest rates.

Large spending could persist another 2-3 years, making for a robust 5-6-year cycle of favorable industry conditions with only episodic demand pressure (like destocking in 2023-24).

Evolving risks set to converge in 2025, most notably labor, supply chain, interest rates, energy transition, and technology. In 2025, U.S. labor should remain tight and incentivize manufacturing investments in Mexico, Asia ex-China, and Canada, although some companies could be holding off on committing new capital to these places because of the U.S. tariff threat. Supply chains could get disrupted by tariffs on growing sources of goods into the U.S. Interest rates appear to be holding at elevated levels, which are often the harbinger of weaker manufacturing. Spending on the energy transition will likely change, favoring conventional sources of power like natural gas, as well as solar and nuclear.

U.S. tariffs could drag on profits, but most companies have options. We estimate the share of imports from China in U.S. critical manufacturing (metals, machinery, electrical equipment, transport equipment) has declined to 10.2% in 2023 from 13.8% in 2017, so companies clearly adjusted their sourcing after tariffs were imposed. At the same time, we estimate that exports to

China account for about 11% of capital goods revenue, which would likely be highly specialized products with little incentive for retaliatory tariffs.

No chill in the forecast for HVAC manufacturers. We rate four HVAC original equipment manufacturers (OEMs) in the U.S., and several Japanese manufacturers we rate also produce HVAC systems. Financial policy decisions will remain a key rating focus for our rated HVAC OEMs in 2025 since we assume operating tailwinds will persist and support continued organic free operating cash flow (FOCF) growth. In 2025 we forecast year-over-year organic revenue growth in the mid-single-digit percent area, on average, across the rated OEMs on both pricing and volume, and for S&P Global Ratings-adjusted margins to remain steady to up modestly from the benefits of volumes on operating leverage. Following several quarters of destocking in the HVAC distribution channels, we assume volumes in residential HVAC in 2025, particularly in the U.S., will grow generally in line with GDP growth trends, though we note some potential volume disruption towards the first half of 2025 as OEMs and distributors unload inventory using the legacy R410A refrigerant. We also assume OEMs benefit from price increases in the high-single-digit percents on a majority of their residential products given the industry requirement to transition to the newer A2L class of refrigerants, which have higher product costs. Our forecast also assumes continued good revenue growth in commercial HVAC, supported by current solid backlogs, improving payback horizons for new equipment, and indications that some commercial verticals such as health care, education, and particularly data centers, will continue to drive good demand for larger applied HVAC projects. Lastly, we assume service revenue, which is generally higher margin, will continue to grow given our assumption for growth in applied products, since applied systems are complex and customers prefer the OEMs to provide service.

We assume HVAC OEM's will allocate their growing FOCF towards shareholder returns and bolt-on acquisitions. We believe Lennox International Inc. and Johnson Controls International PLC (JCI) will manage discretionary spending to levels that will maintain their publicly stated leverage targets. For Carrier Global Corp and Trane Technologies Inc., neither of which has a publicly stated leverage target, we believe both will maintain their leverage in line with, or below, most recent levels.

We saw a few portfolio shake-ups in 2024, with asset divestitures completed by Carrier and a few announced by JCI. Carrier used divestiture proceeds initially for debt repayment, until it deleveraged towards levels it operated at prior to its large acquisition of Viessmann in January 2024, after which the company allocated proceeds towards shareholder returns. While JCI has not stated a specific level, if any, of expected gross debt reduction from asset sale proceeds, we assume the company allocates proceeds such that its leverage remains at the lower end of its target range.

Given expected restructuring efforts and more operational focus on areas of the HVAC industry where each company maintains leading market share already, we believe divestitures may drive EBITDA margin benefits at both Carrier and JCI over time.

Renewables face political pressure while OEMs seek to restore profitability. Notably, we expect profitability to improve at some of the largest renewables companies we rate. GE Vernova and Siemens Energy will continue to improve on profitability after significant equipment-related hiccups. We expect both companies to attain S&P Global Ratings-adjusted EBITDA margins in the mid- to high-single-digit percentage range in 2025 following several different charges. GE Vernova took an approximately $700 million charge in the third quarter of 2024 related to wind blade failures (in Nantuck and the Dogger Bank, an offshore wind facility in the U.K.). We believe these are indications that the industry is still early in its maturity, and think these companies will continue to see fits and starts in the coming years.

These companies face political pressure in the U.S., where we expect the next administration to advocate for conventional power sources. We believe international businesses will remain more receptive to renewable energy while U.S. natural gas businesses will get a boost. Globally, we expect grid businesses to continue to perform well due to the need to upgrade aging infrastructure, as well as the need to hook up renewable power to existing power landscapes. The energy transition will persist, but the pace of change (and profitability) could be slower than anticipated. Accordingly, we believe segments of companies that cater to new technologies could take longer to reach profitability.

Issuers in APAC could face economic headwinds and cost pressures. Further downside in the U.S. economy or China property market could prolong the slowing growth trend, and keep demand stagnant in certain markets (e.g., factory automation for manufacturing). Slowing global growth could dampen earnings, particularly for those issuers dealing with mass market products that have higher sensitivity to macroeconomic conditions. Cost pressures are possible from tight labor conditions, high raw material and utility prices, and supply-chain disruption. Issuers involved in power generation are under pressure to decarbonize and invest more in new technologies. However, APAC is relatively more accepting of conventional, stable power sources.

Related Research

- Great CapExpectations: Tech, Utility Spending Power Capital Goods Revenue Growth In 2025, Jan. 13, 2025
- Tear Sheet: Schneider Electric S.E., Dec. 20, 2024
- Full Analysis: Koch Companies LLC, Dec. 18, 2024
- Tear Sheet: CNH Industrial N.V., Dec. 16, 2024
- Research Update: Siemens Energy Outlook To Stable On Better Operating Performance, High Demand, Net Cash Position; 'BBB-' Rating Affirmed, Dec. 16, 2024
- Tear Sheet: 3M Co., Dec. 6, 2024
- Full Analysis: Deere & Co., Dec. 5, 2024
- Rating Action News: Johnson Controls International PLC's Proposed Senior Unsecured Notes Rated 'BBB+', Dec. 4, 2024
- Full Analysis: Emerson Electric Co., Nov. 26, 2024
- Bulletin: Siemens' Acquisition Of Altair Boosts Its Competitive Position, Nov. 04, 2024
- Full Analysis: Parker-Hannifin Corp., Sept. 26, 2024
- Gas Power Remains Key Pillar For Japan Capital Goods Makers, Aug. 1, 2024
- Research Update: Rockwell Automation Inc. Downgraded To 'A-' From 'A' On More Aggressive Financial Policy; Outlook Stable, July 2, 2024
- Evolving Risks For Credit Quality In U.S. Capital Goods, June 18, 2024

Industry Forecasts: Capital Goods

Chart 9

Revenue growth (local currency)

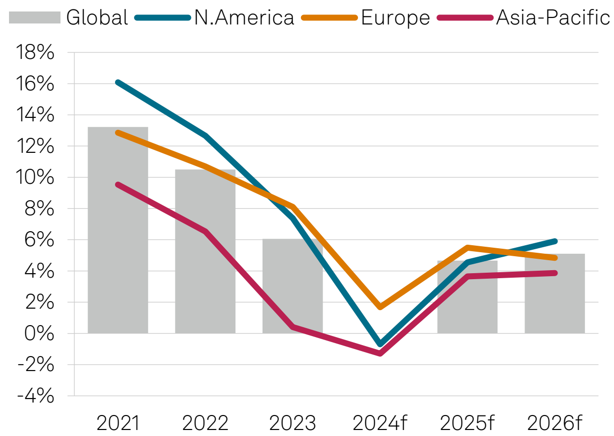


Chart 10

EBITDA margin (adjusted)

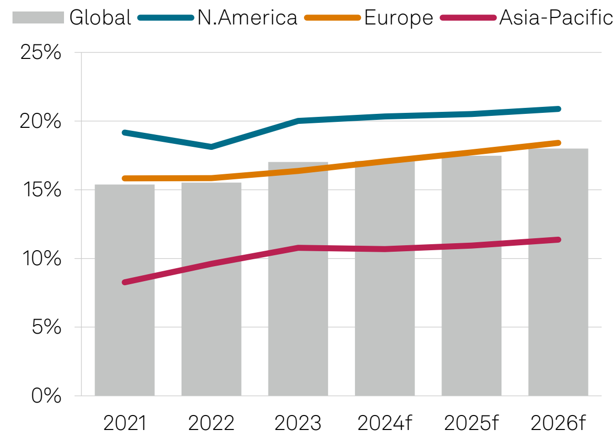


Chart 11

Debt / EBITDA (median, adjusted)

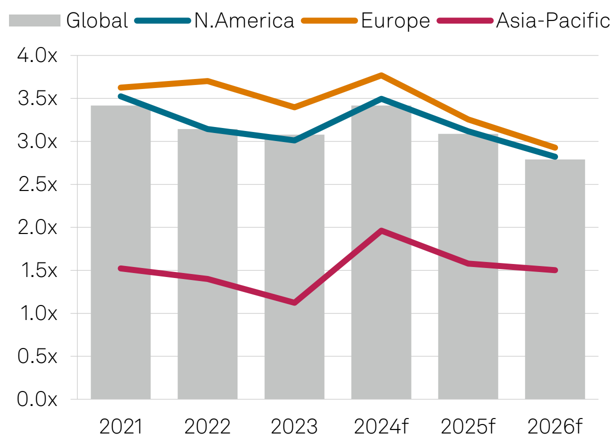
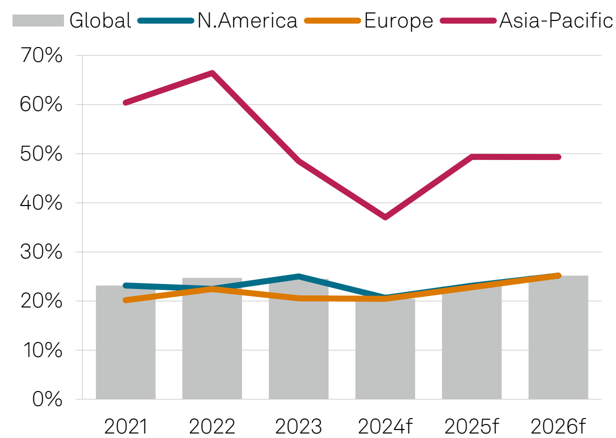


Chart 12

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Capital Goods

Chart 13

Cash flow and primary uses

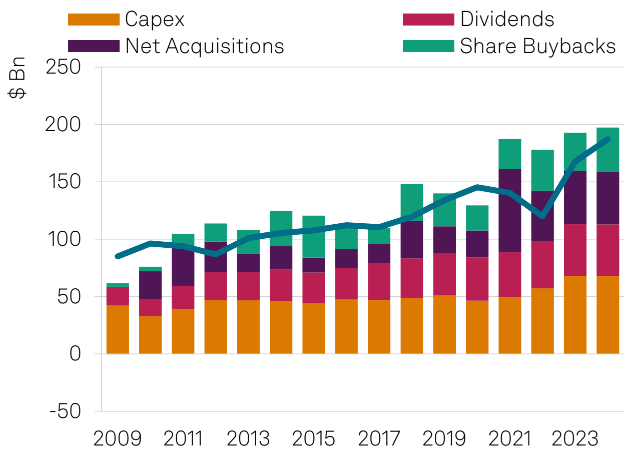


Chart 14

Return on capital employed

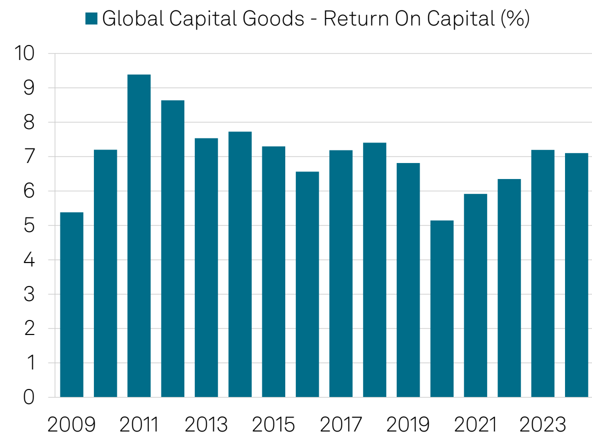


Chart 15

Fixed- versus variable-rate exposure

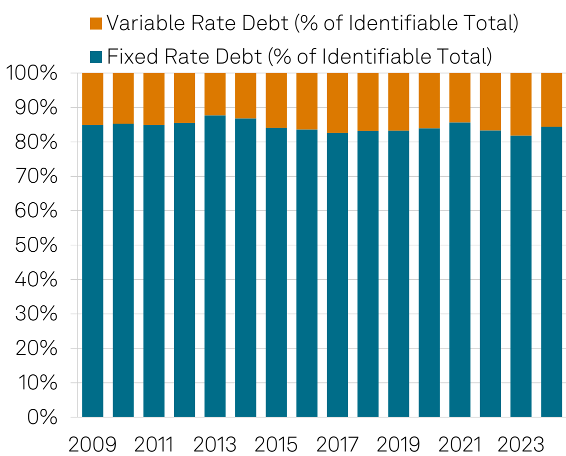


Chart 16

Long-term debt term structure

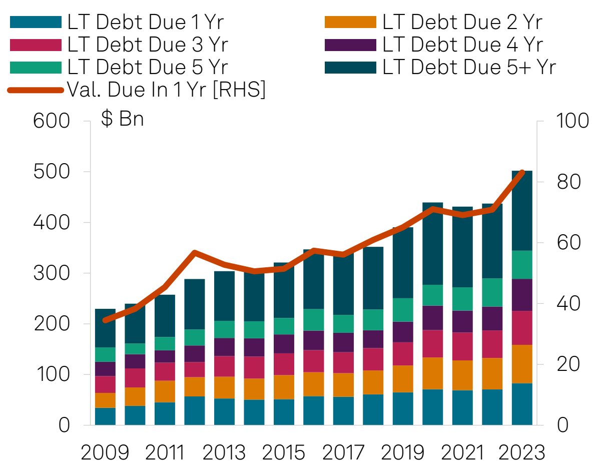


Chart 17

Cash and equivalents / Total assets

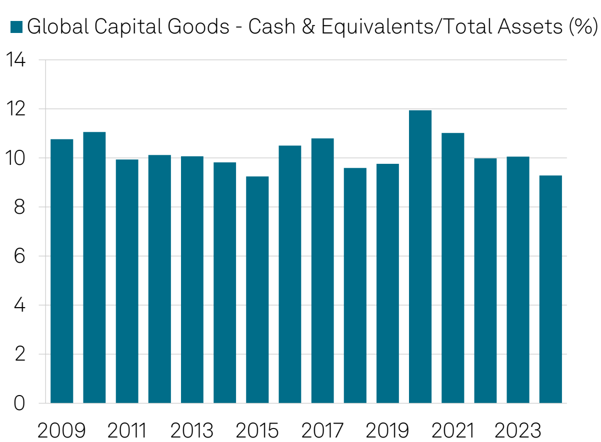
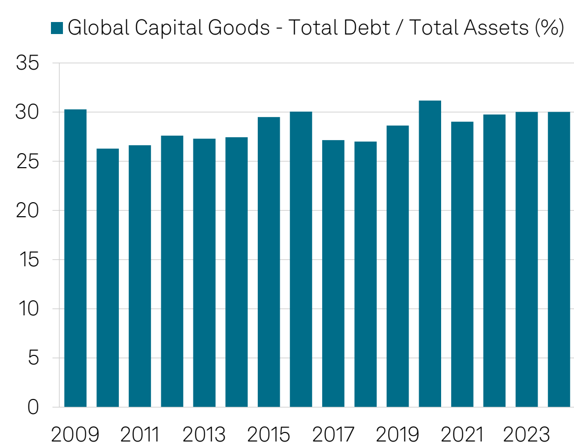


Chart 18

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

S&P Global Ratings

Chemicals

Some improvement, but most markets remain challenged

January 14, 2025

This report does not constitute a rating action.

What's changed?

Petchem outlook remains weaker for longer. A 2025 petchem recovery is unlikely due to additional supply, weak end-market demand, and rising natural gas prices.

Increasing risk of trade disruptions. Geopolitical conflicts, the threat of tariffs, and U.S. port strikes are among factors that could disrupt trade and create supply chain issues.

Destocking has run its course. Customers restocking inventory in 2025 could help bolster demand and supplement growth rates.

What are the key assumptions for 2025?

Affordability spells tough trading conditions for fertilizers. Global demand growth for nutrients may stagnate, but limited capacity additions and reduced Chinese exports support prices.

Global GDP slows to 3%, compared to 3.3% in 2024. This stems from sluggish growth in the U.S. and China.

Demand in certain end markets remains weak. Demand has delinked from GDP growth in some key geographical end markets.

What are the key risks around the baseline?

Trade disruptions. Geopolitical conflicts, trade tensions, tariffs, and the potential for a strike at U.S. ports all raise the risk of supply chain disruptions.

Weakness from certain end markets hinder chemical demand. These end markets include automobiles, housing and construction, electronics, and agriculture.

Our earnings growth expectations might not materialize. Unexpected earnings setbacks could slow down or reverse our base case assumption of earnings improvement.

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Ratings Trends: Chemicals

Chart 1

Ratings distribution

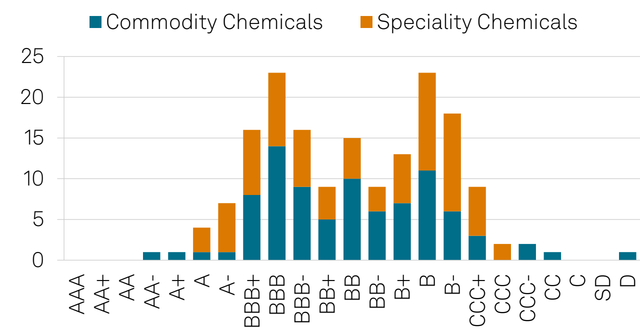


Chart 2

Ratings distribution by region

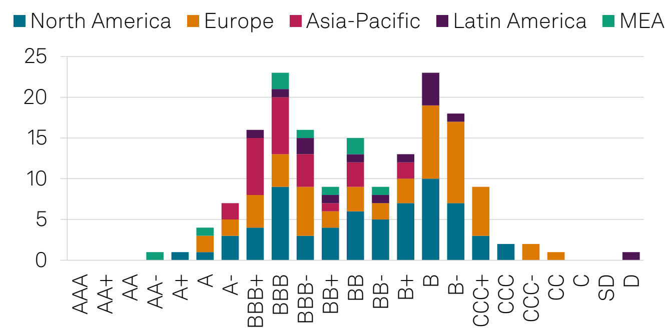


Chart 3

Ratings outlooks

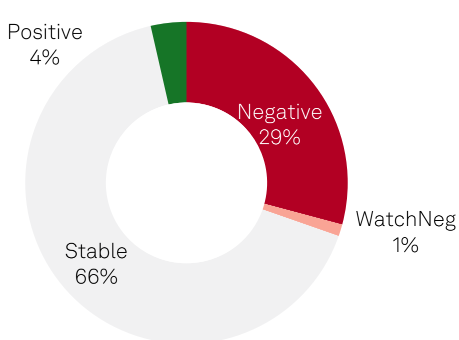


Chart 4

Ratings outlooks by region

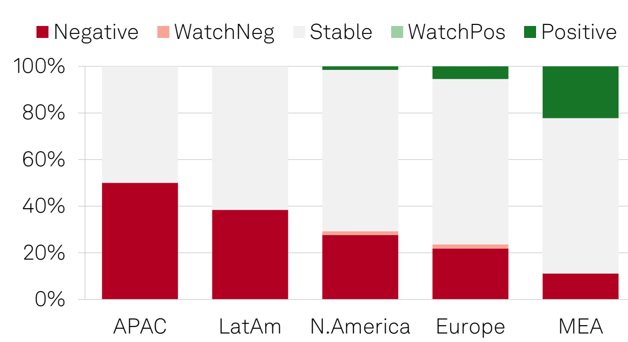


Chart 5

Ratings outlook net bias

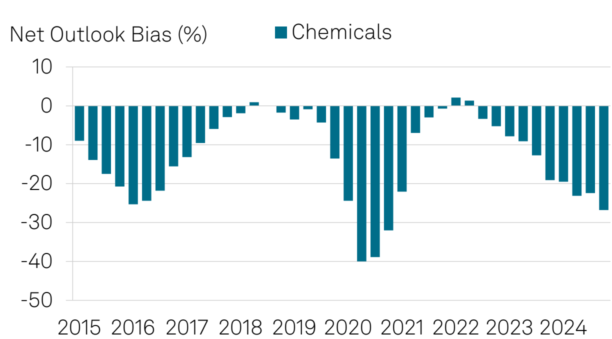
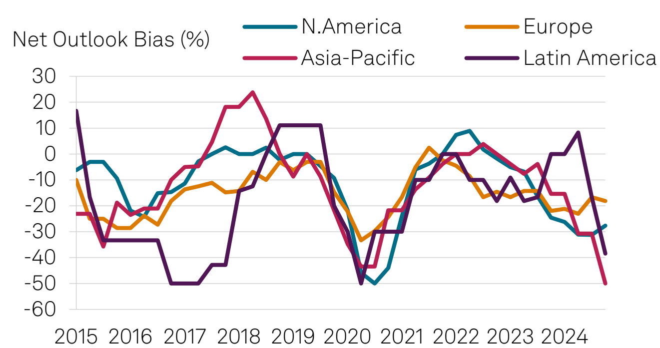


Chart 6

Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

Over a quarter of our ratings outlooks are negative (27%) while only 3% are positive. The net negative outlook bias is the highest it's been since the height of the COVID-19 pandemic. Most of the negative outlooks are concentrated in the speculative-grade space while regional negative outlook distributions are weighted toward Asia and North America.

Asian chemical producers, particularly in the petrochemical (petchem) segment, are losing money regardless of feedstock. Meanwhile, North America reflects the highest concentration of speculative-grade issuers that are experiencing weaker end markets, particularly in the auto and home building segments. While we had anticipated uneven growth across regions and companies as destocking dissipates and petchem recovers slowly, this has largely failed to materialize as China's economy and certain end markets in the U.S. weakened, while energy and feedstock prices remained elevated.

Main assumptions about 2025 and beyond

1. Petchem remains in a prolonged cyclical trough in 2025.

Overcapacity is a persistently depressing operating rates and margins coming into 2025. China remains committed to its self-sufficiency targets, ramping up new capacity in 2025 and beyond. Thus far, announcements of permanent capacity closures have been slower to materialize than expected, although some larger petchem companies have signaled potential strategic reviews of European assets. Large capacity closures in higher cost regions, such as Europe and parts of Asia, are necessary to balance the industry and support a sustained improvement in operating rates and margins. Despite our expectations of trough conditions, we assume a modest improvement in EBITDA, mostly from cost-reduction initiatives with some volume increases.

2. Fertilizers face a somewhat tougher slog.

Following strong demand for fertilizers in 2024, we anticipate tougher trading conditions in 2025, particularly in the first half. This is because challenging farm economics—due to weak crop prices, high agricultural input costs, and a poor harvest in Europe—is suppressing affordability and, therefore, fertilizer offtake. S&P Global Commodity Insights forecasts that this will cause demand growth across all fertilizers to stagnate at about 0.3% in 2025. That said, we assume that prices in 2025 will decline modestly by low- to mid-single-digit percent, depending on nutrient, after 5%-15% declines in 2024 relative to 2023 levels.

3. Global economic growth is set to decline slightly.

In the U.S., we forecast a growth rate of 2% in 2025, with the Eurozone growing slightly at 1.2%. In APAC, 4.2% growth stems from India's healthy GDP and slower but still relatively healthy Chinese GDP. However, our expectations depend on what policies the incoming Trump administration will implement, particularly pertaining to tariffs, trade, and immigration, as well as what they mean for resilient consumer spending. Given the size of the U.S. economy, policy action on any of these fronts could alter our base-case estimates and affect some economies more than others.

The petrochemical sector will remain in a prolonged cyclical trough in 2025. A slew of new facilities has ramped up over the past few years, with more coming online the next few years, primarily in China as it strives to hit its self-sufficiency goals. Specifically, S&P Global Commodity Insights cited an estimated 45 million tons of global ethylene capacity has come online over the past five years, with operating rates in 2023-2024 dropping to the lowest rates in several decades. It also cited an additional 30 million tons of new capacity slated to come online by 2028. The length and depth of the current trough will largely stem from how much capacity gets permanently rationalized. To date, announcements of permanent closures have lagged far behind new capacity additions, although in 2024, several of the larger petrochemical companies have announced strategic reviews of asset footprints, primarily in higher-cost Europe.

While destocking largely ran its course in 2024, a general malaise in key end markets, such as housing and automotives, and slower-than-expected growth in key regions like China led to weaker demand and trough-like conditions persisting through 2024. Cost-cutting measures and some volume from potential inventory restocking will likely lead to marginal EBITDA growth. Based on our current price deck, we assume North American producers based in natural-gas will remain toward the lower end of the global cost curve, trailing Middle Eastern producers but still advantaged compared with more naphtha-based petchem companies in Europe and Asia.

We forecast the U.S. economy will expand 2.0% over the next two years. This incorporates a partial implementation of proposed Trump policies following 2.7% GDP growth in 2024. We expect the Federal Reserve to reduce its policy rate more gradually than considered in our September forecast update, reaching an assumed neutral rate of 3.1% by fourth-quarter 2026 as opposed to fourth-quarter 2025 previously.

As we are unsure to what extent President-elect Trump's campaign promises will materialize, this forecast incorporates high uncertainty. Trump's policy proposals, at face value, could cause higher inflation in the near term and lower growth in the medium to long term. The probability of a disruption to the Fed's easing bias over the next two years has risen. We assume that President-elect Trump will use his presidential powers to impose targeted tariffs on China by raising the weighted-average bilateral effective tariff rate on Chinese imports to 25% (from estimated 14% currently). The Chinese authorities likely would reciprocate with equivalent higher trade barriers on U.S. exports to China.

Eurozone growth will pick up only slightly in 2025, as higher real incomes spur consumption and employment remains high. We forecast eurozone GDP growth of 1.2% in 2025 versus 0.8% in 2024, which remains well below other major regions, such as the U.S. and China. Consumer spending and, subsequently, investment will likely drive expansion as real income growth accelerates, consumer perceptions of disinflation improve, and interest rates decline. Inflation will be slightly lower in 2024 because of a more pronounced decline in energy prices from peak levels. Lower interest rates and another increase in households' purchasing power will likely support the eurozone economy over the coming quarters.

However, European producers still face electricity prices two to three times higher than those in the U.S. and four to five times higher natural gas prices, weighing on competitiveness. This, alongside weak demand, keeps capacity utilization of the European chemical industry well below its long-term average. We anticipate the European Central Bank (ECB) will cut rates more quickly than previously expected due to persistently weak confidence and better visibility on the disinflation trajectory.

APAC's overall economic growth rate will slow slightly to a still healthy 4.2% from 4.5%. Lower interest rates and inflation will offset drag on spending power from slower global demand, slower growth from China, and U.S. trade policy.

Emerging market economies such as India, Indonesia, Malaysia, and the Philippines will continue to post the strongest growth. While China's stimulus measures will support growth, potential onerous U.S. trade tariffs could be highly disruptive. Our base case factors in a rise in the U.S. tariff rate on Chinese imports to 25%, as well as retaliation from China in kind. The country's property weakness continues to weigh on the economy, but the industry has slightly improved due to policy support. We predict the country's GDP growth will slow to 4.1% in 2025 from 4.8% in 2024.

Fertilizer prices remain broadly stable. Limited urea capacity additions from 2024 onwards have created a tight market. Ongoing capacity restrictions in China bode well for prices with support from the largely nondiscretionary nature of nitrogen fertilizers and healthy demand in India.

By contrast, potash demand in China remains generally strong and is potentially rebounding in Brazil and India. However, concerns over affordability and supply risk—related to exports from Belarus and Russia—and the eventually phase 1 of BHP's Janssen project in Canada in late 2026 could pressure pricing.

To sustain phosphate prices, higher global production volumes, notably from OCP, Maaden, and EuroChem, and potential modest supply from China will need to stay on even keel with the underlying demand and phosphate's relative-to-other-nutrients value to farmers.

Geopolitical events could also disrupt the balance of prices, particularly if conflict in the Middle East escalates to hinder trade flows in the Gulf of Hormuz, or due to unexpected supply outages, weather events, or changes to trade policies. However, at present, we do not expect the Trump administration to enact general tariffs on fertilizers.

From the credit perspective, there is not abundant ratings headroom issuers in the fertilizer sector, except for CF Industries and ICL Group. Therefore, balanced financial policies—particularly in relation to capital expenditure and shareholder renumeration—will be key to maintaining ratings.

Credit metrics and financial policy

Generally, we expect muted top-line growth as earnings remain pressured in 2025. However, cost-cutting measures could somewhat bump earnings, as could a limited boost in demand as inventories tighten up.

Although we expect a bear market to persist across the industry for 2025, many companies' balance sheets are in sufficient shape to weather trough industry conditions. Investment-grade companies especially strengthened from robust markets in 2021-2022. Recent negative rating actions arose most in the deep speculative-grade space and in Europe, where high energy costs, destocking, and overall weak economic conditions have led to underperformance and low plant utilization rates for some issuers.

Key risks or opportunities around the baseline

1. A trade war or tariffs could pressure demand.

The risk of a trade war, such as potential U.S. tariffs on China, is rising.

2. Although a tentative deal was struck at the time of this publication, a U.S. port strike could significantly challenge suppliers.

The possibility of a prolonged U.S. port workers' strike at East and Gulf Coast locations, presents a major challenge for chemical suppliers, the economy, and the broader supply chain.

3. North American chemical companies have taken advantage of improving capital market access, although the impact on their cash flows will vary.

Improved capital market access has allowed companies to push out maturities due in 2024-2025. In many cases, the improved debt maturity profile has come at the expense of modestly higher interest costs.

The U.S. economy, while steady for now, could weaken. The new administration looks to energize an economy that is already running at or above potential, raising the specter of higher inflation pressure, higher U.S. rates along the curve, and a stronger dollar. This would tighten U.S. financial conditions and spill onto a swathe of other economies, mainly emerging markets.

More critically, U.S. trade policy could turn much more disruptive if it follows Trump's campaign promises. For example, maximum U.S. tariffs on Chinese imports could damage the economy and cause retaliation from China, like before. We would alter our base-case assumptions if the U.S. imposes a 60% tariff on all imports from China plus new tariffs on other trading partners, cuts personal and corporate taxes, and deports millions of illegal immigrants. If that happens, we anticipate lower U.S. output, higher inflation pressures, and increased volatility and rates along the yield curve. This would, in turn, asymmetrically hinder other economies in terms of activity, trade, and key financial variables.

Tariffs on other trading partners are likely to cause commensurate damage to their economies, with the risk of retaliation, as well. Tariffs will likely destroy growth, lower demand, and further contribute to ongoing economic (and political) fragmentation. Moreover, none of this will help narrow the U.S. trade and current account deficit, which reflects a lack of U.S. savings relative to investment.

Escalating trade tensions could indirectly hurt demand and profitability. The overall impact of tariffs could reduce demand and profitability for China, the world's largest chemicals producer and consumer. The U.S. accounts for 15% of China's total export trading value, and chemicals also have wide end-market applications, including cars, machinery, electronics, and home appliances. Chinese chemicals producers may not be able to fully pass through the tariff costs to customers.

Similar major trade tensions could happen in other regions, with potential retaliations. For example, risks of U.S. trade restrictions are rising for export-centric APAC economies. This complicates and clouds the already challenging chemicals industry outlook.

Potential U.S. tariffs will likely have limited direct impact on most European chemical producers. Many issuers in the sector operate on a global scale and have a well-distributed geographical presence, including production facilities in the U.S., and pursue a local-for-local production strategy. Potential direct exposure is rather likely for downstream specialty chemical producers and their higher value-added products in fields like health care or nutrition.

Nevertheless, escalating trade tensions, barriers, and retaliatory measures could have widespread indirect repercussions. This includes deepening economic uncertainty, impairing key customer industries such as automotive, disrupting complex global supply chains, and increasing competitive pressure as redirected chemical products from China seek new sales markets. Overall, this could hinder economic growth.

A U.S. strike from port workers could hurt supply chains. At the time of this publication the International Longshoremen Association (ILA) had reached a tentative agreement over the use of automation, pending a vote by the union. A prolonged strike could have had massive ramifications not just for the chemical industry but for the economy as well, affecting 36 major ports along the eastern seaboard and the Gulf of Mexico, representing approximately 60% of U.S. shipping traffic and 90% of the waterborne chemical shipments that move in and out of the U.S.

Indeed, these ports on the East Coast and Gulf Coast handle more than 43% of U.S. imports and about $3.7 billion worth of trade daily. Chemical suppliers would have faced large delays receiving and distributing raw materials and products. U.S. polymer producers may have had to shut down plants as they export 30%-50% of production out of these terminals and use railcars as primary storage for certain polymers. Also, a prolonged strike would have created significant inventory builds in almost all segments of the chemical industry, crushing volumes, pricing, and margins. With the threat of tariffs and a strike looming, inventory imports were being pulled forward and inventory levels were beginning to rise.

Even if this particular strike is averted, it highlights how credit risks from labor have increased in recent years. The resilience of the U.S. economy has brought significant labor cost inflation and shortages, and unions have become more assertive. In the context of the reshoring of supply chains and a more bloc-based global trading environment, labor-related risks are likely to become a more significant credit driver for the foreseeable future.

Although many companies addressed near-term maturities in North America in 2024, refinancing risks in 2025 and 2026 remain. Most speculative-grade issuers that refinanced debt in 2024 faced higher average borrowing costs on their new capital structures, as they refinanced debt previously raised in the historically low-interest rate environment before rate hikes in 2022.

Despite a high level of refinancings in 2024, there are still refinancing risks for debt maturing in 2025-2026, particularly for issuers rated ‘B-’ and below, which hold more than half of the maturities. Several low speculative-grade chemical issuers have substantial debt maturities in 2026—most of which we believe will require refinancing. While issuers would welcome lower interest rates in coming quarters and the pace of interest rate cuts will remain a key area of focus, we believe refinancing transactions by themselves may not have a large impact on borrowing costs and credit metrics (assuming they aren't distressed).

However, companies on the lower end of the rating spectrum that hold most of the debt maturing in 2025 and 2026 have relatively limited cushion in their credit metrics to absorb shocks and sustain our ratings on them. We expect maturity risk—and risk of distressed exchanges or default, particularly for issuers with debt trading at a significant discount—will increase next year for such issuers if operating conditions and cash flow continue to languish and markets turn nonreceptive due to macroeconomic and geopolitical uncertainties.

Related Research

- Credit Conditions Asia-Pacific Q1 2025: Bracing For Volatility, Dec. 12, 2024
- Economic Research: Economic Outlook Asia-Pacific Q1 2025: U.S. Trade Shift Blurs The Horizon, Nov. 24, 2024
- Asia-Pacific Credit Outlook 2025: Cutting Through The Noise, Nov. 13, 2024
- Sustainability Insights: Decarbonizing APAC Chemicals - A Looming Competitive Differentiator, Aug. 26, 2024
- Asia-Pacific Agrochemicals: Green Shoots Signal Gradual Turnaround, Aug. 21, 2024
- China Commodities Watch: Trade Tensions Add To The Pain, June 3, 2024
- Credit FAQ: Why The Recovery May Be Moderate For Asia-Pacific Agrochemicals, March 4, 2024
- China Commodities Watch: Upstream Will Hold Up, Downstream Will Suffer, Jan. 15, 2024

Industry Forecasts: Chemicals

Chart 7

Revenue growth (local currency)

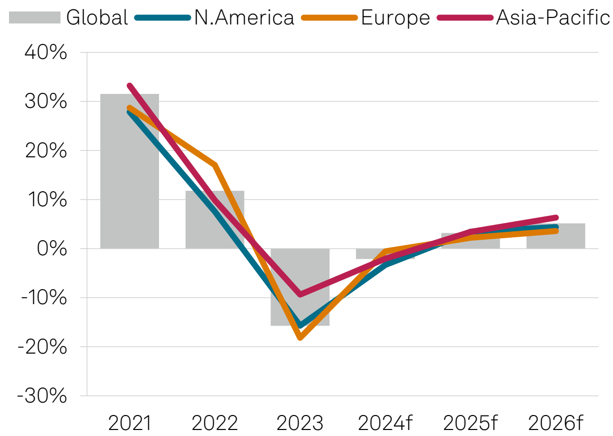


Chart 8

EBITDA margin (adjusted)

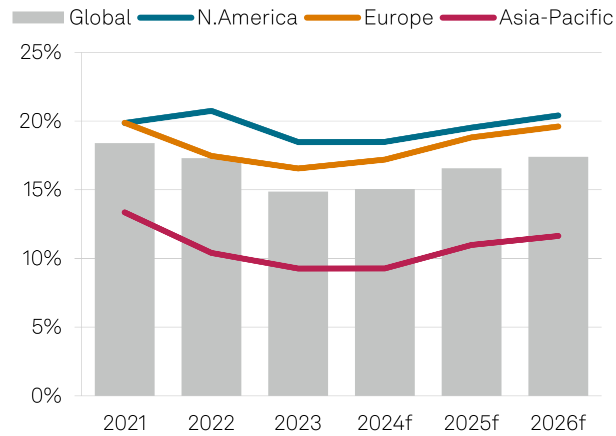


Chart 9

Debt / EBITDA (median, adjusted)

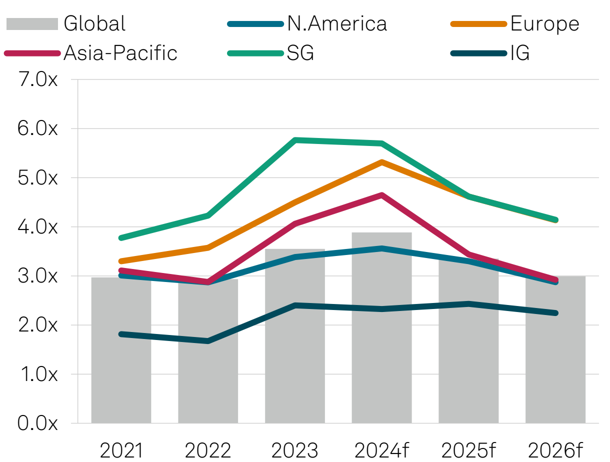
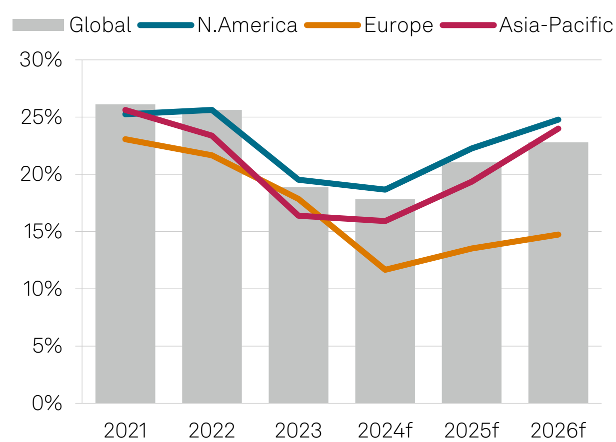


Chart 10

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Chemicals

Chart 11

Cash flow and primary uses

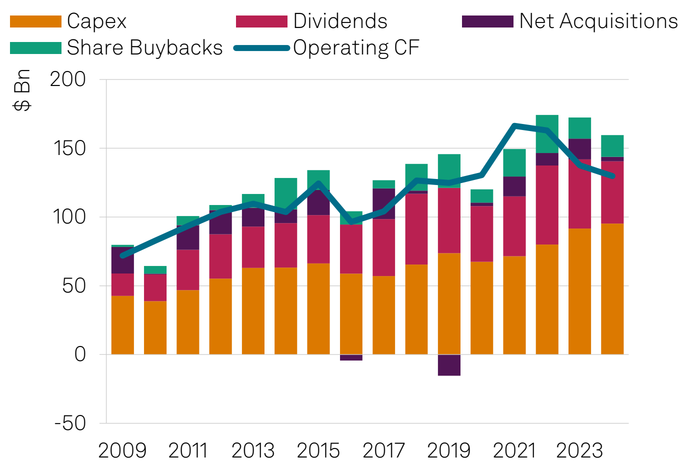


Chart 12

Return on capital employed

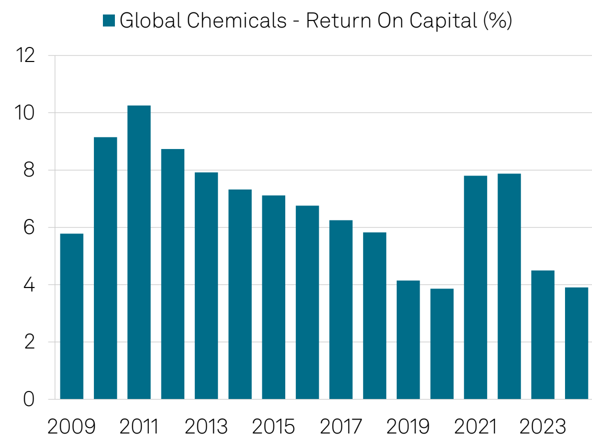


Chart 13

Fixed- versus variable-rate exposure

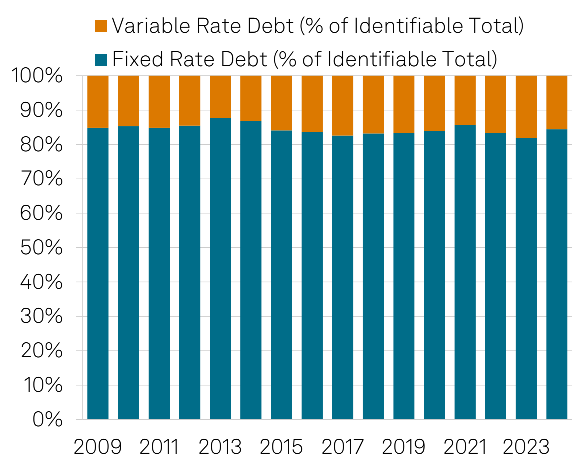


Chart 14

Long-term debt term structure

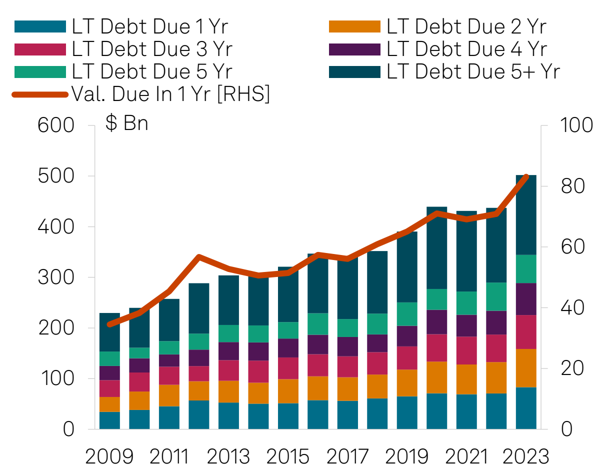


Chart 15

Cash and equivalents / Total assets

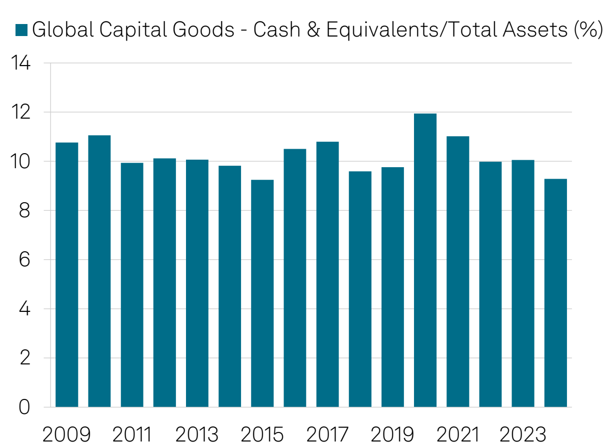
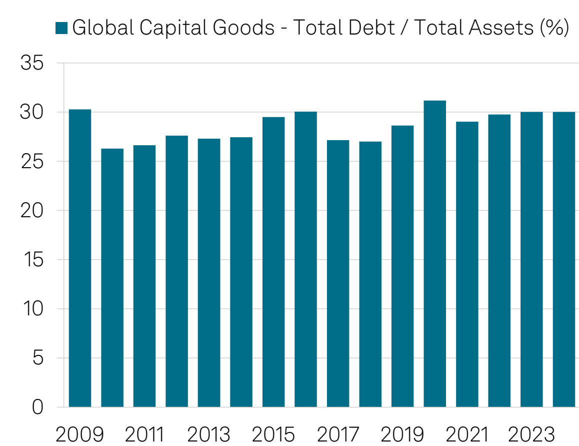


Chart 16

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

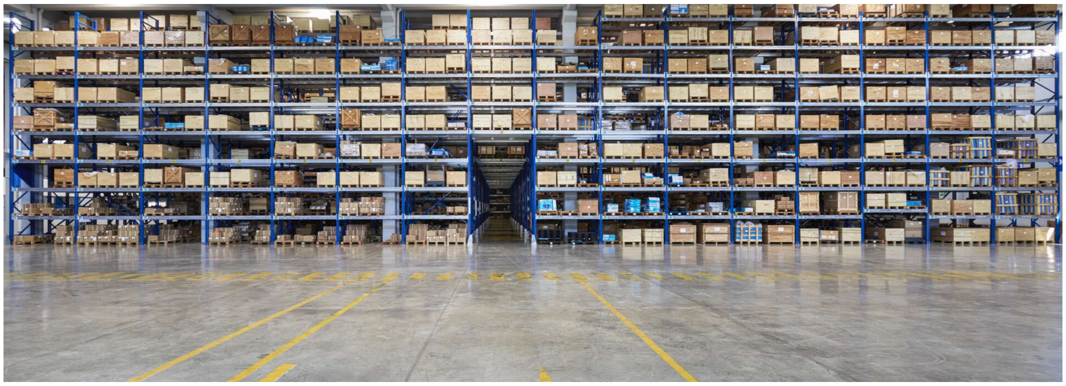
S&P Global Ratings

Consumer Products

Volumes remain anemic even as brands rein in pricing

January 14, 2025

This report does not constitute a rating action.



What's changed?

Rejuvenating volumes is the top priority. As the capacity to raise prices further is limited, consumer goods companies shift their focus from price to volume-driven organic growth.

The appeal of private-label products is up among consumers. With falling inflation, private labels have more flexibility to cut prices compared with brands.

Many companies have dialed back on premiumization. High list prices have temporarily slowed premiumization. However, it will remain a long-term industry trend, especially in mature markets.

What are the key assumptions for 2025?

Promotions will increase even as list prices will remain high. Faced with value-conscious consumers, brands will ramp up promotions and commercial initiatives to regain market share.

The West nears peak volumes. Large consumer markets in Asia, Latin America, and Africa will drive growth opportunities but will not compensate for the sluggish volumes in the West.

Financial policy surprises will be limited. Shareholder returns will be predictable and M&A selective. Conglomerates will carve out noncore, lower-growth, or less-profitable product lines.

What are the key risks around the baseline?

Sales contracting in the U.S. and remaining weak in China. Simultaneous weakness in the large consumer markets will stress operating performance and weaken credit metrics.

Inability to recalibrate growth targets and optimize inventory levels. Weaker demand will lead to increased working capital and hit free cash flow.

Tariffs and geopolitical conflicts. High tariffs and possible retaliatory actions, coupled with the escalation of geopolitical tensions, could severely hit global trade and supply chains.

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Ratings Trends: Consumer Products

Chart 1

Ratings distribution by region

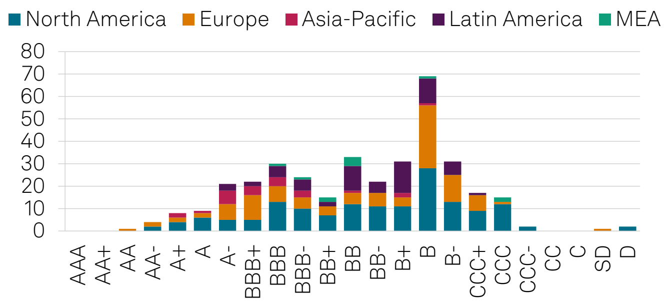


Chart 2

Ratings distribution by subsector

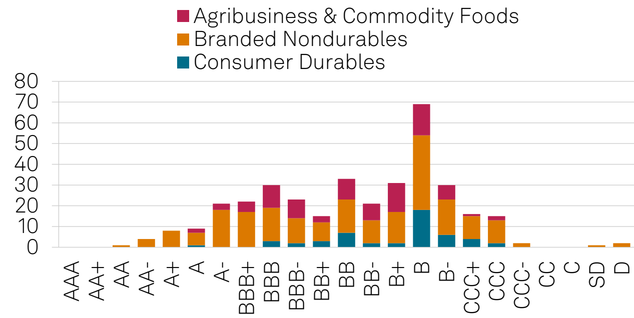


Chart 3

Ratings outlooks by region

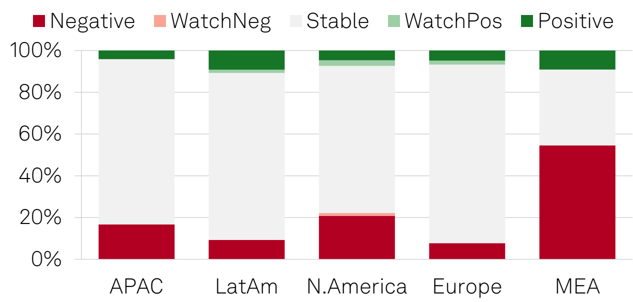


Chart 4

Ratings outlooks by subsector

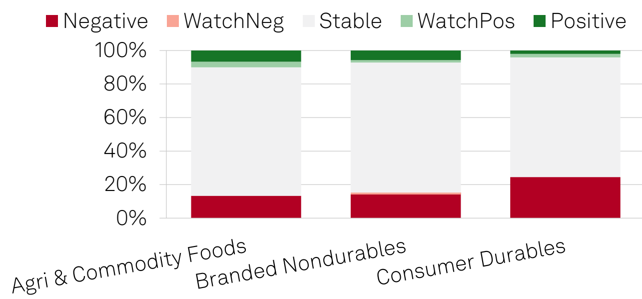


Chart 5

Ratings outlook net bias by region

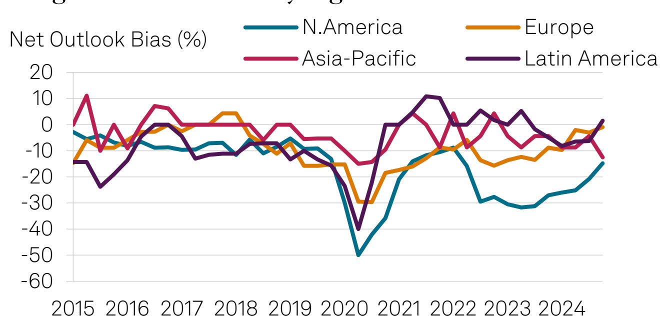


Chart 6

Ratings net outlook bias by subsector

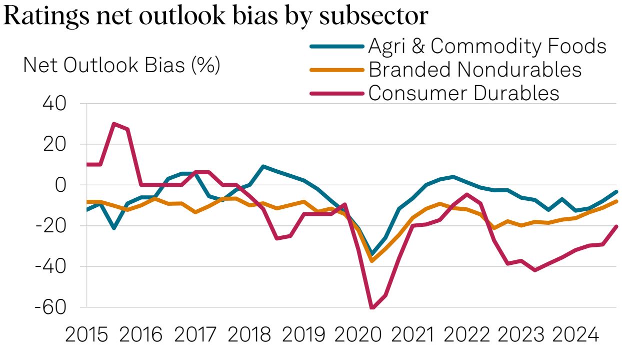


Chart 7

Ratings outlooks

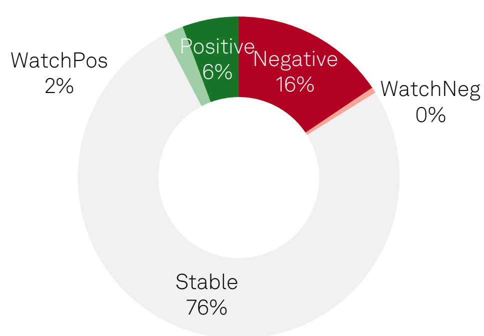
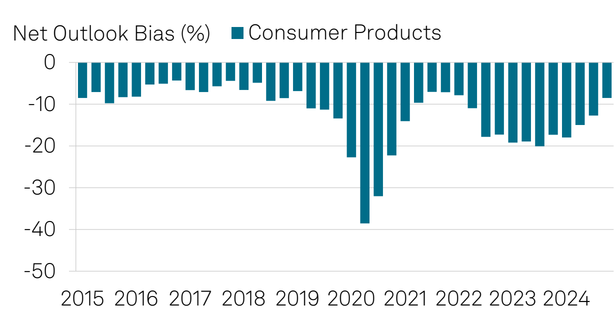


Chart 8

Ratings net outlook bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

In 2024, upgrades and downgrades were almost evenly matched. There were 45 downgrades across the global consumer products sector (across branded nondurables, agribusiness and commodity foods, agricultural cooperatives, and consumer durables) compared with 44 upgrades. Most of the downgrades (38) were to speculative-grade issuers. The negative rating actions were primarily due to these companies' weakness in top lines, stemming from higher exposure to discretionary demand and weaker margins in addition to high leverage. With already-high prices, many of these companies experienced volume pressure and aim to cut costs to improve margins, but risk intensified because of high interest rates and economic uncertainty. Weakening of consumer demand also led to the negative outlook bias remaining high. Globally, we have negative bias (negative outlooks and CreditWatch negative placements) on about 16% of the issuers we rate in the sector—7% lower than a year ago. More negative outlooks in North America reflect the greater proportion of discretionary products manufacturers instead of greater pressure in the region.

In the U.S., rating actions became more positive, with the ratio of upgrades to downgrades at 1.2 to 1. This is opposed to 2023, whereby downgrades exceeded upgrades. Margins improved as inflation moderated and companies lap up the large price increases over the past few years to offset inflation. Some speculative-grade issuers addressed debt maturities as interest rates fell. Still, 70% of ratings on U.S.-based issuers are speculative-grade and negative outlooks constitute about 21% of issuers. About 15% of these issuers are in the 'CCC' category, highlighting the sector's greater default risk.

For 2025, large consumer goods multinationals with strong brands, significant geographical presence, and wide product ranges will strengthen their competitive advantage. These companies have sufficient price and mix flexibility, as well as product range across value, mass market, and premium segments, to curtail the overall impact of tepid volumes. Accordingly, credit prospects are broadly stable for investment-grade companies, given their strong market positions within their categories, generally good product diversification, sound cash flow, and flexibility to tighten discretionary spending in times of stress.

Still, the 'B' rating category accounts for the highest number of issuers in the sector, at about one-third. This group includes many smaller and highly leveraged companies with weak business risk profiles. They remain vulnerable to significant volatility in operating performance and could find it challenging to restore profitability and cash flows. Higher-for-longer interest rates will also gradually intensify the pressure on many, even as these companies' margins and cash flow haven't fully recovered to pre-pandemic levels. Meanwhile, a pullback in consumer spending or disruption to supply chains from geopolitical conflicts could be a tipping point for many issuers with limited financial flexibility.

Main assumptions about 2025 and beyond

1. Consumers will be resilient but still cautious and price-sensitive.

Easing inflation and resilient labor markets in most developed countries should broadly support consumer spending next year. While the eurozone continues to recover, and emerging markets find their footing, we forecast global slower economic growth in the U.S. and China, the world's two biggest economies and largest consumer markets. Coupled with the lingering effects of permanently higher prices on consumer purchasing power and constrained pricing power, we expect most consumer goods companies will be unable to achieve meaningful top-line growth.

2. Moderate improvement in margins on carryover pricing, offset by higher promotions.

The previous price increases' carryover effect should help most consumer goods companies to rebuild their gross margins. However, as competition intensifies, gross margin gains from lower input costs and carryover pricing gains will be deployed to strengthen brand equity. Greater competitive intensity will lead to more spending on advertising and brand building, but also higher price promotions.

3. Consumer goods companies will have to continue to balance investment priorities.

Companies will continue to invest in digital capabilities, so we expect that capital expenditure will remain elevated. However, we also anticipate higher restructuring spend to improve operations and supply chains. Together with largely consistent shareholder returns, this will leave limited capital for M&A, which will be largely limited to bolt-on acquisitions and opportunistic purchase of distressed businesses.

U.S.

Growth in consumer spending in the U.S. has been surprisingly strong, supported by increases in real disposable income and solid household balance sheets. Consumer resilience was marked by recent increases in personal income and the saving rate. Stronger income growth looks to be more supportive of spending capacity, which has caused us to lift our near-term consumption forecast. However, Donald Trump's policy proposals from his campaign, at face value, could result in higher inflation in the near term and lower growth in the medium-to-long term. The probability of a disruption to the Fed's easing bias over the next two years has risen.

Canada

Unlike the U.S., high interest rates and cumulative effects of inflation have caused Canadian consumers to limit spending. With unemployment forecast to be higher in 2025 and shelter expense remaining high, we expect Canadian consumers to focus less on discretionary spending.

China

In China, we expect retail sales to expand 4%-5% in 2025, similar to 2024 levels. Government subsidies provided through the targeted trade-in program has supported retail sales growth in 2024. Home appliances and electronics such as computers and, to a smaller extent, smartphones have been key beneficiaries. While the program ended in December 2024, the government is guiding an extension of it, possibly with expanded categories. We see a high likelihood for extra stimulus—given ongoing property weakness, and the potential U.S. tariffs hikes to hurt exports—and have assumed the benefit to flow across all categories.

Consumers are cautious and rational in spending despite subsidies from the government and discounts from merchants or retailers. Impulse purchases have been largely absent in 2024. Consumers are anchored toward an every-day-low price mentality; they look for higher quality at the same or lower prices. As such, product makers need to roll out stronger value propositions to attract customers.

Eurozone

Confidence in the eurozone remains weak and labor markets appear more fragile. Despite easing inflation, consumer prices have not declined. Energy and food prices even remain at historical highs, with low-income households most affected. In Europe, we believe the labor market slowdown could accelerate in 2025. That the strong disinflation in the eurozone, underway since fourth-quarter 2022, did not result in job losses is unusual. We anticipate the European Central Bank will cut rates more quickly due to persistently weak confidence and better visibility on the disinflation trajectory. We expect European consumers will remain extremely value-focused and will maintain a cautious outlook toward discretionary spending on consumer goods in 2025.

U.K.

General uncertainty about the U.K.'s economic prospects could continue contributing to consumption reticence over 2025. This is also visible in the difference between consumers' confidence regarding their personal situations and their confidence in the wider economy over the past year. Brexit, the pandemic, cost-of-living issues, and geopolitical developments are making households more worried about job prospects. This is also seen in the U.K. household savings ratio, which suggests consumers have been relatively cautious and spent less than they could afford, despite a robust recovery of real disposable income.

Latin America

Real consumption continued to grow especially in Mexico and Brazil, but year over year volumes were impaired, with higher inflation pressuring consumers' pockets. The main risk factor for Brazil is the increasing interest rates, which just rose another 100 basis points to 12.25% and is expected to continue rising in the next six months at least to control inflation. Higher policy rates could drag companies' capacity to invest and led them deploy a significant amount of EBITDA to pay interest. For Mexico, the major risk is potential new policies under the Trump administration that could hinder immigrants' remittances from the U.S., which could affect consumption in Mexico.

Japan

Real consumption in 2024 will likely end up in broadly flat year-over-year. We expect a moderate recovery in 2025. Nevertheless, underlying consumer sentiment will remain weak following past price hikes on everyday items. Expectations of moderating inflation will also weigh on consumer sentiment. The Bank of Japan could pursue an additional rate hike in 2025. Its policy rate as of November 2024 is 0.25%, the highest in more than a decade. We project its policy rate will rise further to 0.75% by 2025 year-end. However, we do not think it will hinder consumer spending because we expect the hike will likely correlate with income and consumption increases.

Subsector assumptions for 2025

Agribusiness. After significantly lower earnings for most agribusinesses in 2024, which reflected a weak industry cycle across various subsegments, we expect a modest rebound in sector earnings in 2025, if below the highs of 2022 and 2023. The one sector that we project to remain depressed in 2025 is U.S. beef processing, as herd rebuilding is not likely until 2026. A rebound has already taken hold for certain segments, including pork and chicken processors globally (which benefited from lower feed costs, a rational supply volume, and price support from high beef prices), and ingredient manufacturers globally for which lower input costs and inventory restocking enabled margins to rebound closer to historical levels. Brazilian sugarcane processors should continue benefiting from high sugar prices and a recovery in productivity levels from this year's decline of 10%-25% due to the severe drought, while ethanol prices continue to recover to parity with gasoline prices. The overall sector could benefit from the change in regulation to increase ethanol blend into the gasoline to 30% from the current 27%. Those trends should continue in 2025, although cautious consumer sentiment elevates the risk for ingredient manufacturers if input cost inflation returns.

Still, global agricultural commodity supplies remain high, which we think will mute the earnings rebound from the lows of 2024. This is particularly the case for grain traders, which we project will face limited margin opportunities given elevated stocks and expected large harvest volume in 2025. Although higher tariffs could cause trade flow dislocations, which would benefit the sector, we think the impact will be muted as trade flows are less likely to be disrupted after they are reconfigured, namely China prioritizing South American imports following any U.S. tariffs. Other headwinds muting a more pronounced rebound is the high level of uncertainty on U.S. biofuel policy, which could keep oilseed crush margins under pressure, though growing biofuel demand in other regions coupled with healthy demand for feed continue to support our expectations for a modest rebound for grain and oilseed processing. Elevated and expected rising interest rates in Brazil could hinder investments and cash generation, especially for highly leveraged issuers that will need to redirect a large part of EBITDA for interest payments.

Overall, credit measures remained largely in line with our expectations during the 2024 downturn, even rebounding for issuers with high leverage as their cyclically weak earnings sequentially improved, resulting in several outlook revisions to stable from negative. As such, any rating pressure in 2025 should be limited to issuer-specific circumstances, including recent M&A, governance, and financial policies.

Alcoholic beverages. With most alcoholic beverage companies underperforming our expectations year-to-date in calendar 2024, we expect performance to remain subdued at least through first-half 2025, when most rated issuers close their fiscal years. The sector continues to face several near-term issues, including weak consumer demand in developed markets (particularly the U.S.) leading to a shift away from premium sales, weak Chinese sales that have further hurt premiumization, lower on-premise demand, inventory destocking (although these are stabilizing), currency issues, and possible tariffs. With regard to the latter, we anticipate amplifying effect on already-weak Chinese sales for European players exposed to the cognac and brandy category, given the ongoing trade spat between the two parties. Chinese authorities formally implemented additional tariffs ranging from 30%-40% in late October 2024. As a result, we have a cautious outlook for 2025, with the possibility of additional risks materializing. Still, there are pockets of growth in certain emerging markets (like Brazil, Southeast Asia, and India) that should offset risks for issuers with a global footprint, particularly brewers. In addition, we view current problems plaguing the sector as temporary and continue to think the trend toward premiumization will continue benefiting the sector beyond 2025. M&A is not likely to pressure credit measures in 2025 as the handful of recent acquisitions have not materially increased leverage while several other issuers have announced divestitures of noncore brands that should lead to debt repayment. Moreover, cash flow remains healthy and credit measures largely in line with expectations such that downgrade risk for the sector in 2025 is largely contained.

Apparel. Our rating outlook on the subsector is negative due to an uncertain macroeconomic landscape and cautiously spending consumers that will lead to flat revenue in 2025. New products could drive brand momentum after industrywide inventory challenges over the past few years. Tight inventory management will be key to avoiding excessive discounting and good cash flow. We forecast profitability metrics to continue improving, mainly from cost-saving actions of recent years and better inventory management. Specifically, we expect EBITDA margins to rise nearly 150 basis points. Footwear continues to evolve as new competition is taking market share and large brands such as Nike, Under Armour, and VF Corp. have had strategy misses.

Given the challenges of the past few years, many issuers in the industry have new management teams focusing on brand turnarounds and elevation. Share repurchases remain turned off or muted for these issuers and we forecast this to continue in 2025 as operating conditions remain uncertain. We expect M&A to be limited to brand management with companies seeking to buy the intellectual property of brands in financial distress.

Beauty and cosmetics. Our rating outlook for the subsector is stable because we forecast modest revenue growth as consumers seek affordable indulgences during weaker economic periods. However, U.S.-based cosmetics company Coty Inc. has lowered its revenue guidance based on weaker consumer demand trends, while Estee Lauder is still facing challenges, primarily in China and its travel retail channel. If consumer sentiment in China improves, we could see a return to more normalized growth of mid-single digits for the industry. Competition has increased, mainly because of e-commerce growth, new brands, and a rise in promotional activities for product launches. Additional competitive pressure comes from small, new, and digitally focused regional players. Skincare, making up more than 40% of the cosmetic market by value, has been particularly resilient and remains one of the key growth factors. The growth spurt in fragrance continues as consumers seek fragrance use for different occasions and to give as gifts. Overall, we expect growth from both price and volume, and margin expansion through lapping higher costs and cost-savings initiatives.

Durables. Our outlook on the subsector is stable, but this could change depending on the magnitude of potential U.S. tariffs and possible retaliatory action from trading partners. This could reignite inflation in the category, dampening demand. Moreover, issuers that sell more expensive products tied to the housing market—like large appliances—could face negative rating actions if interest rates remain elevated, which would continue to depress housing turnover. In the U.S., the building of new houses could suffer, or prices could become more expensive, if sizable deportations that reduce labor availability materialize. Issuers depending on commercial real estate occupancy—such as contract office furniture manufacturers—continue to face office space downsizing risk. However, more recent order and backlog trends suggest improving confidence as clients adapt to a hybrid work environment.

Household appliance manufacturers, Whirlpool (BBB-/Stable/A-3) and Electrolux's (BBB/Negative/A-2) saw negative rating actions in 2024. Whirlpool was downgraded by one notch and we revised our outlook on Electrolux to negative following two downgrades in 2023. These rating actions were due to lower-than-expected volumes and weaker margins, coupled with uncertain recovery prospects.

Absent the tariff risk, we expect subsector net sales in 2025 to rebound by mid-single digits following the weak performance in 2024—as supportive commodity costs and issuer productivity initiatives translate into more promotions and higher customer spending. We think retailers will remain cautious but steady on inventory ordering; this should give manufacturers incentives to produce closer to sell-out levels and reduce the risk of margin damaging production cuts to clear excess inventory.

M&A strategies are unlikely to change from 2024 and will be limited to tuck-ins. We expect financial policies will largely prioritize credit metric improvement over large shareholder payments.

Household products, beauty, and personal care. Our outlook on the subsector is stable, reflecting recurring purchase patterns for these low-cyclicality staple products and margin restoration as issuers benefit from lower inflation, improved supply chains, and productivity initiatives. We expect 1%-3% net sales growth across the subsector in 2025 as the ability to increase prices remains limited to value-added innovation given the cumulative effect of high inflation, while volume increases should track population growth. The growth in S&P Global Ratings-adjusted EBITDA for the subsector should modestly exceed percentage growth in sales, given operating leverage and better supply chain conditions, despite elevated advertising and promotional spending to support the top line.

We expect demand for personal and consumer health care products to fare better than household products. The former benefits from consumer trust of branded products and the latter faces ongoing store brand competition. Still, the timing of a recovery in China—which has been weak following the pandemic and economic softness—remains a risk for personal care product issuers. We also think litigation remains a medium-term risk for consumer health care issuers recently spun off from their pharmaceutical parents. However, the aging population in developed markets and growing middle classes in emerging markets create long-term tailwinds for preventative health care products. We expect large multinational household and personal care product companies' financial policies to remain consistent, with some bolt-on acquisitions, regular dividend payments, and share buybacks.

Personal luxury goods. The industry is experiencing a challenging environment mainly owing to weak demand in China and economic volatility in developed markets. The industry is characterized by increasing polarization in companies' operating performance, with the global luxury players more exposed to an aspirational clientele (as opposed to the ultra-premium segment) experiencing higher volatility. In 2023, the industry experienced average organic growth of 6%-8% year-on-year, while for 2024 we estimate an annual contraction of 2%-3%, with a modest recovery expected in 2025, with a sequential quarterly improvements especially in the second half. We expect the industry growth mainly coming from a positive mix and the recovery in travel retail, together with limited contribution from pricing initiatives. The U.S. and Western Europe show overall resilience while Japan, driven by exceptional tourism spending, represents the fastest-growth country, accounting now for 8%-9% of the total personal luxury industry. Despite the ongoing industry pressures primarily related to significant low consumer confidence in China (impaired by higher saving rates, real estate issues, and demographics), the personal luxury industry has a long track record of positive performance, with few negative trends (examples include the 2008-2009 economic crisis and the start of the COVID-19 pandemic in 2020). Finally, in terms of strategic priorities, global industry players are implementing elevation strategies for their core brands, supported by operating expense in marketing and communication activities and coupled with investment in real estate retail networks and manufacturing capabilities. For this reason, over the next year, we do not assume any profitability upside.

Nonalcoholic beverages. The top-line outlook for nonalcoholic beverage companies in 2025 varies depending on portfolio and channel mix. Categories facing top-line pressure include bottled water, sports, and energy, the latter of which also faces the additional stress of lower convenience store traffic. Some categories face commodity input cost pressure like orange juice, coffee, and high-protein offerings due to still-elevated dairy costs. Moreover, less away-from-home dining should continue to pressure higher-margin fountain volumes at least through first-half 2025. Still, companies with broad portfolios have innovated and managed their price-pack architecture to sustain organic growth. As such, we think the overall sector will grow sales 1%-3% next year and expand EBITDA by similar levels by reducing costs and improving manufacturing efficiencies through automation and stock-keeping unit rationalization to enable longer line run-times. Still, we don't expect margins to rebound to historical levels next year given the mixed demand outlook across categories and channels, pressure to increase promotions, commodity-specific input cost pressure, and the negative impact from the move to more value-oriented pack-sizes. Despite a mixed top- and bottom-line outlook, credit measures remain largely in line for investment-grade issuers for which our rating outlook is largely stable and for which M&A risk is less pronounced given companies' preference for targeted acquisitions of individual emerging brands. Speculative-grade issuers with product concentration in underperforming categories will face rating pressure.

Packaged foods. We expect volume changes will largely remain slightly negative-to-flat through at least first-half 2025 for most industry players as consumer spending remains cautious. For 2025, we estimate sector revenue being flat or rising up to 3% on average, thanks to low price increases, a favorable mix partially offset by slightly negative to modestly positive volumes, and increased promotions. We expect cautious consumer behavior to continue, including value-seeking and buying close to consumption. Assuming inflation remains at current levels, we forecast EBITDA margins will modestly expand for most companies in 2025 that have manageable input costs and higher productivity measures. These measures will help fund investment in promotions, innovations, and brand-building to restore volume growth. While most input costs have decreased, cocoa, coffee, dairy, sugar, packaging, and labor costs remain elevated. Companies with greater exposure to those inputs will implement price increases to partially offset the higher input prices. Higher costs will impede volume growth and lead to more open book pricing negotiations between manufacturers and retailers. In 2025, margins will contract for Hershey and Mondelez, who have greater cocoa exposure than peers. Key risks to our forecast include renewed inflation with proposed tariffs, higher labor costs, and potential food regulatory changes under the new administration. We think additional pricing will be limited because prices remain high, and the consumer is stretched. Higher costs could hurt profitability if companies cannot pass along the cost increases or mitigate them with productivity measures. Increased risks associated with ultra-processed foods and a more widespread use of glucagon-like peptide-1 products, could also weigh on demand for some packaged food companies. Companies that can quickly adapt to changing consumer tastes and preferences will fare favorably.

Consumers have traded down as they seek value, and private labels have gained market share over the past few years, but we think share gains have slowed. We expect companies to continue reshaping their portfolios through divestures of noncore assets and acquisitions—most of which will likely be into faster-expanding categories or new regions. Furthermore, we expect continued dividends and share buybacks will be in line with companies' stated long-term targets.

Tobacco. Our rating outlook on the subsector is stable, reflecting issuers' high margins and cash flow, substantial pricing power, historically moderate elasticity due to nicotine's addictive nature, and conservative leverage profiles, notwithstanding high shareholder payments. We assume combustible cigarette volume declines will remain elevated (mid-single-digit declines, including high-single-digit declines in the U.S.) though pricing will offset much of the negative impact, as it has historically. We think illicit products—including flavored vaping products in the U.S.—will remain a headwind well into 2025 as industry participants, including regulators, try to stem the flow. Combustible cigarette trade-downs by lower income smokers is likely to continue, especially in mature markets; we think this was a factor in Japan Tobacco Inc.'s late 2024 acquisition of U.S.-based deep discount cigarette manufacturer Vector Group Ltd. Issuers owning a portfolio of next-generation smokeless products—including oral, vapor, and heat-not-burn—will fare better as nicotine users move between categories, allocating a portion of their spending to these alternatives. Oral nicotine pouches are now a multibillion-dollar category and have emerged as one of the fastest-growing segments within the U.S. tobacco industry, with manufacturers investing heavily in production capacity expansion to meet the rapidly accelerating demand.

In Japan, the largest market for heated tobacco products, there is a rising likelihood of a tax hike for the category starting in 2026. This would eliminate the tax advantage, because the category has grown sharply in the past 10 years thanks in part to lower tax rates to represent about 40% of the country's total tobacco market. Moderate downtrading is already in place in the category. We think price competition for market share might intensify further before the tax hike, which could leave the growing category less profitable.

Regulatory risks designed to reduce tobacco use or at least move nicotine users to products deemed to have less of a negative impact on public health remain a risk factor. Still, any potential ban on menthol cigarettes in the U.S. would not affect the industry for a few years. If enacted, we think this would be a moderate headwind for issuers since many smokers would switch to nonmenthol products.

In December 2024, the proposed plan for the resolution of the tobacco product-related claims and litigation against the local subsidiaries of Philip Morris International Inc., British American Tobacco, and Japan Tobacco Inc. in Canada was approved. The plan was put forward by a court-appointed mediator, whereby it was proposed that the companies will pay a total settlement of C$32.5 billion (approximately $23.5 billion), solely from the profits and cash and cash equivalents in Canada and split among the three parties in an allocation still to be determined. Following the creditor approval vote, this matter will move to a Sanction Hearing scheduled for Jan. 29-31, 2025, where the court will consider whether to approve the plan. Approval and implementation of the plan would ultimately allow industry players to close a long-standing chapter on this matter, a development we would in general view as credit positive because it removes an uncertainty that has been hanging on the companies for many years. That said, we think the matter's full resolution may take several more months to complete after a potential court approval, as full implementation is still subject to, among other things, agreement by the companies on how to split the total settlement, with Japan Tobacco already signalling some disagreement.

We expect financial policies to remain consistent with recent behavior as issuers focus on maintaining strong credit metrics given sustained smokeable tobacco product volume declines and the desire to make organic investments aimed at strengthening next-generation smokeless product portfolios while paying sizable dividends.

Credit metrics and financial policy

We forecast a moderate improvement in credit metrics for the global consumer goods sector in 2025. This would follow a fairly challenging period, starting with the pandemic through to the period of very high inflation in 2023 when high costs eroded EBITDA margins; the sector's median leverage remained elevated after peaking in 2022. Our forecasts for 2025 indicate a pickup in revenue, mainly from easing inflation and resilient labor markets. The 3% revenue growth in 2025 in local currency is aligned with our economic forecast of global economic expansion of 3% next year.

Overall, adjusted sector EBITDA margins should expand slightly by 40 basis points in 2025 due to the combined benefit of previous strong price increases, and our expectation of waning inflationary pressure. We expect that, with broadly stable financial policies, median adjusted debt to EBITDA will improve to 3.1x in 2025 from 3.3x in 2024.

The bulk of the global consumer goods companies we rate are mostly speculative-grade, with a large majority in the 'B' category. Many have weak business risks profiles, alongside highly leveraged capital structures. Higher-for-longer interest rates will further constrain these companies' already-limited financial flexibility.

At the other end of the spectrum, many large highly rated global multinationals continue to allocate a significant part of their free cash flow to shareholder returns. In the event of any significant operating issues, these companies can choose to limit shareholder returns to preserve cash and increase headroom under the ratings.

In Europe, we do not expect big financial policy surprises. Most rated companies will likely maintain their stated financial policy, with limited revisions to shareholder remuneration. Considering that several challenges continue to restrict management bandwidth, namely higher funding costs and fairly limited financial headroom, we do not anticipate large M&A transactions. We think consumer goods companies will approach sizable M&A with caution, but we continue to factor in portfolio transformation through investment, bolt-on acquisitions, and disposals. This trend also reflects strategies focused more on growing market share in core and higher-margin businesses.

In the U.S., we expect financial policies to remain balanced, but larger M&A could present some risk to ratings. Sustained stagnant demand in both durables and staples, along with lower interest rates, could spur deals for investment-grade issuers. Ongoing portfolio refinements will continue as well, as companies look to shed lower-growth assets. We expect dividends will remain steady and share repurchases opportunistic. Companies will pull back on discretionary buybacks after acquisitions to restore credit measures. Speculative-grade issuers will remain challenged because interest rates remain high.

We expect Canadian companies to focus more on balance sheet strength. With consumers spending less, companies irrespective of product offerings will focus on costs to maintain margins. We don't expect any material change in profitability; high fixed expense will continue to present issues. As a consequence, we expect companies to maintain conservative financial policies. However highly-leveraged issuers will continue to face headwinds associated with high interest rates and tightening liquidity.

In Latin America, we expect companies to remain cautious regarding acquisitions, especially while the largest markets such as Brazil and Mexico face their own uncertainty. For Brazil, higher interest rates will increase the cost of funding, while inflation and opening up of the betting market will continue to limit consumers' spending on goods. In Mexico, companies will likely wait to see potential tariff implementations in the U.S. and their impact on volumes and margins. Inflation in Argentina is gradually being controlled but the related policies have reduced consumer demands. Overall, we see stable to slightly worsening consumption conditions, but easing costs could help maintain operating profits.

In Asia-Pacific, we expect prudent financial policies to not change in 2025, keeping cash flow leverage at the same levels as in the past few years. This will support the credit profiles of consumer product companies in the region amid economic uncertainty. We also expect resilience in operating performance. Still, any material improvement in profitability is unlikely due to limited markup opportunities considering intensified price competitions. We expect consumer sentiment to remain somewhat weak across major regional economies.

We think multinationals in Japan and China will maintain their ongoing financial policies, with spending targeting their focus areas. These companies include Japan Tobacco Inc., Suntory Holdings Ltd., Ajinomoto Co. Inc., and Midea Group Co. Ltd. We saw slightly more aggressive financial activities than before at the rated Japanese multinationals in 2024 such as increased shareholder remunerations, acquisitions, and a reduction in hybrid capital, pushing up at most their respective debt to EBITDA leverage by about 0.5x. We also witnessed Chinese issuers allocating a larger portion of their cash flow to shareholder returns while controlling total cash outlays for their financial soundness.

For most rated issuers, we do not assume material impacts from the potential U.S. tariffs. Some issuers have relatively large exposure to the U.S. However, they locally source goods and manufacture products, which are likely to mitigate any impact. We also think most rated issuers can buffer potential ancillary impacts from effects such as higher volatility in the market.

For China, we assume consumers will remain cautious despite our expectation of continuing subsidies from the government. Households could reduce their spending should the country's property crisis worsen, hitting confidence. Most rated Chinese consumer product companies have sound finances for our ratings on them. However, smaller issuers or those with higher financial leverage could see rating headroom compression given shrinking household wealth and tepid consumer sentiment amid property sector woes. We assume China's property crisis will not greatly affect the credit quality of rated Japanese consumer companies because of limited exposure to the Chinese market.

Key risks or opportunities around the baseline

1. Volumes remain subdued, leading to higher inventory levels.

Consumers might remain reticent and sales volumes might not recover, due to high list prices, persistent competition from private label products, or a downturn in the labor market.

2. Technology enhancing product lifecycle management, provide visibility on supply chains, and help optimize costs.

Consumer goods companies will increasingly continue to use new technology to improve product design and improve personalization options.

3. Physical climate risk, climate transition risk, and customer health and safety are increasingly becoming more material factors.

Physical climate risk will likely increase as natural disasters become more frequent and intense, with credit implications for many subsegments of agribusiness and consumer goods. Consumer goods companies will continue benefiting from trends relating to more consumers embracing wellness and self-care products.

Weak sales volumes stress operating performance and cash flow. Despite price promotions and commercial initiatives to grow volumes, many branded consumer goods companies might not be able to grow sales volumes in line with their growth aspirations. After a period of normalizing inventory levels over much of 2023 and 2024, management teams expect to see a rebound in sales volumes. Many companies, particularly those with exposure to discretionary products, will see weaker cash flows if inventories build up again. This scenario could occur due to high inflation in emerging markets such as India and Brazil, downturn in the labor markets in the U.S. and Europe leading to a contraction in consumer spending and continuing weakness in China despite government stimulus. Given the high list prices of branded products, the improving quality and depth of store brands will continue to pose intense competition.

Digital tools will also help optimize processes and supply chains and partly offset higher labor costs. We also expect consumer goods companies will expand their direct-to-consumer retail channels and interact more directly with their target consumers. This will give them greater control over the user experience and garner customer insights. In addition, consumer goods companies will increasingly continue to use new technology based on AI and Blockchain to design better products for consumers and make greater inroads into personalization.

Physical climate risk, climate transition risk, and customer health and safety will also play key roles**.** Physical climate risk will likely increase as floods and droughts become more frequent and intense due to climate change, with credit implications for many subsegments of the agribusiness and consumer goods sectors in particular. Coupled with geopolitical risks that could affect supply chains, there could be increased earnings volatility, depending on the exposure to affected regions and diversification of operations. Climate transition risk is likely to both benefit and disrupt the sector, which is a major contributor to greenhouse gas emissions, although disruption risks will likely outweigh benefits from biofuels, renewable fuels, and more sustainable food sources. Although rating actions linked to consumer health and safety continue to be company-specific and event-driven, customer health and safety is a social factor that remains highly material to creditworthiness, with operational risk related to product safety and recalls, reputational risk, litigation risk and more intensive regulatory scrutiny.

Consumer goods companies will continue benefiting from trends relating to more consumers embracing products self-care products that enhance health and wellness. We expect more companies will be leveraging scientific evidence to demonstrate the value of their products, command higher pricing premiums, and differentiate from private label products. However, companies need to continue investing in ongoing product development, manufacturing, and brand building to stay ahead of the competition. Brands in subsectors like packaged food, personal care, and beverages will benefit most from these trends.

Related Research

- China Retail 2025 Outlook: Subsidies Will Further Help Stabilize Spending, Jan. 7, 2025
- Sector Review: Sector Update: Consumer Health, Dec. 20, 2024
- EMEA Consumer Goods: Credit Stories Unfolded, Dec. 12, 2024
- ESG Credit Brief: Agribusiness, Dec. 4, 2024
- Consumer Product Companies: The Road To Volume Growth Remains Elusive, Oct. 15, 2024
- Sector Update: Sportswear: Robust Growth Prospects Amid Intensifying Competition, June 25, 2024
- Credit FAQ: Unilever Streamlines Its Portfolio By Separating Its Ice Cream Business, April 16, 2024

Industry Forecasts: Consumer Products By Region

Chart 9

Revenue growth (local currency)

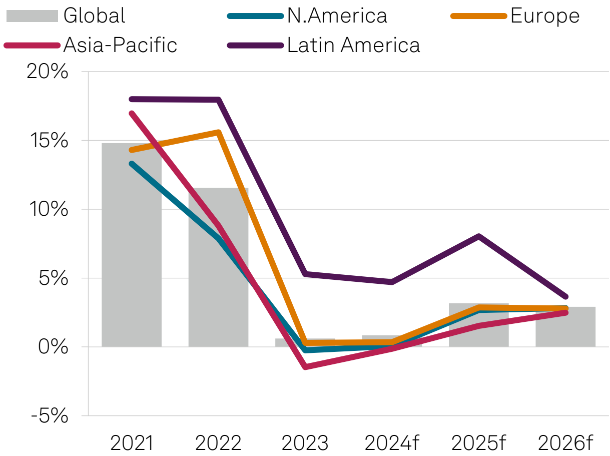


Chart 10

EBITDA margin (adjusted)

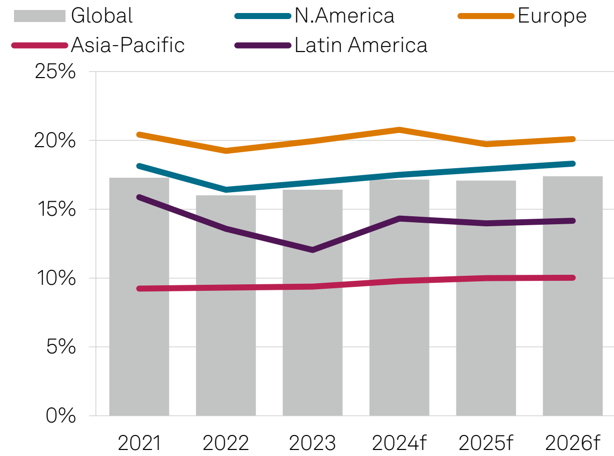


Chart 11

Debt / EBITDA (median, adjusted)

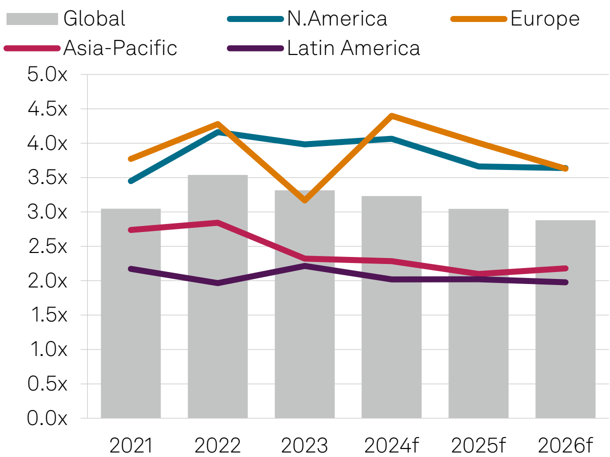
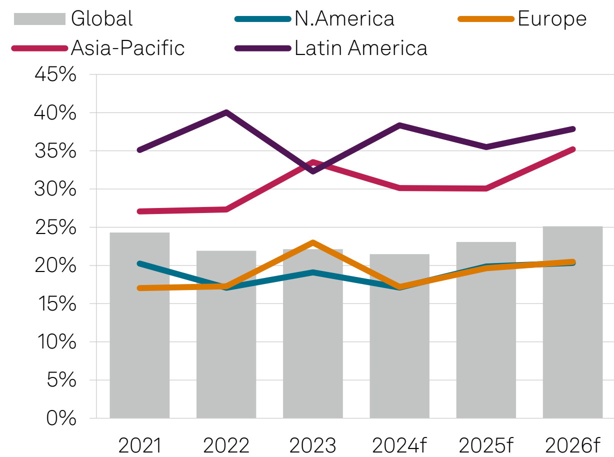


Chart 12

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Industry Forecasts: Consumer Products By Subsector

Chart 13

Revenue growth (local currency)

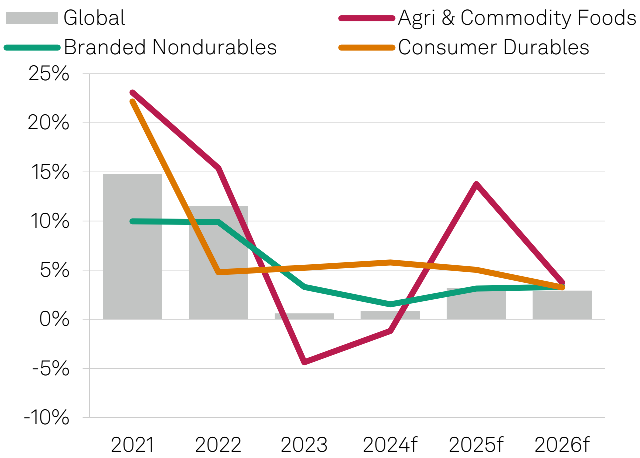


Chart 14

EBITDA margin (adjusted)

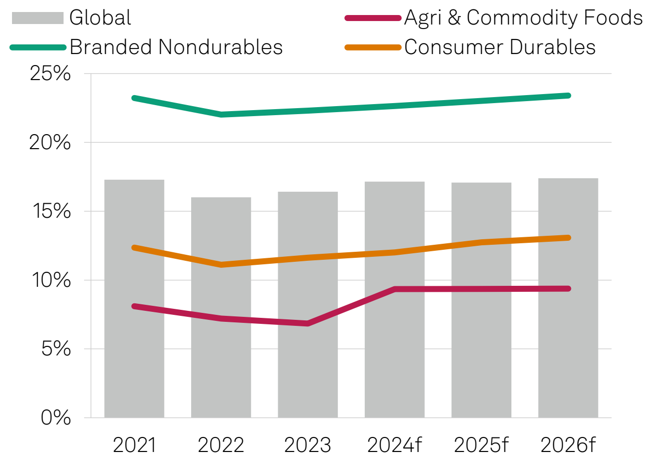


Chart 15

Debt / EBITDA (median, adjusted)

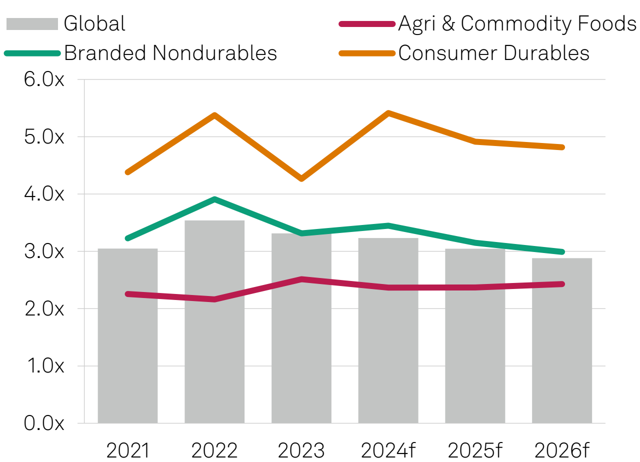
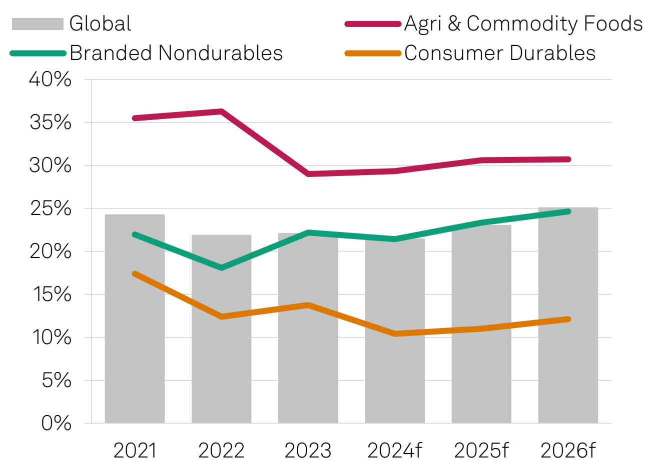


Chart 16

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Consumer Products

Chart 17

Cash flow and primary uses

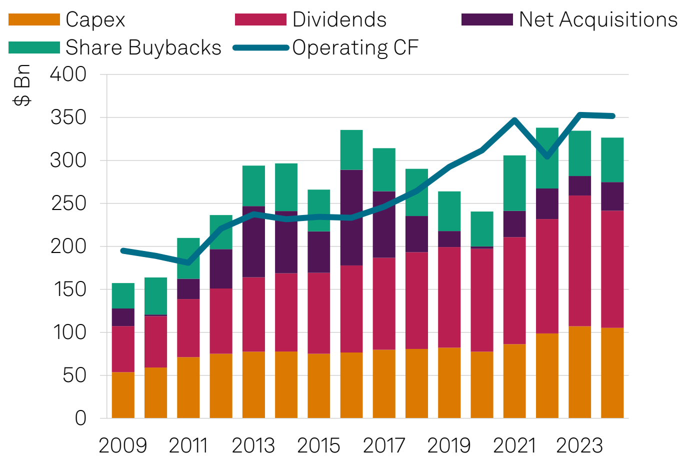


Chart 18

Return on capital employed

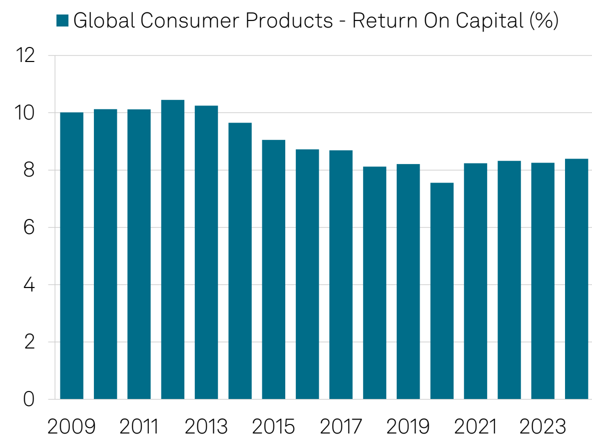


Chart 19

Fixed- versus variable-rate exposure

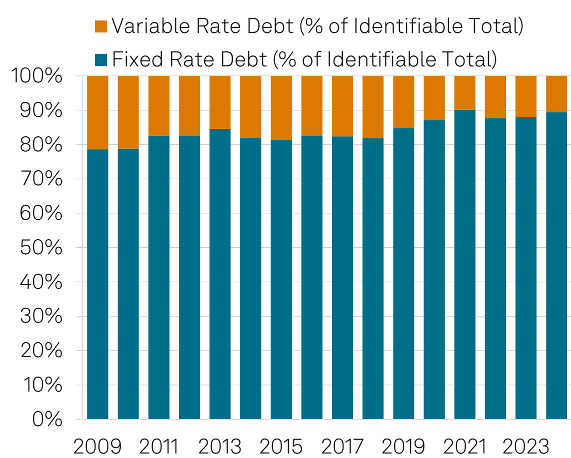


Chart 20

Long-term debt term structure

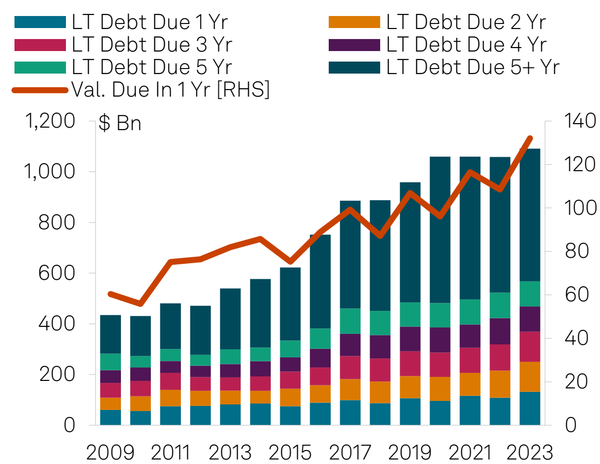


Chart 21

Cash and equivalents / Total assets

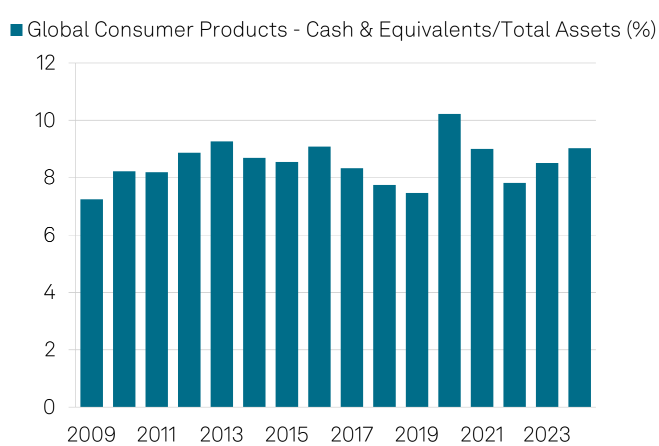
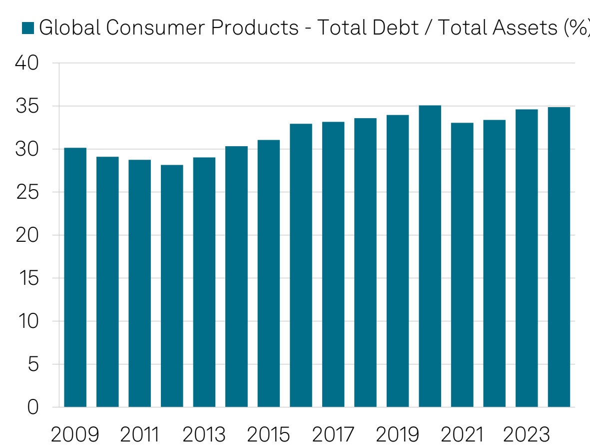


Chart 22

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Engineering and Construction

E&C continues to expand on sound infrastructure spending

January 14, 2025

This report does not constitute a rating action.

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What's changed?

E&C issuers will grow at a more moderate pace in 2024 and 2025, relative to their peak levels in 2022 and 2023. Most are poised to expand over the next several years, supported by the sound infrastructure spending in most regions amid favorable project funding conditions, the energy transition, and the exponential demand for data centers. Conversely, in China we expect the E&C sector's output will rise by the low-single digit percent area in 2025 on a high base and declining new orders.

What are the key assumptions for 2025?

Lower interest rates will accelerate investments, though not immediately. We assume additional rate cuts during 2025 will support construction activity but anticipate a lag from planning to execution will lead to a more material impact in the back half of 2025 and 2026.

Moderating revenue growth in China. Given elevated leverage pressure and the government's tighter control on investment projects, Chinese E&C companies will also likely exhibit a reduced appetite for debt-funded growth.

What are the key risks around the baseline?

Materials cost increases and trade policies. In the U.S., the magnitude of tariffs imposed could increase construction materials prices, potentially leading to cost overruns or project delays.

Skilled labor availability remains a risk in both the U.S. and Europe. The availability of skilled labor could worsen in the U.S. due to the immigration policies of the incoming administration.

Narrowing ratings headroom for Chinese E&C companies, due to worse-than-expected receivables turnover and impairment ratios stemming from prolonged payment cycles because of weaker financial conditions for project owners (e.g. local governments in lower-tier cities).

Ratings Trends: Capital Goods

Chart 1
Ratings distribution

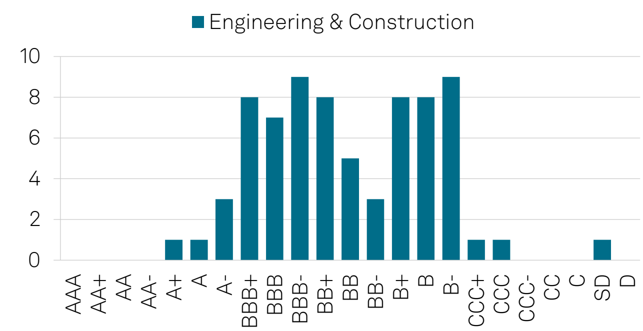


Chart 2
Ratings distribution by region

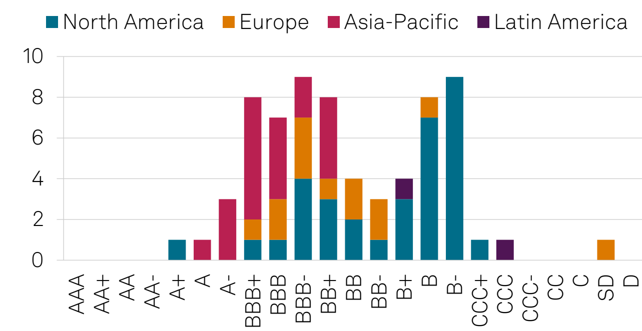


Chart 3
Ratings outlooks

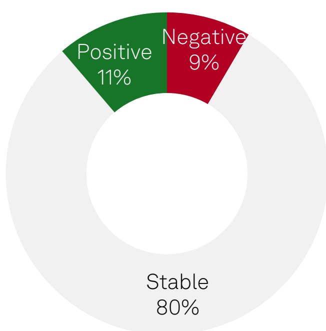


Chart 4
Ratings outlooks by region

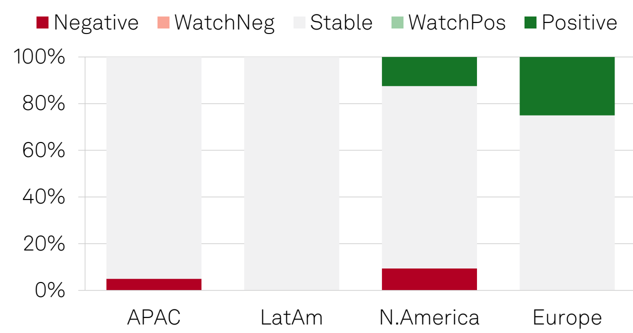


Chart 5
Ratings outlook net bias

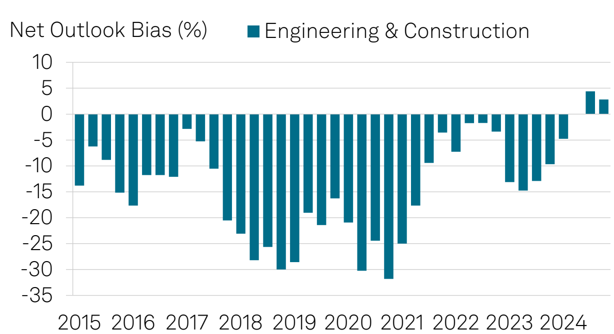
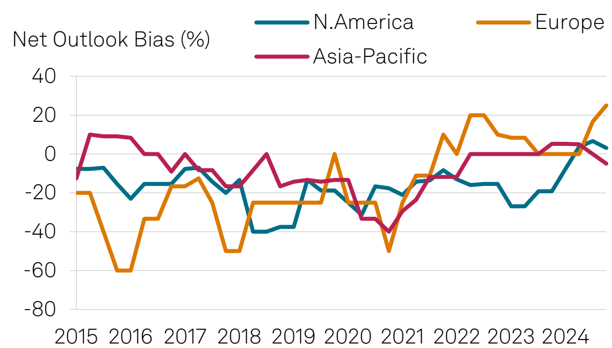


Chart 6
Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

We have stable outlooks on 80% of the issuers in our rated E&C universe and a modest net positive outlook bias (3%). We expect our ratings on these companies will remain relatively stable over the next 12 months, supported by low- to mid-single digit percent revenue growth and mildly improving operating margins. Other than in China, steady industrial investment and the constructive backdrop in most sectors, particularly transportation and water and power infrastructure, will be the key sources of growth.

E&C issuers with good scale, low leverage, and healthy cash flow generation are well positioned to capture above-average growth, supporting modestly improving credit metrics. In Europe and the U.S., this has led to several positive rating actions over the past year, including 9 upgrades and 6 outlook revisions to positive, which by far outpaced the number of negative rating actions. We believe positive rating activity will continue to outweigh negative actions in 2025, though likely at a reduced pace.

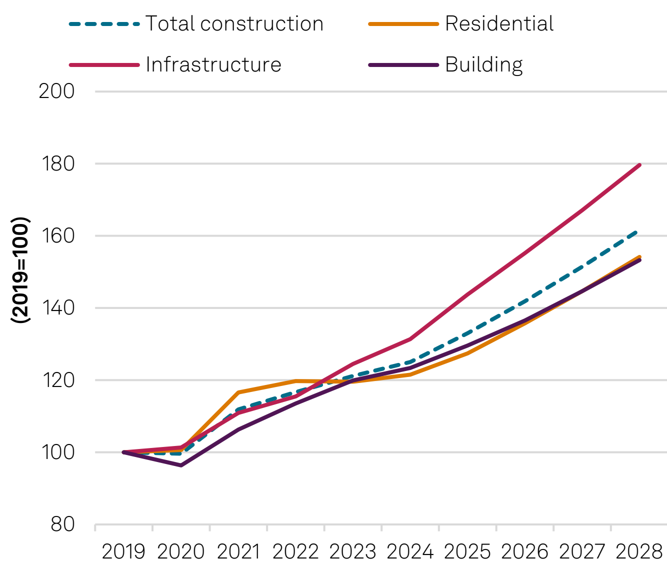
In the U.S., the positive ratings bias is geared toward issuers that we expect will realize outsized benefits from power and infrastructure project opportunities. Strong business prospects will likely underpin improved cash flows and leverage metrics, like what occurred in 2024. Provisions to protect margins, cost efficiencies, and a commitment to balance sheet stability will be notable tailwinds for certain issuers.

We also took some positive rating actions on Europe-based issuers in 2024 to reflect continued business growth, both domestically and internationally (namely in Australia and the U.S.), and reduced leverage. Our rating bias remains slightly positive, which incorporates our expectation for continued revenue growth from contract wins, solid backlogs, and the expected mitigation of persistent inflationary pressures.

S&P Global expects nominal global construction spending will reach $14.7 trillion in 2024 and $15.6 trillion in 2025, which represents a 3.2% and 6.4% year-over-year increase, respectively (see chart 7). Infrastructure spending is the key driver and accounts for about 33% of total construction. We expect steady growth across all regions, albeit at a varying pace (see chart 8). We anticipate the highest rate of business expansion will be in Europe, the Middle East, and Africa (EMEA). In the Americas, we assume growth will slow modestly in 2025 to more-normalized levels following an outsized peak, particularly in 2023.

Chart 7

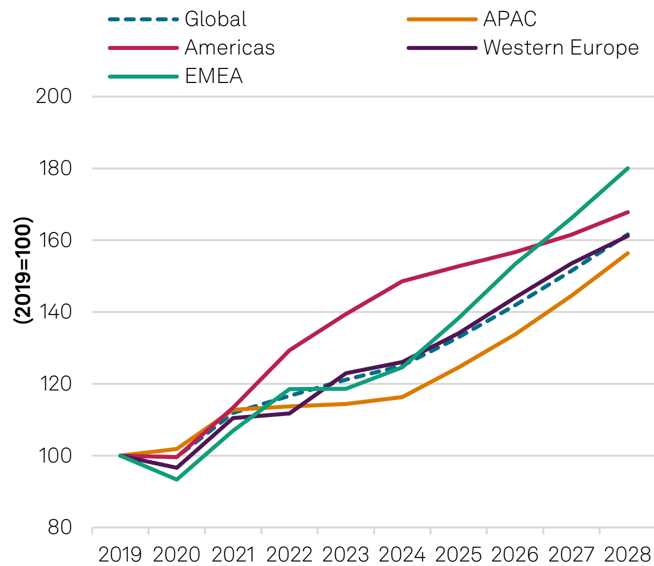
Global construction outlook



Source: S&P Global Market Intelligence data insight as of October 2024.

Chart 8

Construction outlook by region

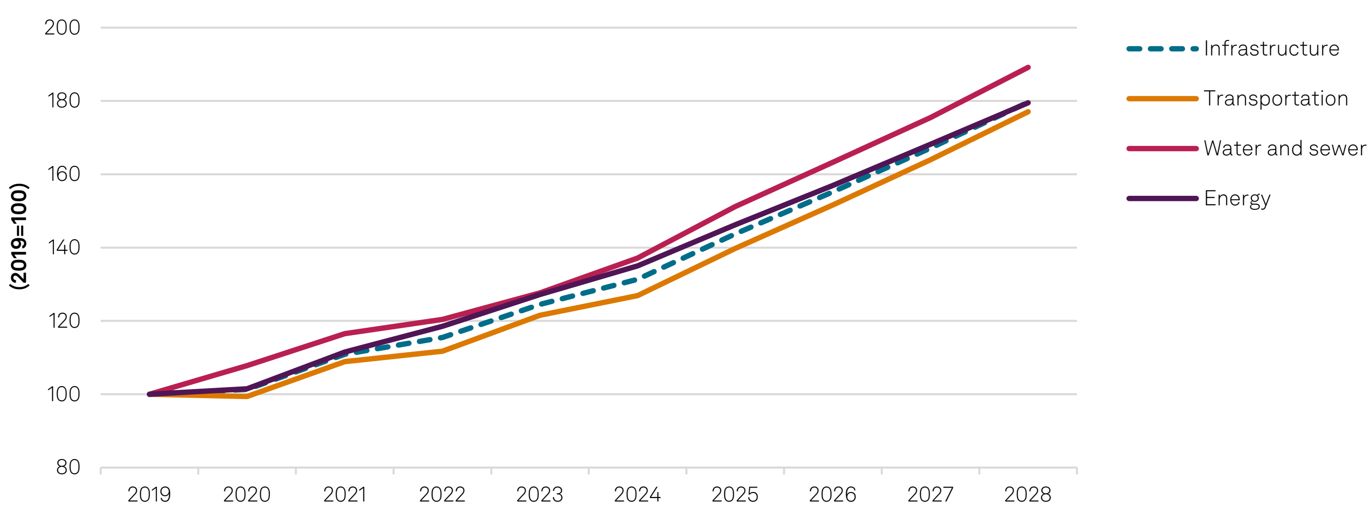


Source: S&P Global Market Intelligence data insight as of October 2024.

We expect global infrastructure funding will remain sound (see chart 9). Our positive outlook for infrastructure construction spending is a key driver in the U.S., Europe, Australia, and Canada, as well as in certain emerging markets such as India, Saudi Arabia, and Singapore. We expect global infrastructure spending will rise by about 9.4% in 2025, outperforming other non-residential construction sectors. We expect the Transportation and Water and Sewer sectors will experience outsized growth and expand by about 10% in 2025. We expect the Infrastructure Investment and Jobs Act (IIJA) and autumn budget in the U.S., the Next Generation EU plan in the EU, and AMP8 in the U.K. will drive growth for our E&C issuers (except for Chinese issuers), led by infrastructure projects.

Chart 9

Global infrastructure spending



Source: S&P Global Market Intelligence data insight as of October 2024.

Megatrends for the energy transition will support multi-year green capex. We believe the trends toward grid modernization and security, system hardening initiatives, electric vehicle adoption, and load growth will be key growth opportunities. Carbon capture, low-emission fuels, electrification, renewables, nuclear, and battery storage will support increasing energy consumption globally, which will provide growth opportunities for many of our rated E&C issuers over the next several years. In our view, larger issuers with an established presence and solutions across the value chain have a competitive edge to capture the growth stemming from utilities and energy customers.

The surge in data center demand will further support the long-term growth of the sector. Data center growth has been exponential amid the digitization of the global economy, boosted by cloud migration and further propelled by the broad adoption of artificial intelligence (AI). The E&C issuers we cover have benefitted from the spillover from data center buildouts, power generation (including renewables, natural gas, and nuclear power), electricity distribution and transmission, and connectivity requirements; and we observed a rapid increase in their backlogs supported by expanding scope and complexity.

E&C is a highly fragmented industry, which tempers the rating upside for many issuers. S&P Global Ratings rates many of the largest and leading industry participants, which we consider to be best positioned to benefit from the strong underlying fundamentals. A strong track record of completing projects on time and on budget are key differentiators when winning awards. In addition, we consider scale as an advantage because it enables companies to mitigate the risks arising from supply chain disruptions and skilled labor availability constraints. Many of our rated E&C issuers have well outlined training and development processes and provide attractive compensation that keep their attrition rates below the industry average.

Pandemic-induced project delays and cost increases underscored the risks associated with fixed-price contracts. Following a wave of contract repricings and an increased focus on cost efficiencies, the margins of E&C issuers are well positioned to expand modestly over the next couple of years. We expect these companies will maintain a more-conservative approach to the bidding process, incorporating contingencies and wider cost-escalation ranges. We also expect issuers, particularly those that engage in civil infrastructure projects, will seek more favorable contract models and commercial terms to protect their margins. Issuers are increasingly migrating toward cost-plus and variable-price contracts and using delivery methods such as progressive design-build. The latter emphasizes early collaboration between the design and construction phases, which reduces the risk for cost overruns due to order changes and delays. In addition, E&C issuers with a higher focus on value-added services are seeing incremental margin gains.

A different story in China. In China, E&C output will likely see muted growth in 2025. The expansion in China's E&C output moderated to 2.5% year over year in the first nine months of 2024, which compares with 5.8% in 2023. The industry's new E&C contracts declined by 5.9% year over year for the 12 months ended September 2024. We believe this was due to a high base, weaker demand for housing construction, tightened controls on public-private partnership (PPP) projects, and the generally tightening fiscal capacities of local governments. With a high base and declining new orders, the pace of expansion in the E&C industry will likely further moderate in 2025.

Meanwhile, our base case assumes EBITDA expansion and slowing debt growth on more-cautious financial management at the Chinese E&C issuers we rate in 2025. That said, some of their rating headroom narrowed in 2024 amid enlarging working capital outflows due to longer receivable collection cycles stemming from the financial constraints facing project owners (e.g. local governments and their financing vehicles).

Main assumptions about 2025 and beyond

1. We estimate a mid- to high-single digit percent revenue expansion for our U.S. portfolio.

We anticipate high infrastructure spending and stronger energy and data consumption will support sustained growth for U.S.-based E&C issuers.

2. In Europe, the volume recovery will be gradual and sustained by civil engineering.

The European construction outlook remains gloomy in 2025, especially in Germany and Italy. Growth is unlikely to improve until the second half of 2025 when we anticipate a progressive recovery in the volume of residential construction, mainly driven by renovations. Nonresidential building construction will likely display modest growth. In contrast, civil engineering volumes continue to rise, supported by new public-funded investments.

3. A moderate profitability improvement amid flattish revenue growth in China.

This will mainly be supported by more-stringent cost controls at major E&C companies to mitigate the intense competition amid slowing growth.

We expect a sustained—though uneven—expansion across our global E&C portfolio, stemming from infrastructure spending, energy transition tailwinds, and government support, over the next few years. We expect the revenue growth among U.S. E&C issuers will outpace the expansion in other regions, supported by the issuers' record backlogs and energy transition momentum relative to other regions. We expect a sustained flow of public and private funding will support an about 6% revenue increase in 2025 for our E&C portfolio. We expect issuers with higher exposure to transportation, water, and power infrastructure will capture above-industry average growth boosted by contributions from the IIJA.

Following the approval of the $1.2 trillion IIJA in 2021, there has been a constant flow of new projects that will continue to fuel an expansion in the backlogs of the bulk of our rated E&C issuers. The impact of the infrastructure bill will be direct for E&C issuers that engage in civil infrastructure projects. However, it will also have a cascade effect for several other service providers and contractors in other end markets, such as communications, through the Broadband Equity Access and Deployment Program (BEAD) program ($42 billion). Year to date, the government has only disbursed one third of these funds, which bodes well for domestic U.S. activity over the next few years. That said, there are questions regarding the sustainability of the IIJA due to the incoming Trump administration. However, in our view, the bipartisan nature of the bill, the successful economic spillover (including for Republican-led states), and the upside from remaining awards make this unlikely. We anticipate infrastructure spending will rise by about 9.3% in 2025 (6.9% on a real basis) in the U.S. and exceed the global average.

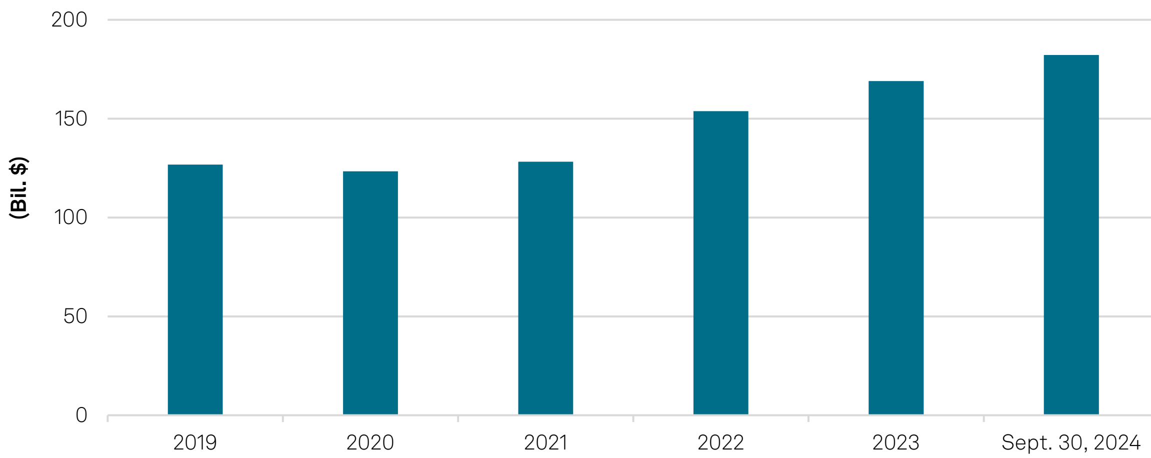
For non-residential construction, we anticipate sound growth for communications as the government allocates construction funds through the BEAD program beginning in the second half of 2025. This follows a slowdown in the sector due to reduced capex on wireless infrastructure. Other industrial end markets that we expect will show sustained growth over the next couple of years include advanced technology, such as data centers, semiconductors, and life sciences. Conversely, we expect commercial construction will remain somewhat challenged and office construction will continue to decline due to the secular shift toward e-commerce and remote work.

This is boosted by investments in wind, solar, and battery storage assets, which support strong secular tailwinds as companies invest to achieve their energy transition goals. In our view, the E&C issuers with the highest exposure to maintenance-related revenue will likely experience a lower level of volatility in their earnings and cash flow relative to other firms.

As of Sept. 30, 2024, the backlog for our selected rated U.S. E&C issuers rose by nearly 8% from year-end 2023, which we believe provides them with good revenue visibility over the next 12 months (see chart 10).

Chart 10

Backlog of selected rated U.S. E&C issuers

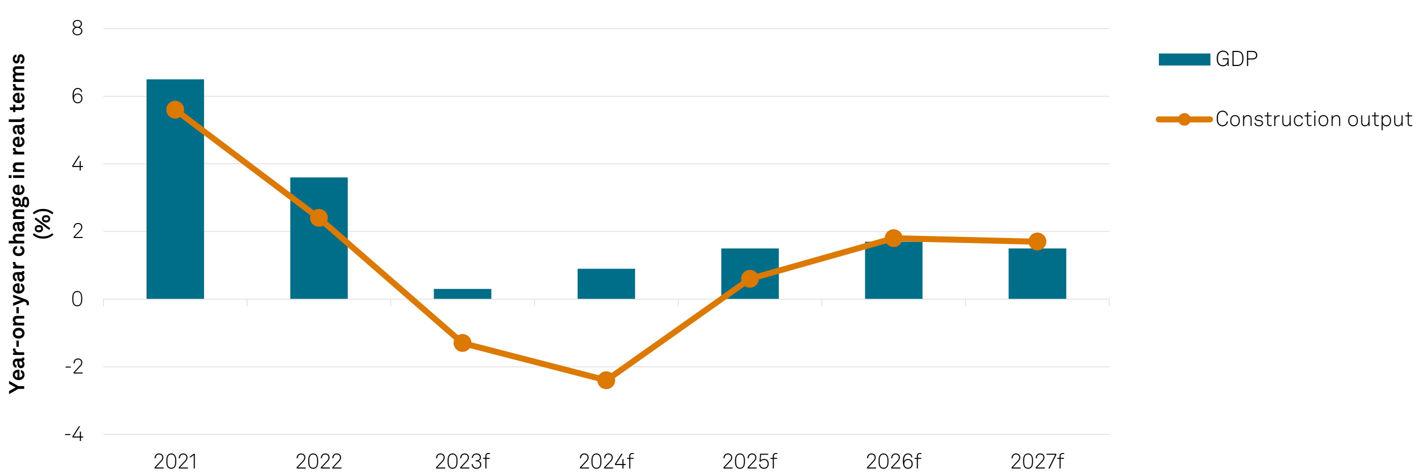


Source: S&P Global Ratings' calculations based on company disclosures.

In Europe, civil engineering construction will be the key determinant of the sector's growth. We assume construction output improves modestly (by 0.6%) in 2025, which compares with the contractions experienced over the past two years (see chart 11). We assume the fiscal stimulus announced by the EU and national governments to boost economies following the COVID-19 pandemic were the key driver of this rebound. This includes the multiannual financial framework (2021–2027)—the EU's long-term budget—and the Next Generation EU (NGEU) program, which is one of the largest stimulus packages ever financed in Europe. Specifically, the Recovery and Resilience Facility (RRF), which forms the centerpiece of the NGEU, has supported public investment in infrastructure projects in EU member states since its launch in 2021 and will remain a key driver of this segment's growth over the medium term. The RRF makes available €648 billion of grants (€357 billion) and loans (€291 billion) to support various investments and reforms outlined in EU member states' Recovery and Resilience Plans (RRPs) by the end of 2026.

Chart 11

GDP and construction output in Europe (EC-19, % change)



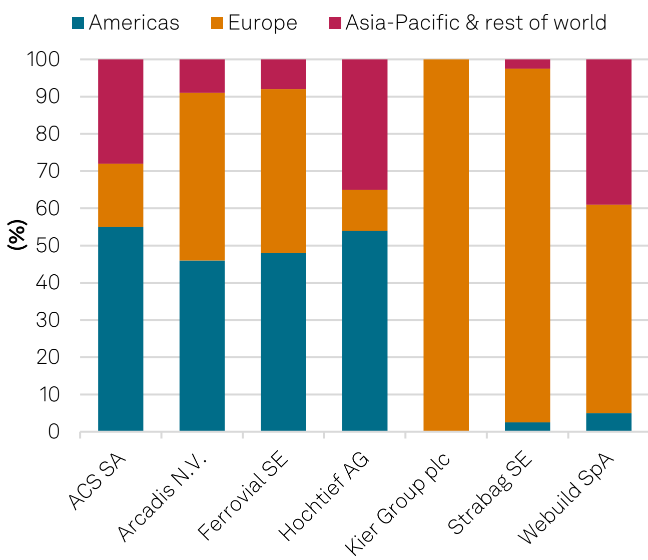
f—Forecast. Source: Euroconstruct.

The green transition and digital transformations are key priority areas. Green initiatives have grown in importance, with 42% of total RRF funds earmarked for climate objectives. More than half of the RRF funds have been disbursed to member states so far in 2024 (or 37% of the total EU budget). This suggests that disbursements will likely ramp up in the final two years of the RRF, although there are concerns around whether some member states will be able to complete the projects needed to unlock all of the approved funding by the 2026 deadline. Transportation will be the key driver of infrastructure spending in Europe in 2025-2026. In the U.K., the National Infrastructure and Construction Pipeline outlines £164 billion of planned investment in major infrastructure and construction projects over the next two years.

Most rated construction companies based in Europe will continue to increase revenue for their local business in both 2025 and 2026. This is because they mainly operate in the civil engineering and non-residential construction spaces. Furthermore, our rated European companies benefit from their significant geographic diversity, particularly in North America and Australia where they derive a material proportion of their business (see chart 12). The order intake of European-based construction companies remains solid thanks to new projects in the infrastructure segment across Europe, the U.S., and Australia. The backlog to revenue levels among these companies are well above 1x on average. Webuild SpA displays the highest revenue visibility in 2024-2026 because of its backlog (see chart 13).

Chart 12

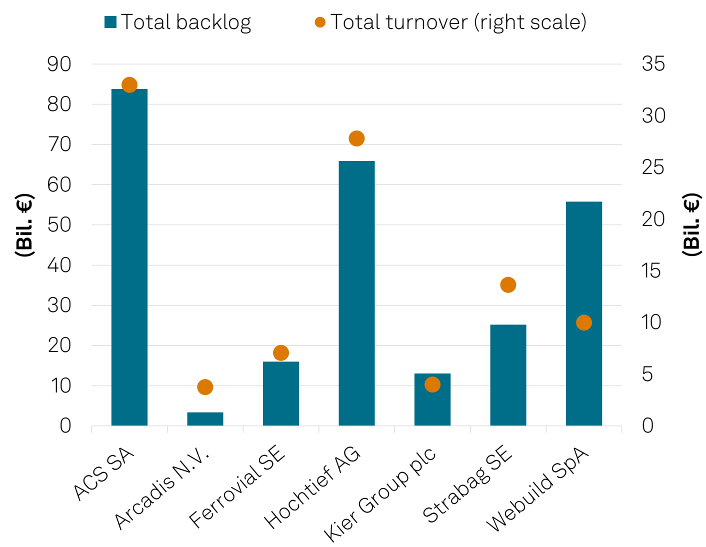
Total revenues by geography



Data as of Dec. 31, 2023.
Source: S&P Global Ratings.

Chart 13

Total backlog and total turnover



Backlog as of June 30, 2024. Turnover as of Dec. 31, 2023.
Source: S&P Global Ratings.

Revenue growth among major E&C companies in China will likely remain weak in the low-single-digit percent area in 2025. Despite the declining volume of new contracts in the industry, Chinese E&C companies generally have sufficient orders on hand to support a moderate increase in their revenue during the year. Amid an anticipated market slowdown and elevated leverage pressure, they will likely prioritize improving their margins and operating cash flow (OCF), over aggressively expanding their business scale, to protect their credit profiles.

We expect slightly improving profitability for major Chinese E&C companies in 2025. Although fierce competition will continue to weigh on the margins of E&C projects, we believe major E&C companies will step up their cost-control measures in 2025 to mitigate this margin pressure.

Meanwhile, proposed debt swaps for the hidden debts of local governments could increase their spending power. This could support faster receivable collection for E&C companies and likely lower their receivables impairment ratio, leading to a mild improvement in their EBITDA margins and OCF during the year.

Credit metrics and financial policy

Overall, we expect the leverage metrics of our global E&C portfolio will improve, supported by higher earnings and stronger free cash flows as issuers across the globe focus on cost efficiencies, protecting their project margins, and working capital management.

Rated U.S. and European E&C issuers remained strongly focused on improving their working capital cycles, leading to reductions in their days sales outstanding (DSOs) and higher cash conversion. We believe these improvements are sustainable and will support stronger cash flow generation in 2025. In addition, many of the large issuers we rate have an increased exposure to renewables projects, which are typically working capital positive due to the advanced payments for crew mobilizations. Free cash flow improved substantially over the past two years, and we expect this trend will continue as the backlog of renewable projects grows.

In the U.S., the median S&P Global Ratings-adjusted FOCF to debt improved to 7% in 2023, from below 1% in 2022, and we expect it will approach 10% in 2025. We consider the likelihood for incremental debt as low and estimate these issuers' S&P Global Ratings-adjusted debt to EBITDA will decline by about half a turn as of year end 2024, relative to 2023, and a further 0.2x in 2025. We expect issuers will use their discretionary cash flow primarily for acquisitions and opportunistic shareholder rewards, with higher earnings supporting an improvement in their leverage. However, a high share of our rated issuers are owned by financial sponsors, which typically adopt more-aggressive financial policies that preclude material sustained deleveraging.

In Europe, we expect E&C issuers' credit metrics will remain supportive on strong order intake, notably outside of Europe, and good working capital management. Several rated issuers, such as the ACS group and Webuild, continue to bid and win large projects in the U.S. and Australia. For example, a consortium including the ACS Group was recently awarded the construction and operation of the SR400 Express Lane in Atlanta, with a construction value of more than $4.6 billion (€4.2 billion). On average, their backlog to revenue ratios are well above 1.0x (see chart xx). We also anticipate that European E&C issuers will continue to leverage global megatrends such as digitalization and electrification. As such, these companies have expanded into the construction of datacenters. For example the ACS group, through its U.S. subsidiary Turner, will form part of the consortium that will build datacenters for Meta for $10 billion in Richland Parish, La.

In China, we believe our rated issuers will focus on improving their earnings and cash flow over the next one to two years. At the same time, they will likely incur moderately lower capex due to their tightened control on PPP projects. That said, the rating headroom amid rated Chinese E&C companies is diverging. Anticipated EBITDA expansion and slowing debt growth in 2025 will likely lead to elevated uncertainties depending on the degree of fiscal capacity improvement among local governments during the year.

Key risks or opportunities around the baseline

1. Materials cost increases and trade policies.

In the U.S., the magnitude of tariffs imposed could push construction materials prices higher, for example for steel and lumber, potentially leading to cost overruns or project delays and cancellations due to budget revisions.

2. Skilled labor availability and wage inflation remain risks in both the U.S. and Europe.

So far, companies have managed this risk well; however, it may become challenging for contractors to deliver all of their projects on time, given their currently high backlogs.

3. Worse-than-expected receivables turnover and impairment ratios will narrow the rating headroom of China's E&C companies.

Further delays in the payment cycles of project owners could elevate the receivable impairment ratios of E&C companies. This could also reduce their operating cash inflows and push up their debt leverage. Such a scenario could stem from worsened funding conditions for project owners (e.g. local governments in lower-tier cities) whose payment capability deteriorated during the prolonged property market downturn.

Geopolitical tensions are a key threat for E&C issuers globally due to inflation and supply chain disruptions from extended and escalating conflicts. Governments around the world aim to increase infrastructure spending to fuel economic growth, though a global economic slowdown, high sovereign indebtedness, and a reliance on the successful implementation of government programs pose a risk to the cadence of the top-line expansion among our rated E&C issuers.

Under the incoming Trump Administration in the U.S., we believe there is a risk some of these sectors will slow because the President-elect leans toward favoring fossil fuels, which could lead to a potential reduction or elimination of subsidies for green energy and tax credits under the Inflation Reduction Act (IRA). Under this scenario, we think issuers with a diversified end-market platform would better weather these headwinds.

Inflationary pressures have subsided but not disappeared. Cost increases for construction materials have plateaued at elevated prices and we do not expect a decline. In the U.S., Trump's universal tariffs pose an additional risk for the construction industry and increase construction materials costs, such as for steel and lumber. For example, we assume hot rolled coil prices (a common benchmark for other grades of steel) in the $700-$800 per ton area on average over the next two years, which is only modestly above prevailing levels. Although the majority of materials are domestically sourced, they are influenced—to an extent—by the price of imports.

At the same time, wage inflation is persistent due to the scarce availability of skilled labor in the sector, which we believe will remain the key driver for cost increases over the next couple of years. In addition, Trump's immigration policies could further increase wages, given the sector's high reliance on immigrant workers.

According to the U.S. Census Bureau, the percentage of immigrant workers in the construction industry stood at nearly 30% in 2023, representing a 5% compound annual growth rate since 2020. However, the magnitude and timing of the impact from the incoming administration's immigration policies is uncertain.

Project cost inflation remains a risk to profit margins in most markets across the globe. Larger issuers with stronger bargaining power and self-perform approaches are less exposed. In Europe, most rated E&C issuers continue to focus on projects in low-risk countries or regions such as

Western Europe and the U.S. These companies have reduced their presence in the emerging markets, where the infrastructure and legal frameworks are less supportive, over time. However, some legacy projects remain outstanding in the emerging markets. We believe that E&C issuers' credit metrics could, at times, be affected by the risks of cost overruns, operational issues, and litigation, as they have been in the past.

We also note that the Europe-based rated issuers are increasing their presence in the Middle-East, given that several countries have initiated large government-led infrastructure projects. The most important one is Neom, an urban area construction project in Saudi Arabia with a budget of over $1,000 billion, which is part of the Saudi Vision 2030 program. While these mega-projects could be an important source of activity over the coming years, these companies have a limited track record on such projects, which could see further changes to their characteristics. For example, The Line, a futuristic project under Neom, was recently scaled down amid funding challenges.

In China, cash flow improvement remains the key for anticipated deleveraging among E&C companies. Further delays in receivable collection from project owners could worsen the working capital outflows and OCF generation of China's E&C companies, which would ultimately elevate their debt leverage. The downside risks will increase if such situations persist absent signs of improvement.

Related Research

- Global Engineering And Construction 2024 Outlook Update, July 25, 2024
- Record U.S. Infrastructure Spending Is Colliding With Higher Construction Costs And Other Hurdles, May 14, 2024
- China Engineering & Construction 2024 Industry Outlook: Rated E&C Companies Should Ride Through The Speed Bump, Jan. 15, 2024

Industry Forecasts: Engineering and Construction

Chart 14

Revenue growth (local currency)

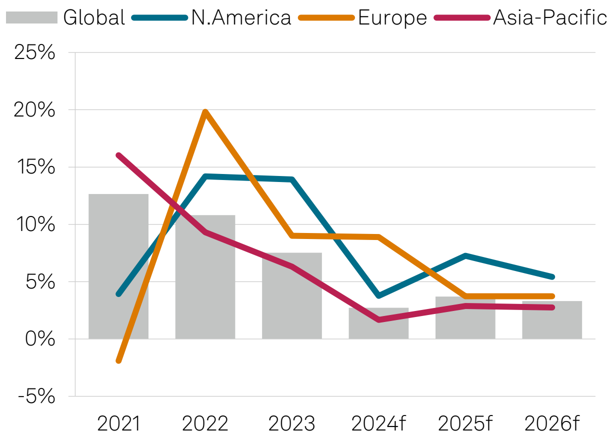


Chart 15

EBITDA margin (adjusted)

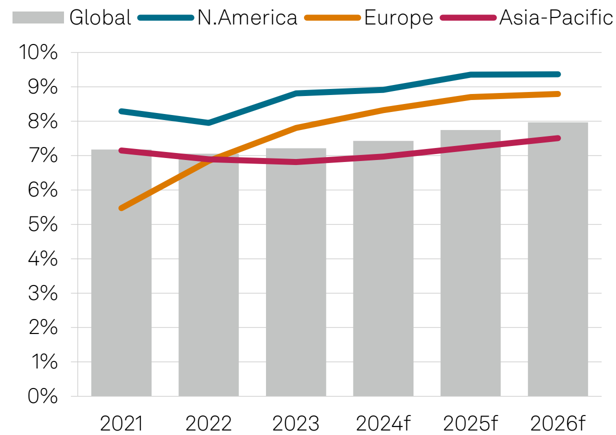


Chart 16

Debt / EBITDA (median, adjusted)

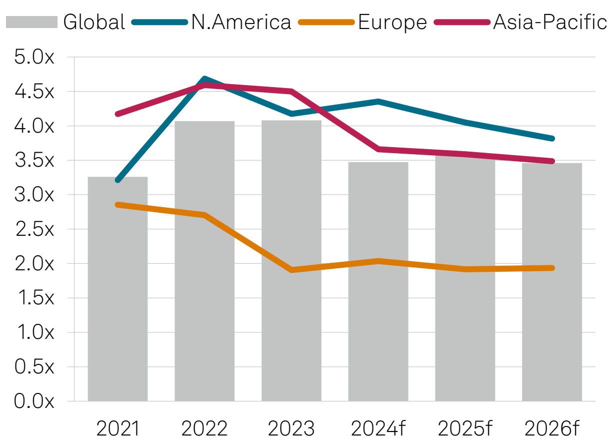
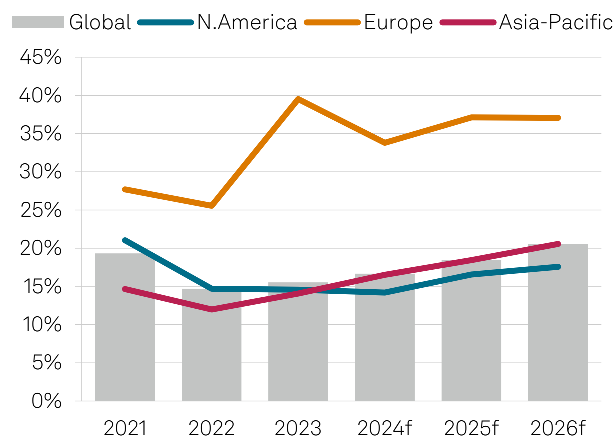


Chart 17

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Engineering and Construction

Chart 18

Cash flow and primary uses

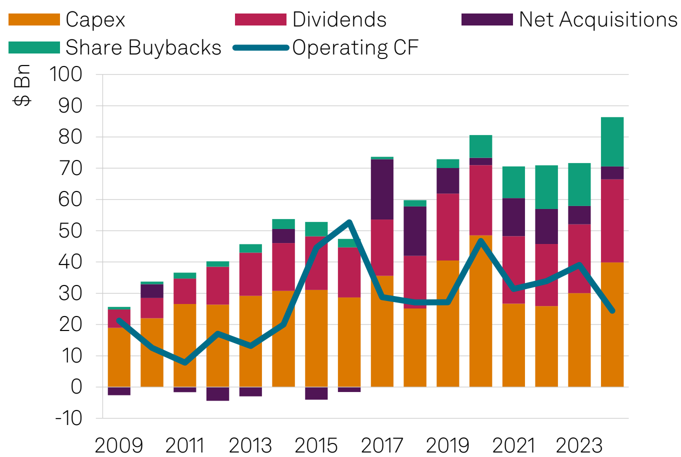


Chart 19

Return on capital employed

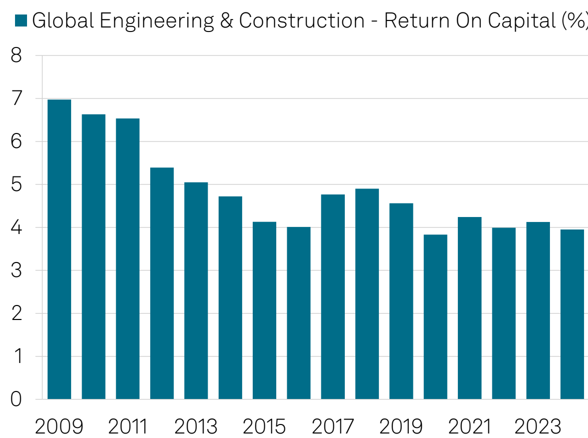


Chart 20

Fixed- versus variable-rate exposure

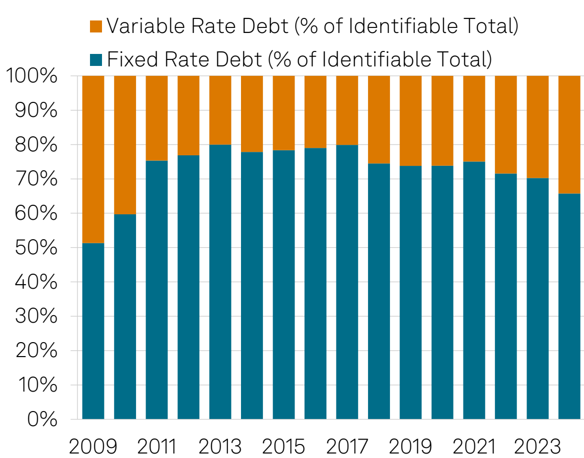


Chart 21

Long-term debt term structure

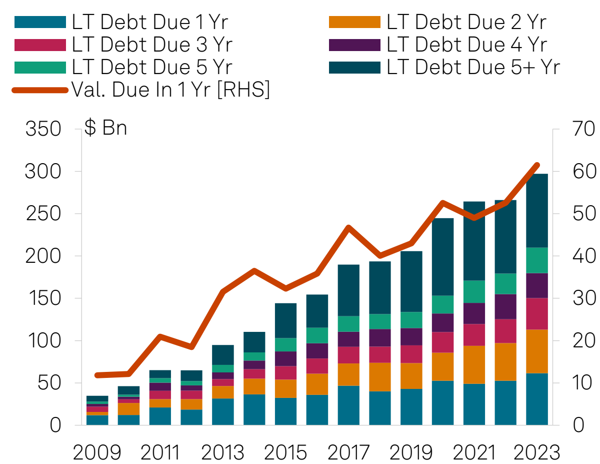


Chart 22

Cash and equivalents / Total assets

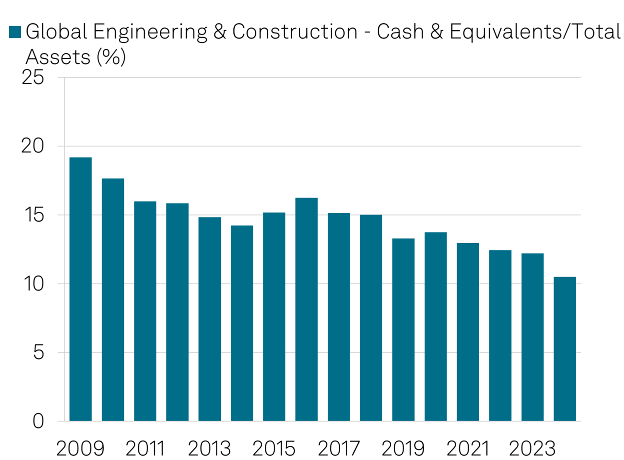
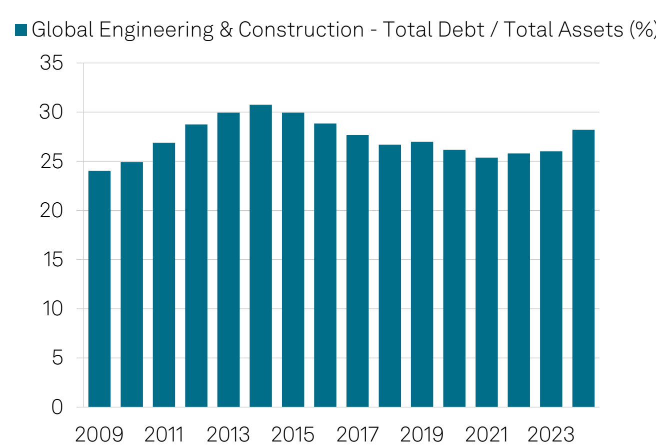


Chart 23

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Health Care

Ratings deterioration to moderate as cash flows improve

January 14, 2025

This report does not constitute a rating action.

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What's changed?

Ratings deteriorated. Lower-rated companies in the health care services subsector led the overall sector ratings to deteriorate. Still, we maintain a stable outlook on the sector.

Revenues normalized. Demand is steady, inflationary pressures moderated, but cash flows are anemic given the Change Healthcare cyberattack and claim delays.

A record number of defaults for the third year in row. Leverage for many companies remained too high and shortfalls in free cash flow generation led to restructurings and defaults.

What are the key assumptions for 2025?

Demand to remain solid. We project industry growth of 4%-7% across the sectors.

EBITDA margins and cash flows to improve, especially for the health care service providers.

Increasing mergers and acquisitions (M&A), even among the heavily private-equity owned, highly leveraged, speculative-grade service providers.

What are the key risks around the baseline?

Inflationary and labor pressures return. Labor costs continue to be a long-term challenge.

Increasing reimbursement and cash flow pressures. Rising health care spending, driven partly by increased utilization of health care, inflationary pressures, and growing use of GLP-1s may lead to tougher pricing negotiations and increased claim denials, pressuring margins and cash flows.

Incoming U.S. administration brings uncertainty. We do not expect rating actions in the near term but consider any potential increased legislative risks to be a credit negative.

Ratings Trends: Health Care

Chart 1

Ratings distribution by region

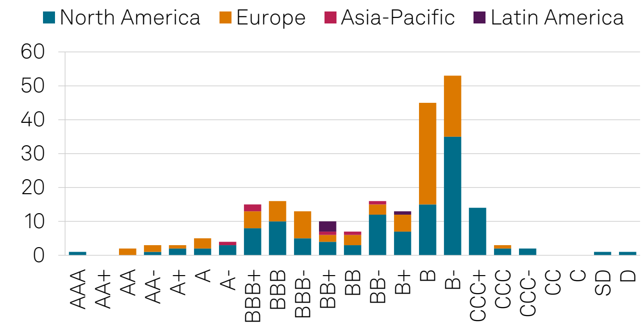


Chart 2

Ratings distribution by subsector

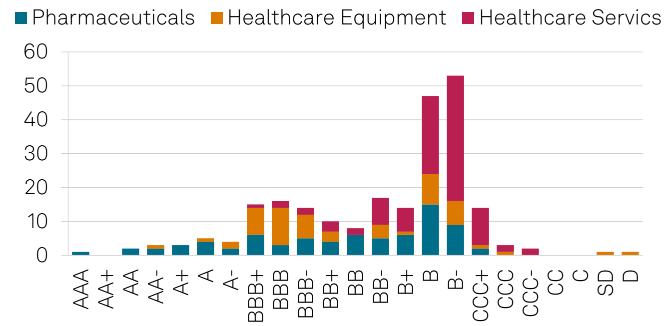


Chart 3

Ratings outlooks

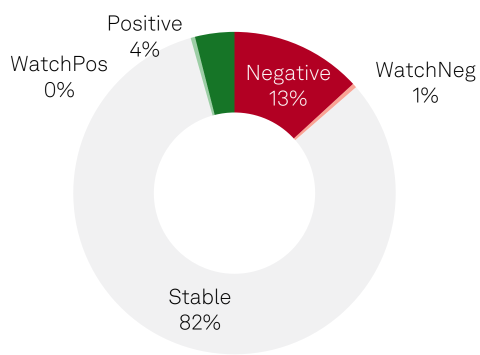


Chart 4

Ratings outlooks by subsector

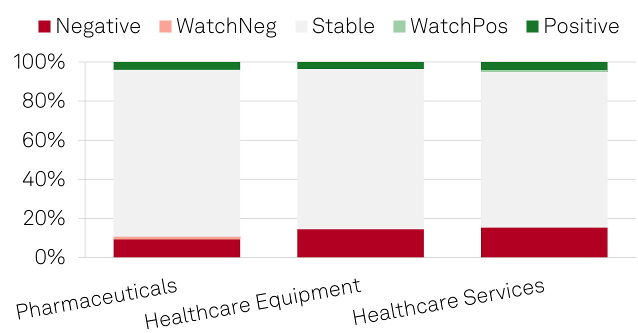


Chart 5

Ratings outlook net bias

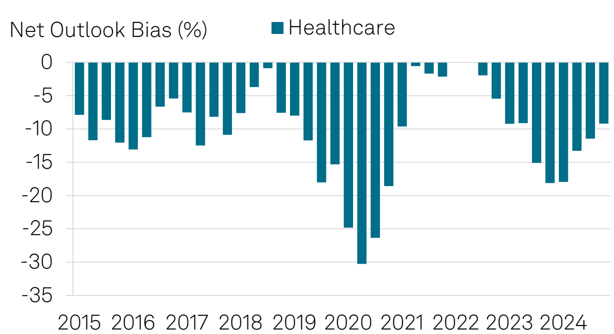
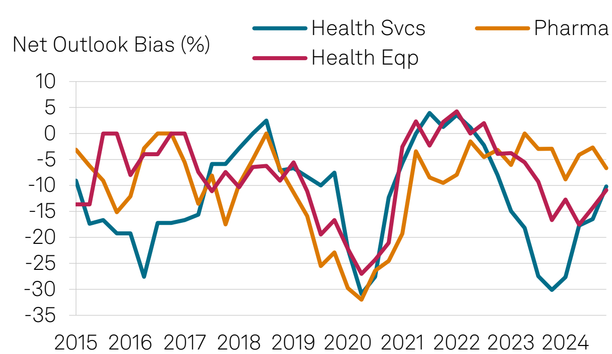


Chart 6

Ratings net outlook bias by subsector



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

We maintain an overall stable outlook on the health care sector. The majority of pharmaceutical and medical device and product companies have a stable outlook. A negative bias still exists for health care services companies, as they grapple with elevated leverage, leaving little room for operating shortfalls that contributed to downgrades and defaults. However, we expect continued improving operating environment, including normalization of demand, moderating labor and inflationary costs, and a more favorable interest rate environment. Therefore, we believe the ratings deterioration will slow.

Sector credit metrics will likely stabilize in the first half of 2025. Health care ratings continued to deteriorate in 2024, almost entirely due to low-end speculative-grade entities (rated 'B+' and below) concentrated in the health care services subsector. Many of these issuers are largely owned by private-equity firms that typically have a more aggressive financial policy and a higher tolerance for leverage. In 2024, many of them struggled to generate adequate sustained free cash flows amid still elevated interest rates and an improving, but still inflationary, environment. The No Surprises Act and Medicaid redetermination process, as well as the Change Healthcare cybersecurity breach that significantly delayed claims processing and cash collections, disrupted cash flows in the first half of 2024, further weighing on ratings. Indeed, for the speculative-grade rated health care companies, which account for most of our rated universe, downgrades outpaced upgrades by a ratio of 2:1 and unfavorable outlook revisions outpaced favorable outlook revisions by 3:1.

We expect cash flows will improve in the first half of 2025 as the effects of the Change Healthcare cybersecurity breach dissipate and the delays in claim processing normalizes. As a result, we expect ratings deterioration will slow in 2025 and may revise our outlook to stable from negative for the health care services sector in the first half.

In the meantime, we believe demand is stable, with patient and procedure volumes and acuity largely normalized. We project 4%-7% revenue growth across the major subsectors. Insurance coverage rates continue to be at all-time highs, with the level of uninsured at 8%, supporting demand. While the incoming Trump administration may allow COVID-era subsidies that have helped people gain coverage via the Affordable Care Act (ACA) to expire and lead to an increase in uninsured rates, we believe the overall growth and aging of the population will continue to drive utilization.

S&P Global Ratings-adjusted EBITDA margins for the services subsector have improved due to moderating inflationary pressures and implementation of efficiency measures. Still, labor costs remain elevated, and we expect they will remain so long term, given continued shortage of health care professionals (see "Despite Some Improvement, Weaker Health Care Services Companies Continue To Struggle," published May 2, 2024).

We expect defaults will moderate in 2025. The health care sector saw a third year of record number of defaults in 2024. Despite improving conditions, leverage for many companies remained too high and shortfalls in free cash flow generation led to restructurings and defaults. However, we believe sector defaults will moderate in 2025, given interest rate cuts, lessening inflationary pressures, and improving free cash flows. Still, defaults will likely remain above historical levels because of high labor costs and the borderline unsustainable capital structures of many speculative-grade companies (see "Record-High Health Care Defaults Will Moderate In 2025, Though Higher Than Normal," published Nov. 20, 2024).

The outlook for medical devices and products remains stable. We forecast the subsector will return to revenue growth in 2024, increasing 3.7%. We also forecast profitability will modestly improve by 70 basis points (bps) to aggregate S&P Global Ratings-adjusted EBITDA margin of 25.2%, largely due to easing of inflationary pressures and dissipating supply chain challenges; we consequently revised our outlook on Koninklijke Philips N.V. to stable.

We expect revenue for the medical devices and products sector will increase 4.2% in 2025 and EBITDA margin will expand in aggregate by 100 bps. We continue to view the health care equipment development sector favorably, despite stretched health care budgets in the largest markets of U.S. and Europe, with increasing need for cost efficiency driving the use of advanced technology.

Our outlook for the pharmaceutical sector remains stable, given our expectation for healthy revenue growth through 2027 for many companies due partly to increasing sales of GLP-1s (weight loss drugs), oncology treatments, and new classes of Alzheimer's treatments. We forecast growth despite headwinds from patent expirations, increasing biosimilar competition, and the looming Medicare drug price negotiations as part of the Inflation Reduction Act (IRA) that go into effect starting 2026.

M&A activity in the pharmaceutical sector will likely increase from the unusually low levels we saw in 2024, given its strategic importance to product pipelines and portfolios, and to future revenue growth. Many Big Pharma and biotech companies used the year to build or rebuild debt capacity at their current rating levels, following the flurry of M&A in 2023, including Pfizer's $43 billion acquisition of Seagen Inc., Merck's $10.8 billion acquisition of Prometheus Biosciences, and Amgen's $26 billion acquisition of Horizon Therapeutics, among others. Going forward, improving interest rates and the likelihood of lessened scrutiny from the Federal Trade Commission (FTC) could contribute to increased acquisitions (see "Pharmaceutical Industry 2024 Credit Outlook Is Stable As Revenue Growth Mitigates Pressures," published June 24, 2024).

We expect no immediate ratings actions to stem from the Trump administration. The incoming U.S. president's tone on health care policy and some of his proposed appointees to head key health care agencies could ultimately increase the degree of legislative risk on the sector. However, we don't expect major changes to ratings in the near term to stem from this. We are monitoring areas such as changes to the ACA, Medicaid funding, the support of Medicare Advantage, Medicare drug price negotiation, FTC scrutiny of M&A, and the implementation of tariffs and their potential impact to supply chains. We are also following the priorities of the new head of Department of Health and Human Services (HHS). For example, shifts in the federal government's stance on vaccines could result in lower sales for pharmaceutical companies that have significant vaccine sales, such as those for shingles, pneumonia, and RSV (see "The Health Care Credit Beat: Republican Red Wave A Net Negative For Health Care," published Dec. 2, 2024).

Main assumptions about 2025 and beyond

1. Demand remains healthy for health care.

Patient and procedure volumes and acuity have largely normalized, and we project 4%-7% annual revenue growth across the subsectors.

2. EBITDA margins improve, but labor remains a challenge.

We expect flat to slight improvement for all major subsectors as inflationary and labor pressures moderate. However, labor costs continue to be a long-term challenge.

3. Health care service providers' cash flow to improve.

Cash flow generation has not reflected the improvement in sales and EBITDA margins for health care services. We project improvement as the effects of No Surprises Act and Change Healthcare cyberattack dissipate.

Demand remains steady, with mid-single-digit percent growth rates across all subsectors. With the exception of a few service lines and geographies, we believe patient and procedure volumes and acuity have normalized and that the backlogs of delayed procedures have largely run through the system. The health care labor cooled somewhat, which has enabled providers to increase hiring to handle the growing treatment capacity, and they project single-digit percent revenue growth. Given the normalization of patient and procedure volumes, we also expect stable demand for medical device and product companies. For the pharmaceutical sector, the projected growth of sales of GLP-1s and new classes of cancer drugs will lead to solid 5%-6% revenue growth for the sector in 2025, despite patent expirations and continued pricing pressure.

EBITDA margins will improve in 2025. We project median EBITDA margins will remain flat to slightly improved across the subsectors. Given moderating inflationary pressures, especially on labor costs, and the implementation of efficiency efforts, we also project flat to slightly improved margins for service providers at 16%. For pharmaceutical companies, we project slight EBITDA margin improvement to 28%. Medical device and product companies will also see margin improvement to median EBITDA margin of 25% because supply chain pressures and shipping costs have eased.

Labor will remain a long-term challenge for health care service providers because we expect shortages of nurses and physicians will persist beyond 2025 and possibly through the balance of the decade. Labor costs growth will likely remain elevated, though moderated. We expect efficiency measures and a greater usage of permanent staffing versus more expensive temporary staffing will enable service providers to stabilize or slightly improve EBITDA margins.

Still, cash flows in the subsector are likely to improve. Cash flow generation for service providers was weak in 2024 because of the effects of No Surprise Acts and the Change Healthcare cybersecurity breach. The denial and delay of claims processing by insurers have also resulted in increased collection times. We project these effects will dissipate and normalize in the first half of 2025. This, along with more favorable interest rates, will lead to improving cash flows.

Credit metrics and financial policy

We expect credit metrics for the health care industry will improve in 2025, absent a major pickup in M&A activity, supported by our expectation for stable demand, revenues growing 4%-7% annually, margins further improving as inflationary pressures ease, and interest rate cuts. We believe M&A activity will increase in 2025 compared to 2024, pressuring credit metrics; however, we believe the increase will be gradual and costs will not likely match the highs of prior years.

Labor costs will likely remain a longer-term challenge given physician and nursing shortages and highlighted by health care costs continuing to outpace overall labor market growth. We are also monitoring the reimbursement environment because a tougher reimbursement environment would result in lower margins and cash flows, especially at a time when providers are still facing a tough labor market and inflationary pressures.

M&A activity will pick up. M&A was relatively muted in 2024 for an industry that's typically among the most active in such activity. This, along with continued solid growth and strong EBITDA margins and operating cash flows, enabled the pharmaceutical industry's S&P Global Ratings-adjusted leverage to improve and capacity for future M&A at the current ratings to increase.

We believe M&A in the health care services subsector will return in earnest sometime in 2025 driven by the strategic need for economies of scale and higher reimbursement rates from payors. However, we believe capacity is limited given the still very high leverage at many companies.

Key risks or opportunities around the baseline

1. EBITDA margin pressure intensifies.

If inflationary pressures, labor, or reimbursement challenges become larger issues, margins could be squeezed.

2. Free cash flow generation improvement fails to materialize.

If unforeseen negative developments occur, such as the Change Healthcare cyber security breach in 2024, cash flows could again be tight, leading to ratings deterioration.

3. M&A activity returns more aggressively than expected.

We could see ratings deterioration as a result.

4. A bigger focus on supply chains.

Capacity limitations could slow sales growth of GLP-1s, and possible tariffs could upset supply chains, adding costs to the health care system.

5. Legislative policy risks could rise.

The incoming Trump administration's health care policies could have ratings ramifications for the industry.

Margin pressure could intensify. We project further improvement in 2025 on median S&P Global Ratings-adjusted EBITDA margins for the three major subsectors—health care services, medical devices, and pharmaceuticals—after being stable or slightly improved in 2024. However, issuers will be under constant pressure to find efficiencies, with employers and governments scrutinizing health care spending, major health insurers looking to lower their medical cost ratios, and labor costs remaining elevated.

Health care services providers will have to continue to look for efficiencies to improve margins. They continue to have high exposure to labor costs (35%-55% of cost base), relatively low margins (mid-teens percent), and tight labor supply over the long term. Inflationary pressures have moderated, and labor cost growth continues to slow, in part due to companies' efficiency measures and declined usage of more-expensive temporary staffing. However, if labor costs spike up, margin improvement could stall.

Also, reimbursement levels, which have been relatively stable, could also become pressured, as health insurers look to lower their medical cost ratios and employer health plan sponsors see their annual health care costs grow by high-single-digit percent (with some approaching double digits). If companies fail to achieve additional efficiencies, we could see margin improvement for this more vulnerable group stall and even fall.

Free cash flow generation levels could remain low. Cash flow generation for the speculative-grade rated health care companies was relatively weak in 2024, contributing to liquidity issues and overall ratings deterioration. This is highlighted by the 2:1 downgrade-to-upgrade ratio among speculative-grade rated health care companies and a record level of defaults. We project cash flows will improve in 2025. However, for many issuers in the sector there is little cushion to downgrade thresholds. Also, we have seen reports of insurers increasing the rejection rate of both pre-approval and reimbursement claims, which could slow cash collections. Furthermore, any shortfall in demand or margins could weigh on cash flow generation and quickly lead to further ratings deterioration, especially for service providers.

M&A activity could be more aggressive than expected. Consolidation continues to be strategically important for much of the highly fragmented health care industry, and we expect M&A across all the subsectors. Health care service providers will use it to gain efficiencies and increase negotiating leverage on reimbursement rates. For pharmaceutical companies, M&A has deepened and diversified their pipelines and portfolios, especially given loss of exclusivities (LOEs) and looming Medicare drug price negotiation going into effect 2026. Medical device and product companies have not been as active on the M&A front, though we expect an increase in activity in the sector in the intermediate term and believe several companies are actively looking.

We are monitoring potential supply chain risks that are more likely to affect the pharmaceutical sector than the medical device and products industries. The fastest growing pharma segment is obesity, which could reach about $130 billion in annual sales by 2030. Existing players in the market, notably Novo Nordisk and Eli Lilly, continue to focus on scaling up production capacity. The bargaining power has somewhat rebalanced in favor of contract development and manufacturing organizations (CDMOs), especially those with skills on biologic molecules. For example, we recently lowered our ratings on German pharmaceutical issuer Cheplapharm due to operating issues, mostly related to its supply chain.

Players with lower dependence on CDMOs tend to perform better because they can better control in-house production, but they need to substantially invest in fixed assets. For example, Novo Nordisk is acquiring Catalent Inc. to expand production capacity for its diabetes and obesity franchises, which would result in total capacity investment of 125 billion DKK (about $17.6 billion) since 2021.

Potential legislative risks. Every recent incoming U.S. presidential administration has brought uncertainty to the health care industry, and the incoming Trump administration is no exception. But since the Republicans will control the White House and both chambers of Congress, the speed at which potential legislation could be enacted could be greater, and the risk for the industry is greater as a result.

Potential legislation includes changes to the Inflation Reduction Act (which includes Medicare Drug Price negotiations provisions), subsidies as part of Affordable Care Act, tariffs, and tax law changes. And proposed appointees to lead various government agencies and departments, including Robert F. Kennedy Jr. to HHS, could significantly change the tone regarding federal mandates on vaccinations and research and development funding, which could have credit implications on pharmaceutical companies.

Related Research

- Health Care Credit Beat: Republican Red Wave A Net Negative For Health Care, Dec. 2, 2024
- Record-High Health Care Defaults Will Moderate In 2025, Though Higher Than Normal, Nov. 20, 2024
- Code And Care: Navigating Private Credit Risk In The Software And Health Care Services Industries, Nov. 19, 2024.
- Health Care Credit Beat 2024: Highlights From Our 2024 Health Care Hot Topic Event, Oct. 11, 2024
- How Business Strength Varies Across Top Branded Pharmaceutical Companies (2024 Update), Aug. 6, 2024
- Health Care Credit Beat: U.S. Supreme Court's Chevron Decision Holds Mixed Implications For Industry, July 19, 2024
- How Will AI Transform The Health Care Industry?, June 27, 2024
- Despite Some Improvement, Weaker Health Care Services Companies Continue To Struggle, May 2, 2024
- Pharmaceutical Industry 2024 Credit Outlook Is Stable As Revenue Growth Mitigates Pressures, Jan. 24, 2024

Industry Forecasts: Health Care

Chart 7

Revenue growth (local currency)

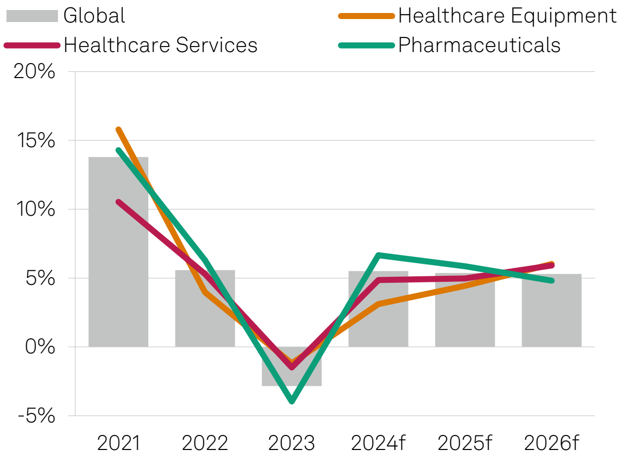


Chart 8

EBITDA margin (adjusted)

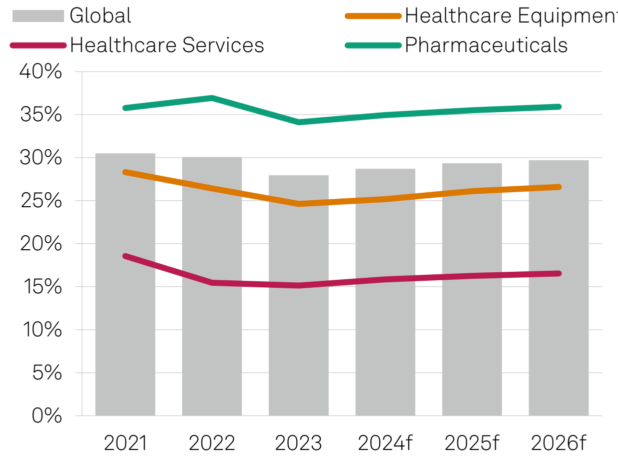


Chart 9

Debt / EBITDA (median, adjusted)

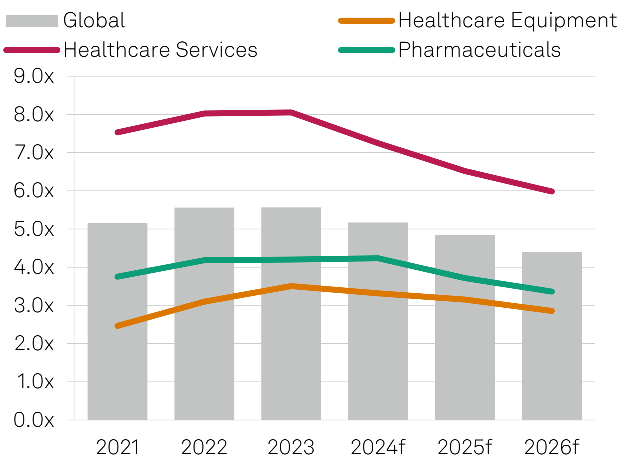
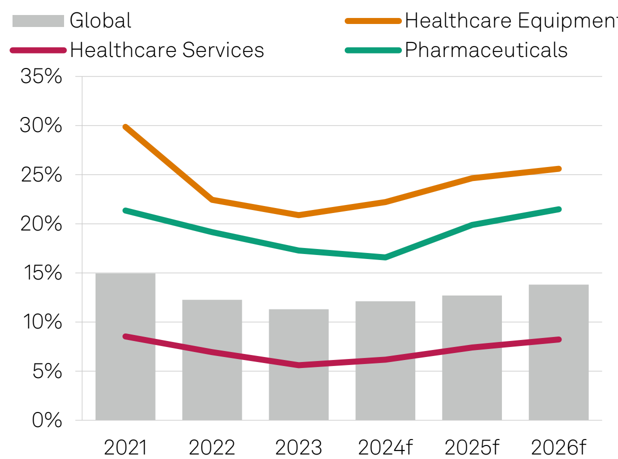


Chart 10

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Sector

Chart 11

Cash flow and primary uses

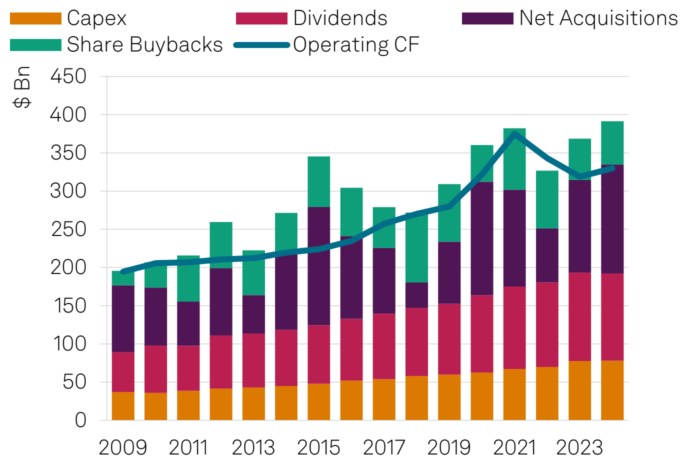


Chart 12

Return on capital employed

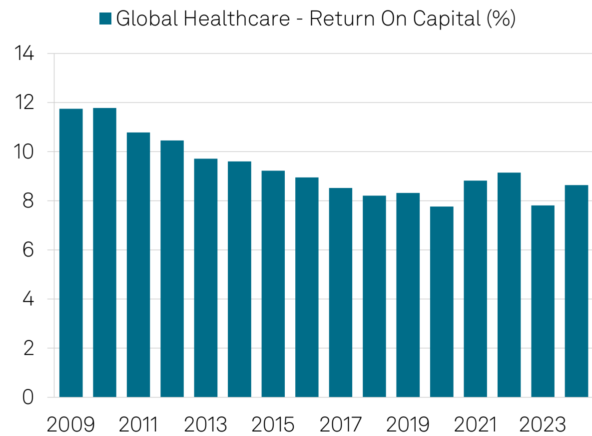


Chart 13

Fixed- versus variable-rate exposure

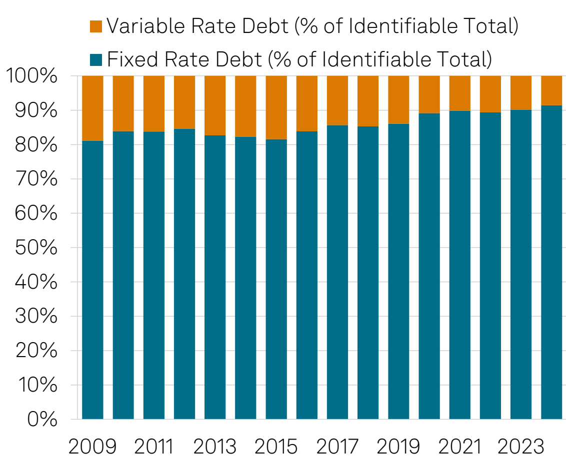


Chart 14

Long-term debt term structure

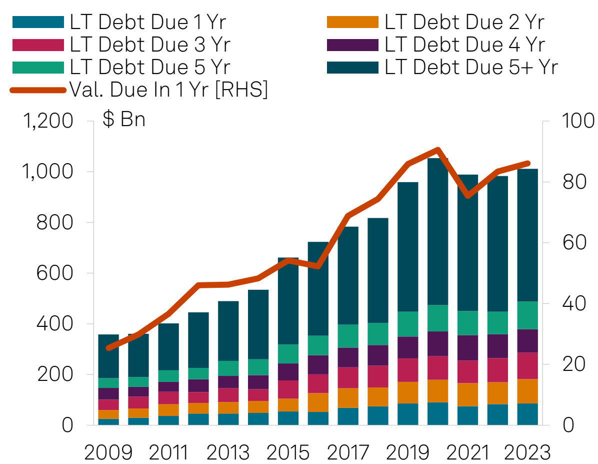


Chart 15

Cash and equivalents / Total assets

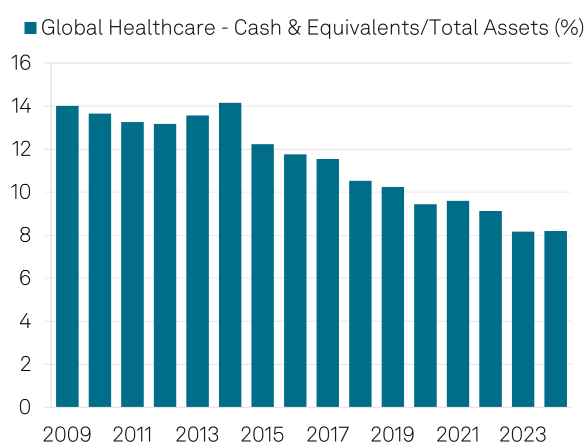
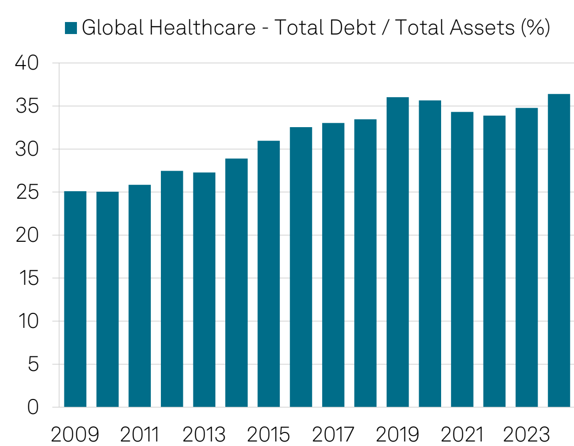


Chart 16

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Homebuilders and Developers

Tariffs will test the foundation

January 14, 2025

This report does not constitute a rating action.

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What's changed?

Prices of raw materials remain high. European cement remains 40% higher today versus 2021. Despite the higher cost base, construction activity and economic growth in Europe remains high.

U.S. mortgage rates remain high despite two federal rate cuts. The 30-year fixed rate mortgage began the year at 6.6%, was 7.2% in May, and is 6.8% at the end of November.

What are the key assumptions for 2025?

High home prices and higher than expected mortgage rates are pricing many U.S. buyers out of the market; the share of first-time homebuyers has declined sharply.

China's primary property sales will decline by 4%-6% in 2025, primarily due to increasing inventory levels and market-driven pricing.

Brazilian builders manage debt and reduce leverage thanks partly to increased cash generation and the Minha Casa Minha Vida program.

What are the key risks around the baseline?

New trade policies in the U.S. Higher tariffs on Canada and Mexico and mass deportations of undocumented immigrants could increase costs for materials and labor. Higher tariffs on China could slow its economy, causing land developers to slow their investments.

Geopolitical risks could disrupt supply chains or increase investor risk-aversion and ultimately undermine homebuilders' and developers' margins and demand.

High interest rates in Brazil may pose risks to the financial health of the Brazilian homebuilder sector, restricting access to savings-funded mortgages and increasing debt servicing cost.

Ratings Trends: Homebuilders and Developers

Chart 1

Ratings distribution

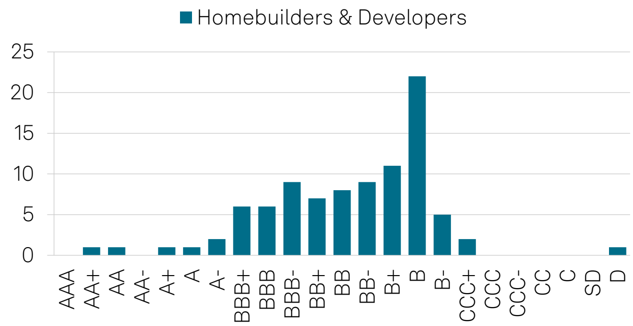


Chart 2

Ratings distribution by region

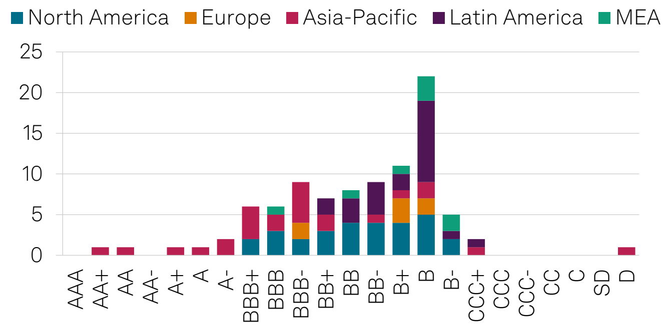


Chart 3

Ratings outlooks

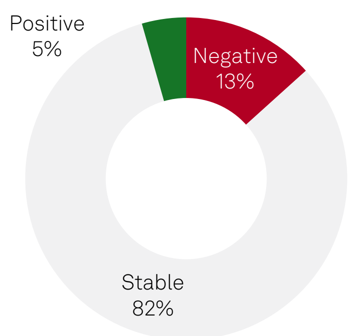


Chart 4

Ratings outlooks by region

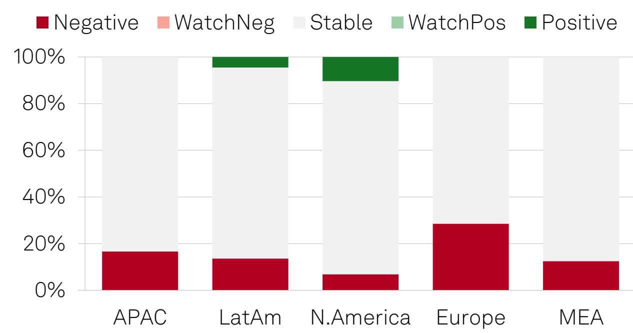


Chart 5

Ratings outlook net bias

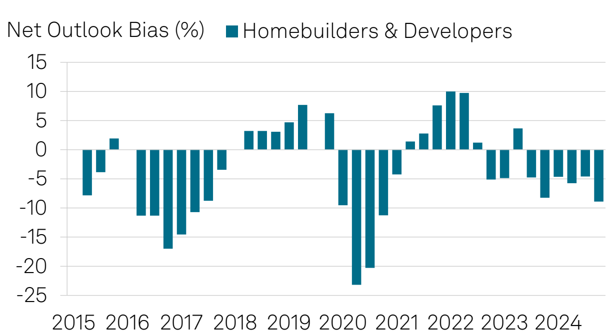
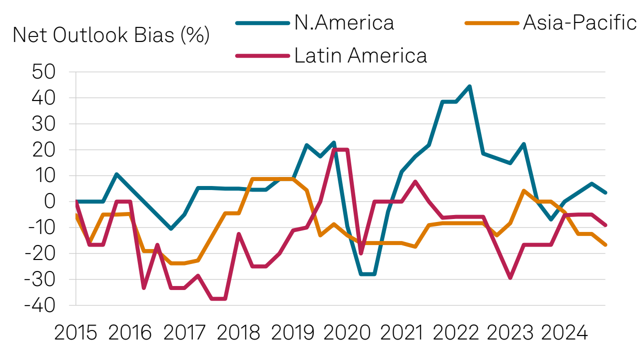


Chart 6

Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook: U.S.

Ratings trends and outlook

S&P Global Ratings' overall outlook for the U.S. homebuilding sector is stable. Of the homebuilders and developers we rate, 83% have stable outlooks, 10% have positive outlooks, and 7% have negative outlooks. This means we currently expect about five rating changes over the next 18 months, probably three upgrades and two downgrades. For contrast, in 2024 we upgraded eight credits (28% of our rated universe), revised outlooks on seven, placed MDC Holdings on CreditWatch with positive implications, and began rating Landsea Homes Corp.

Despite our stable outlook on the sector, it benefits from good long-term demand, tight supply, low existing home inventory, a healthy labor market, good cost management, and thoughtful capital allocation. Many builders used the windfall from peak operating performance in 2022 to reduce debt and bolster land holdings to improve their balance sheets.

As of Jan. 1, 2025, we publicly rate 29 issuers in the U.S. homebuilding and real estate developer sector. Issuers' revenues range from $595 million to slightly over $35 billion. Currently 24% of our ratings on U.S. homebuilders and developers are investment grade ('BBB-' or higher) while 38% are in the 'B' category. Of our rating outlooks, all except five credits are stable. The New Home Company Inc, PulteGroup Inc., and Toll Brothers Inc. are all on positive outlook with LGI Homes Inc and Adams Homes Inc. on negative outlook.

Main assumptions about 2025 and beyond

1. Affordability challenges for first-time homebuyers persist.

The share of first-time homebuyers has declined sharply while the median homebuying age for this group has risen sharply.

2. Higher-than-expected incentives due to higher-for-longer mortgage rates.

Customer incentives help builders maintain their sales pace but also pressure profitability. If the level remains higher than normal, we could see a further decline in gross margins.

Affordability remains an issue. High home prices and higher-than-expected mortgage rates are pricing many buyers out of the market. The share of first-time homebuyers dropped to 24% in 2024, the lowest since 1981, when the National Association of Realtors started tracking the metric. From 1981 to 2008 the share of first-time buyers averaged 40%. In addition, the median first-time homebuyer age has increased to about 38 years old from about 33 right before the pandemic. If the proportion of first-time homebuyers to all-home sales continues to shrink, we would expect it to have long-term implications for those builders who are focused or have adjusted their focus to the entry level product.

Mortgage rates have remained high despite two rate cuts in 2024. The 30-year fixed rate mortgage began the year at 6.6%, peaked at 7.2% in May, and was 6.8% at the end of November. Homebuilders that offer a rate buy-down incentive were able to mitigate those higher mortgage rates for customers. This, in addition to reducing the size of homes to be sold, provided better affordability for customers and a steady sales pace for homebuilders and developers.

However, these incentives have resulted in a decline in profitability, and we expect gross margins, on average in our rated universe, to decline to 23.9% in 2025 from 24.7% in 2024. S&P Global economists currently expect 30-year fixed mortgage rates of 5.9% for 2025. As the rate sinks, we expect fewer of these incentives to be offered, aligning to pre-pandemic levels. All else the same, this could help stabilize margins.

Credit metrics and financial policy

Financial discipline before and during the pandemic yielded stronger ratios and a growing credit buffer for most homebuilders and developers, indicating their credit quality improved. We expect most issuers in the sector to sustain solid credit protection measures with robust profitability and lower debt levels, given the aforementioned buffers and the continued improvement in construction cycle times. Since the global financial crisis, builders pivoted to a focus on returns over profitability. Since the pandemic, incentives and cost inflation are causing gross margins to decline, although not by much, relatively; 2019 gross margins for our rated universe were 18.7%, compared to 2024 margins of 24.7%.

While leverage for the sector is lower than before the pandemic, it does not necessarily mean broad-based higher ratings. Our assessment of each credit's financial risk incorporates leverage, but the rating also incorporates our assessment of each credit's business risk, which has remained relatively steady. We did upgrade 28% of our rated universe during 2024 as some higher-rated credits took market share; however, we still do not see homebuilding as an investment-grade sector. At least not yet.

We still see mergers and acquisitions (M&A) as opportunistic and view it on a case-by-case basis, but note that M&A activity has increased over the past three years. Noteworthy is the acquisition of MDC Holdings by Sekisui House, a foreign buyer with a low cost of capital, further expanding its exposure in the U.S. market.

Key risks or opportunities around the baseline

1. New administration's policy of mass deportations could increase labor costs.

Undocumented workers make up an estimated 13% of the U.S. construction industry and any loss of that workforce would probably drive up the cost of wages.

2. Proposed tariffs could increase the cost of materials.

Canada, which now has a tariff of 14.54%, could face a tariff of 25% under the Trump Administration. Softwood lumber, used to frame buildings, often comes from Canada. Both Mexico and Canada export gypsum, which the U.S. imports to make drywall, and cement. The U.S. is also the world's top importer of iron and steel, vital housing materials. Higher tariffs on these countries would lead to higher costs.

3. Existing home inventories increase from low levels.

If mortgage rates decline enough for existing homeowners to feel confident to sell, the increase in existing home inventories could siphon sales from prospective new-home buyers.

Mass deportations would lead to higher labor costs. Any large-scale and quick deportation actions by the new administration would significantly reduce the labor supply for construction trades. Undocumented workers make up an estimated 13% of the construction industry—more than twice that of the overall workforce, according to a recent estimate from Pew Research Center. The loss of the immigrant workforce would drive up the cost of wages for some positions and leave others unfilled. Even one particular trade being disproportionately affected because of a concentration of undocumented workers (such as roofers) would impact the entire home construction cycle.

In such a scenario we would expect the larger, better capitalized builders to be hurt less, to better absorb the higher costs, and possibly to increase market share.

Any additional tariffs on Canada and Mexico could increase construction costs. Nearly 10% of building materials used in residential construction are imported, according to the National Association of Home Builders (NAHB), and lumber from Canada probably accounts for the bulk of it. Canadian softwood lumber, used to frame buildings, now has a tariff of 14.54%. Currently the new administration is proposing up to 25% tariffs on Canadian and Mexican goods. In most cases, we would expect homebuilders and developers to pass along these costs increases to consumers.

The U.S. is also the world's top importer of iron and steel, essential housing materials, with about a quarter of America's $43 billion in imported iron and steel coming from Canada as of 2022. That same year, the U.S. imported $512 million of cement from Canada and $254 million from Mexico. Gypsum, which is used to make drywall, is also imported from both countries and has already jumped nearly 50% in price since 2020, according to the NAHB.

Less resale competition generally increases the buyer pool for new homes, and we believe this will persist while interest rates remain elevated. Currently one-third of housing inventory is new construction compared to historical norms of a little more than 10%, according to the NAHB. Combined with the slowdown in new home construction starts over the past several quarters, this has only increased the housing deficit. The lock-in effect—in which existing homeowners do not list their homes due to their below-market mortgage rates—is compounding the limits on the resale market. About 76% of homeowners with a mortgage have a fixed rate below 5%, according to John Burns Research and Consulting, with current market rates of about 6.8%. The lock-in effect provides strong support for the new home market and has resulted in market share gains for publicly traded homebuilders. If mortgage rates decline enough to allow existing homeowners to feel confident to sell, the increase in existing home inventories could siphon off sales from prospective homebuyers who see existing homes as more affordable than newly built. There is evidence that this has already begun in Texas and Florida, two of the fastest growing U.S. states by population growth.

Industry Outlook: EMEA

Ratings trends and outlook

We continue to expect credit rating pressure for European homebuilders and developers as illustrated by the 33.3% of negative outlooks (or two issuers out of six). The European market has been particularly hit by rising interest rates as the share of mortgage rates in developers' sales is generally higher. However, easing inflation and mortgage rates will help stoke housing demand. A strong and resilient labor market should also help restore homebuyer confidence.

Main assumptions about 2025 and beyond

1. Prices and volume should pick up as mortgage rates ease and purchasing power grows.

Demand for newly built residential should benefit from improving affordability and benefit to homebuilders and developers' sales.

2. Two-speed market, with Spain leading the pack.

European homebuilders are not performing equally across countries, with those most exposed to mortgage sales lagging.

3. Margin will recover gradually as construction costs remain elevated.

Cost of construction has eased but quite moderately and should continue to weigh on developers' margin in 2025.

Labor market resilience, rising purchasing power, and cheaper credit should boost demand for newly built residentials. The European Central Bank (ECB) has lowered its policy rates, which has triggered lower mortgage in most European countries. We expect the ECB deposit rate to reach 2.5% by mid-2025 and remain at this level toward 2027 (versus 4.0% in 2023). We believe long rates should remain broadly at the current level toward 2027. Real estate affordability should improve from a year ago, allowing developers to launch more projects and increase volumes. Most European countries should benefit from resilient job markets and higher disposable incomes, which would support the demand for new housing.

The market remains two-speed, with a longer recovery in France. This is due to the end of a government tax incentive and budget woes that are impeding potential support for property developers. For Spanish developers, we see a brighter trajectory. The country enjoys lower exposure to mortgage loans and higher demand from international investors, particularly on coastal areas. Spanish developers have shown greater resilience in passing on inflationary pressures to final buyers through price increases, despite rising interest rates. This has allowed them to protect profitability and production volumes.

We expect the cost of building materials to remain high, despite easing from high price increases in the past 18 months. Prices for raw materials, such as cement, increased 40% in 2022 and remain 40% higher today versus 2021. Despite this, construction activity remains high, fueled by recovery of public infrastructure projects financed through Next Generation European (NGEU) Funds and economic growth in Europe. This supports demand for raw materials, which maintains currently high prices, and we expect them to remain around current levels over the next two years. This could continue to affect developers' profits and consequently their credit profiles.

Credit metrics and financial policy

Revenue should recover in 2025-2026, after a strong decline in 2023-2024 thanks to higher sales in value and volume. EBITDA margins should improve gradually due to slowly easing construction cost inflation. Debt to EBITDA and funds from operations (FFO) to debt should recover in 2025 as more projects materialize and generate proceeds for recently taken out debt. EBITDA to interest should increase slightly thanks to revenue growth, albeit remain lower than 2020-2021 levels on average given the more elevated interest environment.

Key risks or opportunities around the baseline

1. Geopolitical risks could delay the recovery.

Geopolitical risks could lead to supply chain disruptions or stoke investors' risk aversion and ultimately undermine homebuilders' margins and demand.

2. Support from governments could help.

Any governmental attempt to revive housing demand, either through household incentives or large orders, will benefit property developers.

3. More environmental requirements.

While these are fueling demand for new builds, the requirements also represent additional costs, administrative hurdles, and technical challenges for developers.

Geopolitical instability remains our top risk in Europe. Even if political pressure from the new U.S. administration eventually leads to a wind-down in hostilities, the risks are enormous. Event risk could stoke investor risk-aversion, disrupt supply chains, and undermine the cohesion within NATO while shifting European governments' spending priorities. In such event, homebuilders could face shortage of materials, delays, and rising cost of constructions that could put their margins under pressure. Uncertainty and risk aversion would undermine demand, notably if rates were to increase. Lastly, any government budgetary constraint induced by a shift in spending could further reduce the likelihood of support to the real estate sector.

Government interventions could help correct the supply-demand imbalance. We continue to observe minimal support to the sector, unlike historically. In France the dismissal of the Pinel scheme—the last version of a long-dated tax incentive to buy newly built residentials—will end in 2025. There is a growing housing agenda in Europe, including the U.K. government's plan to build 1.5 million homes in five years, by setting housing targets for councils, streamlining planning, and incentivizing homebuilders. However, the tough market conditions (namely elevated interest rates and construction costs) and governments' tight budgetary headroom remain important constraints to provide more support to the sector.

Environmental requirements could be an opportunity or a risk for developers. As regulations become more restrictive toward low-energy-efficient housing, such as through minimum energy performance certificate (EPC) standards, they encourage the purchase of new builds that are typically more energy efficient and safer than aging or second-hand residentials.

However, these requirements may also delay the execution of projects and pile on costs to developers. Restrictions on building permits to limit land artificialization may also constrain the launch of new developments in coming years, especially in Western Europe.

Industry Outlook: Other EMEA

Gulf Cooperation Council

Dubai real estate had a tremendous year with presales poised to beat the record for 2023. Off-plan sales amounted to $34.3 billion in the first half 2024, on track to exceed $58.3 billion in full-year 2023. Dubai's resident population increased to 3.7 million at year-end 2023, and we project it will reach 4.0 million by 2026 on the back of an increasing number of expatriates and high net-worth individuals moving to the country. We expect Dubai's economy will remain relatively resilient and real GDP growth will remain close to 3.0% on average over 2024-2027 (3.3% in 2023).

The government's economic agenda, D33, aims to attract more investments in real estate alongside investment reforms and supportive regulations for businesses, boosting Dubai's real estate market. Dubai's dynamic economic environment, its reputation as a safe haven, and the low tax regime sustain the emirate's attractiveness for global investors.

We therefore expect primary property prices will remain stable over the next 18 months and to decline in 2026 due to significant potential supply pipeline. We expect sales prices per square foot in the primary market will remain stable in 2025 as developers focus more on increasing sales volumes rather than price growth. The share of luxury developments will likely reduce in 2025 since developers will continue to focus on affordable and mid-market properties and even the pace of new launches will decrease over the next 12-24 months given the market may not be able to absorb similar inventories as 2024. Against this backdrop we expect our ratings on developers will remain resilient in a weaker market environment due to reduced leverage, strong cash flow generation, and good liquidity buffers.

So far, the escalation of geopolitical conflicts in the Middle East has had no significant effects. Historically, the UAE—including Dubai—benefited from regional conflicts as they are considered a safe haven. This even led to population growth and investment inflows. The current conflict, however, is more complex and unpredictable than previous ones, in our view. It's liable to persist well into 2025, with potentially lasting effects. Economic disruption could affect capital flows, tourism, and even population growth since expatriates still account for a large portion of the UAE's population.

Saudi real estate remains fueled by domestic considerations, including homeownership targets and reforms. Residential prices and rents continue to soar in the kingdom. The cities of Riyadh and Jeddah saw year-on-year sales prices jump by 10% and 5%, respectively, in the first half of 2024. Economic indicators and population growth will remain strong in 2025 given the significant government investment in Vision 2030 (see below), new household formations, and strong outlook for non-oil growth. We expect demand for residential real estate will remain high, particularly in Riyadh and Jeddah due to domestic migration.

Vision 2030 targets a 70% homeownership rate in Saudi Arabia by 2030, and the kingdom is on track to achieving this, with the rate hitting 63.7% at the end of 2023, driven by various initiatives by the government. While foreign direct investments (FDI) remain low in the sector, visa policy reforms and regulatory changes could accelerate growth. For example, the government has introduced five new products to the Premium Residency program to stimulate demand from foreign buyers.

The present conflict in the Middle East has not had much impact on Saudi Arabia, with debt yields remaining broadly stable and tourism inflows robust. However, if tensions were to escalate, we could see a higher risk premium on debt; weaker tourism, FDI, and capital inflows; and more pressure on defense spending. This, in turn, could prevent Saudi Arabia from achieving some of its Vision 2030 targets.

Israel

The housing market is showing signs of recovery, even with the ongoing war and high interest rates. Transaction volumes are on the rise, with the number of apartments sold in the first three quarters of 2024 increasing by approximately 34% compared to the same period in 2023. This growth was even more significant in the new apartment market, with approximately 47% rise in sales. The heightened demand has led to an increase in the home price index, reflecting a moderate real increase when accounting for inflation. We believe this sales growth is partly due to buyers adapting to the war but mainly driven by developers' intensified marketing efforts. These efforts included favorable payment conditions (such as only 20% advance payment with the remainder upon delivery, attractive mortgage options), exemption from linkage to the construction cost index, and improved apartment specifications. We think developers are pushing these sales efforts to mitigate the burden of rising financing and construction costs. However, this strategy increases the funding requirements for homebuilders and puts pressure on profitability.

The inventory of unsold new homes has reached a historic high. Due to the war, the construction industry suffered a workforce shortage along with disruptions in the supply of raw materials, which in turn caused cost overruns and delays in construction. Building starts and completions were weakened in the first half of 2024 and, compared to the same period in 2023, were lower by about 7% and 13%, accordingly. Even with the increase in sales and the drop in building starts, the number of unsold new homes reached about 70,000 in September, one of the highest levels historically.

The pace of sales will continue to rise, with prices increasing at a moderate rate. Israeli demographics, which support steady demand growth, along with expectations of economic recovery in 2025 and a low unemployment rate, should lead to an increase in transaction rates towards the second half of 2025. This, in turn, should result in a higher rate of increase in the housing price index. However, in the short term, high construction costs, workforce shortages, high interest rates, and the sales efforts are putting negative pressure on the credit quality of weaker and more leveraged companies.

Industry Outlook: Asia-Pacific

Ratings trends and outlook

We expect Chinese developers to face shrinking liquidity buffers and rising leverage as sales and margins continue to decline. That said, we believe China's property sales could stabilize toward the second half of 2025, depending on the government's continued support of favorable funding conditions.

In Hong Kong, we expect rated developers to be cautious in land spending to control debt and leverage. Developers may sacrifice margins to destock in the next year or two.

In Indonesia, we expect developers' refinancing risks will be reduced significantly in 2025 due to liability management exercises performed in 2024.

Main assumptions about 2025 and beyond

1. China's primary property sales will decline.

National average primary home prices will decline in 2025, primarily due to increasing inventory levels and market dynamics, and developers may resort to price-cutting. In higher-tier cities, prices may stabilize gradually.

2. Hong Kong's primary residential supply will outstrip demand.

Primary residential sales volume will rise in 2025, and developers could adopt conservative pricing strategies to clear inventories, which could hinder a rebound in Hong Kong's home prices.

3. Indonesia's property sales could contract without further stimulus.

The scheduled expiration of value-added tax (VAT) reduction at the end of 2024 will dampen housing demand in 2025.

China's average primary home prices will decline by 4%-6% in 2025, primarily due to increasing inventory levels and market-driven pricing. National unsold completed homes stood at 732 million square meters (sqm) as of September 2024, compared with about 500 million sqm during 2018-2021. As inventories continue to rise, developers may resort to price-cutting to destock. The price cut will be more severe in lower-tier cities. In 2025, we expect primary housing prices in China's tier-one cities to fall by 3%-5%, tier-two cities to fall by 5%-7%, and lower tier cities to fall by 7%-9%. In higher-tier cities that have less supply and stronger demand, home prices could stabilize first and developers will face less destocking pressure. As of the end of July 2024, primary home inventories (including completed and uncompleted units) in 100 cities was 26.6 months, of which inventory at tier-one cities was 20 months, tier-two cities was 23 months, and lower-tier cities was 34 months.

Primary residential supply in Hong Kong will outstrip demand. As of September 2024, completed but unsold inventories stood at 21,000 units, which exceeds our demand forecast for 2025 and the annual demand for most of the past five years, the peak of which was only 21,108 units in 2019. Furthermore, some 77,000 units of new supply are under construction and set for completion over the next three to four years. We expect sales volume of primary residences to rise to 20,000 units in 2025 from an estimated 18,000 units in 2024, on the back of easing mortgage rates and market-boosting measures by the government. We expect developers will adopt conservative pricing strategies to clear inventories, which will hinder a rebound in Hong Kong's home prices.

Indonesia developers' free operating cash flow will remain thin. Indonesia's property sales could contract by 5%-10% in 2025 without further stimulus. The scheduled expiration of VAT reduction at the end of 2024 will dampen demand in 2025, which in turn will dampen operating cash inflow in 2025. In addition, as more developers refinanced their U.S. dollar offshore notes with domestic bank loans, annual amortization of these loans will consume the majority of the free operating cash flow. That said, easing inflation and moderating mortgage rates will partially mitigate the contraction.

Credit metrics and financial policy

In China, we expect developers' revenue and margins to decline due to both lower sales volume and average selling price. Consequently, their average debt-to-EBITDA ratio is likely to increase from 6.3x in 2023 to 7x in 2024. We also expect developers' liquidity buffer to shrink and that they will need to ensure their access to financing channels. For the time being, developers that have better financing pathways are those who have state backing or have sufficient investment property assets that could be pledged to obtain bank borrowing.

In Hong Kong, we believe developers' margin squeeze is not over. We anticipate further pressure over 2025-2026 as developers book lower-margin residential projects. By our estimate, rated developers' weighted average adjusted EBITDA margin will edge down to 34.9% in fiscal 2026 from 36.5% in fiscal 2024, which could pressure leverage levels. But we expect developers will have the flexibility to cut land spending to control leverage because most of them have a sufficient land bank in Hong Kong for development for the next five years.

Indonesian developers have divergent credit metrics. For developers with weaker credit quality, we expect revenue to soften in 2025 due to lower sales if there are no further stimulus policies in 2025. This will reverse a temporary boost in credit ratios in 2024 following several below-par tender offers. In contrast, developers in the 'BB' rating category should maintain stable credit metrics in 2025, as growing recurring income from the investment portfolio will offset a potential decline in property development revenue. Developers with higher recurring income have more flexibility to engage in selective expansionary capital spending or opportunistic acquisitions.

Key risks or opportunities around the baseline

1. Property demand in China could weaken if the U.S. hikes tariffs significantly.

Significant hikes in U.S. trade tariffs on Chinese goods could make developers less inclined to invest, and prompt prospective homebuyers to delay making purchases. This would hamper the stabilization of the property market.

2. The decline in Hong Kong's mortgage rates could slow if U.S. inflation rise.

We expect investment-driven homebuying demand to increase as the gap between mortgage rates and residential rental yields narrows.

3. Proposed property taxes cut in Indonesia may support demand.

Indonesia's president-elect proposes to suspend property taxes, including the 11% VAT and 5% land and building acquisition tax, for the next one to three years.

China property demand could slow further if the U.S. hikes trade tariffs significantly. The stabilization of China's property market relies on the restoration of confidence of developers and homebuyers. If China's economy softened due to significant hikes in U.S.'s trade tariffs on Chinese goods, we believe developers would be even less inclined to invest. Prospective homebuyers that sense developers lack confidence in the market may further delay their purchasing decisions. As a result, China property sales could fall below our base case and it would take a much longer time for China's property market to stabilize.

China could roll out more property stimulating measures should property demand wane further. For example, in mid-November, the Ministry of Housing and Urban-Rural Development announced that the government will target 300 cities for the redevelopment of urban villages and dilapidated housing, instead of the originally announced 35 cities. Furthermore, the government also reduced property-related taxes in mid-November to stimulate demand. In our view, these demand-side policies, if implemented effectively, could help absorb existing inventories.

The decline in Hong Kong's mortgage rates could slow if U.S. inflation rise. We expect investment-driven homebuying demand to increase as the gap between mortgage rates and residential rental yields narrows. Mortgage rates have further room to drop in Hong Kong if the U.S. Federal funds rate continues to fall. However, if inflation expectations in the U.S. rise, the Fed funds rate could be higher than our current forecast.

Mortgage rates in Hong Kong have generally dropped to 3.625% in November from over 4% before the U.S. Federal Reserve's cumulative 75 basis point cut since September. However, as home prices drop and residential rents rise—the latter rose more than 5% in the year to September—rental yields rise. As of September 2024, we estimate the gross rental yield for midsized mass-market properties (40-100 square meters) was about 3.3%. For properties under 40 square meters, their gross rental yield of 4.6% already surpassed the mortgage rates.

Proposed property taxes cut in Indonesia may support demand. Indonesia's president-elect proposes to suspend property taxes, including the 11% VAT and 5% land and building acquisition tax, for the next one to three years. The proposal is pending approval from the Ministry of Finance. If approved, it will boost property sales.

Industry Outlook: Latin America

Ratings trends and outlook

Homebuilders and developers will continue to recover gradually. Although more than 80% of our rated portfolio has a stable outlook, given the cyclicality of the homebuilding industry and economic and political volatility in Latin America (LatAm), we continue to be uncertain about the long-term outlook for the sector.

In Brazil, profit margins have weakened. Work stoppages during the pandemic and supply-chain disruptions coupled with the persistently high interest rates lifted construction costs and delayed project completions, resulting in a drop in homebuilder and developer profitability during 2022-2024. We now expect their profitability to rebound in the next few years at a slower pace than we previously forecasted, given the higher inflation and still-high interest rates in Brazil. Although most of the rated companies in the sector have some cushion on their balance sheets, margin recovery and cash generation trajectory amid a high-interest rate environment will permeate potential future rating actions.

In Mexico, housing demand to surpass the tight supply of units. This should allow homebuilders to keep passing inflation costs to homebuyers and protect their profit margins. Moreover, we expect financial institutions to remain well capitalized, with mortgage financing availability and a modest improvement in financing conditions as the central bank continues cutting the reference interest rate. President Claudia Sheinbaum's strategy of building 1 million new homes over her six-year term could represent an opportunity for Mexican housing starts to rebound, but will likely be accompanied by challenges. Overall, we expect rated homebuilders to maintain their healthy balance sheets, supported by conservative financial policies toward the use of debt, prudent liquidity management, and their flexible business models.

Main assumptions about 2025 and beyond

1. Brazilian homebuilders' launches and sales to continue benefit from changes in the housing program.

We expect mid- to high-tier developers to start constructing low-tier homes due to changes in the Minha Casa Minha Vida (MCMV) program that took place in 2023 and 2024, which expanded subsidies, enhancing access for buyers and profitability for developers.

2. They're also poised to manage debt and reduce leverage.

About 40%-60% of rated Brazilian homebuilders' debt consists of debentures and corporate instruments, with 25% maturing in 2025. Increased cash generation from project deliveries and the MCMV program will enable them to reduce leverage.

3. Mexico's rated homebuilders would maintain healthy revenue growth, profitability, and leverage.

We expect homebuilders to continue benefiting from the housing deficit in the country, allowing them to pass on most inflation costs to homebuyers.

MCMV program changes to increase housing launches in Brazil. Housing launches and net sales jumped in 2023 and 2024. Despite the slowdown in savings account-based home financing, which potentially weakens builders' pricing power, the drop in inflation accelerated the sales pace. This has expanded the pool of potential homebuyers.

In addition, we expect mid- to high-tier developers to engage in construction of low-tier houses. This shift is largely due to modifications to the MCMV program. For instance, in July 2023, the federal government raised the price ceiling for homes sold under the program's Bracket 3 from R$264,000 to R$350,000 and expanded housing subsidies. We believe these changes will increase access to the MCMV program for potential homebuyers. Simultaneously, these changes are likely to raise the profitability of low-tier homes sold through the program.

Therefore, we expect housing launches to rise to high-single digits in 2025. However, high basic interest rates, squeezing available credit for homebuying, could pose risks for mid-tier projects. This is particularly the case during the transfer phase, where the increase in initial mortgage payments may not align with buyers' gross monthly incomes, potentially leading to increased sales cancellations and delays in cash-flow recovery.

In Brazil, operating improvements likely to help reduce leverage. Approximately 40%-60% of the reported debt among the Brazilian rated homebuilders consist of debentures and other corporate debt instruments. The remaining portion is related to construction credit lines, which are also linked to unit transfers to banks through real estate credits.

Out of the total debt outstanding among these entities, around 25% will mature in 2025. Considering the expected cash generation starting in 2025 stemming from the higher number of project deliveries, and cash-flow benefits from launches under the MCMV program, we believe Brazilian builders will use cash to reduce leverage.

However, a significant portion of their debt will likely need refinancing, prompting homebuilders to tap capital markets and seek financing from banks. We don't view this as a major credit risk as we believe the depth of the Brazilian capital and banking markets would be sufficient to cover those needs for entities with solid credit fundamentals. In addition, due to likely growth in housing launches, we believe homebuilders will seek financing to execute projects and acquire land.

Mexican homebuilders should keep a steady operating and financial performance in 2025. We expect revenue to grow near 4%-8% in 2025 on the back of low-single-digit percent unit growth and average price increases. We expect homebuilders to continue to benefit from an easing on inflation in key input costs, which should help to keep healthy profit margins. Moreover, we assume rated homebuilders will continue to pass on most inflation costs to homebuyers through average price increases, particularly in medium and residential segments that tend to be more inelastic to price changes, and because of their proven ability to adapt to market needs. We expect rated homebuilders will remain prudent in terms of new developments and debt, which should keep their leverage broadly stable in the next 12 months.

Housing starts in Mexico remain at low levels, with about 129,700 units in the 12 months ended October 2024. In our view, this is due to tough business conditions over the last few years, the dwindling number of federal subsidies, and relatively high inflation, which weighs on homebuyers' investment decisions.

Still, the country faces a large housing deficit and the announced new housing strategy from the government of building 1 million new homes over its six-year term holds promise for homebuilders, notwithstanding that half of the potential homes would address a segment of the population that is not the core market of rated homebuilders. We continue to expect rated homebuilders to benefit from the housing deficit, slowly growing formal employment and stable mortgage rates. Moreover, government-owned entity, Instituto del Fondo Nacional de la Vivienda para los Trabajadores (Infovanit) and el Fondo de la Vivienda del Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado (Fovissste) will continue looking to expand their housing programs and customer bases, in line with the national housing plan. We also expect house price appreciation to moderate, in line with easing inflation.

In our view, these factors support the expected 2025 growth trajectory of the following Mexican rated homebuilders: Consorcio ARA S.A.B. de C.V. (national scale: mxAA-/Stable/--); Inmobiliaria Ruba S.A. de C.V. (national scale: mxAA-/Stable/mxA-1+); and Vinte Viviendas Integrales S.A.B. de C.V. (global scale: BB-/Positive/--; national scale: mxA-/ Positive /--). We expect rated Mexican homebuilders to continue leveraging their competitive positions and business flexibility from strong inventories, landbank reserves, and geographic, product, and financing diversification to keep a steady operating and financial performance.

Credit metrics and financial policy

Metrics will gradually improve for Brazilian homebuilders in 2025. Following the 2015-2017 Brazilian economic crisis, the overall housing sector adopted a more-conservative approach in terms of financial policy, with most of rated issuers maintaining extended debt maturity profiles. For most of the companies we rate, this helped them get through 2022 and 2024 without significant negative rating impacts, excluding some specific cases. Nonetheless, persistent high interest rates, with our expectation of an average basic interest rate of 10.9% in 2025, are still weighing on companies' interest burden and coverage ratios. In this scenario, we have been seeing some rated issuers focusing on liability management, whether through refinancing or by reducing gross debt. Additionally, we expect Brazilian homebuilders to continue to rely heavily on construction financing debt or even structured product issuances, as these lines usually have better cost and terms. Given the above, we forecast credit metrics to improve from 2025 for Brazilian homebuilders, with an FFO-linked ratios presenting an upward trajectory in the next quarters.

Mexican homebuilders to maintain prudent financial policies. We expect rated Mexican homebuilders will continue to prioritize strong balance sheets, relatively low leverage, sound liquidity, and making investment decisions subject to their financial position. Following two years of high investments in land and housing construction, working capital needs should moderate in 2025, which should result in slightly positive free operating cash flow and credit metrics consistent with the ratings. Moreover, we view refinancing needs as low for 2025, due to proactive liability management.

Further consolidation of the Mexican housing industry is unlikely in 2025. In May 2024, Vinte Viviendas Integrales S.A.B. de C.V. announced its intention to acquire up to 100% of Servicios Corporativos Javer S.A.B. de C.V.'s capital stock through a mix of equity and debt. We believe further consolidation in the industry is unlikely at this moment. Although they may bring economies of scale, some of the potential remaining targets operate within the same markets as potential buyers, making transactions less attractive in terms of geographic diversification. Moreover, a potential acquisition would likely result in higher use of debt, which would be a departure from the prudent financial policies established by rated entities like Consorcio ARA or Inmobiliaria Ruba.

Key risks or opportunities around the baseline

1. Macroeconomic downside risks.

Economic and political conditions in the LatAm region have proven relatively volatile in past years, raising questions regarding long-term prospects for the homebuilder industry in the region.

2. Solid medium- to long-term growth prospects.

The region maintains a significant housing deficit and benefits from a growing middle-class and well capitalized banks, which suggests growth opportunities for homebuilders in the medium to long term.

3. Brazilian regulatory changes benefit capital raising.

The new resolution has restricted the eligible collateral for issuing Real Estate Receivables Certificates (CRIs), with the aim of prioritizing funding for the real estate sector. This change has significantly narrowed the pool of potential issuers, which could enable developers to raise capital at more attractive rates.

4. High interest rates chip away at primary source of mortgage funding.

Since 2021, savings deposits have stagnated, while residential loans have seen significant growth. To diversify funding sources, banks are increasingly issuing letters of credit and securitizations, a trend we expect to continue.

Brazil's regulatory changes facilitate capital raising at more attractive rates. The introduction of Resolution CMN 5,118 on Feb. 1, 2024, restricted the eligible collateral for the issuance of Real Estate Receivables Certificates. The primary objective of this change is to prioritize the allocation of funds raised through CRIs to companies in the real state sector. As a result, the pool of potential issuers has significantly narrowed. In our view, this should reduce competition for financing, enabling developers to raise capital at more attractive rates.

Challenges from the MCMV program. Mid- to high-tier developers' participation in the MCMV program requires a certain level of expertise to ensure project profitability, such as navigating the bureaucracy involved in applying for the program. Moreover, given the lack of inflation adjustment after the transfer of newly built units to banks, the high speed of construction and the high cost of land and labor pose difficulties in maximizing the profitability of each project and reducing exposure to potential inflationary spikes.

High interest rates chip away at primary source of mortgage funding. In Brazil, banks are required to allocate 65% of special savings deposits (SBPE) for mortgage lending due to a lack of long-term funding options. Since 2021, savings deposits have stagnated while residential loans have grown significantly.

To diversify funding sources, banks have increased the issuance of LCIs and securitizations. We expect this trend to continue as high interest rates impact deposit growth. We anticipate that the share of mortgages in total loans will remain stable, with Caixa Econômica Federal (BB/Stable/B) holding a significant market share. However, restricted access to saving accounts-funded mortgages and high interest rates may pose risks to the financial health of the homebuilder sector.

Mexican economy to slow in 2025. Our base case assumes the Mexican economy will continue to slow down in 2025 with an expected GDP growth of 1.2%, reflecting higher uncertainty regarding its trade relationship with the U.S., which we believe will take a toll on investment. In addition, recently approved Mexican reforms—such as changes to the judicial system— could delay investment decisions until there is more clarity on the implications of those bills. In our view, a weaker-than-expected economy amid elevated house prices could result in weaker demand, which could undermine homebuilders' capacity to pass through cost increases or raise working capital, and ultimately undermine operating and financial performance if not addressed.

Solid medium-to long-term growth prospects to Mexican housing industry. We believe the Mexican housing industry should benefit from structural factors such as a housing deficit of about 8 million, a gradual rise in formal employment, and mortgages availability from well-capitalized financial institutions. We also expect financial conditions to improve in the next 12 months as the central bank continues to cut the reference rate. Although we do not expect this to have a major effect on mortgage rates, it could improve households' disposable income. These factors should support long-term demand for the formal housing sector.

Additionally, President Scheinbaum's housing strategy considers that Mexico's largest mortgage lender, INFONAVIT, will deliver 500,000 homes, although how it would manage this remains to be seen. If INFONAVIT decides to subcontract part or the full construction process to the private sector, homebuilders could benefit.

Related Research

- French Developers Are Navigating The Storm As Spanish Sail Ahead, Oct. 29, 2024
- Real Estate Monitor: Rate Cuts Could Spur Sector Recovery, Sept. 11, 2024

Industry Forecasts: Homebuilders and Developers

Chart 7

Revenue growth (local currency)

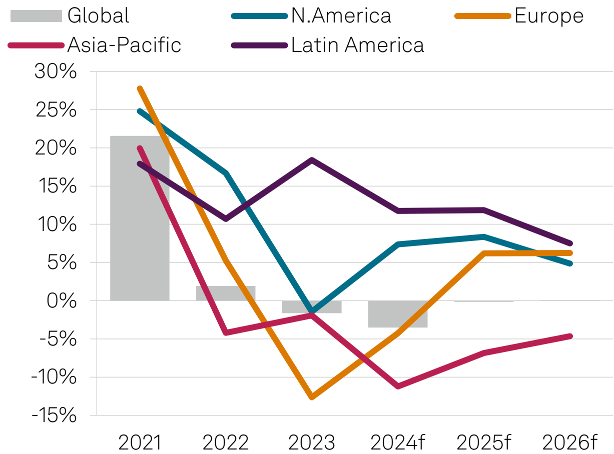


Chart 8

EBITDA margin (adjusted)

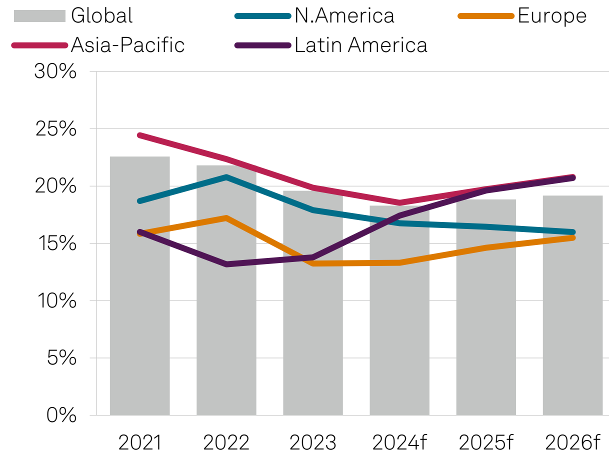


Chart 9

Debt / EBITDA (median, adjusted)

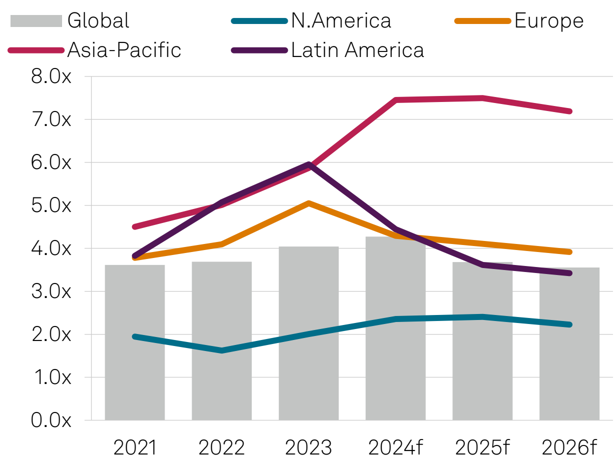
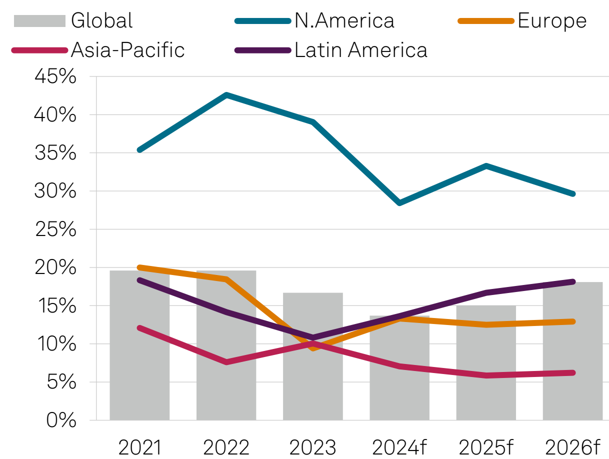


Chart 10

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Homebuilders and Developers

Chart 11

Cash flow and primary uses

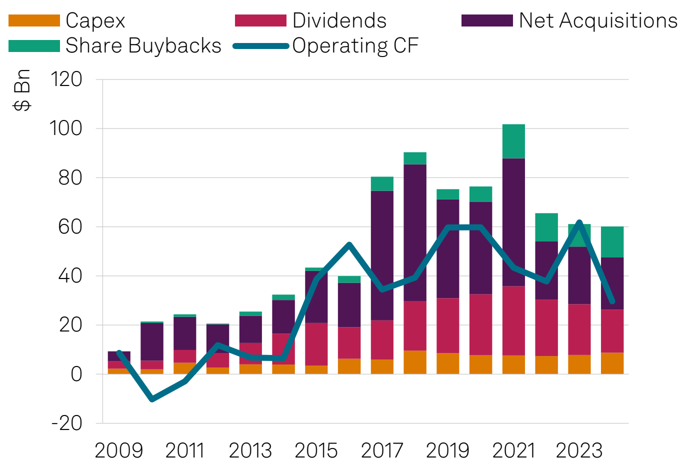


Chart 12

Return on capital employed

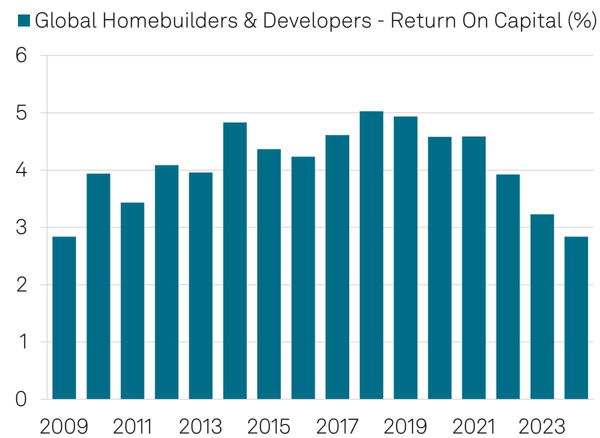


Chart 13

Fixed- versus variable-rate exposure

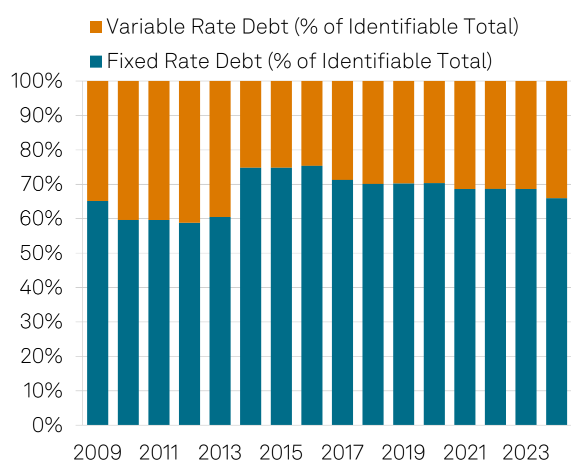


Chart 14

Long-term debt term structure

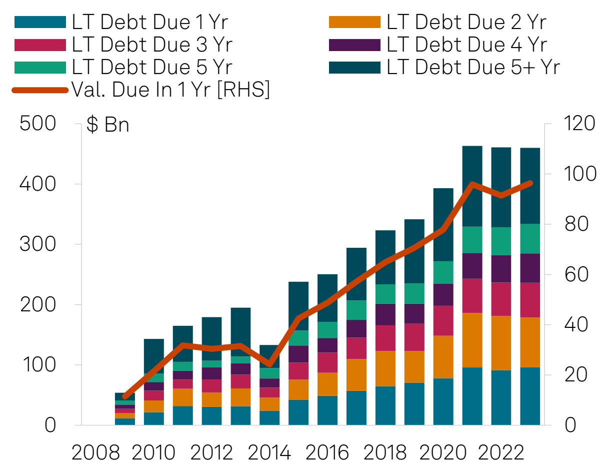


Chart 15

Cash and equivalents / Total assets

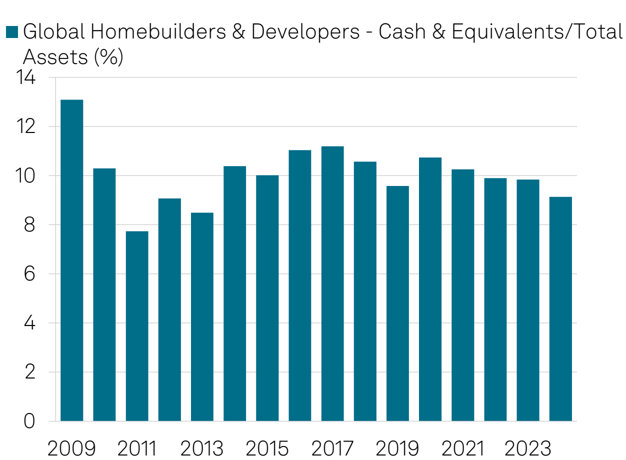
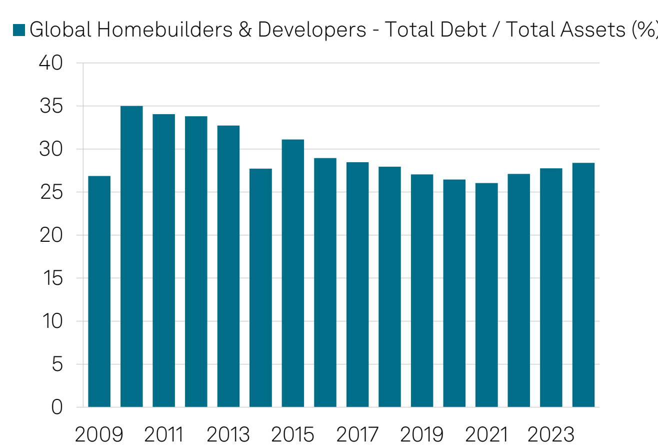


Chart 16

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

S&P Global Ratings

Hotels, Gaming, And Leisure

Travel and leisure spending faces policy uncertainty

January 14, 2025

This report does not constitute a rating action.

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What's changed?

Significant policy uncertainty. It's uncertain if still-fairly resilient discretionary travel and leisure spending will hold amid possible tariffs, labor constraints, and slower pace of further Fed easing.

Big-ticket discretionary leisure products have underperformed. Revenue and EBITDA for boats, RVs, powersports, and motorcycles are far below our base case because of high prices and interest rates. but retail sales have fallen so far they have likely reached a trough for most products.

The low-income gaming consumer deflates. Spending is being reined in at casinos in some markets where low-income consumers reduce entertainment budgets.

What are the key assumptions for 2025?

Gaming. Macao's mass gaming market will remain strong, regional gaming revenue and spending in Las Vegas face a strained consumer, and regulation in Europe consolidates market shares.

Lodging. U.S. RevPAR improves modestly due to higher business and group travel, European hotel owners face higher costs, and timeshare operators continue to invest in new owners.

Cruise. Forward bookings for 2025 that are on pace with or ahead of historical levels and at higher prices will support the industry's absorption of modest incremental capacity.

What are the key risks around the baseline?

M&A deals and shareholders distributions that are not currently in our base case could have negative impacts on ratings.

Inflation is reignited by tariff and immigration policies that raise the cost of imports and reduce labor supply, increasing input costs and wages and hurting discretionary consumption.

Ratings Trends: Hotels, Gaming, and Leisure

Chart 1

Ratings distribution by region

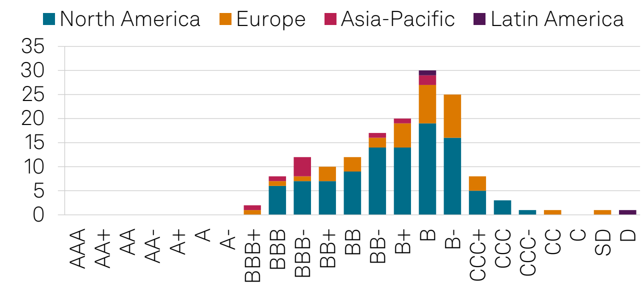


Chart 2

Ratings distribution by subsector

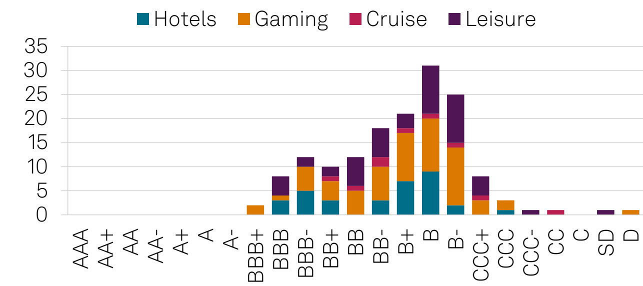


Chart 3

Ratings outlooks by region

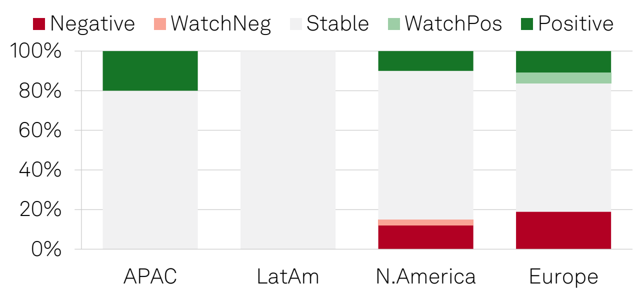


Chart 4

Ratings outlooks by subsector

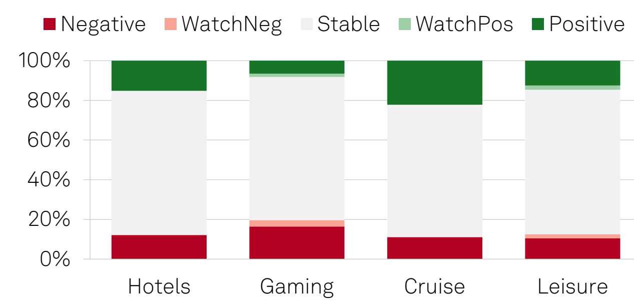


Chart 5

Ratings outlook net bias by region

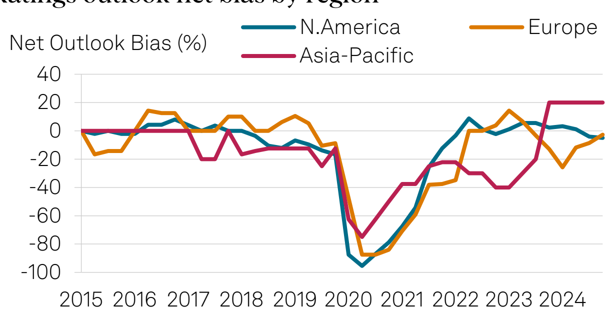


Chart 6

Ratings net outlook bias by subsector

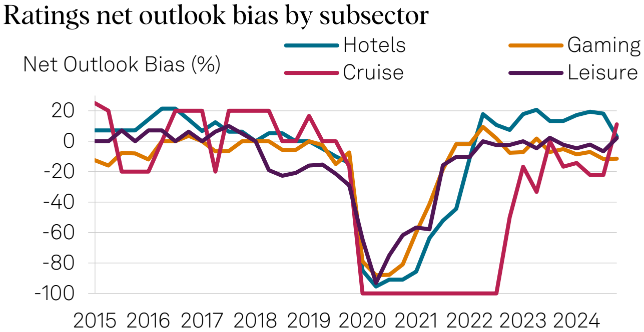


Chart 7

Ratings outlooks

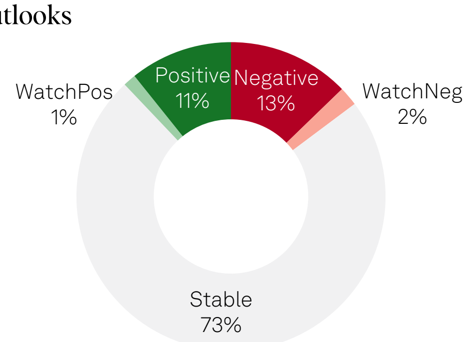
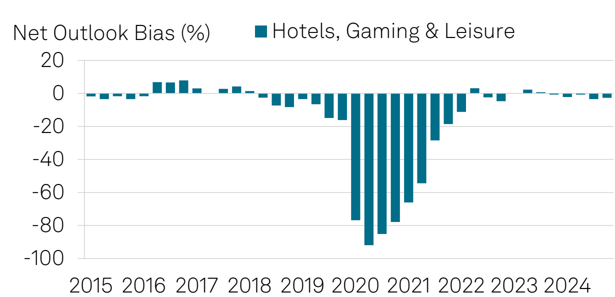


Chart 8

Ratings outlook net bias



Source: S&P Global Ratings

Industry Outlook: Gaming

Ratings trends and outlook

Recent downgrades are largely concentrated among small scale, highly leveraged gaming issuers facing intensifying competition for a strained consumer. While most rating outlooks are currently stable, the gaming sector has the largest number of credits within the leisure sector. Gaming also has the largest negative outlook bias, mostly because of M&A or development spending straining credit measures, or regulatory pressure and a weak consumer.

Main assumptions about 2025 and beyond

1. Strong momentum in Macao's mass gaming market will continue.

We project Macao's total gross gaming revenue (GGR) will increase 5% to 6% in 2025 compared with 2024. We base our growth forecast on continued strength in mass market GGR.

2. Regional gaming revenue and spending in Las Vegas may be pressured by a slowing economy.

Slower consumer spending combined with rising unemployment may hurt discretionary spending on gaming, leading to modestly lower regional gaming revenue in some markets and less spending in Las Vegas. An unfavorable event calendar comparison in Las Vegas could exacerbate the effects of a slowing economy.

3. European operators increase positions in regulated markets, reducing negative repercussions.

European operators benefit from online sports betting and regulatory changes for online casinos that increase barriers to entry. Consolidation may further improve large operators' market positions, but M&A leverage may hinder material improvements in credit metrics.

Strength in Macao's mass gaming market will support further EBITDA growth for rated issuers. Our latest base-case assumptions project Macao's 2025 total GGR will grow 5%-6% year over year. We based this mainly on continued strong momentum in the mass market segment, which we expect to be 15%-20% above 2019. We believe mass market GGR will grow in 2025 as visitation to Macao returns to pre-pandemic levels, aided by solid demand from premium mass customers and expanded hotel capacity. Supporting this is visitation from Mainland China, which surpassed 2019 during Golden Week 2024. We also expect to see further recovery in base mass visitation and GGR, particularly from casual players. However, total GGR will remain about 15%-20% below pre-pandemic levels, due to the tightened regulations on junket (VIP) operators. As a result, VIP volume will likely stay near current levels, as operators are unlikely to significantly expand junket VIP operations amid tighter regulations. EBITDA will likely expand as visitation recovers and some gaming operators, such as Studio City, Sands, and Galaxy, continue ramping up new capacity and new investments.

A slowing economy could pressure regional gaming revenue and spending in Las Vegas. We expect 2025 to be another year of muted regional gaming revenue growth as consumer spending weakens and unemployment rises. Some markets and properties may benefit from hosting events like the Super Bowl or new investments, but others may struggle in a softening economy, especially those that may cater to more value-oriented customers, or where competition is increasing. In Las Vegas, an unfavorable event calendar in 2025 compared with 2024 could magnify the impacts of a slowing economy. Some cracks are already beginning to show as the market faced the anniversary of the inaugural Formula 1 Grand Prix race in the fourth quarter. The first year of a new race is typically the strongest. We expect the unfavorable year-over-year comparison to bleed into the first quarter as Las Vegas hosted the Super Bowl in 2024, which drove strong room rates and revenue. A contraction in room inventory in the market as the closures of several properties offset new rooms at Fontainebleau may provide a modest buffer against falling room rates in a weaker economy. Nevertheless, most gaming operators generate most of their cash flows from a small percentage of customers in their databases. As long as these customers remain relatively healthy and operators can maintain cost controls and marketing discipline, most have some cushion to navigate softer operating performance next year. While brick and mortar gaming revenue might soften next year, overall total commercial gaming revenue in the U.S. could rise as sports betting and iGaming growth will likely remain strong as existing and new markets continue ramping up.

European operators' increased positions in regulated markets reduces negative repercussions. Demand for gaming in EMEA has remained resilient thanks to some recovery in consumer sentiment and real wage growth. Despite recently eased inflation, margin improvements are expected to be minor in light of continued cost increases. We believe increasing regulation and related costs raise barriers, benefiting established operators. This is especially the case for online sports betting and casino offerings. We expect operators with previous retail operations in newly regulated online markets to benefit from their brand awareness. At the same time, restrictive, regulatory-driven marketing initiatives, player protection, affordability checks, and potential tax levies could make offerings less attractive and pressure margins.

European issuers, such as Entain and Flutter, are highly engaged in the regulated U.S. markets for online sports betting and gaming. In 2024, operators consolidated their market share and we expect this trend to continue in 2025 as they prioritize growth over profitability. As a result, we see material improvements in earnings and cash generation after 2025. Some of the European operators with a smaller presence, such as Tipico and Evoke, are gradually exiting the U.S. market, which should help preserve cash flows and credit metrics, since the U.S. expansions require meaningful capital investments.

Key risks or opportunities around the baseline

1. Economic headwinds and potentially higher operating expenses could hurt cash flow.

Despite our forecast for GGR growth in Macao, a weakening economy and potentially higher operating expenses targeting premium mass players could impair cash flow and leverage improvement.

2. Development projects could add incremental leverage over time.

Global and U.S. gaming operators could bid for three full-scale casino licenses in New York. The scale of these projects could add leverage compared with our base-case forecasts. We don’t currently incorporate New York developments into our forecasted credit measures because of significant uncertainty over when New York will award licenses and which bids will be successful.

3. Faster shift to a regulated European market could accelerate growth, however regulation and related costs could impair product attractiveness and profitability.

In Europe, a faster-paced regulation of the market should benefit rated operators as it enables underlying growth and reduces regulatory risks.

Economic headwinds and potentially higher operating expenses could impair Macao cash flow. Macao faces greater risks compared with other gaming markets, given its very high dependence on mainland visitors. Softer gaming revenues may materialize in 2025 if Chinese visitors broadly pull back leisure spending amid persistently soft macro conditions. In our view, base mass players are more sensitive to changing economic conditions – particularly weak employment or earning prospects. Premium mass players with higher net worth are generally less sensitive to economic volatility. This segment has been resilient despite declining asset prices over the past two years. However, this could change if asset prices decline further. Competition for mass GGR could also propel higher marketing spend and operating expenses for Macao casinos. With the VIP segment stagnant, all Macao operators are targeting premium mass players, which could lead to higher promotional spend or higher costs related to enhancing the customer experience. This could lead to slower EBITDA growth and slower deleveraging, especially for those operators ramping up new properties. That said, the risk of gaming revenue volatility (due to economic headwinds) and potentially higher operating expenses is less of a credit concern because most of our rated issuers have largely restored their balance sheets and have sufficient cushion in credit measures to absorb this volatility.

Higher capital expenditures could delay deleveraging or add incremental leverage. Global and U.S. operators such as Las Vegas Sands (LVS), Wynn Resorts Ltd., MGM Resorts International, Genting Bhd., and Caesars Entertainment Inc. will likely bid for up to three full-scale casino licenses available in New York. The scale of these projects could add leverage compared with our base-case forecasts, slowing improvement in the operator's credit measures or eating into substantial leverage cushion for others. The project sizes range from $2 billion on the low end for expansions or redevelopments to more than $6 billion for new developments, and we believe these original development cost estimates could escalate as time passes. We believe New York could award licenses in late 2025 but don’t anticipate winning bidders would initiate any material capital spending before 2026 or 2027. These developments could take several years to complete given the complexities of building in New York and the likely large scale of these projects. Many of these operators also have development projects underway in other regions of the U.S., and around the world in Singapore, the United Arab Emirates, and Japan. Thailand is also in discussions to open its gaming market as soon as 2025, which could add future development risks for LVS, MGM, and Wynn. Despite these development risks, many of these operators have cushion to absorb higher development spending but these risks limit rating upside at this time.

A faster shift to a regulated European market could foster growth but burden profitability. In Europe, a faster-paced introduction of regulation should benefit rated operators as it will enable the opening of new gaming markets and will reduce regulatory uncertainty. Specifically, this would apply to online casino offerings that have yet to be legalized in some European markets, such as France or Finland. It is also possible that increased regulation could impair the attractiveness of some product offerings. We also believe the sector is increasingly scrutinized by the public, which could lead to additional cost burdens, such as taxes or license fees.

Industry Outlook: Hotels And Timeshare

Ratings trends and outlook

Most of our rating outlooks on lodging companies are stable thanks to solid credit metrics stemming from durable leisure demand and improving group and business travel trends. Easing inflation and declining interest rates could spark M&A deals and shareholder distributions not currently in our base case, which could in turn have a negative impact on ratings.

Main assumptions about 2025 and beyond

1. U.S. hotel revenue per available room (RevPAR) growth improves modestly between 1% and 3%, but largely in line with consumer spending.

U.S. lodging performance will continue to reflect weakness among lower-income travelers, a strong dollar that incentivizes outbound travel, partly supported by low supply growth in the domestic market.

2. European RevPAR grows modestly, although higher operating costs could threaten profitability.

RevPAR should increase modestly in the low-single digits in 2025 given already high ADRs and flat occupancy rates. The profitability of asset-heavy operators may be challenged by high labor and lease costs, while asset-light and diversified groups should prove more resilient.

3. Latin America's lodging companies' operating performance remains steady in 2025.

Business travel and leisure activities were stable in 2024 amid disinflation in the region and benefited by a strong dollar. Our base case for 2025 assumes economic activity grows 2%, ADR grows 3% to 4%, and occupancy is flat, which should help companies maintain steady operating performance.

4. Timeshare operators will continue to focus on investing in new owners.

New owner investment will likely translate into higher tour flow and lower volume per guest (VPG), resulting in low-single digit contract sale growth in 2025.

We expect U.S. hotel RevPAR will grow 1%-3% in 2025. Upscale properties in key lodging markets will likely continue to outpace the overall lodging market through 2025 as group demand and business transient travel continue providing tailwinds, benefitting higher end chain scales. We expect occupancy and ADRs will increase 0.5%-1.5% over the next year, with most of the gains coming from upscale properties. While we do not believe RevPAR will continue to decline at midscale and economy hotels, we believe they will continue to lag the overall market as lower end travelers maintain tighter travel budgets. RevPAR year to date through November was strongest amid upper upscale (+2.7%), luxury (+2.0) and upscale (+1.9%) hotels. At the same time, growth in 2024 was concentrated among top markets that had not fully recovered as businesses bring workers back to offices and travel budgets are increased. RevPAR year to date in the top 25 U.S. markets was up 2.4% compared with the overall U.S. market up 1.6%. Houston (+15.4%), New York (+8.6%), Chicago (+7.6%), New Orleans (+7.5%), Boston (+6.7%), and Seattle (+6.8%), were the leading cities. Meanwhile, lower chain scales have continued to lag the overall market despite signs of resilience in the past few months with economy segment RevPAR down 2.3% through November 2024. Also propelling growth in the U.S. lodging market is multiple years of historically low supply, driven down by lower development activity overall amid a high interest rate environment. While development has already accelerated in certain luxury and upper upscale markets, it could pick up more broadly if the Federal Reserve continues easing its monetary policy. However, it may take a couple of years for incoming supply to affect overall occupancy rates and ADR.

European RevPAR should grow modestly, but higher costs could threaten profitability. We believe real GDP growth in Europe, about 1%-2% in 2025, should support low-single-digit growth in RevPAR for European lodging operators, given already high ADRs achieved in the past two years. However, we expect occupancy rates to remain flat, as a result of moderating leisure demand, somewhat offset by a recovery in business travel. Given the fragmentation of the European lodging market, we expect owners and operators to continue their development activity in 2025, either by allocating more resources to development expenditures or through M&A deals.

In addition to stagnant macroeconomic trends, we believe downside risks remain concentrated around higher operating costs, potentially curbing profitability especially on asset-heavy operators, such as AccorInvest Group SA or B&B Hotels. Pressure on households' disposable income is forcing operators to increase marketing expenses to sustain demand, while wages and lease costs rise in line or above national inflation levels and may squeeze EBITDA margins of lodging operators further.

On the upside, we expect European countries to remain a strong destination for leisure travel, while trade fairs and professional events should support occupancy growth as business travel continues to recover. We believe the most diversified asset-light operators, such as Accor SA and Intercontinental Hotels Group PLC, are well positioned to profit from these trends and offset negative margin pressures thanks to a nimble operating model.

We expect operating performance at LatAm's lodging companies will remain steady in 2025. Business travel and leisure activities were stable in 2024 amid disinflation in the region and a strong dollar, resulting in a solid demand from international travelers. Our base case for 2025 assumes 2.0% growth in economic activity in the region. As a result, we estimate ADR will grow 3% to 4%, after mid- to high-single-digit growth in 2024. We assume occupancy remains relatively flat because operators may favor holding ADR levels over gains in occupancy. We expect profitability to remain stable as disinflation continues, mitigated by persistent wage pressures. This should help the companies maintain healthy revenue and EBITDA growth in 2025. For all-inclusive resorts across Mexico, the Caribbean, and Central (excluding Jamaica) and South America, we expect a strong high season based on operators' publicly disclosed forward booking data. We expect Jamaica's all-inclusive resorts will have a tough year-over-year comparison in the high (winter) season due to the negative impact of the U.S. State Department's travel advisory in the first quarter of 2024. In the second half of the year, cost fatigue could pressure currently high ADRs and pressure net package RevPAR as operators attempt to stimulate demand by managing ADRs.

We expect sales growth among timeshare operators will remain muted, as the companies continue to pursue new owners. We forecast low- to mid-single-digit tour growth as leisure travel remains stable and companies with exposure to Maui benefit from continued visitation recovery to the island. We expect volume per guest (VPG) among our three rated issuers will begin to stabilize as the companies have materially shifted their sales mix over the past two years. Additionally, we expect default rates and loan loss provisioning (as a percentage of outstanding receivables) to remain stable, albeit moderately higher than historical trends. Default rates among some issuers have modestly increased either because the company has shifted sales toward lower income demographics, such is the case for Hilton Grand Vacations, or broader economic pressures and sustained increases in maintenance fees (as higher operating costs have been driven up by inflation and are passed on to owners). Lastly, while M&A activity has slowed since Hilton Grand Vacations' purchase of Bluegreen Vacations in January 2024, we believe operators will continue looking for portfolio acquisitions that strengthen the profile of their existing resort base.

Key risks or opportunities around the baseline

1. Easing U.S. monetary policy could spur higher M&A activity and leverage while policy proposals could result in cost inflation across chain scales.

The Federal Reserve's path to reducing rates remains uncertain, but deal activity could increase gradually if it eases rates further. Meanwhile, reduced immigration and increased tariffs could result in lower margins among domestic hotels.

2. In Europe, higher-than-anticipated cost inflation, combined with large acquisitions and shareholder remuneration, could pressure credit metrics.

Wage pressure remains a challenge for European lodging operators, given the structural shortage of staff, particularly affecting the U.K. Acquisitions and expansionary investments have restarted, alongside shareholder remuneration, and these outflows need to be carefully balanced by a strong financial policy to avoid weakening credit metrics.

3. A slowdown in economic activity across major economies could result in lower travel activity in LatAm.

We believe downside risks to our forecasted economic growth in LatAm are high, amid trade-related uncertainties across major economies, which could slow down economic and travel activity, given the discretionary nature of the sector.

4. Higher default rates and increased provisioning represent the greatest near-term risk to timeshare companies.

Incremental inflationary pressure on homeowners' association fees could result in marginally higher defaults.

Uncertain policies from the incoming administration could affect the U.S. hotel sector. The sector remains fragmented, cyclical, and highly competitive, which leads to potential consolidation opportunities. And while deal activity has been quiet for the past few years, notwithstanding Choice Hotel's bid for Wyndham in 2023, dampened by macroeconomic uncertainty and interest rates, many of our rated lodging issuers currently have cushion in leverage measures for ratings and we expect they may use it to pursue M&A deals as interest rates come down. Additionally, specific policy proposals from the incoming presidential administration could lead to higher operating costs for hotel owners. What is eventually enacted remains highly uncertain, but S&P Global economists recently estimated a universal tariff could add as much as 1.8 percentage points to inflation, which we expect would result in higher operating costs at hotels. Additionally, policy proposals around immigration could affect the landscape among hourly wage earners, among which hotels draw from for a portion of their labor. Net migration outflows could constrain the labor pool available to hotels, forcing them to increase wages to attract workers.

In Europe, cost inflation and large acquisitions and shareholder remuneration could pressure credit metrics. Wage inflation remains elevated with significant headwinds in countries such as the U.K., where higher minimum wages and increases in national insurance could intensify pressure on margins. We also believe the asset-heavy operators, such as Motel One and Travelodge, are more exposed to rising lease costs due to inflation indexation clauses in their lease agreements, despite renegotiation opportunities. Moreover, the European hotel sector is very fragmented, and we are seeing many hotel operators jumping on consolidation opportunities, taking advantage of easing interest rates to conclude sizeable investments or hotel deals. While expansionary investment could help operators to benefit from stronger competitive positions, we see a risk that elevated expansionary investment could weigh on credit metrics and ratings, if not balanced with restarting shareholders' remuneration.

Our base case assumes LatAm will grow 2.0% in 2025. However, downside risks to our forecast are high, amid trade-related uncertainties across major economies. A higher-than-expected increase in trade protectionism could hit economic growth in the region by reducing trade volumes or foreign direct investment. This may lead to a decline in occupancy rates as consumers prioritize nondiscretionary spending under a deteriorating macroeconomic environment. Lower occupancy may also pressure companies' ability to continue passing on cost increases through higher ADRs.

Higher default rates and increased provisioning represent the greatest near-term risk to timeshare companies. We don't believe elevated interest rates have had material impacts on overall vacation ownership sales over the past several years, primarily because interest rates on timeshare loans are untethered from the federal reserve base rate. However, inflation – and subsequent maintenance fee increases – have driven up defaults and resulted in higher provisions for loan losses. We have modeled in higher provisioning into our base case, but we believe defaults could remain elevated or increase further if inflation picks up due to proposed tariffs and higher operating costs are passed on to consumers.

Industry Outlook: Cruise, Recreation, Fitness, And Play

Ratings trends and outlook

There have been recent upgrades among cruise and theme park companies in the U.S. The upside bias remains for cruise companies for which we anticipate credit measures will benefit from increased bookings and higher yields in 2025. Rated RV dealers have been downgraded as retail sales volumes plummeted, but we believe the RV space reached a trough in 2024. Ratings on RV original equipment manufacturers (OEMs) held up better because of comparably more operating flexibility and cushion in credit measures. Rating outlooks in this broad and diversified collection of companies, which also include fitness operators and toy companies, are mostly stable because of forecasted credit measures in alignment with ratings.

Main assumptions about 2025 and beyond

1. Current forward cruise bookings for 2025 should support moderate yield growth next year.

We believe forward bookings are on pace with or ahead of historical levels and at higher prices, which will support the industry's absorption of modest incremental capacity. However, we expect yield growth to moderate in 2025 following two strong years of yield growth.

2. Consumers may remain wary of financing big-ticket discretionary leisure purchases.

Modest interest rate declines will likely not provide a windfall of consumer demand for largely financed purchases.

3. We expect good demand in the premium and budget fitness segments to continue in 2025.

We believe luxury and budget fitness operators will continue benefitting from good demand amid a growing focus on health and wellness among consumers.

4. Growth in early season pass sales and group visitation support higher U.S. theme park attendance in 2025.

Higher season pass sales and group attendance should support attendance growth, though international visitation will likely take longer to recover.

5. The toy industry is flat to down modestly in 2025.

Cost fatigue pushes consumers to seek value in toy purchases in 2025.

Moderate yield and capacity growth will support cruise revenue in 2025. The cruise industry experienced another year of strong yield growth and onboard spending in 2024 and occupancy largely returned to pre-pandemic levels. With the industry's occupancy recovery largely complete, we expect moderate yield and capacity growth to drive revenue growth in 2025. However, after several years of very strong yield growth, we assume it will be more moderate than in the past two years. We believe the recent yield growth is unsustainable and will likely converge closer to consumer spending and more in line with historical yield growth. As a result, we are forecasting net yields for large cruise operators will grow 2%-4%. The large cruise operators have been reporting forward bookings for 2025 in line with or ahead of historical levels and at higher prices. This suggests the industry is absorbing capacity added in recent periods and can absorb modest capacity growth expected in 2025. Cruise Lines International Association (CLIA), the cruise industry trade association, estimates global cruise capacity measured by the number of cruise ship berths will increase about 3% in 2025 compared with 2024. We expect cruise operators will continue to see cash flow and leverage improvement over the next year, but the pace of leverage improvement will be determined by a combination of a company's capacity growth, yield growth, and their ship delivery schedule.

Demand for big ticket discretionary items could remain soft through at least 2025. While S&P Global macroeconomists expect inflation to ease and for interest rates to gradually recede in 2025 from the high levels of 2024, we do not expect a significant increase in retail demand for powersports as consumer spending could remain stagnant for sales of high-ticket discretionary leisure products (such as RVs, boats, motorcycles, and ATVs).

Big-ticket sales could take multiple years to meaningfully recover and we believe they will remain below the records set during the buying spree immediately following the pandemic lockdowns in 2020 and 2021. However, we believe these industries reached a trough in late 2024 and anticipate their retail sales and unit shipments will begin to stabilize in 2025. Weakened consumers may continue to delay spending on big-ticket leisure items and focus on more family-oriented options at more competitive price points, which could continue to increase competitive pressures on leisure manufacturers.

Solid demand to continue driving overall growth in the luxury and budget fitness segments. Fitness center issuers' revenue has benefited from a recovery in memberships due to an ongoing spending shift toward experiences and in-person fitness options. We believe both luxury and budget fitness operators will continue to benefit from good demand amid a growing focus on health and wellness among consumers. The premium segment will likely remain strong in 2025 as luxury offerings resonate with consumers' values. Currently, there are no signs of a slowdown in the high-end fitness space. While total memberships still lag pre-pandemic levels, increases in both membership pricing and overall ancillary spending—particularly for personal training services—have led to a full top-line recovery for most high-end fitness operators. This supports further revenue and EBITDA upside for these issuers in 2025. In response to members' growing desire to holistically integrate health and wellness into the fitness experience, high-end operators continue to expand ancillary offerings. Relative resiliency within the luxury consumer space is generally consistent across industries, and we believe high-quality gyms and lifestyle brands still resonate with core members. Throughout 2023, luxury gym operators successfully took aggressive price increases to offset lower membership levels compared with pre-pandemic levels. While some issuers believe there is still room for price hikes, we expect any increases going forward will be moderate, and membership growth trends could slow as even wealthy consumers begin to feel inflation-induced cost fatigue.

U.S. regional theme park operators are reporting growth in early season pass sales for 2025, while theme parks in Europe are affected by muted demand. After completing its merger with Cedar Fair, Six Flags reported on its third quarter earnings call that early sales of season pass units across the combined portfolio were up 2% year over year. Although United Parks & Resorts Inc. reported flat pass sales so far through October 2024, the company recently launched an improved premium pass program for 2025, which has led to double-digit sales growth and the company expects it will drive a strong pass base for the remainder of 2024 and into 2025. Operators have also benefitted from the continued recovery in group bookings in 2024, which we expect to continue heading into 2025. The expected opening of Comcast's Epic theme park in May 2025 will likely bring increased visitation to the Orlando market, which could have positive spillover effects at competitor parks in the region. Barring any disruptions from extreme weather events during peak periods, we expect regional theme park attendance growth in the 1%-2% range in 2025, driven by increased group visitation, higher season pass sales, and the opening of new park attractions. We still expect overall attendance will remain below pre-pandemic levels, as higher costs of travel due to persistent U.S. dollar strength continues to affect the recovery in international visitation. S&P Global economists forecast U.S. GDP growth will slow in 2025 due to weaker real consumer spending growth and a modest increase in unemployment over the next two years. Since the monthly growth rate of real personal disposable income has been lagging the growth rate of consumer spending the past six months, households' aggregate spending is likely to ease in the coming quarters. Lower discretionary spending may lead consumers to pull back on leisure spending, which could limit theme park operators' ability to continue raising prices and lead to muted per capita spending growth. We expect per capita spending growth of 0%-2% at regional theme parks in 2025, in line with broader consumer spending. We expect revenue of European park operators to improve 3%-5% in 2025, while margin growth remains modest. We expect attendance to improve somewhat in the absence of negative factors that hurt 2024, like weak consumer demand, adverse weather, and large sporting events during the summer. In-park spending should increase modestly due to optimized ticket offerings and in-park marketing solutions.

We expect the toy industry to be flat to down modestly for 2025 because of cost fatigue. We believe 2024 holiday season retail sales for the toy industry were probably a few percentage points below 2023, and the overall industry likely experienced a low single digit decline for the full year. In addition, the industry this past year saw a boost in demand from adult buyers, which boosted demand in certain toy categories. However, we believe these consumers will be more fickle and more prone to forego purchases in deteriorating macroeconomic conditions than typical parent toy buyers. In 2025, our macroeconomic forecast has consumer spending slowing to about 2.3% because excess savings has dwindled. Amid persistent inflation, consumers' preferences for experiences over goods, and lower consumer spending, we believe the toy industry will be flat to down modestly in 2025 as a wearied consumer continues seeking value in toy purchases. In addition, a better-than-expected holiday season in 2024 could be a tough comparison for topline growth for toy manufacturers in 2025. Still, some manufacturers will look to counteract this and potentially aim for growth amid a stagnating industry driven primarily by toys linked to a heavier slate of feature entertainment releases scheduled throughout the year. We continue to believe the toy industry is somewhat resilient to economic slowdowns. Despite persistent inflation and an uncertain macroeconomic environment, we continue to believe consumers will reliably purchase toys for their children albeit in modestly lower volumes.

Key risks or opportunities around the baseline

1. A slowing economy may prove to be less of a headwind for the cruise industry.

The combination of a wider-than-usual gap between cruise and land-based vacations and moderating ship delivery could support deleveraging even in a slowing economy.

2. Higher interest rates could delay big-ticket leisure purchases.

While inflation came down meaningfully in 2024, some policy proposals introduce uncertainty to how quickly the Federal Reserve will lower interest rates, which could have broader implication on consumer demand for financed purchases.

3. Mid-tier operators face increased competition from high- and low-priced alternatives.

Mid-tier operators may face higher trade-down risk as consumer spending trends continue to evolve following multiple years of high inflation in a highly competitive and fragmented market.

4. Higher planned growth capital expenditures could impair financial flexibility.

Theme park operators announced significant growth capex plans to increase visitation and spending at their parks.

5. With heavy exposure to China, material tariffs could increase input costs for toy manufacturers.

We believe a universal tariff and sharply higher tariffs on Chinese imports could mean an increase in input costs and ultimately dampen gross margins for toy manufacturers.

A slowing economy may prove to be less of a headwind for the cruise industry. In our view, a slowing economy may not lead to choppy seas in 2025. Although the price gap between a cruise vacation and comparable land-based vacation has narrowed, it is still wider than usual. This gap could benefit cruise operators if customers who want to take a vacation have less money to spend and are looking for a value alternative. Therefore, we believe the risk of discounting to fill the ships is lower than in previous economic slowdowns. Furthermore, cruise operators typically have good revenue visibility over the next 12 months given a long booking cycle. The industry doesn't usually see significant spikes in cancellations if the economy weakens modestly. For large cruise operators, the booking window is around six months on average. If the economy begins slowing next year, we see more risk to yields, onboard spending, and booking volumes later in 2025 and into 2026. Nevertheless, a more moderate ship delivery schedule should allow operators to absorb some potential operating volatility and still reduce leverage despite new-ship related debt. After years of not ordering ships during the pandemic, the large cruise operators resumed ship orders in 2024. However, most operators, aside from NCL, were unable to secure deliveries earlier than 2027. NCL secured a spot for a small ship delivery in 2026. As a result, Royal will only take delivery of one ship in 2026 after two in 2025 and Carnival will have no ship deliveries in fiscal 2026 after one delivery in fiscal 2025.

The incoming U.S. administration's policies could affect big ticket leisure purchases. While many of our leisure manufacturers, especially for RVs, boats, and motorcycles, have largely domestic manufacturing facilities, widespread tariffs could result in marginally higher input costs. More importantly, if inflation picks up again or if uncertainty regarding the path downward for inflation reasserts itself, Federal Reserve officials could choose to maintain interest rates higher than our base-case forecast. This could result in a more prolonged recovery for big-ticket discretionary items, given a significant percentage of purchases are financed with consumer debt.

We believe the rise of boutique and no-frills, low-cost clubs is the biggest risk for mid-tier operators' member retention. While consumer spending is not wilting away as fast as previously expected, our most recent economic forecast for a moderation in spending in 2025 suggests members may begin to trade down to value options to save money amid persistent inflation. More specifically, gym-goers may choose budget-friendly alternatives with fewer services that still satisfy their fitness needs, a targeted fitness option, or both. We believe this consumer evolution could pressure mid-tier fitness operators and lead to consolidation. Persistently higher build costs in 2025 may result in a higher cost per square foot for new club builds, which could result in fitness center issuers pulling back on overall growth capital expenditures and the number of new clubs in development. This would potentially result in a moderation of new members over time and lower top-line growth. Operators who struggle to adapt could become acquisition targets, leading to consolidation—especially in the highly fragmented mid-tier space. With persistent high build costs potentially slowing topline growth, we could see an increase in M&A activity as fitness operators look for external avenues for growth.

Higher growth capital expenditures could reduce regional theme parks' financial flexibility in the near term**.** While the regional theme park sector benefits from high barriers to entry due to significant capital requirements and limited land availability to build new greenfield parks, the industry competes more broadly with other forms of entertainment for consumer wallet share, including live events, gaming, and leisure travel. Therefore, operators must continuously reinvest in their parks to improve the guest experience and increase visitation.

For example, Six Flags recently announced it expects to invest between $500 million and $525 million in capital expenditures in both 2025 and 2026. The investments will be primarily focused on accelerating the integration of its recent merger with Cedar Fair, growth projects aimed at increasing demand and driving higher levels of guest spending, and addressing deferred infrastructure needs across the portfolio. United Parks & Resorts Inc. continues to explore opportunities for hotel development on land adjacent to its parks. Disney has announced a significant increase in capex over the next 10 years, some of which will be spent on updating and opening new attractions across all of Disney’s parks globally.

We believe theme park operators have prioritized cash flow recovery and leverage improvement ahead of park improvements. However, improving balance sheets and the need to reinvigorate parks with new rides, attractions, and amenities to stay competitive may cause a significant increase in capital outlays for rated theme park issuers.

To the extent there is a meaningful pullback in discretionary spending that leads to broad declines in attendance and per capita spending at theme parks, rated theme park operators could be exposed to heightened risks and limited financial flexibility to reduce leverage during a period of elevated investment.

Increased tariffs could pressure toy manufacturers margins. Our current macroeconomic forecast assumes President-elect Trump will impose targeted tariffs on China by raising the bilateral effective tariff rate (weighted average) on Chinese imports to 25% (from estimated 14% currently). Prodded in part by tariff threats in 2019 under the first Trump administration, there has been a long-term trend across the toy industry to make fewer toys and games in China by relocating factories and diversifying supply chains. Rated toy manufacturers Mattel and Hasbro have made efforts to shift production away from China, and only about 50% and 40% of production in 2024 is sourced from China respectively with both issuers pursuing strategies to reduce exposure further in 2025. While exposure to China has decreased over the past few years, we believe a universal tariff and sharply higher tariffs on Chinese imports could mean an increase in input costs and ultimately dampen gross margins. While toy manufactures will try to pass on these higher input costs to the degree they can, ultimately retailers' willingness to continue to share higher input costs with toy manufacturers depends on consumers' willingness to pay higher prices. We believe amid a somewhat flat toy industry, material tariffs could pose a significant burden on margins and may lead to weaker credit metrics.

Related Research

- NCL Corp. Ltd. Outlook Revised To Positive On Expected Deleveraging, Proposed Unsecured Notes Rated 'B+' (Recovery: '4'), Jan. 7, 2025
- Carnival Corp. Outlook Revised To Positive On Favorable Bookings And Expected Deleveraging; 'BB' Rating Affirmed, Dec. 23, 2024
- T&L Holdco Ltd. (Travelodge) Outlook Revised To Negative On Soft Demand And More Cost Pressure; 'B' Rating Affirmed, Dec. 16 2024
- Affinity Interactive Downgraded To 'CCC+' From 'B-' On Weak Performance, Refinancing Risks; Outlook Stable, Dec. 3, 2024
- Catawba Nation Gaming Authority Assigned 'B' Issuer Credit Rating; Outlook Stable; Proposed Debt Rated, Dec. 2, 2024
- Merlin Entertainments (Motion Midco Ltd.) Downgraded To 'B-' Following Weak Trading Performance; Outlook Stable, Nov. 28 2024
- TUI Cruises Upgraded To 'BB-' On Stronger Earnings And Deleveraging; Outlook Stable; Proposed Notes Rated 'B+', Nov. 18 2024
- Ticketing Companies Win Big From Funflation In Live Entertainment, Nov. 4, 2024
- Caesars Entertainment Inc. Outlook Revised To Stable From Positive On Weaker Operating Performance; 'B+' Rating Affirmed, Nov. 1, 2024
- Royal Caribbean Cruises Ltd. Outlook Revised To Positive On Expected Improvements In 2025, Oct. 29, 2024
- Aimbridge Acquisition Co. Inc. Downgraded To 'CCC' On Rising Refinancing Risk; Outlook Negative, Oct. 10, 2024
- Hotel Owner And Operator AccorInvest Group Assigned 'B' Rating; Outlook Stable; Notes Rated 'B+', Sep. 26 2024

Industry Forecasts: Hotels, Gaming, and Leisure

Chart 9

Revenue growth (local currency)

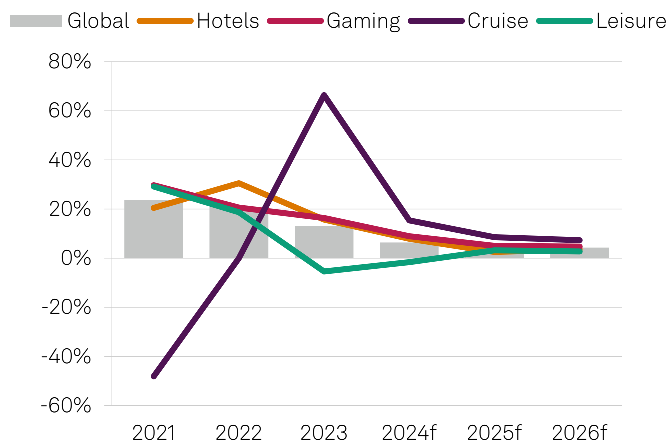


Chart 10

EBITDA margin (adjusted)

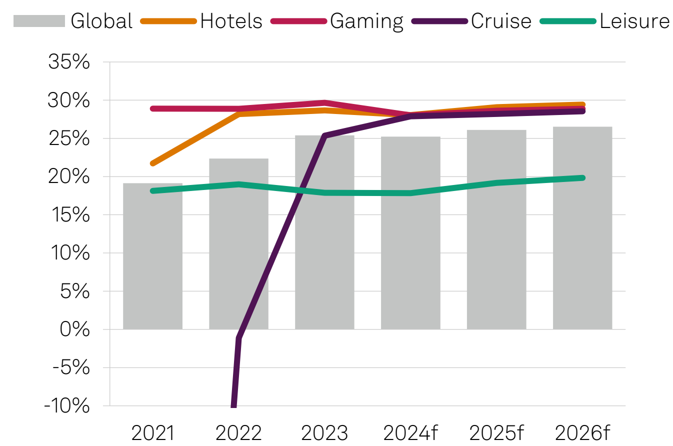


Chart 11

Debt / EBITDA (median, adjusted)

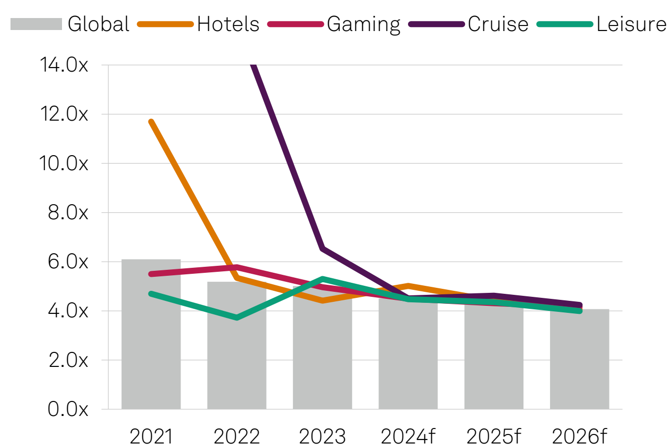
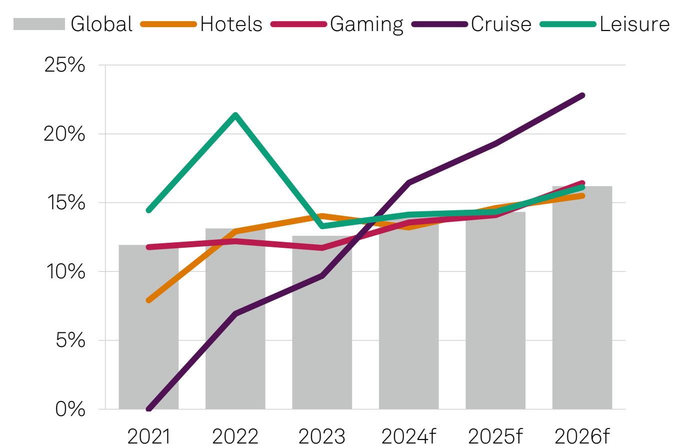


Chart 12

FFO / Debt (median, adjusted)



Source: S&P Global Ratings.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Sector

Chart 13

Cash flow and primary uses

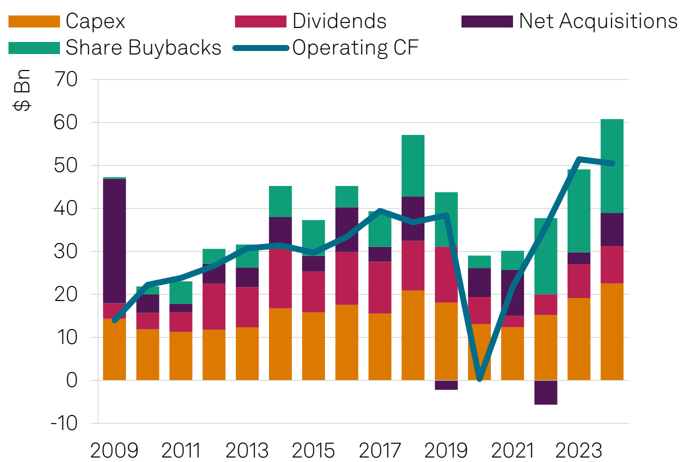


Chart 14

Return on capital employed

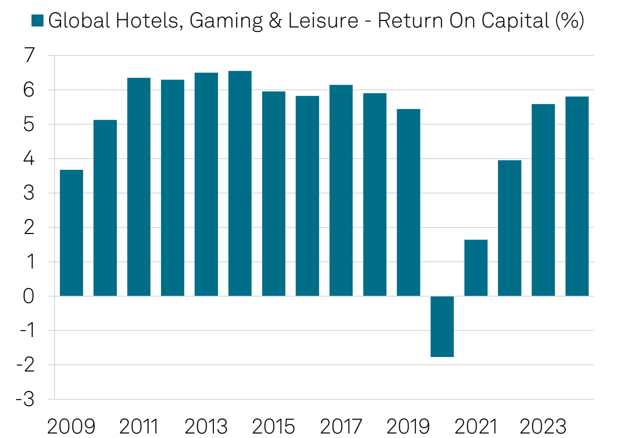


Chart 15

Fixed- versus variable-rate exposure

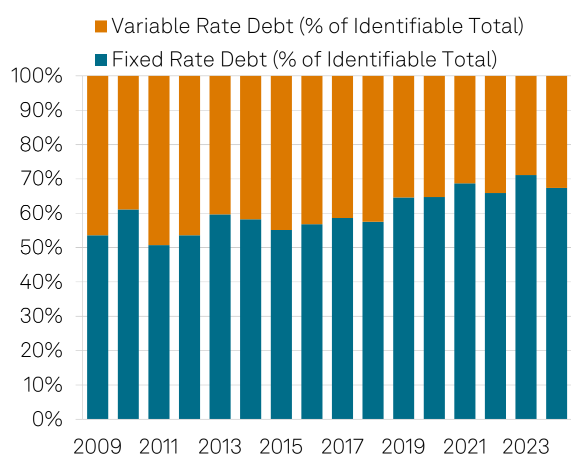


Chart 16

Long-term debt term structure

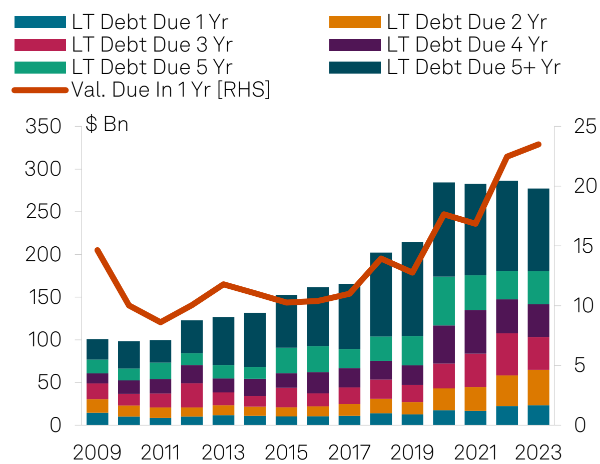


Chart 17

Cash and equivalents / Total assets

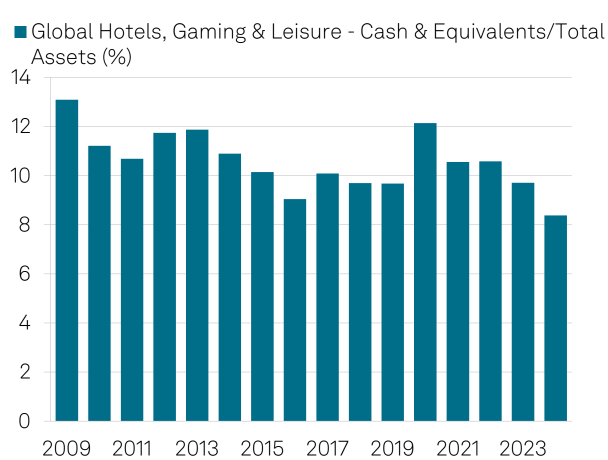
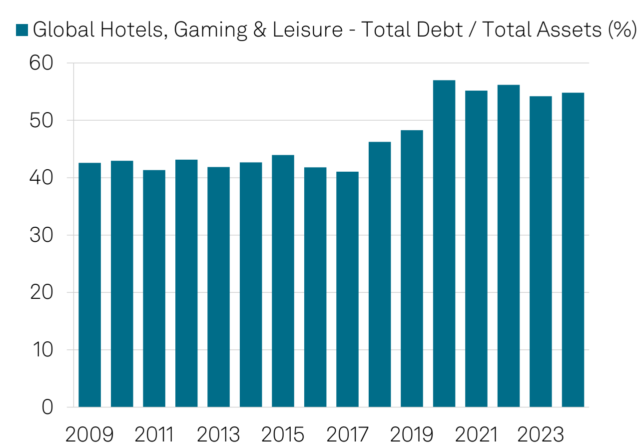


Chart 18

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

S&P Global Ratings

Media and Entertainment

Watching for potential M&A

January 14, 2025

This report does not constitute a rating action.

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What's changed?

Streaming reaches profitability. Several legacy media companies have finally attained profitability in streaming.

Secular advertising trends. Legacy media platforms face accelerating challenges. Advertising on U.S. linear TV continues to decline.

Content remains king. The streamers reduced their programming spend after the 2023 Hollywood strikes.

What are the key assumptions for 2025?

Streaming profitability should grow, putting legacy media companies on stronger footing.

Global advertising to continue growth, despite a year with no Olympics and fewer political ads.

Content remains king and spending will resume in 2025 although at a more modest pace than in the previous 3-4 years. Fewer projects may hurt smaller independent studios and companies supporting the studio ecosystem.

What are the key risks around the baseline?

Accelerating secular trends across the entire media ecosystem. Worsening declines in linear TV and shifts in advertising away from legacy media could weaken media issuers' credit metrics.

Failure to scale streaming. Not all media companies will build scale with their streaming services. There will likely be a maximum number of streaming services the world needs.

Macroeconomic weakness/geopolitical shocks/a global trade war could hurt consumer discretionary spending, which will affect streaming subscription growth and advertising.

Ratings Trends: Media and Entertainment

Chart 1
Ratings distribution by region

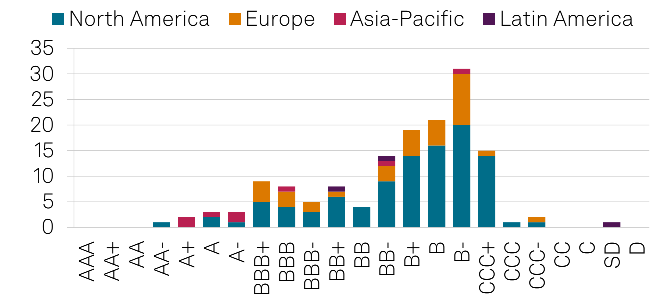


Chart 2
Ratings distribution by subsector

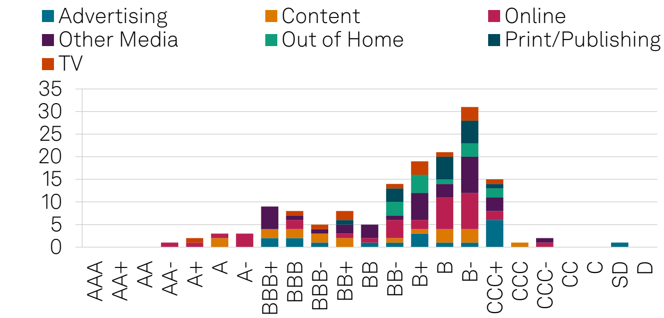


Chart 3
Ratings outlooks by region

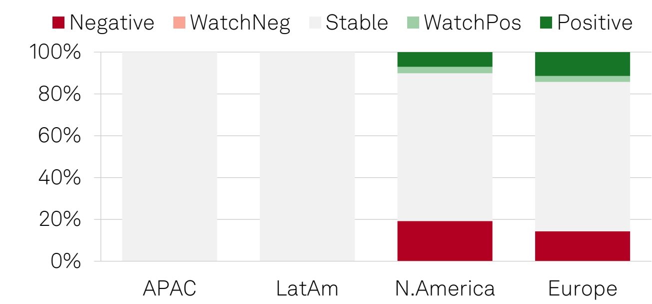


Chart 4
Ratings outlooks by subsector

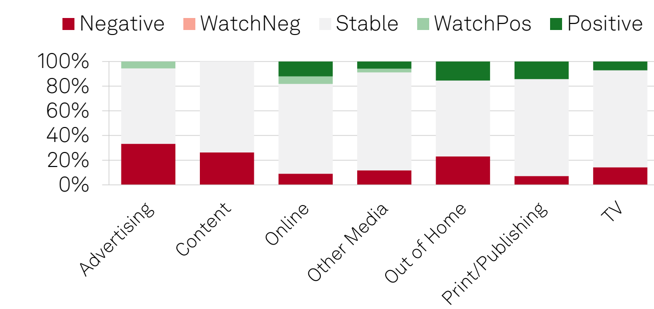


Chart 5
Ratings outlook net bias by region

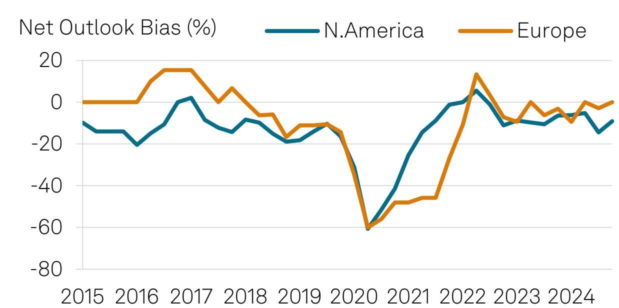


Chart 6
Ratings net outlook bias by subsector

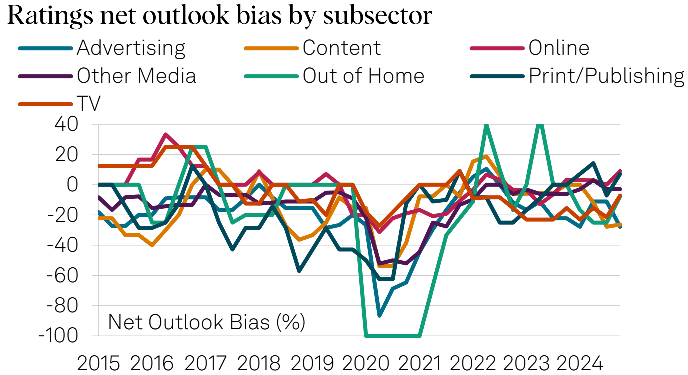


Chart 7
Ratings outlooks

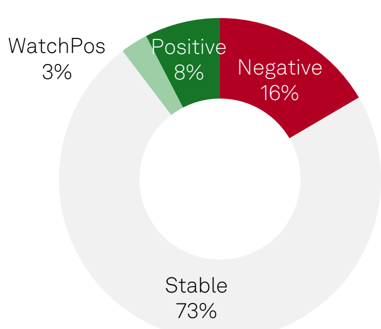
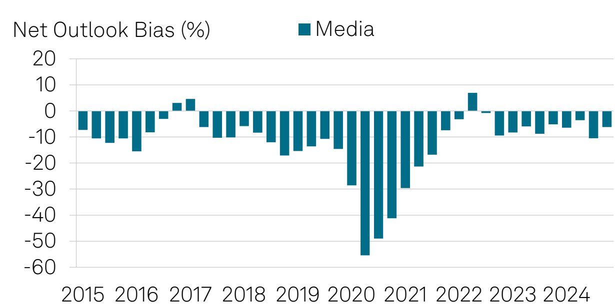


Chart 8
Ratings net outlook bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook: Media and Entertainment

Ratings trends and outlook

Secular pressures and the ongoing transition to digital distribution continue to hurt many legacy media sectors and companies, but our ratings outlook on the sector is stable. After two years of negative ratings actions, restructurings, and defaults, and of struggling to address issues in content creation, distribution, and advertising, the industry may have turned the corner.

Content creation has scaled back. Content—including film, episodic TV, music, video games, sports leagues, concerts, books, newspapers, magazines, and even consumer generated content—has never been in such high demand around the world. Over the last few years, though, legacy media companies were making too much of it. The 2023 Hollywood strikes gave them the opportunity to reevaluate their content budgets and to scale back, delay, or eliminate projects that were unlikely to be profitable. Content creation will never be a stable, predictable business but it may be moving toward being a more rationale one.

Distribution achieves profitability. Digital platforms democratize content by cutting distribution costs, but also limits the price distributors can charge consumers, which has hurt legacy media companies who depend on distribution fees to pay for creating that content. But now, after five years of experimentation and missteps, a number of media companies have crossed the breakeven profitability line for their streaming services and are now faced with the next challenge: to build subscriber and advertising scale and improve profitability, to overcome the declining profitability at linear media.

Global advertising continues to bifurcate, with digitally focused media platform (such as search, streaming, social media, digital commerce, retail media networks, and connected TVs) growing advertising revenue at a high-single-digit percentage rate in 2025. Advertiser spending on legacy media (TV, radio, and print), on the other hand, has declined at a low-single-digit percentage rate, though markets outside of the English-language universe are seeing more moderate secular trends. We expect these trends to continue beyond 2025.

Secular challenges remain. There remain subsectors within media that face an uncertain future. Five years of secular pressures, which included two years of a global pandemic, has left some segments of the media sector a shell of its former self. Consumption has become so fragmented that media's cultural impact is weakened. And the quality difference between certain professionally produced and user-generated content is shrinking. Artificial intelligence (AI) is accelerating this.

Credit metrics and financial policy

Credit metrics should improve in 2025 as streaming profitability grows. This includes the global diversified media companies that, since 2019, have heavily invested in their new streaming services, which has weakened credit metrics. As many of these companies are now moving from cash-flow-breakeven to generating substantial profits, we expect streaming EBITDA to grow faster than legacy linear TV EBITDA declines. We expect companies to apply excess free cash flow to debt reduction and lower leverage further. Still, many have credit metrics exceeding our downgrade thresholds. How we address our ratings on these companies, by maintaining or lowering ratings, will depend on their ability and pace to return to credit metrics appropriate for the ratings.

Key risks or opportunities around the baseline

1. The potential for sustainable streaming profitability margins.

Disney recently provided guidance for 10% operating income margins by 2026 and double-digit margins longer-term, and Netflix is approaching sustainable 30% margins. This level may be out of reach for legacy media companies with smaller global scale and greater dependence on high-priced sports programming.

2. Media consolidation.

With the change in U.S. administration and expectations for a more lenient regulatory environment, mergers and acquisitions (M&A) look more likely. However, we believe continued regulatory bias against tech companies, a lack of capital for legacy media companies, sizable differences in perceived valuation, and cultural issues will limit significant M&A in 2025.

3. AI presents both opportunities and risks.

Companies have already identified, and in some cases already implemented, ways in which AI could unlock material workflow efficiencies. How AI can be used to create content is still being determined and may be fraught with legal and regulatory risk.

Significant M&A is challenging and needed. We saw limited M&A activity in 2024 as companies focused primarily on balance sheet repair, though a few notable transactions were announced: the proposed mergers of Skydance and Paramount Global, and of Omnicom and Interpublic Group (IPG); the sale of All3Media by its partners, Liberty Global and Warner Bros. Discovery (WBD), to sponsor RedBird. In Brazil, Globo Comunicação e Participações S.A. acquired a controlling stake in Eletromidia S.A., the country's largest out-of-home media company. And Comcast announced its intent to spin off much of its domestic cable networks into a separate company.

Significant M&A among U.S. legacy media companies will be difficult to pull off in 2025 for several reasons. First, global regulators have sought to block most transactions involving the global media and technology companies, and we don't expect this to change with the change in U.S. presidential administration in the U.S. Second, as one would expect from a people-oriented industry, cultural compatibility remains a key consideration. Third, we believe a significant valuation gap exists between what potential acquirers are willing to pay and what potential targets think they're worth. Sellers point to continued cash flows and see long-term value, while buyers are more skeptical about the long-term viability of the sector and ascribe no terminal value. And finally, balance sheets remain stretched among both potential acquirers and targets, limiting debt-financed deals and making targets expensive.

Prospects for industry consolidation in Europe, the Middle East, and Africa (EMEA), especially in linear TV broadcasting, remain uncertain. Obtaining approvals from regulatory and competition authorities could be challenging, given that so far they have ruled against cross-border consolidation in France. Also, synergies in content acquisition and cross-country operating costs would likely be limited, reducing the attractiveness of cross-border transactions.

Adoption of AI by legacy media companies will be gradual as the technology and its regulations and legal boundaries evolve. Despite the global frenzy over AI last year, it has yet to materially shift legacy media companies' business strategies or financial and credit metrics, though we note that ad tech firms including Alphabet, Meta, and Tencent have dramatically increased capital spending on AI infrastructure. Over the near term, we expect media companies to use AI to reduce the time and costs of creating content. Film and TV studios are likely to use it for pre-production preparation and post-production finishing. Global ad agencies have already adopted it for creative campaigns. Over the long term, we believe technological disruption, including the adoption of generative AI, will likely enhance ad agencies' service offerings and market positions. They already own some technology and experience in this area and will continue to invest. This positions them well to advise and educate clients on AI's application and related regulatory, legal, and compliance considerations.

Industry Outlook: Content

Ratings trends and outlook

Our rating outlook for companies focused on creating and owning film and TV content is generally neutral. The resolution of the 2023 Hollywood strikes cleared the way for a resumption of content creation, and while production volumes improved in 2024, the content spending recovery was flattish to 2023—a year in which major studio production came grinding to a halt. Looking ahead, growth in content spending in 2025 will be at a slower pace than the levels that characterized the 'Peak TV' era. Nonetheless, we maintain that content remains king; companies with robust franchises and intellectual property (IP) are poised to thrive amidst a strategic flight to quality.

Content creators also include music publishers, video game developers, and sports leagues, and our rating outlooks for these sectors is positive. In the music industry, strong tailwinds are propelling growth, including a rising number of subscribers, price increases by streaming services like Spotify and Apple Music, and improved monetization from licensing with social media and gaming platforms, superfan-oriented business models, and merchandising. The integration of music into social media platforms such as Meta and TikTok has opened new revenue streams and enhanced visibility for artists and labels. In our view, AI-generated content poses limited risks for major record labels at this stage. We believe credit quality of Universal Music Group N.V. and Warner Music Group Corp. will benefit from these trends and see growing rating headroom. Meanwhile, premium video-game publishers with established IP, dedicated fan bases, and known brand names are benefiting from sustained user engagement and demand, despite declines in the mobile gaming segment. Meanwhile, sports properties remain in demand and companies like TKO Group Holdings Inc., which owns UFC and WWE, are capitalizing on it. WWE's live weekly flagship program, WWE RAW, being set to air on Netflix highlights a significant shift that could pave the way for future growth in live-stream sports. This move is likely to drive up the value of sports rights in future media rights negotiations, benefiting sports operators like TKO.

In EMEA, TV content produced by independent and vertically integrated studios is returning to more normalized operations. Delivery schedules are yet to fully normalize, and we expect a high number of productions to be completed in Q4 2024, lifting up full-year performance metrics for most studios after the declines in organic revenue growth they reported in the first 9 months of 2024.

We expect positive organic revenue growth for content producers in 2025, bolstered mainly by demand for high-quality content from global streaming platforms and, to a lesser extent, from broadcast networks. EMEA-based studios benefit from demand for local content and supportive regulation that incentivizes investment into local productions. However, medium-term growth prospects are uncertain and we note risks that streamers will maintain discipline in their content spending, suppressing demand for and pricing of new commissions. If M&A activity picks up among the larger, diversified media companies and broadcast networks, this could also disrupt and delay demand for commissions while these companies integrate operations and rationalize their combined content budgets. We expect demand from linear TV broadcasters will remain constrained by the structural declines in viewing and need to protect profitability. At the same time, we expect independent studios will continue to see robust growth in less cyclical and highly cash-generative content distribution and licensing.

There is appetite to consolidate film and TV studios to gain scale and increase efficiency, especially outside the U.S., and the EMEA-centered M&A deals that closed in 2024 illustrate this point: RedBird IMI acquired All3Media (which remains an independent producer), Mediawan merged with Germany-based Leonine, and Fremantle acquired Asacha Media Group. Bertelsmann, owner of Fremantle, recently announced they could consider selling a minority stake to another production company. We also believe independent producers will continue to diversify into adjacent media business—for example, into live events and advertising.

Main assumptions about 2025 and beyond

1. Escalating sports rights is pressuring non-sports content budgets.

Sports is increasingly a key programming component for any media company. However, the rising cost of the rights to broadcast sports is putting pressure on non-sports content budgets. As the streaming services scrutinize their non-sports spending, smaller independent film and TV studios are particularly vulnerable to shifts in spending.

2. Studios will benefit from more theatrical releases—and more potential blockbusters.

The expanded productions in the second half of 2024 are set to drive a larger global release slate in 2025, resulting in a stronger box office performance year over year.

3. Content—mainly supported by strong established IP and franchises—remains king.

As content budgets have reset lower, streamers are prioritizing quality over quantity. This will particularly benefit those studios with established IP and franchises, as well as supporting industries such as talent agencies that represent a strong A-list client base.

The escalating costs of sports rights are exerting significant pressure on content spending. Media companies continue to prioritize live sports to maintain stable viewership and expand their subscriber bases on streaming platforms, while also trying to mitigate the secular decline in linear TV. This financial strain is contributing to a sluggish pace of recovery in content creation post-strike, with studios reassessing their budgets such that growth that has lagged pre-strike levels. Smaller independent content creators, who rely heavily on licensing revenues, along with less-diversified talent agencies and studio lots, are particularly vulnerable to these shifts, facing heightened challenges in an increasingly competitive and resource-constrained environment.

Film studios will release more films into the theaters and have more potential blockbusters. After being decimated by the pandemic and the two Hollywood strikes, U.S. box office metrics continue to improve. Thanksgiving week's record-breaking results in 2024, in which three blockbuster films (Walt Disney's "Moana 2," Comcast Corp.'s "Wicked," and Paramount Global's "Gladiator 2") amassed over $400 million in domestic ticket sales, suggests that consumers will still flock to movie theaters if presented with compelling content. Still, the 2024 domestic box office ended 4.1% below its 2023 level and 24.8% below its 2019 level, due in part to holes in the release slate resulting from 2023’s strikes. We expect the domestic box office to strengthen in 2025 due to more wide releases (more than 2,000 screens) and, in theory, the potential for more blockbusters. In particular, Disney has three Marvel releases (versus just one in 2024) and an Avatar film, and Warner Bros. Discovery has planned 12 releases (versus 11 in 2024), including a highly anticipated Superman movie in July. In all, we expect box office to improve to about $9.3 billion versus about $8.5 billion last year, though this remains below the $11.4 billion in 2019.

Key risks or opportunities around the baseline

1. Consolidation among film and TV studios.

We anticipate the incoming Trump administration will foster a more favorable environment for M&A, offering smaller studios opportunities to achieve much-needed scale and enhance efficiency.

2. Measuring the risks and benefits around the use of AI.

As AI tools grow in sophistication and speed, their use-case will become increasingly compelling for content creators. However, there remain uncertainty around the evolution copyright, film/TV studios might confront labor-related challenges while video gaming publishers could see strong productivity gains and cost savings. For music publishers, balancing potential copyright infringements and lower development costs could be particularly difficult.

AI's path is far from clear. In the realm of film and TV, studios such as Lions Gate (through their partnership with Runway Partners) are beginning to leverage AI primarily during the pre-production phase to save development costs and time. AI tools can also streamline tasks such as script analysis, casting, and location scouting, thereby accelerating the development process, as well as translation, subtitling, and producing animation. However, full production usage remains constrained by agreements with the Writers Guild of America (WGA) and the Screen Actors Guild (SAG).

In the video gaming industry, AI holds the potential for significant production efficiency gains, and major game studios are developing custom engines centered around AI to enhance various aspects of game development. This is particularly germane for Triple-A games, which have become increasingly expensive to produce.

Meanwhile, in the music industry, AI presents a double-edged sword. On one hand, it poses a threat of copyright infringement through the use of unlicensed IP to train AI models. On the other hand, it offers opportunities to streamline music development and generate additional revenue. For instance, licensing music catalogues to social media companies can become a lucrative venture, and AI can assist in creating new compositions or enhancing existing ones.

More M&A under Trump. M&A could help smaller independent studios in particular to gain scale and increase efficiency, and we expect the Trump administration to be more friendly to it in the U.S. However, constrained balance sheets, weak equity prices, and a wide difference in perceived valuations may pose significant challenges.

Industry Outlook: Distribution

Ratings trends and outlook

Our rating outlooks for media companies distributing content through direct-to-consumer video streaming services and movie exhibitors is neutral. However, it remains negatively biased for those media companies with significant exposure to linear TV as digitalization (i.e., the internet) changes the way content is distributed and paid for. Our outlooks for U.S. national TV and local broadcasters, which face the brunt of these changes, is solidly negative while those with streaming services that have turned the corner on becoming sustainably profitable are less pressured. These secular changes are most pronounced in the U.S., but will eventually affect linear TV across the world, and our country-specific views reflect that varied pace.

European TV secular pressures are less acute for non-English language markets. TV viewing declines are more gradual for markets such as France and Germany, where there are strong local language programming options. Conversely, many English language markets, including the U.K. and Australia, are not far behind the U.S. in terms of competitive pressures from streaming services. Media companies in Europe are adjusting to this by building out local streaming platforms. This will continue to weigh on their profit margins in the next two to three years, as most such streaming services are still loss-making, although we believe most have already passed the peak of streaming losses. In the near term, we expect local streaming propositions will mainly provide broadcasters with digital advertising revenue from free ad-supported subscription tiers, which will broadly make up for the decline in linear TV advertising. Subscription revenue from premium tiers will likely remain marginal in the context of overall revenue

Main assumptions about 2025 and beyond

1. Streaming 2.0 is officially here.

After five years of experimentation and investments by the legacy global diversified media companies, 2025 could finally be an inflection point in the transition to streaming. Although legacy media companies demonstrated they can get to at least break-even profitability in 2024, they still have work to do to attain double-digit profit margins long-term.

2. The decline in linear TV continues unabated.

Pressure on the global linear television ecosystem is intensifying as audiences leave digital platforms and advertising remains weak, but these trends are most pronounced in the U.S. We expect U.S. pay-TV subscriber declines to remain steady at about 6% in 2025. Overall pay-TV penetration in the U.S. has declined to about 50% and we don’t expect the declines to moderate over the next two years.

3. Global box office is on more solid footing.

The global box office recovered nicely in the second half of 2024 on a stronger slate of films, and we expect the momentum to continue into 2025, which should help improve credit metrics for movie exhibitors that are still reeling from the pandemic and Hollywood strikes.

Streaming 2.0 has seen media companies prioritize profitability over growth. Streaming services have shifted their strategies by increasing prices, focusing on growing advertising as a monetization stream, and reduced spending across content, marketing, and international expansion. These efforts have significantly improved profitability and Disney, Paramount, and Warner Bros. Discovery are all expecting to reach some level of it in 2025 and to improve it from there. Netflix remains the gold standard, with margins approaching 30%, but both Disney and WBD expect to reach 10% or better by 2026. We believe it's possible for legacy media companies to achieve double-digit percentage margins over the long term, which will go a long way in replacing the lost earnings at their linear TV businesses.

Media companies in Europe are not trying to compete with global behemoths. Local broadcasters are building their strategies primarily around local content and as such don't directly compete with global platforms such as Netflix, Amazon, and Disney, which dominate most subscription video-on-demand markets and a have much higher capacity to invest in content and marketing. Broadcasters in non-English speaking countries particularly benefit from the popularity of local content and are better able to fend off competition from global platforms. In the U.K. competition is more intense, leading to a very fragmented streaming market. Over the medium term, this fragmentation could continue to constrain profitability and cash flow generation.

At the same time, many European broadcasters own integrated production studios that help them produce and acquire original content and build broader libraries that underpin their streaming offerings. Near term, we expect local streaming propositions will mainly provide broadcasters with digital advertising revenue from free ad-supported subscription tiers, which will broadly make up for the decline in linear TV advertising. Subscription revenue from premium tiers will likely remain marginal in the context of overall revenue.

In the U.K., digital advertising now comprises close to 25% of ITV's total advertising revenue and likely increased by double-digit rates in 2024, while subscription revenue remains very low. In the second quarter of 2024, ITVX reached 14.6 million monthly active users and had close to 1 million paying subscribers. Bertelsmann-owed RTL Group in Q3 2024 reached 6.5 million paid subscribers across its RTL+ and M6+ services in Germany, France, and Hungary, an increase of more than 20% year over year, and continues to target reaching profitability in 2026. CME Media Enterprises Ltd.'s streaming service Voyo competes very successfully against global platforms in the Czech Republic because of its focus on local content and is on track to reach about 1.5 million paid subscribers in 2025.

Linear TV is still hemorrhaging viewers. We forecast that U.S. pay-TV subscriber declines will remain steady at about 6% in 2025, resulting in a low- to mid-single-digit percentage annual decline in affiliate revenues, and that overall viewership, excluding for sports, will decline at the current teens percentage rate, resulting in a mid- to high-single-digit decline in advertising revenues.

Linear TV has historically been supported by sports programming, but more media companies are also putting it on their streaming platforms, which could exacerbate linear TV's decline. Additionally, sports leagues are getting more comfortable putting more rights exclusively on streaming, with Netflix getting three Christmas day games in 2025 and winning the U.S. rights for the next two FIFA Women's World Cup, and Amazon winning one of the three major packages for the NBA. In the fall of 2025, Disney—owner of ESPN, the leading sports-focused network in the U.S.—plans to launch an ESPN streaming service that would have the same content as its linear TV network, which could further accelerate the decline of linear TV.

For U.S. local TV, we believe retransmission revenue has peaked, following low-single-digit retransmission revenue growth in 2024. We believe it will start to modestly decline beyond 2025, and expect cord-cutting to remain elevated over the next few years, such that price increases won't offset subscriber declines. We expect local advertising will continue to be more resilient than national advertising, although local TV is not immune to audience declines and we expect this revenue stream will modestly decline over the next few years. As a result, we believe local TV broadcasters will increasingly rely on political advertising revenue in even years for cash flow. However, it is becoming increasingly difficult to predict the number of competitive political races and those that will fall within a specific company's geographic footprint in any given year, and thus we expect more earnings disparity, especially among smaller broadcasters. Still, the near-term forecast on local TV broadcasters in the U.S. is less negative than nationally focused TV network and cable network companies due to relatively low content spending needs and more moderate near-term pressures on key revenue streams.

Movie exhibitors see daylight ahead. The impact from the Hollywood strikes lasted well into 2024 but production is finally back on schedule and the release slate has normalized. A strong second-half slate (Moana 2, Wicked, Gladiator II, and Mufasa) in 2024 resulted in domestic box office only being down 4.1% on the year at $8.5 billion. We forecast an even stronger 2025, driven by a normalized theatrical release slate, resulting in a gross domestic box office of about $9.3 billion, or about 9% growth. We expect cinema operators will continue to increase average ticket prices and concessions per patron by shifting towards more premium experiences and product offerings. This will allow cinema operator revenue and profit growth to outpace industrywide box office growth over the next 12 months.

If the recovery follows our base case in 2025, it could allow cinema operators to reduce leverage even while increasing capital expenditure (capex) investment. Cinemark Holdings Inc., for example, has proactively reduced gross debt and interest expense, while AMC Entertainment Holdings Inc. has completed debt for equity swaps and extended near-term maturities (although we still view its capital structure as unsustainable). New Cineworld Midco recently refinanced its capital structure, achieving lower cash interest payments and a positive rating outlook.

Key risks or opportunities around the baseline

1. Streaming 2.0 to offset linear declines.

Streaming services have largely passed the inflection point for profitability through more rational content and marketing spending, and are in the process of building a business that can generate operating margins to offset the declines at their linear TV businesses.

2. Legacy media hunt for their share of digital advertising.

Linear audiences are declining at a double-digit rate and linear advertising is following suit. Legacy media companies are building out their ad-supported streaming platforms to try and capture as much of the shift in advertising spend from linear to digital. However, the market is far more competitive.

3. Meaningful M&A is still remote.

M&A remains muted but there are signs that could indicate more opportunities in 2025. We expect the regulatory environment to ease with a change in the U.S. administration, and media companies may be more amenable to deals as investments in streaming taper off.

For legacy media companies, credit metrics will depend on countering linear declines. Companies like Disney, WBD, and Paramount have had the double whammy of streaming losses and declining linear TV revenue and earnings for the past several years as they invested heavily in building their streaming services. In 2025 there is an opportunity for these companies to generate positive EBITDA growth such that it offsets linear TV declines. If they can sustain this, credit metrics should improve. This trend has already begun: In 2024, Disney's direct-to-consumer (DTC) segment improved EBITDA by $2.5 billion compared to its linear EBITDA only declining by $725 million for almost a $1.8 billion improvement. Paramount saw a net increase in

EBITDA of about $700 million as losses in its DTC segment were $960 million less than the previous year to date (though still negative). WBD saw a net decrease in EBITDA of about $500 million year to date as modest improvements in DTC EBITDA were not enough to counter the over $600 million decline. We expect that 2025 will see DTC gains offset linear declines for all three companies as they continue to benefit from subscriber and average-revenue-per-user (ARPU) growth while continuing to manage costs tightly. However, if this fails to materialize, especially for WBD and Paramount, it could pressure credit metrics and ratings and be a sign that it will be difficult to consistently grow DTC EBITDA fast enough to offset linear declines.

Streaming video advertising is growing rapidly but is highly competitive. Audiences have been migrating to streaming video from linear TV for many years, but advertising dollars did not follow suit at the same pace. That changed in 2024, and linear advertising is increasingly shifting towards streaming as ad-supported subscribers are growing rapidly and each streaming platform is building its ad infrastructure. This is impacting legacy media companies with significant linear advertising exposure as they saw high single- to low-double-digit declines, and we expect that to continue into 2025. Much of this lost advertising is being captured through streaming advertising, but the marketplace is far more competitive as tech-focused streaming services like Amazon Prime, Netflix, YouTube, and others are aggressively building their own ad-supported subscriber base and infrastructure.

This is also playing out with tech companies being more aggressive to secure sports rights, which remains the most prized content for advertisers. Amazon secured one of the three major NBA rights packages and Netflix is entering the space with multiple Christmas day NFL games, a global rights deal with the WWE, and U.S. domestic rights for the 2027 and 2031 FIFA Women's World Cup.

While the streaming video advertising opportunity is significant, legacy media companies face a more competitive landscape as they try to defend their video advertising market share as the ecosystem shifts from linear to streaming.

Impediments to M&A are easing. For local TV broadcasters, a Republican administration may be more supportive of in-market consolidation. The FCC can consider this on a case-by-case basis following the Supreme Court's 2021 ruling in favor of the FCC to relax certain media ownership rules, including the ability to own more than one top-four rated TV station in a single market. We believe material M&A would likely require a change to the national ownership cap, which may require Congressional action and is unlikely to be a near-term priority. Given elevated leverage among many local TV broadcasters, we believe there is limited ability to pursue leveraging transactions.

M&A in EMEA will be more challenging. We think consolidation between EMEA linear TV broadcasters could allow these companies to gain scale, reach wider and better targeted audiences, and provide significant synergies in developing unified streaming platforms. However, we remain uncertain whether such deals could get approvals from local regulatory and competition authorities, which so far have been challenging mergers. There might be appetite for M&A deals involving the attractive in-house vertically integrated studios owned by broadcasters, including joint ventures, but these in our view would face execution risks of separating the operations from the core business.

Industry Outlook: Advertising

Ratings trends and outlook

We believe the advertising sector is poised for continued healthy growth in 2025. While we anticipate a slower growth rate than 2024, we still believe it will outpace GDP growth, based on the following:

- Total ad growth is primarily driven by the expansion of digital advertising, which we expect will grow at a high-single-digit percentage rate, while traditional media formats such as television, radio, and print face continued secular declines.
- For outdoor advertising we expect mid-single-digit growth over the medium term, driven by the rise of digital outdoor formats, which now constitute over 30% of industry revenues. Despite potential challenges from macroeconomic volatility, the sector stands to benefit from the ongoing recovery in global mobility.
- Exposure to advertising spending by vertical, including recovery of the tech industry globally, while the auto industry in Europe is weakening.
- Advertising is sensitive to macroeconomic fluctuations, and we expect risks will be particularly high in countries such as Germany and France, where we expect weaker GDP growth in 2025 compared to 2024.

Advertising in the U.S. continues to be robust, despite macroeconomic issues, in particular the underlying financial health of the U.S. consumer. We attribute this strength to consumers continuing to spend despite their perceived fears about the U.S. economy, the emergence of cross-border advertisers (in particular those based in China who have spent lavishly in the U.S. and Europe), and the entrance of new e-commerce advertisers.

We expect overall advertising in the U.S. to grow 4.3% in 2025, although trends continue to diverge between legacy media and digital. The former (with the exception of outdoor) should continue its mid-single-digit percentage decline as audiences shrink and advertisers find alternative media to reach consumers. In contrast, search, social, retail media (headlined by Amazon), connected TVs, and streaming will grow at double-digit percentage rates and expand share of ad spend while national and local TV and radio will see declines (with local performing better than national). National TV's headline numbers will reflect mid-single-digit organic declines as well as the impact of a non-Olympics year. And local TV will face the loss of what has been record political advertising spending in 2024. We believe risks to our forecast will generally come from macroeconomic issues and geopolitical risks from a trade war between the U.S. and China, including high tariffs, that could adversely affect Chinese-based advertisers. In addition, the incoming Trump administration may seek to ban or limit pharmaceutical advertising on TV. Pharmaceutical advertising skews toward national television and the loss of this key vertical could hurt television, though we expect the overall impact to be neutral as pharmaceutical companies should move those ad dollars to other media.

We expect ratings to remain stable in 2025 for most advertising companies in Europe. This reflects our expectation of their solid growth prospects, diversification that should absorb macro pressures, focus on cost efficiencies, and sound financial positions that provide flexibility. For the ones most exposed to particular industries—for example, S4 Capital, which depends heavily on ad spending by its clients in the tech industry—recovery in credit metrics will be linked to the recovery in the underlying industries.

We expect TV advertising revenue in the U.K., Germany, and France, which expanded by 1%-3% in 2024, will be broadly flat or decline slightly in 2025, and will be subject to risks of slower economic growth and accelerating declines in TV viewing. Germany in particular could be vulnerable to lower real GDP growth and political uncertainty that may weigh on advertising budgets, leading to a more substantial decline in TV ad revenue.

As the advertising industry remains fragmented, we see further consolidation opportunities. The recently announced acquisition of IPG by Omnicom in the U.S. aims to create the largest global ad agency. We view a successful integration as the biggest challenge facing both companies given the size of the transaction, without disrupting the individual agencies. In our view, consolidation of ad agencies benefits the broader sector with a likely positive impact on the pricing in the sector and more efficient media buying. In addition, we believe European ad agencies have solid balance sheets, which could allow for some M&A without impacting our credit ratings.

Main assumptions about 2025 and beyond

1. Ad growth will surpass GDP, with digital increasing at the highest pace.

We anticipate global advertising to grow at mid-single-digit rates and exceed GDP growth rates. Advertising growth reflects a global economic expansion, with signs of recovery in the eurozone and despite the U.S. economy slowing towards 2%, and digital advertising being a growth driver.

2. Weakness in legacy advertising to persist.

We expect legacy linear TV and radio advertising to decline, especially in the U.S., and at a slower pace in Europe due to continuing secular trends and advertising dollars shifting to online.

3. Revenue and margin of ad-driven companies should not decline due to adoption of AI.

AI will continue transforming the entire media industry, including ad agencies. We expect ad agencies' AI adoption could enhance their operating efficiency and their clients' return on investments (ROI). We expect clients' saved budgets will likely to be redeployed in ad spending, hence not impacting the revenue and profitability margins of ad companies.

Global ad growth outpaces GDP thanks to surge in digital. We expect global advertising revenue to expand at a mid-single digit rate and exceed our 3% 2025 forecast for global real GDP growth. Digital advertising will continue to thrive at a high single-digit percentage rate, and legacy advertising (including TV and radio) will remain weak, declining at a low-single-digit percentage rate. We expect digital video and retail media will remain the fastest-growing segments in 2025, benefiting from the ongoing shift towards online shopping, the rising popularity of digital video and connected TV, and enhanced demographic targeting through video on demand.

Tepid consumer spending and rising trade tensions weigh on China's ad spending. China's advertising revenues are likely to decelerate in-line with GDP growth in 2025. Online advertising revenue growth is likely to be modestly higher, benefiting from faster e-commerce growth relative to offline retail spending. Though government trade-in and localized stimulus programs have spurred consumer spending recovery in the fourth quarter of 2024, the benefits are likely to diminish in 2025 without broader-based stimulus or an economic recovery.

Slowing advertising growth is also weighing on short-form video platforms' ad revenues. The number of monthly active users on short-form video apps is plateauing, and average users are already spending more than two and a half hours a day on them. The platforms therefore will need to increase market share in the highly competitive e-commerce segment to sustain double-digit revenue growth. This is increasingly difficult as merchants push back on the high return rates on these platforms. Smaller ad-driven internet companies face even greater challenges as larger rivals leverage their vast resources to build out AI infrastructure amid U.S. restrictions on advanced chip exports into China. AI is helping these large Chinese internet companies to gain share in advertising revenues by improving the targeting and relevancy of advertisements on their platforms.

AI could boost efficiency gains of ad agencies and their clients' ROI. We anticipate that ad agencies will continue expanding the use of AI across the whole value chain, from planning to process to production. This will enable these companies to enhance targeting and personalization while automating some routine tasks and increase cost efficiencies. We expect clients' budgets saved as the result will be redeployed in ad spending, enabling ad agencies to maintain their revenue growth and profitability margins. Furthermore, some ad agencies could create additional revenue streams from AI-driven solutions and content utilizing their extensive consumer data.

We expect online classified platforms will show resilience in 2025. The growth pace will depend on the dynamics in their respective industry verticals. As hiring needs will gradually increase and interest rates decline, online job and real estate classifieds will stabilize and benefit from increasing listings activity. Auto classifieds' growth could be impacted by weaker underlying trends of the auto industry, albeit in the longer term.

Credit metrics and financial policy

We expect credit metrics for ad companies to remain broadly stable in 2025 resulting from a solid advertising environment and disciplined financial policies. We assume most companies will remain focused on cost efficiencies and wage inflation. We expect this will allow them to invest their savings into AI and data and tech innovation, without weighing on profitability.

We see further consolidation opportunities globally. In our view, European ad companies with strong balance sheets and ample ratings headroom such as Publicis or WPP could pursue some M&A without significantly damaging their credit metrics. WPP still owns a sizable stake in Kantar, which it might monetize in the next couple of years if the private equity sponsors that own the majority stake progress towards an exit from their investment.

The recently announced acquisition of IPG by Omnicom does not impact the rating on Omnicom, as it is an all-stock deal. The merger will add significant scale in providing advertising services and media buying to clients given both Omnicom and IPG's strong positions in the advertising services ecosystem. In our view, the biggest challenge will be successfully integrating both companies into a streamlined holding company structure without disrupting the individual agencies.

Key risks or opportunities around the baseline

1. Weaker economic growth could hurt advertising growth.

Although not our base case, weaker global GDP growth and deterioration in particular industries could reduce consumer spending and advertising growth.

2. AI-driven efficiency gains could reduce ad agencies' revenues and margins.

If clients don't redirect their savings to other advertising areas, agencies' top lines could come under pressure.

Weaker economic growth and consumer confidence in the U.S. and Europe, especially in Germany and France, could hurt consumer spending and advertising budgets. Sticky inflation and slower interest rate cuts could add to these pressures. Lastly, weaker growth in particular industries, for example advertising spending by the tech sector, autos in Europe, or a ban or limit on pharmaceutical advertising on TV in the U.S., could constrain ad revenue growth.

AI-driven savings not redeployed with ad companies could squeeze agencies' margins. With further adoption of AI across the whole value chain, ad agencies could achieve efficiencies that translate into higher ROI for their clients. If those clients don't redeploy the savings with the agencies it might translate into lower revenues of ad agencies and declining profitability, weakening their margins and cash flows.

Related Research

- U.S. Media And Entertainment: Looking For The Winds Of Change In 2025, Dec. 12, 2024
- Assessing The Credit Quality Of Large U.S. Media Companies (2024 Update), Oct. 14, 2024
- Secular Pressures Reduce Recovery Prospects For U.S. Local TV Broadcasters, Oct. 9, 2024
- Credit FAQ: Can Warner Bros. Discovery Inc. Bounce Back After Being Blocked By The NBA?, July 30, 2024
- Sports Rights: The Jump Ball In The Streaming Ecosystem, June 18, 2024
- Credit FAQ: U.S. Digital Publishers Have Cause For Concern Over Google's AI Overviews, May 23, 2024
- Credit FAQ: Outlooks Diverge For U.S. Local TV Broadcasters As Industry Faces Secular Challenges, April 15, 2024
- Credit FAQ: Proposed Sports Pay-TV Bundle Is Not The Heavyweight Investors Fear, Feb. 21, 2024
- U.S. Speculative-Grade Media Outlook 2024: A Mixed Story, Feb. 2, 2024
- U.S. Advertising Forecast Powered By Digital, Jan. 2, 2024

Industry Forecasts: Media and Entertainment

Chart 9

Revenue growth (local currency)

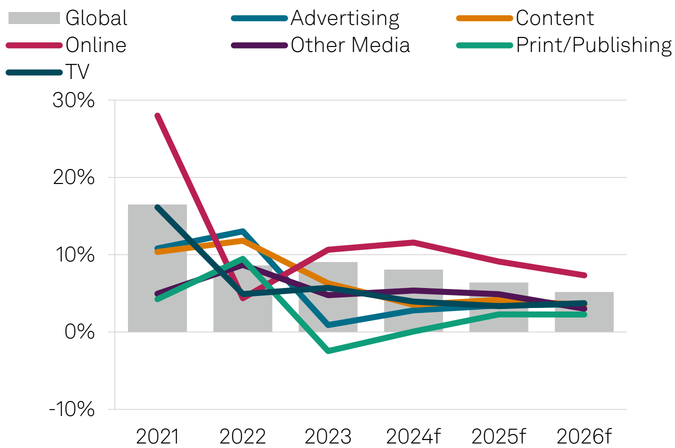


Chart 10

EBITDA margin (adjusted)

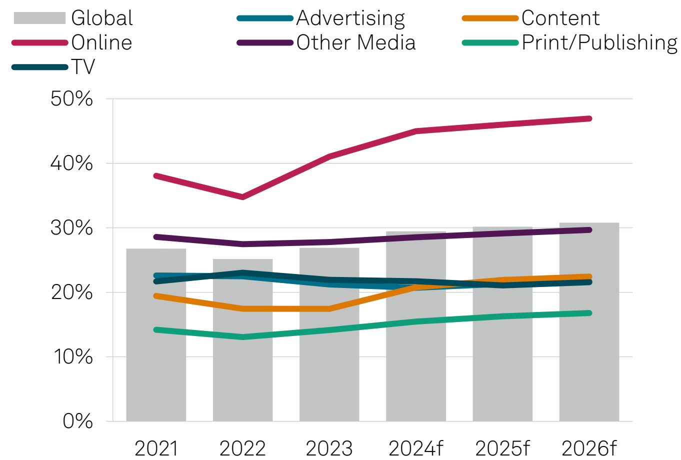


Chart 11

Debt / EBITDA (median, adjusted)

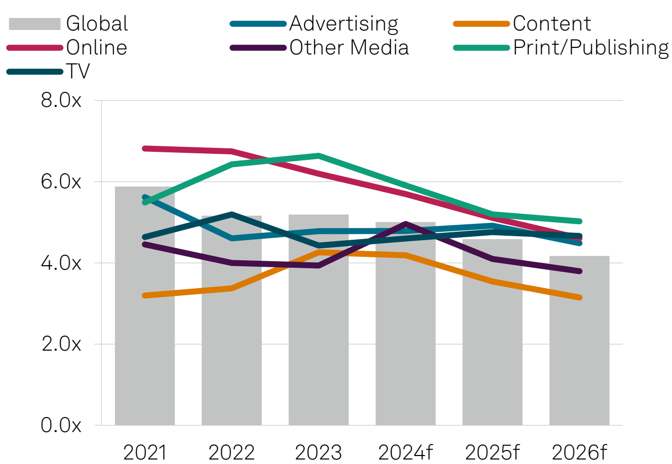
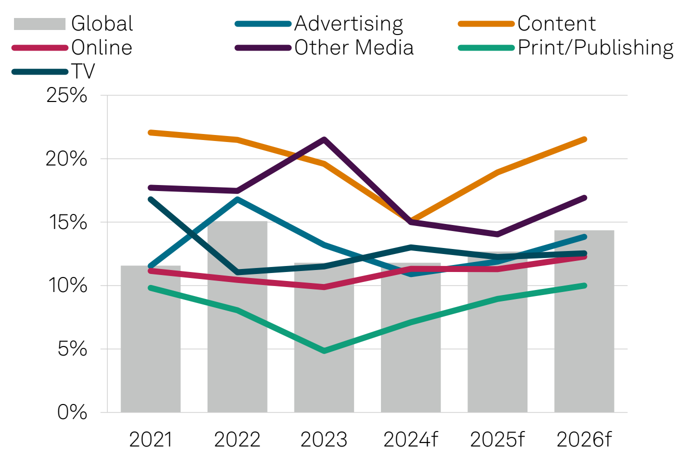


Chart 12

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Media and Entertainment

Chart 13

Cash flow and primary uses

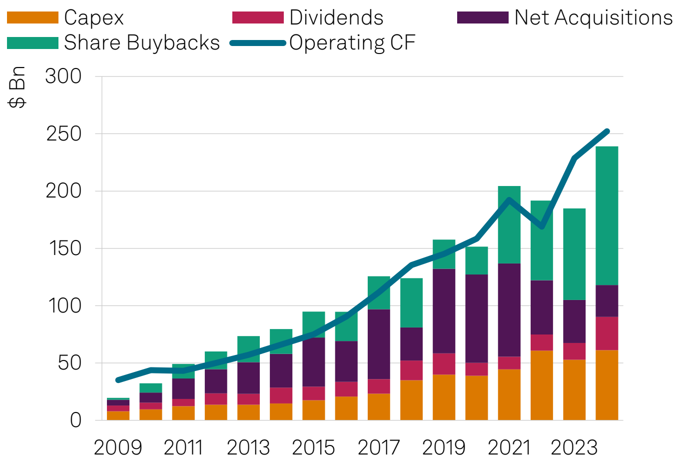


Chart 14

Return on capital employed

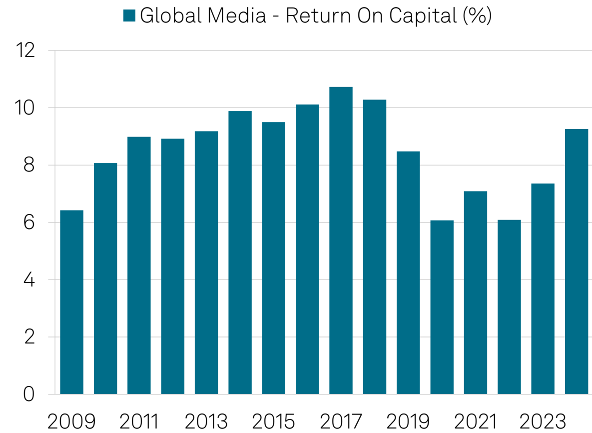


Chart 15

Fixed- versus variable-rate exposure

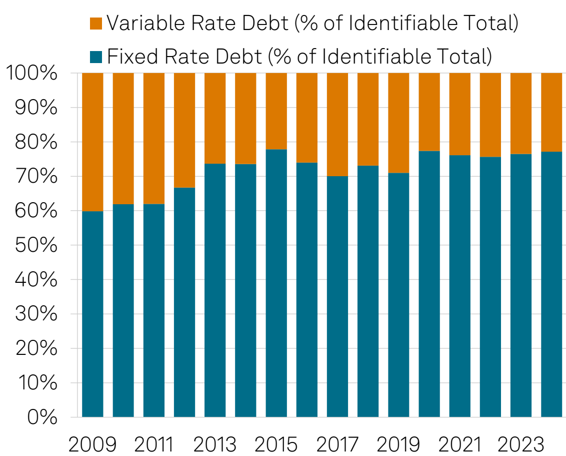


Chart 16

Long-term debt term structure

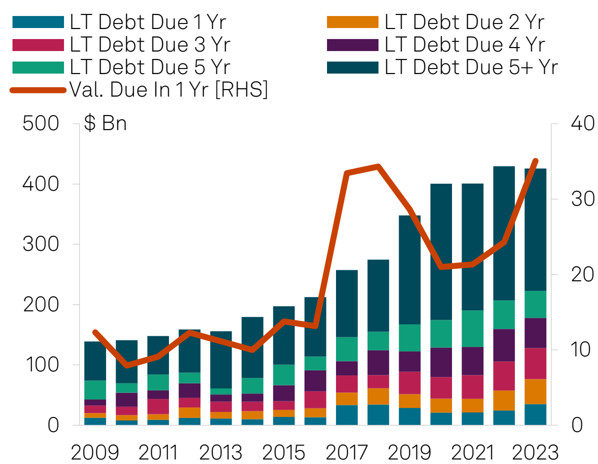


Chart 17

Cash and equivalents / Total assets

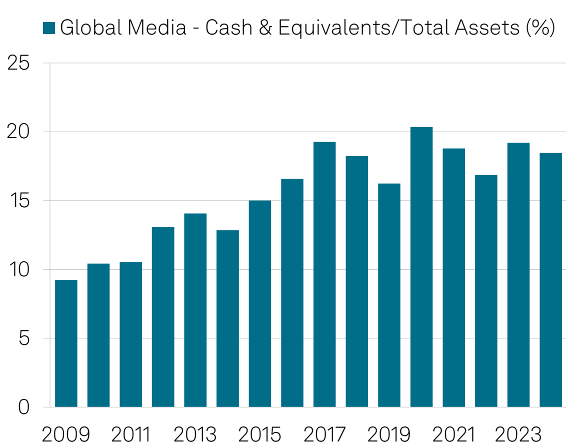
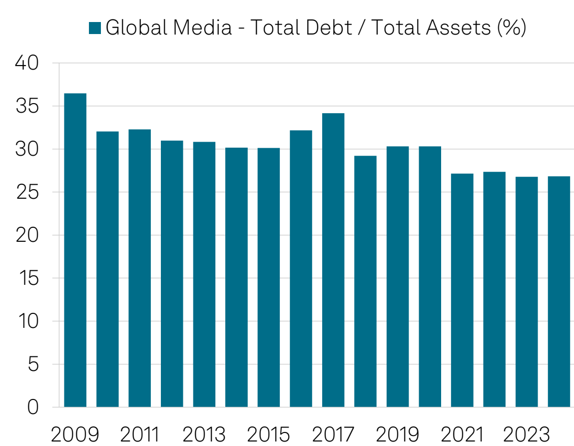


Chart 18

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Metals and Mining

Critical assets support credit quality

January 14, 2025

This report does not constitute a rating action.

What's changed?

Metals stay solid in an unsteady world. Hard assets—like mines, mills, furnaces, and smelters—are increasingly important amid rising global tensions. The acquisition of United States Steel Corp. by Nippon Steel Corp. is being blocked because of potential risks to U.S. national security and supply chains.

Sustained inflation could support higher prices. The 20% spike in producer prices for 2021-2022 included high metals prices, and the PPI now shows input costs holding at elevated levels.

What are the key assumptions for 2025?

Price assumptions hold steady amid economic headwinds, but costs stay high. Our price assumptions have mostly held steady in 2024, with minor upward revisions to reflect tight markets despite slowing economic growth. Margins and returns face perennial pressure from declining ore grades for miners and heavy reinvestment to maintain a large asset base.

Financial discipline prevails. Outstanding debt is at a decade low, M&A is cautious and disciplined, and shareholder payouts often vary with unstable cash flows. As such, financial policies have sparked stronger credit ratings around the world in the last few years.

What are the key risks around the baseline?

Financial policies loosen or large spending consumes cash flow. Ambitious debt-funded corporate development or large capital blowouts on important projects could consume the financial buffers that companies have spent a decade building.

Disruptions hit assets. Scrutiny on these heavy assets can lead to unexpected political, regulatory, or community factors that affect operations.

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Ratings Trends: Metals and Mining

Chart 1

Ratings distribution

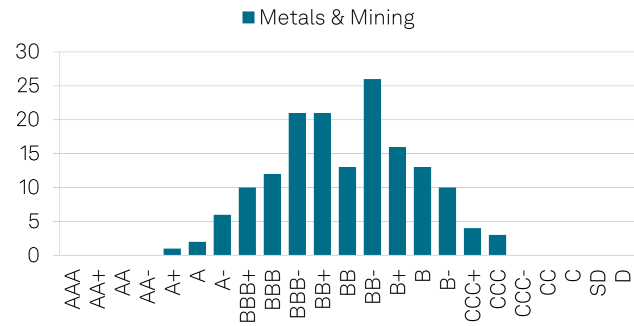


Chart 2

Ratings distribution by region

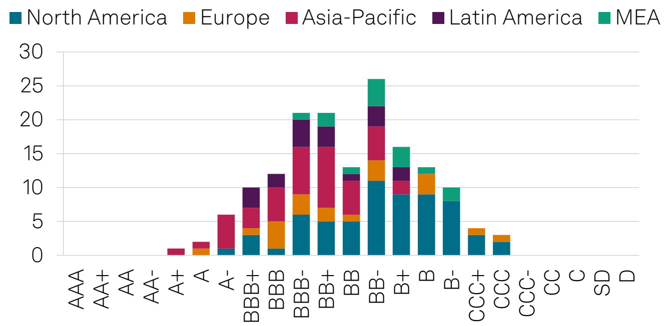


Chart 3

Ratings outlooks

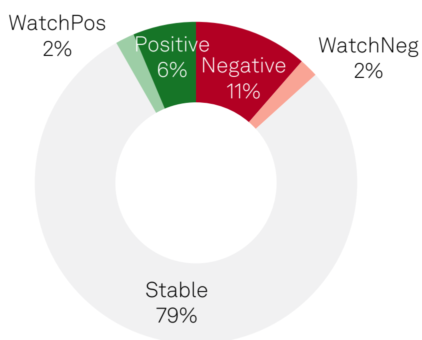


Chart 4

Ratings outlooks by region

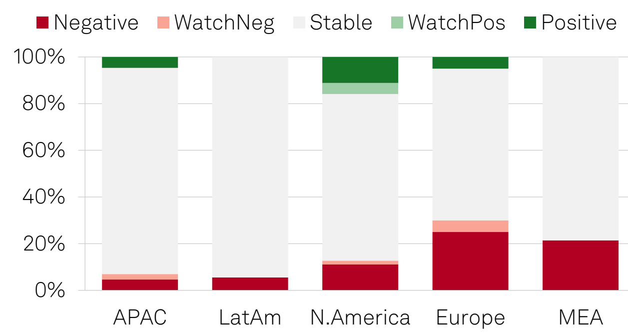


Chart 5

Ratings outlook net bias

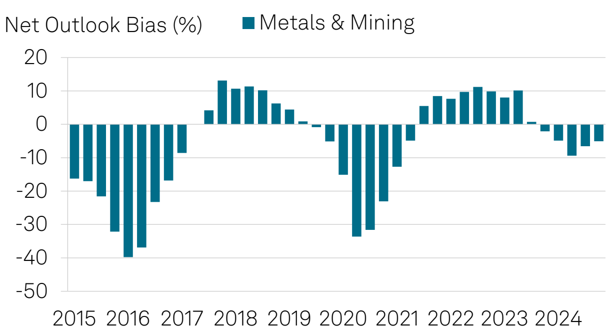
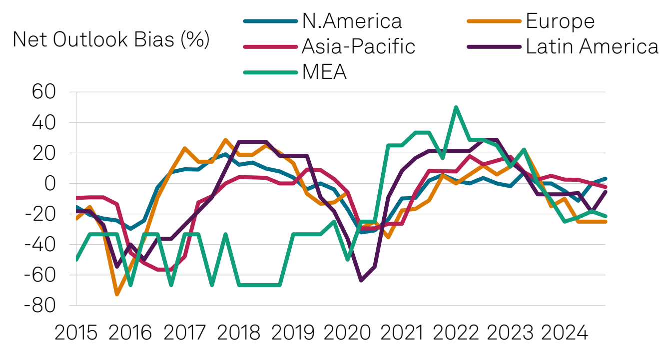


Chart 6

Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

Credit quality holds up as prices settle down. The ratings outlook bias in global metals and mining is modestly negative after balanced upgrades and downgrades in 2024. Earnings and cash flow are lower for a second consecutive year after a windfall in 2022, so flexible shareholder return policies are kicking in, preserving cash, and supporting credit quality. Total debt in the sector is lower than five years ago, and profits are about 20% higher since the 2021-2022 inflation spike. Many issuers now use variable mechanisms to distribute excess cash flow to shareholders during market peaks and cut back as cash flows shrink in a downturn. This has reduced the capacity or willingness to deploy cash for large corporate developments, and provides some balance sheet protection for projects underway through lower dividends.

The favorable outlook bias in steel and aluminum moderates. We still have positive outlooks on a few large names globally (ArcelorMittal S.A., BlueScope Steel Ltd.) after we upgraded others in 2024 (Gerdau S.A., Tata Steel Ltd.). We believe that the strong interest among several competitors in acquiring United States Steel Corp. (BB-/Watch Pos/--) in the last 18 months highlights the strategic importance of U.S.-domiciled assets, including some of the industry's oldest coal-burning blast furnaces. U.S. trade barriers have held longer than any in the past few decades, and they are set to hold for another four years, at least. The start of the Carbon Border Adjustment Mechanism in January 2026 is set to support European steel markets, potentially by making carbon-intensive steel from blast furnaces in Asia more expensive in the EU and providing some price cover for European producers.

Global forces reshape steel and aluminum. Blast furnace steel producers in North America have been rationalizing decades-old capacity, investing in next-generation assets, reducing emissions, and boosting credit quality. Even with a surge of electric arc furnaces to consume scrap and encroach on their markets, the remaining coal-fired blast furnace steelmaking facilities in North America have emerged as scarce and strategically important assets.

Aluminum products for transportation and packaging have a good long-term demand trajectory, which prompted the concurrent construction of two the of the world's largest downstream aluminum rolling mills in the U.S. Primary aluminum production in North America relies mostly on smelters with abundant low-cost electricity, such as in Quebec, where 90% of the metal is exported to the U.S. Aluminum rolling mills, however, can be furnished with scrap metal, which is cheaper than primary metal because of much lower energy costs.

Chinese steel producers reduce output and increase exports. In a strong signal of weaker domestic economic conditions in China, S&P Global Commodity Insights forecasts steel production to decrease 1.1% year on year in 2024, reaching slightly over 1 billion metric tons, while exports rise about 20% from 2023 to 100 million metric tons, which dwarfs most countries' domestic production. A surge in imports from China into places like Vietnam, Indonesia, Saudi Arabia, and Brazil can disrupt those markets or cause trade friction, but their ambitious infrastructure plans and domestic steel deficits mean they are less likely to impose anti-dumping tariffs, in our view.

Margins remain weak for Brazilian steel producers. Although the Brazilian government implemented quotas to help domestic players compete with large and cheap imported Chinese steel, this support did not offset the impact on margins. Pronounced lower imports only appeared in late 2024, which could help price adjustments in 2025.

However, the main point of economic attention is the high and rising interest rate in the country, which could weaken consumption that remained resilient in 2024, especially for the real estate, automotive, and home appliance sectors. Real rates are approaching 9%, which can hit consumer spending and steel company volumes in the early months of 2025.

We upgraded Gerdau recently thanks to its sound geographic diversification and very low debt levels, keeping credit metrics consistent despite weakness in the Brazilian market. On the other hand, we downgraded Companhia Siderugica Nacional (CSN) amid large capital expenditure (capex) and interest burden, while cash generation declined.

Lithium producers face headwinds following a collapse in prices. Spodumene prices falling towards $800 per tonne from more than $6,000 in late 2022 has tested the profitability of all but the lowest cost producers. Accordingly, some higher cost mines have been shuttered, and near-term expansion plans have been shelved. Nevertheless, the energy transition and associated demand for battery electric vehicles means producers remain bullish over the long-term prospects for lithium. Reflecting this positive sentiment Rio Tinto plc accelerated its move into lithium in 2024 by proposing to acquire Arcadium Lithium plc for US$6.7 billion while also announcing its plans to spend $2.5 billion expanding the Rincon project in Argentina.

Main assumptions about 2025 and beyond

1. Prices stay firm at supportive levels.

Balanced markets in most mined metals rely on outright tight supplies instead of producer discipline, like in previous cycles. An economic downturn could push prices lower for all metals, but high production costs for marginal producers should quickly tighten markets with curtailments.

2. Costs keep rising.

Cash production costs can set metal prices in a downturn, and producer cost profiles can define credit strength at all points in the cycle. Even with metals prices that are 30%-40% higher than 10 years ago, margins and returns are steady because of cost inflation and relentless capex requirements.

3. Financial discipline holds.

Lower shareholder distributions buffered a decline in cash flows in 2023 and 2024. Debt-funded mergers and acquisitions (M&A) have been minimal, but the pressure to recast business risks and opportunities could prompt big moves.

Higher costs underpin higher prices. We raised several metal price assumptions earlier in 2024 due to entrenched higher costs that require higher clearing prices. Mine-by-mine data for 2023 demonstrated a rise in the cash production costs of most metals. For example, we raised our third-year price assumption for gold three times in the last year, and our base-case assumption is above $2,000 per ounce for the first time ever. Using cash cost data from S&P Global Commodity Insights, unit costs for the 90th percentile of global metallurgical coal rose 45% to $200/tonne from $140/tonne in 2018. By comparison, that 90th percentile cost for iron ore rose only 20% over five years to $90/tonne. Hence, the dollar value of the fuel/energy component in a unit of steel has risen twice as fast as the metal component over the last five years, which is important considering potential costs for carbon emissions, as well as local factors like pollution.

In 2024, we raised the third year of our three-year price assumptions for metallurgical (met) coal by 25% to $200/tonne, but our iron ore assumption still averages $100/tonne, as it has for several years. Further, our price assumptions reflect the fact that unit cash costs for the 90th percentile of global copper rose 27% to $2.69 per pound (lb) in 2023 from $2.12/lb in 2018, while nickel cash costs rose 56% in the same period.

Compared to base and precious metals, steel and aluminum have excess capacity around the world and a propensity to overproduce from time to time to cover high fixed costs, pressuring prices and earnings. As such, we rely more on constraints like availability of energy or raw materials inputs to support our assumptions, rather than producer discipline to balance supply and demand.

The American Iron and Steel Institute reports that the U.S. mill utilization rate was about 75% in early December 2024, dropping for three consecutive years after peaking at 81% in 2021. This also highlights the sensitivity of the U.S. steel industry (and especially blast furnace producers) to changes in output and efficiency. A utilization rate above 80% is a good indication of a cyclical profit peak for steel producers in the U.S., and a utilization rate near 70% likely wipes out earnings and cash flow. For example, at peak utilization of 80% in 2021 and 2022, Cleveland-Cliffs Inc. and U.S. Steel combined generated almost $10 billion of EBITDA both years and a margin of about 18%. At a utilization of about 76% in 2024, combined run-rate, last-12-months EBITDA is 80% lower at only $2 billion, with a 7%-9% EBITDA margin.

Most mining companies are signaling continued capital restraint, particularly for M&A. Transactions have been cautious and infrequent, and include little new debt, suggesting a persistent gap in valuation between buyers and sellers. Steelmakers, however, have shown more willingness to stretch to acquire assets. Cleveland-Cliffs in late 2024 closed the acquisition of Canadian steelmaker, Stelco Inc., funding the acquisition with $2.8 billion of incremental debt. Nucor Corp. continues to acquire steel-adjacent manufacturing businesses as part of its commercial strategy focused on megatrends.

Credit metrics and financial policy

Even when market conditions are fairly stable, cash flows and credit ratios in metals and mining are volatile and vary highly across issuers, depending on product mix, cost profile, capital spending, and debt loads. A decade-long shift in financial policy to emphasize free cash flow and return on capital from mining, with less debt usage despite steadily lower interest rates. Consequently, we expect median debt to EBITDA in global metals and mining to finish 2024 around 2.1x, compared with 3.1x in 2019. In addition, variable shareholder returns policies coupled with the sector's more robust balance sheets should support credit metrics through weaker price cycles.

The metals and mining industry benefits from major barriers to entry that stem from resource scarcity and the capital intensity of the assets, which support credits with hard asset value. Mines need heavy capital (and operating) spending to sustain output, while steel blast furnaces and aluminum smelters are heavy assets with their own large capex needs (sometimes including mining). Innovations—like electric arc furnaces (EAFs) used in minimills to produce steel; solvent-extraction and electrowinning (SX-EW) used to produce copper from low-grade deposits; or high-pressure acid leach (HPAL) used to extract nickel from laterite ores—can cause a step-change in production costs, profitability, and competitive balance. However, these highly unusual technological breakthroughs are rare and challenging to achieve. For example, significant resources are being devoted to the development of low-carbon “green steel”, but there are few signs of a commercial product emerging.

Large greenfield asset construction in metals and mining has been rare in North America in the last few decades, except for fast-growing EAF mills, which benefit from relatively new technology that consumes scrap metal from the world’s largest, most advanced scrap basket. As such, debt in the American steel industry could increase, as competitors add assets and prune some steelmaking capabilities.

Key risks or opportunities around the baseline

1. Mines receive extraordinary demands that affect profitability.

Mines are unique assets, and governments and citizens around the world demand they build and maintain long-term facilities for health, education, and infrastructure.

2. Capital investments take longer and cost more.

Outlays for large metals facilities are usually in the billions of dollars. The size and complexity of these assets has caused cost overruns and startup delays.

3. Metals enable megatrends, like the energy transition.

The energy transition and investments in manufacturing are important for metals demand. The availability of key metals is vital to next-generation renewable energy technologies.

Miners face continually rising costs to sustain and grow production, partly because ore grades tend to decline with the age of an ore body. In addition, friction around mining operations is fairly common, and public scrutiny of mining operations or financial demands could be rising with consideration of environmental and social effects.

Irrespective of negotiated arrangements, numerous local issues can arise for these unique, critical assets. For example, copper mines in Peru and Panama stopped output because of social unrest. Alcoa Corp. is reworking its bauxite mining plan in Western Australia to address a change in its permitting approvals. Disruptions can also be financial if governments adjust ownership, taxes, or royalties over the life of an asset.

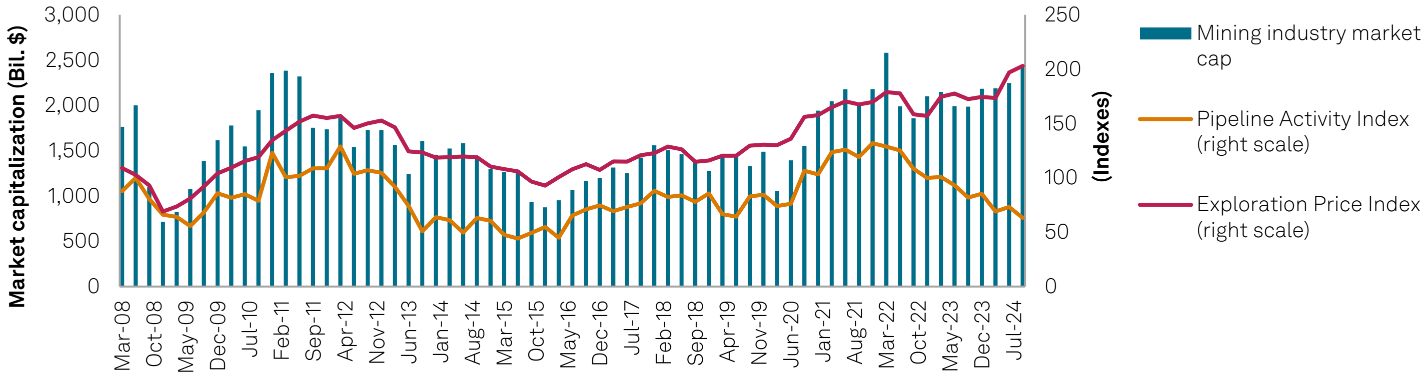
New mines are often more remote and more difficult to operate, as the world's easiest and most economically attractive deposits are already being mined. As such, miners face a continual grind on capital and operating costs to advance mines and support incremental processing with generally declining ore grades. Copper output appears unlikely to grow substantially for any sustained period, which incentivizes production from smaller, high-cost assets. Nickel, by comparison, has been adding large sources of new material from laterite deposits in Indonesia that are processed using HPAL. Such innovations can cause a step-change in the world’s economically mineable reserves, as seen with SXEW for copper. At the same time, HPAL innovations in Indonesia are adding low-cost new output to a saturated market, pushing down prices and profits for higher-cost nickel mines.

Metals consumption is rising due to population growth, economic expansion, and the energy transition. The transition to renewables requires critical raw materials, like copper, lithium, cobalt, and nickel, while steel and aluminum helps construct renewable energy assets. Even with growing demand for metals like copper and nickel, exploration activity in mining has declined since the 2022 spike in prices and profits, while the mining industry’s market cap remains near all-time highs.

The S&P Global Market Intelligence Pipeline Activity Index (PAI) is an overall measure of the exploration sector (see chart 7). S&P Global Commodity Insights recorded fewer initial resource announcements and lower significant drill results in 2024. That lower exploration pipeline also coincides with intractably higher costs for the inputs to exploration, such as labor, equipment, and consumables.

Chart 7

Pipeline Activity Index and mining industry market capitalization, 2008–current



As of Oct. 22, 2024. The quarterly Pipeline Activity Index is calibrated so that June quarter 2008 = 100. The quarterly Exploration Price Index is the average of the monthly Exploration Price Index, which is calibrated so that May 2008 = 100.
Source: S&P Global Market Intelligence.

Related Research

- Bulletin: United States Steel Corp. And Nippon Steel Corp. Remain On CreditWatch Following Lawsuits Over Blocked Merger, Jan. 8, 2025
- Full Analysis: Rio Tinto PLC, Dec. 20, 2024
- Research Update: Cameco Corp. Outlook Revised To Positive From Stable On Durable Uranium Demand; 'BBB-' Rating Affirmed, Dec. 19, 2024
- Tear Sheet: Nucor Corp., Dec. 10, 2024
- Bulletin: Anglo American PLC's Sale Of Its Remaining Coal Assets Is A Major First Step Toward Its New Stand-Alone Strategy, Nov. 26, 2024
- Asian Steelmakers' China Strains Will Roll On, Nov. 6, 2024
- S&P Global Ratings Metal Price Assumptions: Prices Hold Steady Despite Headwinds, Oct. 16, 2024
- Trade Tensions Won't Tarnish China Steel Exports, Oct. 15, 2024
- Research Update: Posco Holdings And Posco 'A-' Ratings Affirmed On Likelihood Of Disciplined Financial Policy; Outlook Stable, June 24, 2024
- Research Update: Kinross Gold Corp. Outlook Revised To Stable From Negative; Ratings Affirmed On Strong Gold Prices And Debt Reduction, July 16, 2024

Industry Forecasts: Metals and Mining

Chart 8

Revenue growth (local currency)

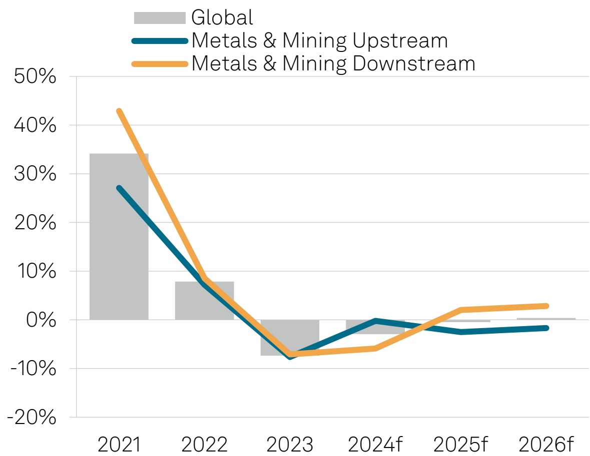


Chart 9

Capex Growth

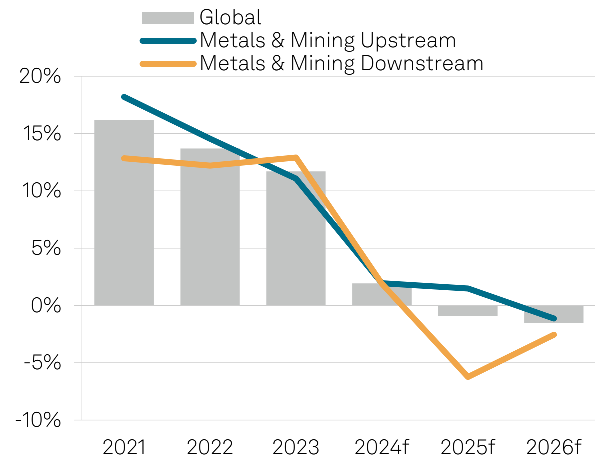


Chart 10

Debt / EBITDA (median, adjusted)

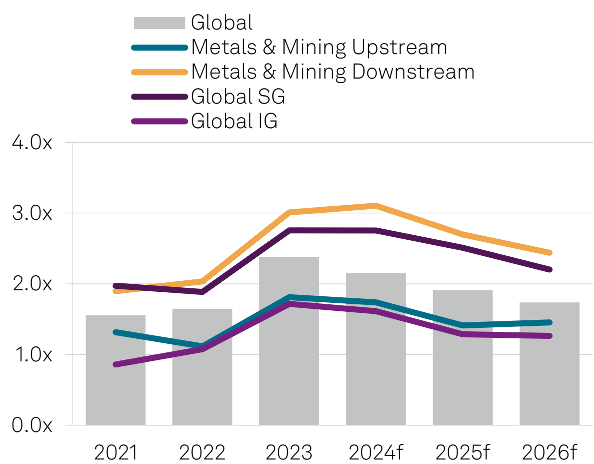
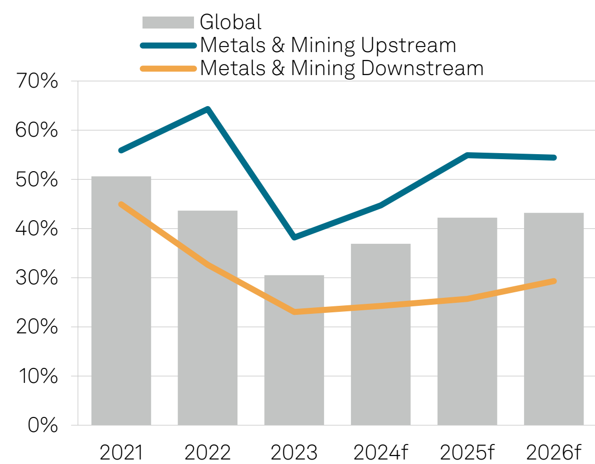


Chart 11

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Metals and Mining

Chart 12

Cash flow and primary uses

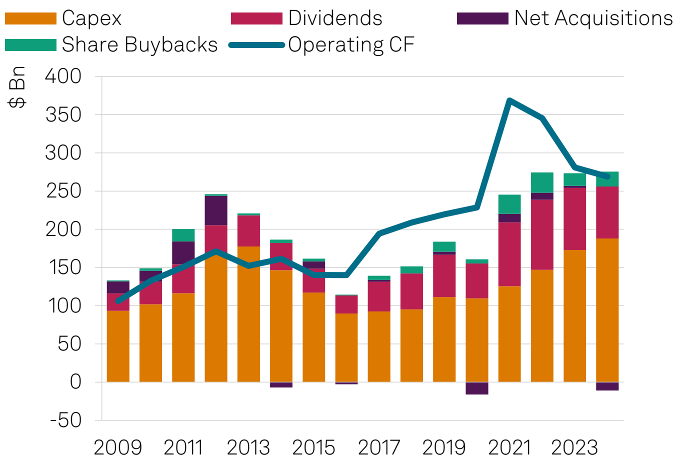


Chart 13

Return on capital employed

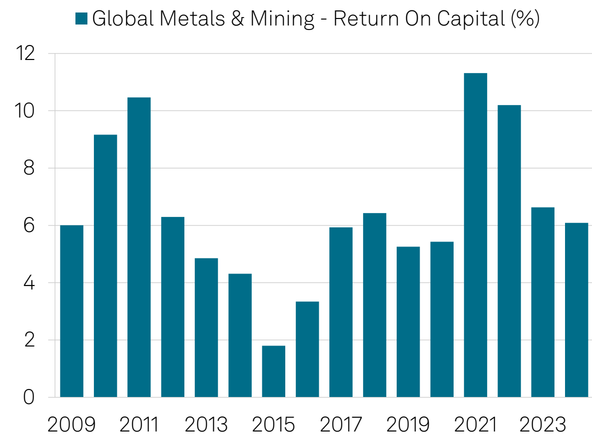


Chart 14

Fixed- versus variable-rate exposure

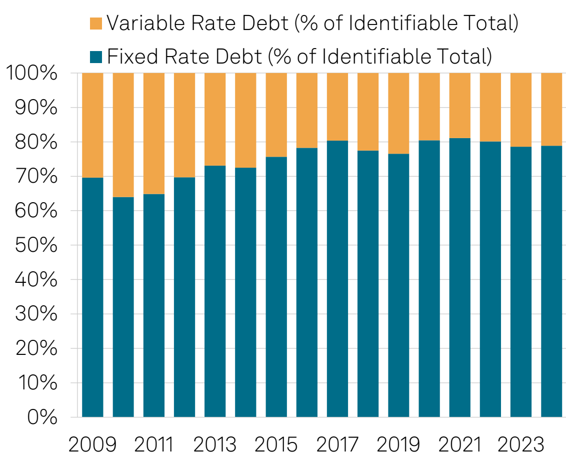


Chart 15

Long-term debt term structure

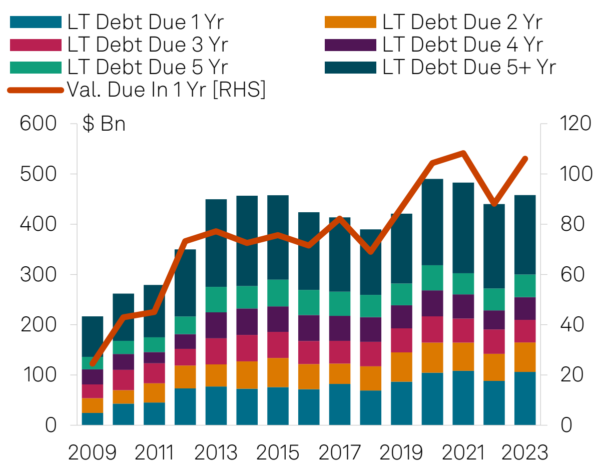


Chart 16

Cash and equivalents / Total assets

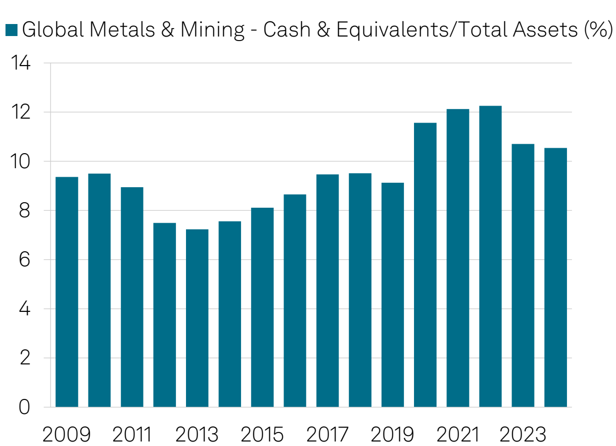
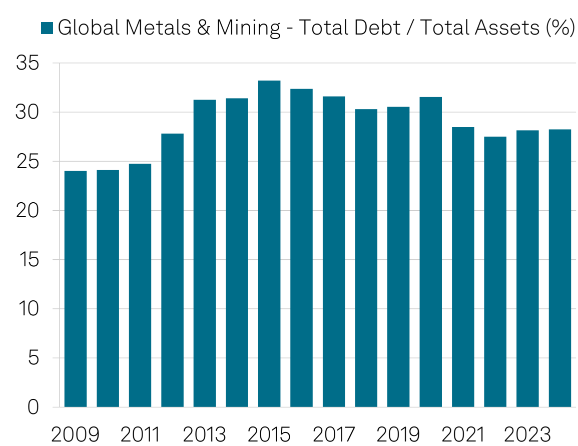


Chart 17

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Oil and Gas

The industry credit profile should remain healthy

January 14, 2025

This report does not constitute a rating action.

What's changed?

M&A. After extremely robust M&A activity last year, particularly in North America, the pace is slower but still relatively high. The main reason is to replace inventory and diversify production.

Global refining capacity additions will be more than offset by announced closures. Additions of about 1 million bbls/d will be mostly offset by closures and renewable fuel conversions.

The new Trump administration will have a limited impact on U.S. oil and gas production. The administration will likely make it easier to drill on federal lands and garner drilling permits, but economics and commodity prices will continue to be the deciding factor.

What are the key assumptions for 2025?

Gas demand in U.S. expected to rebound. Data center buildout and LNG infrastructure spending will lead to demand and price appreciation for natural gas.

North American upstream spending will remain muted. Capex will likely be either flat or slightly lower due to lower oil prices and continued emphasis on generating cash flow.

Refining margins will marginally weaken. We expect global margins to soften due to slower demand growth and new supply from capacity additions.

What are the key risks around the baseline?

OPEC unleashes production. Although recent OPEC announcements have demonstrated support for oil markets, the rhetoric from OPEC members to increase production has intensified.

Shifts away from conservative financial policies. Such a shift and outspending cash flow could lead credit quality to deteriorate.

Refining margins could have more downside risk. Refining margins could be weaker than expected if the Trump administration imposes a 25% tariff on Canadian and Mexican crude oil.

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Ratings Trends: Oil and Gas

Chart 1

Ratings distribution by subsector

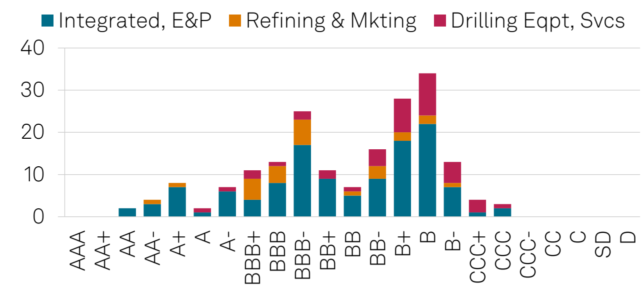


Chart 2

Ratings distribution by region

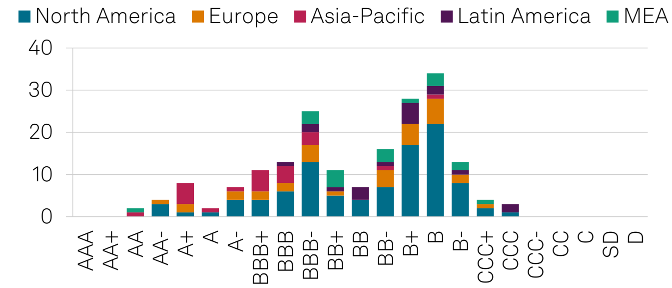


Chart 3

Ratings outlooks by subsector

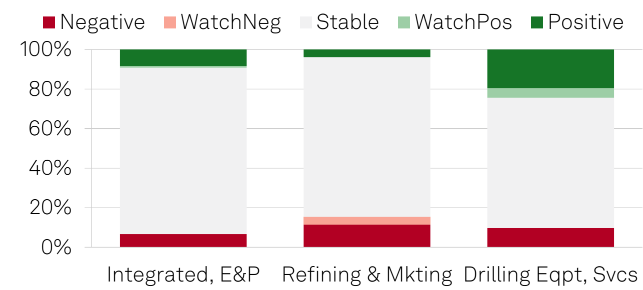


Chart 4

Ratings outlooks by region

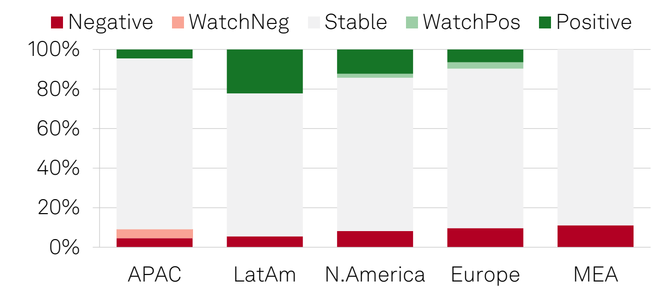


Chart 5

Ratings net outlook bias by subsector

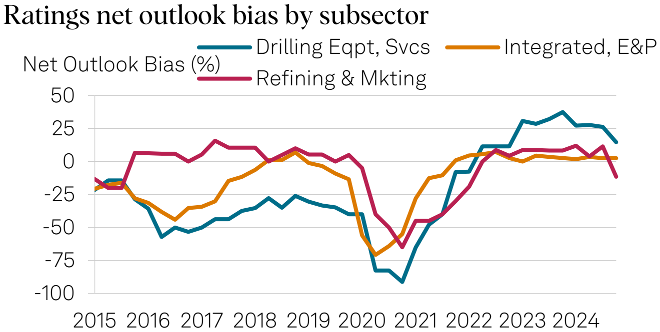


Chart 6

Ratings net outlook bias by region

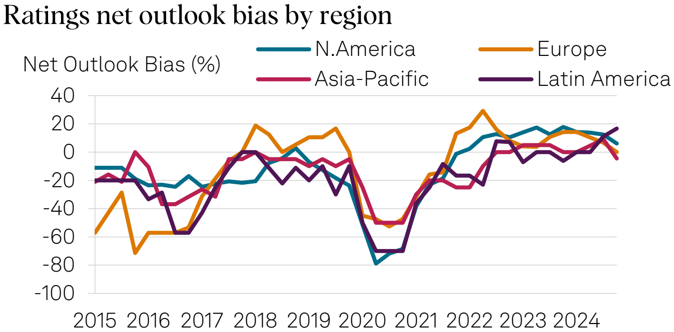


Chart 7

Ratings outlooks

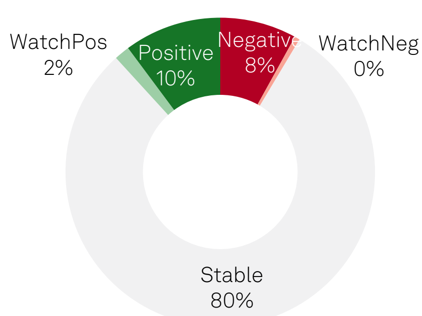
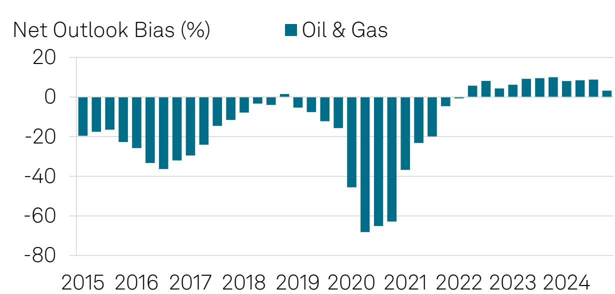


Chart 8

Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

The overall positive rating trends we have seen in previous years continued in 2024. Healthy oil and Dutch Title Transfer natural gas prices and financial discipline that limited production growth allowed companies to garner strong earnings and cash flow. Producers remain focused on a financial discipline that targets limiting outspends of cash flow. Merger and acquisition (M&A) activity in 2024 has largely been positive for ratings, with companies, similar to 2023, largely using equity and maintaining financial discipline. Oil field services have been slower to join the positive rating trends due to upstream capital discipline and heavy M&A activity, but recent upgrades and positive outlook revisions reflect improved margins and a focus on the balance sheet. Nevertheless, overall leverage in the space remains at higher levels than exploration and production companies. Also, with North American spending expected to be flat to slightly down, service companies' top-line growth will be muted. North American-based service companies that have the capability will look to international markets for growth.

We believe the global refining industry will come under added pressure in 2025 because of weaker demand and the pace of capacity additions that will influence the overall supply of refined products. S&P Commodity Insights (SPCI) expects global gasoline demand to peak in 2025 at approximately 27.14 million bbl/d, mainly due to increased electric vehicle (EV) adoption and fuel efficiency gains. At the same time, capacity additions in Africa, Mexico, and the Middle East will increase gasoline production and shift product flows, which will likely pressure refining margins in the Atlantic Basin, particularly in Europe; the northeastern U.S.; and possibly markets in Asia. While we expect refinery closures to mostly offset the capacity additions, the pace of closures could pressure margins in the near term, which will have different impacts on creditworthiness in 2025. We also believe that margin improvement will be more dependent on a reduction in global capacity than increased demand, as was the case in past refining cycles.

In North America, we expect the large, geographically diverse, and more complex refineries to maintain a competitive advantage over their smaller and less diverse and complex peers. These larger investment-grade companies have stronger balance sheets and liquidity than their weaker peers and have more optionality to advantaged feedstocks in most cases. We also believe that gasoline demand destruction will outpace diesel demand, which means the price differential will favor assets that can upgrade to more valuable distillates such as jet fuel and higher-value diesel using lower-value heavy crudes. According to SPCI, U.S. Gulf Coast refining assets will maintain very high utilization until the mid-2030s but may need to rationalize capacity of up to 1.7 million barrels per day (bbls/d) after that due to growing long positions of gasoline and diesel. That said, advantaged access to natural gas and crude oil feedstocks will help maintain the region's competitiveness versus the rest of the world for the foreseeable future, in our view. The West Coast will see more capacity rationalization due to more stringent environmental regulations and costs.

Carbon intensity will increasingly become an important factor for the global refining industry and initially will be more of a driver outside of North America. Exporters will seek the last growing markets in Latin America and Africa, which will become very competitive and likely increasingly difficult for all but the top-tier European refineries. Europe has already announced about 495,000 bbls/d of refining capacity closures in 2024, and SPCI estimates that another 1.1 million bbls/d will need to be rationalized by 2030 to keep the supply-demand balance in the region in check.

Main assumptions about 2025 and beyond

1. Oil is range bound, mostly trading within a $60-$70 band.

Oil prices over the past several months have retreated due to lower global demand and the reconciliation among warring factions in Libya that would return approximately 700,000 bbls/d of offline oil production. We believe this trading range reflects current supply/demand fundamentals and the assumption that OPEC will not in any meaningful way resume the 2.2 million bbls/d of offline production it is considering returning next April.

2. OPEC continues its support of oil prices.

Due to weakening demand and global markets likely to be in surplus in 2025, we believe OPEC will continue to support the oil markets. OPEC's recent announcements have demonstrated its willingness to delay reintroducing surplus capacity until global demand improves.

3. U.S. natural gas demand and prices begin to recover.

After a couple of years of weak fundamentals, we expect natural gas demand and prices are expected to recover through the end of the decade. Liquefied natural gas (LNG) and data center buildout will drive the demand side of the equation and lead to robust growth and price appreciation. Underlying this assumption is the expectation that the Trump administration will unwind the LNG export pause enacted by the Biden administration.

We are expecting that after two years of global oil demand growth outstripping global oil supply growth, oil markets will be in surplus in 2025. Estimates of supply increasing by approximately one million bbls/d from non-OPEC+ nations, such as the U.S., Canada, Brazil, and Guyana, will outstrip global demand growth estimates of 600,000-700,000 bbls/d. Demand growth continues to weaken largely due to China. Chinese domestic oil demand has been slowing, largely a result of China becoming the leader in EV penetration, and has rapidly been converting its fleet of diesel truck engines to compressed natural gas (CNG). Indeed, SPCI believes Chinese demand for diesel and gasoline recently peaked due to the rate of EV penetration.

Although supply is expected to outstrip growth, global inventories remain low and could support some additional supply. A key assumption around this base line is that OPEC remains supportive and keeps its estimated surplus of 5.2 million bbls/d of production offline. Since its June 2024 announcement that it would return 2.2 million bbls/d of production, it has delayed doing so three times, with the latest announcement in early December, stipulating it would consider reintroducing these barrels next April over an 18-month period. In our base case, we believe OPEC+ remains supportive of oil markets and would like to see oil demand improve and support oil prices above $80. However, global inventory levels are low and remain supportive for some moderate level of OPEC+ resuming production. Nevertheless, if OPEC+ were to move forward and reintroduce the full 2.2 million bbls/d of production, we believe oil prices would collapse and be hard to sustain at levels over $50/bbl.

Natural gas demand and prices are set to rebound. Natural gas prices, especially in North America, have been very weak, largely due to a warm winter last year, record production, the Freeport LNG terminal being offline, and uncontrolled biproduct natural gas production from the Permian basin that does not abide by the laws of economics. Inventory levels in North America are at five-year highs, acting as a cap on prices. However, we believe that is about to change. The Biden administration's pause on LNG export permits, which has delayed LNG build out and caused confusion in the energy and capital markets, is likely to be revoked once the Trump administration takes office in January. Over the next four to five years, we expect LNG capacity buildout will likely result in LNG U.S. gas feedstock more than doubling (approximately 14 billion cubic feet per day [bcf/d]) from current levels. We expect the Permian and Haynesville basins to mostly benefit given their proximity to the Gulf of Mexico. Some producers in the Marcellus basin will not garner higher realizations at the Henry Hub due to a lack of take-out capacity. Given the difficulties of gaining approval of the Mountain Valley Pipeline, it is unlikely additional pipeline capacity from the Northeast to the Gulf will be approved and constructed. It's unlikely the Trump administration will repeal Inflation Reduction Act tax credits related to solar and wind. However, early expiration of the credits could be on the table, which would increase power supply uncertainty. This could present an opportunity for natural gas to address any supply concerns and shortfalls.

Another tail wind for natural gas is the significant amount of datacenter build out that is occurring. The power markets, after experiencing 0% growth over the last 10 years thanks to energy efficiency and reduced power usage, are about to undergo a generational growth phase. Several market reports have put the compound annual growth rate of U.S. power demand at an average of 2.5%-3% through the end of the decade.

What this ultimately means for natural gas demand is difficult to quantify because a lot of this growth likely will be met through renewables. However, various estimates of gas demand increasing range anywhere from 3 bcf/d to potentially 12 bcf/d. We estimate that U.S. data centers' increasing energy demands will lead to additional gas demand of between 3 bcf/d and 6 bcf/d by 2030. Our model of data center energy demand growth (see "Data Centers: Surging Power Demand Will Benefit And Test The U.S. Power Sector," Oct. 22, 2024) concludes that if 50% of incremental capacity comes from natural gas-fired units (including baseload and peak suppliers), the grid would require up to 50 gigawatts of incremental generation supply. Up to 3 bcf/d of this demand could be met with natural gas. That estimate may change depending on the energy mix that serves data centers, with a greater share of natural gas potentially increasing incremental demand from data centers by as much as 6 bcf/d by 2030. Total natural gas demand in the U.S. in 2023 averaged about 89.1 bcf/d, of which the power sector was the largest consumer at about 35.4 bcf/d, according to the U.S. Energy Information Administration—a 7% increase over 2022.

Credit metrics and financial policy

Although we have lowered our hydrocarbon price decks on several occasions during the year, they remain supportive of credit quality. We have flat West Texas Intermediate and Brent oil prices for the next three years at $70 and $75 per barrel, respectively. Our Henry Hub and Canadian Alberta Energy Co. (AECO) natural gas decks increase along with the expected demand pull from LNG and datacenter build out. Our Henry Hub and AECO price decks for the next three years are at $3.25, $4.00, and $4.25 and $2.25, $3.00, and $3.25, respectively. We expect companies to allocate more cash flow toward shareholder rewards rather than debt retirement given the lack of maturities and balance sheet targets being met. We anticipate global capital expenditure (capex) growth in the low-single-digit percent area, largely driven by international spending. We believe companies will continue to conduct most M&A in a credit-friendly manner.

Key risks or opportunities around the baseline

1. New U.S. administration could impose tariffs.

Tariffs could result in slightly higher gasoline prices in some part of the U.S. and lower realizations for Canadian producers.

2. Refining margins could have more downside risk in the next few years.

The key drivers that could affect weaker margins include weaker demand growth than expected, higher EV penetration, and slower capacity rationalization to rebalance supply and demand. However, carbon costs in certain regions will also come into play, which could affect the pace of structural changes that could have an outsized influence on margins and profitability.

3. Financial policies relax in the face of softer prices and margins.

Financial discipline has been a sector watch phrase for most public companies. We see a risk that some seek to sustain both capex and meaningful returns to shareholders in spite of lower cash generation

Higher trade tariffs could reduce global oil demand. President-elect Trump, during his campaign, said he will impose tariffs on imported goods, especially on Chinese products. If they are to be implemented, the level and duration are unknown at this point. But anything significant would have the effect of lowering global oil demand, which, given the current weakened demand picture, could affect oil prices. A tax on Canadian and Mexican oil and oil products could raise the cost of gasoline for U.S. consumers, something we believe Trump is against. Across regions, diesel is more vulnerable to higher tariffs than gasoline or jet fuel. The impact of a tax on Canadian oil would likely be shared by Canadian producers and U.S. refiners, with most of the brunt shared by Canadian producers who have limited ability to import elsewhere and will be competing at the margin with untariffed heavy barrels. PADD 3 refineries would however bear the brunt of tariffs because of a lack of alternative heavy crude sources.

Mexico has the ability to reroute its largely waterborne exports to the U.S. and can thus circumvent U.S. tariffs.

While the pace of refining rationalization will be an important factor in future refining margins, carbon costs could put some regions at a disadvantage in the next few years. SPCI assumes that the EU, Singapore, California, and Northeast Asia will have carbon policies in place while the rest of the world does not. These carbon policies will likely drive the refining industry to invest in more decarbonization, such as producing lower emitting biofuels and renewables, and possibly a move into petrochemicals. However, the cost to decarbonize will also likely drive refining companies to avoid such regions because of the lower profitability and investments required to be compliant. We have already seen this occur in the California market and expect more rationalization in Europe. It remains to be seen how competitive refiners burdened with a carbon regime will be in the global market and if certain compensation mechanisms or subsidies will be put in place to allow products produced in these regions to compete with barrels that do not have the same cost structure. At a minimum, we think refining margins could at times have significant volatility and downward pressure depending on the pace of such changes.

Since 2020, reducing debt and bolstering balance sheets have been themes across the sector but especially for largest integrated companies. As both oil prices and refining margins continue to decrease from 2022 levels into 2025, we may see some differentiation between companies. The way management teams elect to deploy likely significant but lower cash flows and the extent to which balance sheets are used to maintain shareholder distributions could result in companies' financial profiles diverging from their typically strong year-end 2023 positions. Most companies have some—or even significant—financial headroom at their ratings, with reported credit metrics comfortably above our cash flow coverage thresholds. We are alert to this headroom being eroded in our forecasts for 2025 and beyond, by both lower prices and cash flows, as well as the incremental year-on-year consequences of net debt increases, if internally generated cash flows don't cover net investments and shareholder returns on a consistent basis.

Related Research

- Energy Brief: Energy Supermajors' Share Buybacks May Strain Their Credit Profiles, Dec. 17, 2024
- Commodities: Could Oil Prices Shock The Global Economy?, Dec. 4, 2024
- Data Centers: More Gas Will Be Needed To Feed U.S. Growth, Oct. 22, 2024
- S&P Global Ratings Revises Its Oil Price Assumptions; North American And Dutch Title Transfer Natural Gas Price Assumptions Unchanged, Oct. 1, 2024
- Occidental Petroleum Corp.'s CrownRock Acquisition Delays Potential Return To Investment Grade, Aug. 19, 2024

Industry Forecasts: Oil and Gas

Chart 9
Revenue growth (local currency)

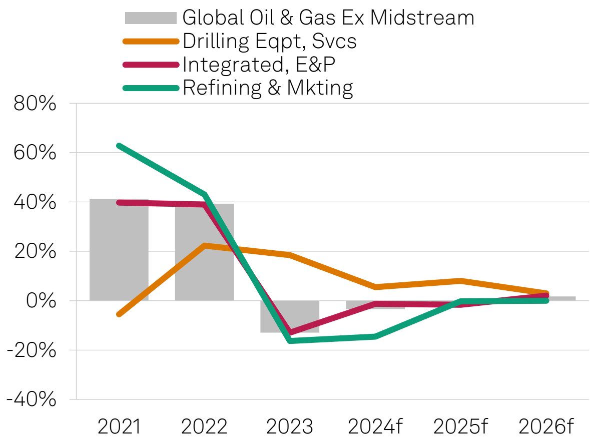


Chart 10
Capex Growth (USD, adjusted)

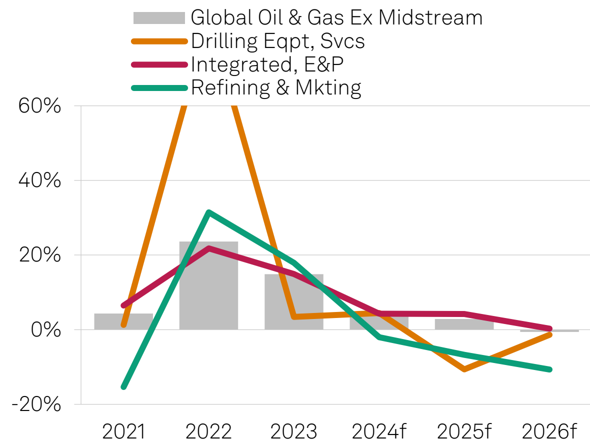


Chart 11
Debt / EBITDA (median, adjusted)

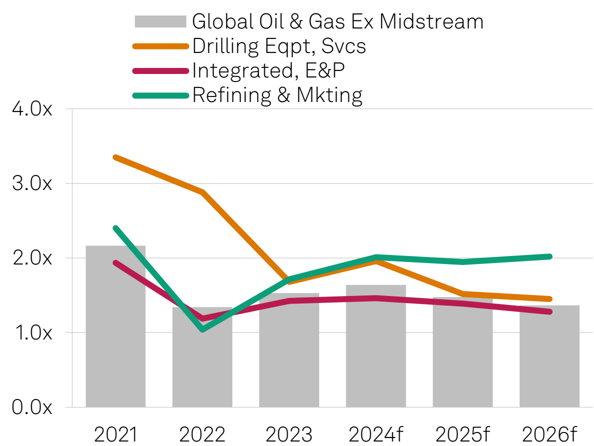
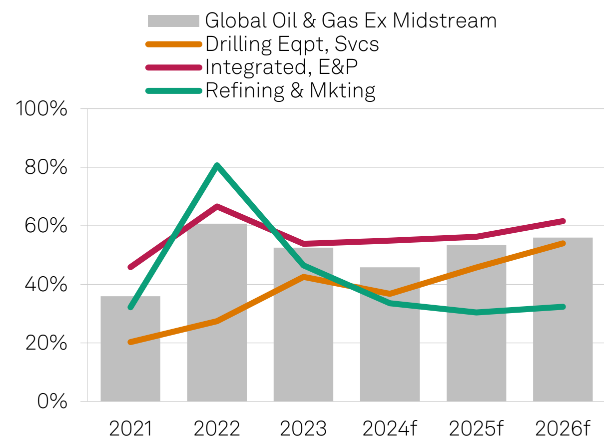


Chart 12
FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Oil and Gas

Chart 13

Cash flow and primary uses

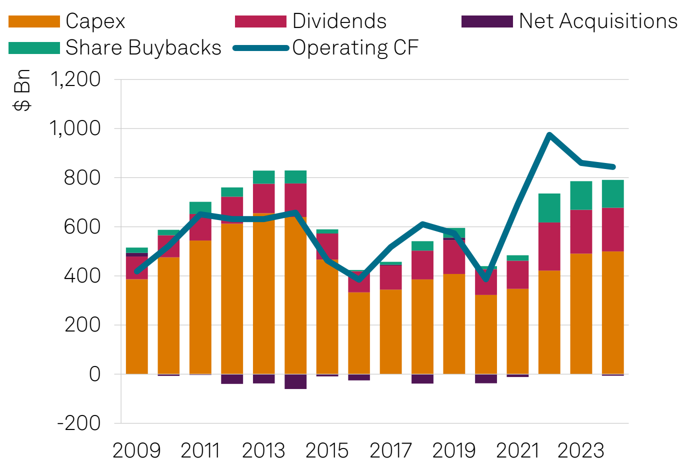


Chart 14

Return on capital employed

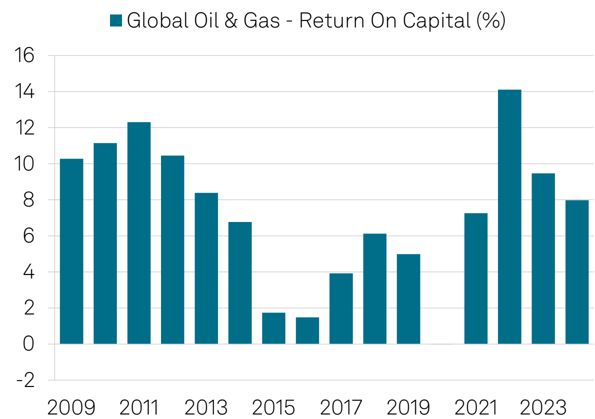


Chart 15

Fixed- versus variable-rate exposure

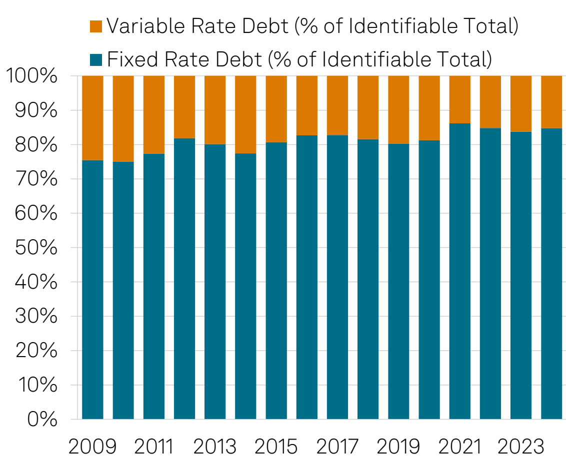


Chart 16

Long-term debt term structure

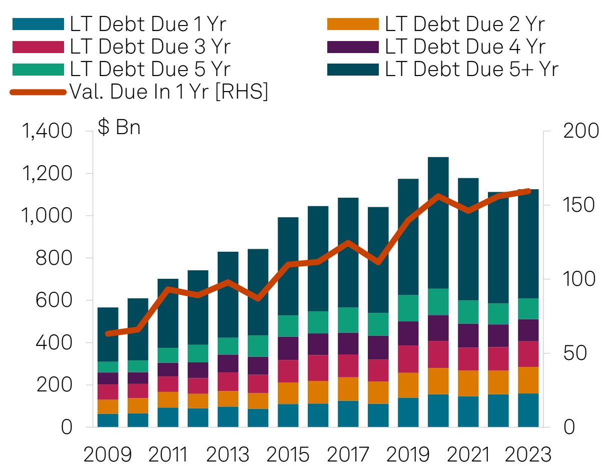


Chart 17

Cash and equivalents / Total assets

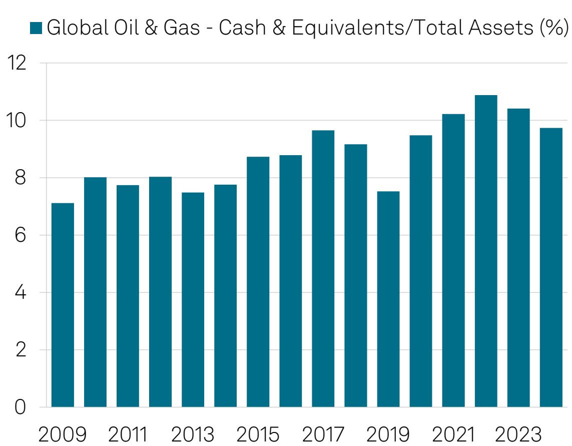
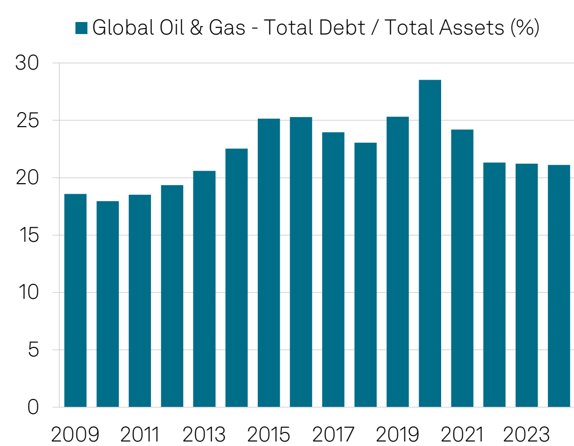


Chart 18

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Real Estate

Office REITs lag the sector's recovery

January 14, 2025

This report does not constitute a rating action.

What's changed?

Lower interest rates drive sector recovery, improving operating conditions and stabilizing asset valuations.

Improving access to capital alleviates some refinancing risk. Lower rates, tighter bond spreads, and recovery in equity prices will help companies refinance at lower costs.

Asset values will stabilize for most property types because valuations have reset at higher cap rates, though lower quality office properties are still under pressure.

What are the key assumptions for 2025?

Modest operating metrics improvement. We expect positive rental growth across most assets, but some office assets may see further deterioration.

Improving transaction activity. As valuations stabilize, landlords will have better ability to sell assets to improve financial flexibility.

Refinancing risk remains manageable for most due to recent rate cuts, improving access to capital, and other capital initiatives.

What are the key risks around the baseline?

Higher-than-expected interest rates could delay credit metrics improvement, which could keep financing costs high, pressuring credit metrics.

Landlords fail to monetize assets to deleverage on a timely basis. Inability to sell assets could limit financial flexibility.

More aggressive growth plans could jeopardize credit quality. Accelerating acquisitions, increases in dividends, or share repurchases could pressure ratings.

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Ratings Trends: Real Estate

Chart 1

Ratings distribution

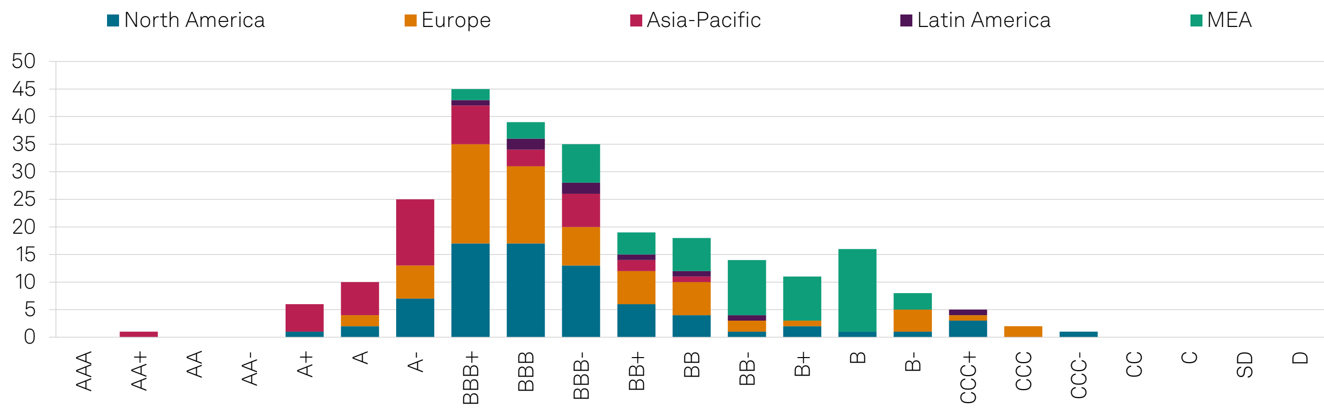


Chart 2

Ratings outlooks

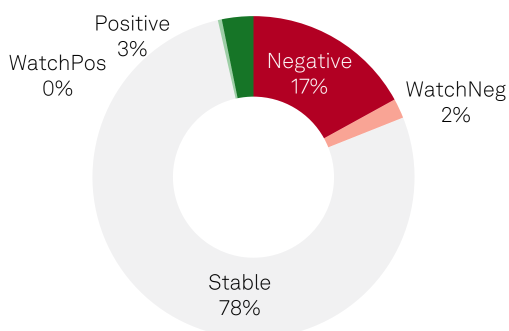


Chart 3

Ratings outlooks by region

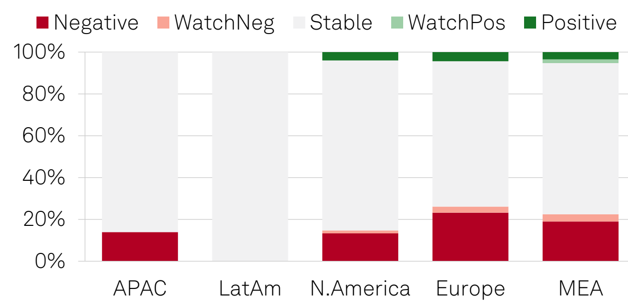


Chart 4

Ratings outlook net bias

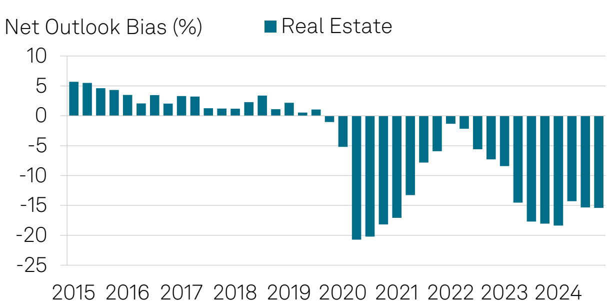
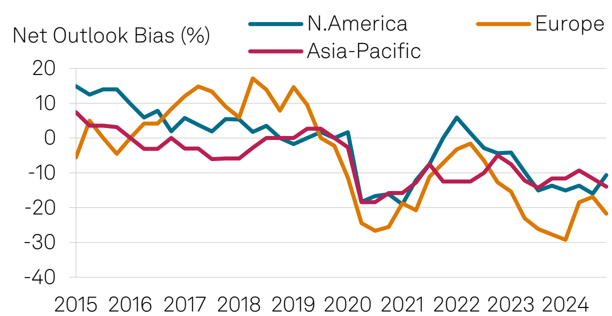


Chart 5

Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook: U.S. REITs

Ratings trends and outlook

We maintain a negative ratings bias on U.S. office REITs (about 36% of ratings have a negative outlook). Leverage for office REITs remains elevated compared to other property types, and material improvement among office REITs is unlikely in 2025 given below-average utilization and weak tenant retention relative to pre-pandemic levels. That said, office REITs' operating metrics are beginning to stabilize and access to capital has improved modestly following recent interest rate cuts.

In 2024, we downgraded 18 U.S. REITs and upgraded five. Most of the downgrades were because office REITs faced operating pressure from secular headwinds, and higher borrowing costs deteriorated their credit metrics. By contrast, we upgraded three retail REITs due to solid performance, increasing demand for high quality spaces, and improving credit metrics.

We expect downgrades will moderate in 2025.

Main assumptions about 2025 and beyond

1. Slower-than-expected rate cuts.

This may keep borrowing costs elevated through 2025, which could mute acquisition appetite.

2. Recovery in demand modestly improves operating metrics.

Demand for retail, housing, and health care assets remain resilient, with signs of stabilization in the office sector.

3. Access to capital has improved, and equity issuance is up year over year.

We expect volumes of transactions will increase in 2025 and improving equity prices will provide REITs better access to capital.

Elevated interest rates could pressure cash flow. We expect the Fed will cut interest rates more gradually than we previously anticipated. Despite a cumulative 100-basis-point rate cut in 2024, interest rates remain elevated and could pressure credit metrics as debt maturities are refinanced at higher rates. Therefore, refinancing risk for debt maturities over the next two years remains high, particularly for struggling property types. Upcoming debt maturities could pressure liquidity and financial flexibility, particularly for many speculative-grade issuers whose weighted-average maturity of debt continues to decline.

We expect net operating income (NOI) growth will remain modestly positive, given resilient demand. Leasing activity has been robust for retail REITs given limited new supply, resulting in healthy rent growth and high occupancy levels. While an increase in supply could constrain rent growth for multifamily REITs that have exposure to sunbelt markets, we expect rental housing will remain resilient given home prices remain high, and the 30-year mortgage rate is around 7%.

Most office REITs reported relatively stable operating results in recent periods due to some recovery in leasing and relatively stable occupancy. Higher-quality office assets show signs of stability, and tenants are focusing on landlords with more robust financial health and ability to invest in property improvements. By contrast, conditions remain more challenging for speculative-grade office REITs with lower quality assets.

We expect transactions to pick up over 2025. According to Coldwell Banker Richard Ellis (CBRE), commercial real estate investment volume stabilized in the third quarter, at $90 billion, down 2% year over year. Access to capital has improved for real estate companies because of narrowing bond spreads and higher equity prices. This led to higher debt and equity issuance in 2024, with public REITs issuing about $44 billion of debt through November 2024, compared to $37 billion a year ago. We expect transaction volumes will continue to increase in 2025.

Credit metrics and financial policy

We expect EBITDA interest coverage and fixed charge coverage will remain under pressure in 2025—particularly for issuers with significant upcoming debt maturities—as interest rates remain elevated. We expect debt to EBITDA will gradually improve across most property types due to organic low-single-digit percent NOI growth, although leverage will likely remain elevated for office REITs.

Given a tighter lending environment, some issuers have opted to refinance maturing unsecured bonds with shorter-term secured debt. Issuers facing sizable upcoming debt maturities could see tighter liquidity and financial flexibility, particularly for some office REITs and speculative-grade issuers. Because average debt maturity profiles shortened over 2024, we applied a negative capital structure modifier to several REITs with weighted maturity profiles of less than three years.

We expect the financing environment will improve as additional rate cuts boost REITs' access to capital markets. As financing costs decline, transaction activity could also gain momentum with more price discovery from an increased volume of transactions, which would support asset valuations. Historically, interest rate cuts have been positive for real estate given the sector's capital intensity. We expect asset values will stabilize after the reset in cap rates for most property types, although the office sector could remain under pressure.

We expect U.S. REITs will increase their acquisitions in 2025 as cap rates stabilize. We expect well-capitalized REITs with balance sheet capacity will pursue a more normal level of acquisitions following a period of muted activity.

Key risks or opportunities around the baseline

1. Rates remain elevated for longer due to inflationary pressure.

Higher-than-expected inflation could keep interest rates higher than expected. This could delay the recovery in credit metrics.

2. Recovery of office REITs more robust than anticipated.

Signs of stabilization in leasing trends are emerging for certain markets and continued momentum could lead to better-than-expected rental growth and occupancy trends.

3. More aggressive growth plan that results in higher leverage.

A more aggressive acquisition strategy, particularly for higher-rated REITs, could pressure credit metrics if funding is largely debt-financed.

S&P Global economists expect inflation will remain above the 2% target for longer than expected, with the 10-year Treasury rate staying around 4% over the next year. If inflation remains elevated for longer, the pace of interest rate cuts could also be delayed. This could stall the improvement in credit metrics and limit transaction activity.

The recovery of office demand could be stronger than expected due to better-than-expected job growth or if tenants decide to expand their footprints as employers implement stricter return-to-office (RTO) policies.

Following a period of low acquisition activity, we expect REITs will increase growth through higher acquisitions and development activity. While we expect rated REITs will remain disciplined in their growth strategies, larger-than-expected debt-funded acquisitions could pressure credit metrics.

Industry Outlook: European REITs

Ratings trends and outlook

Since 2022, 20 European real estate companies have been downgraded. In the beginning of 2024, 27% of rated European REITs had negative outlooks or were on CreditWatch with negative implications, which is an improvement from 33% a year before. Most asset classes saw significantly improving funding conditions and stabilizing valuations.

Rated European REITs bond issuances reached €19.3 billion in 2024, an increase from €17.0 billion and €5.3 billion in 2022 and 2023, respectively. We expect the sector will continue to improve in 2025.

Main assumptions about 2025 and beyond

1. Rental income growth will normalize, not stabilize.

We believe rental income will remain positive across most property segments. Low supply will support rents and occupancy.

2. Valuations will be stable, except for nonprime offices.

Government yields have decreased and somewhat stabilized, so valuations will increasingly be the result of rent growth expectations and capital expenditure (capex) requirements. However, nonprime offices, which face rising vacancy and obsolescence, could lose more value.

3. Investment market will revive gradually.

Transactions will likely resume in 2025 as funding conditions improve. Moreover, repricing is reducing the price gap between buyers and sellers.

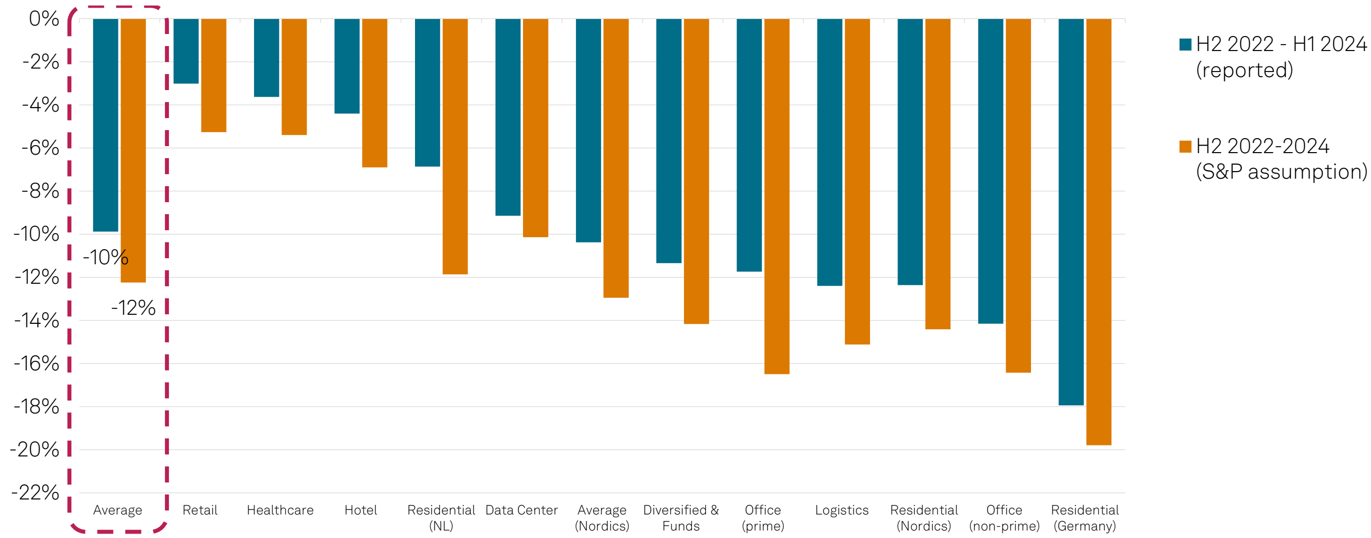
Rental income will grow in 2025 for most asset classes, albeit more moderately than 2024 due to lasting tailwinds from inflation. We forecast CPI inflation in the Eurozone will be 2.1% in 2025, down from 2.4% in 2024. We also expect rental growth will benefit from improving consumption levels and increasing GDP growth. We expect real GDP growth will reach 1.2% in the Eurozone in 2025, versus 0.8% and 0.5% in 2024 and 2023, respectively. Residential rents will continue to be supported by a strong housing shortage, particularly in Germany and Sweden, and elevated indexation. Retail landlords will likely benefit from rising real disposal income as inflation fades, after successfully passing on a large part of inflation to tenants via rent increases.

Most valuations have stabilized, except for nonprime offices, which we believe could continue to experience difficulties in 2025. Between June 30, 2022, and June 30, 2024, asset valuations of European REITs declined by about 10% on average (chart 6). We expect the European Central Bank (ECB) will cut its deposit rate to 2.5% by the summer of 2025, from 3.25% currently, and maintain that rate over the following two years. Therefore, we think long-term rates will remain stable and no longer affect property yields in the coming appraisals.

Chart 6

Reported devaluations are still within S&P Global Ratings' expectations

Valuation LfL growth since June 2022 for rated REITs in EMEA, reported versus S&P Global Ratings' assumptions, as of Sept 2, 2024



LfL—Like-for-like. Source: S&P Global Ratings.

On the other hand, rental growth expectations and capex requirements will increasingly determine valuation changes. We think nonprime offices, which face growing vacancy and renovation needs, will therefore continue to see further devaluations.

Acquisitions will increase in 2025. We believe improving funding conditions will reduce the risk of distressed sellers and leave buyers with more funding options. The wide repricing that most properties underwent in the last 24 months will likely reduce the bid and ask gap, as evidenced by lower discount between share price and net asset value (NAV). Transactional activity is an important consideration for real estate companies because it sets a benchmark for their portfolio valuations, which, in turn, affects their loan-to-value (LTV) ratios.

Transactions in Europe are recovering from the very low level of 2023, but they were still 41% below the five-year average in the first nine months of 2024, according to Savills Research. Large institutional investors that were constrained by allocation limits following commercial real estate (CRE) losses in 2022 and 2023 could make a comeback in 2025 as the situation improves.

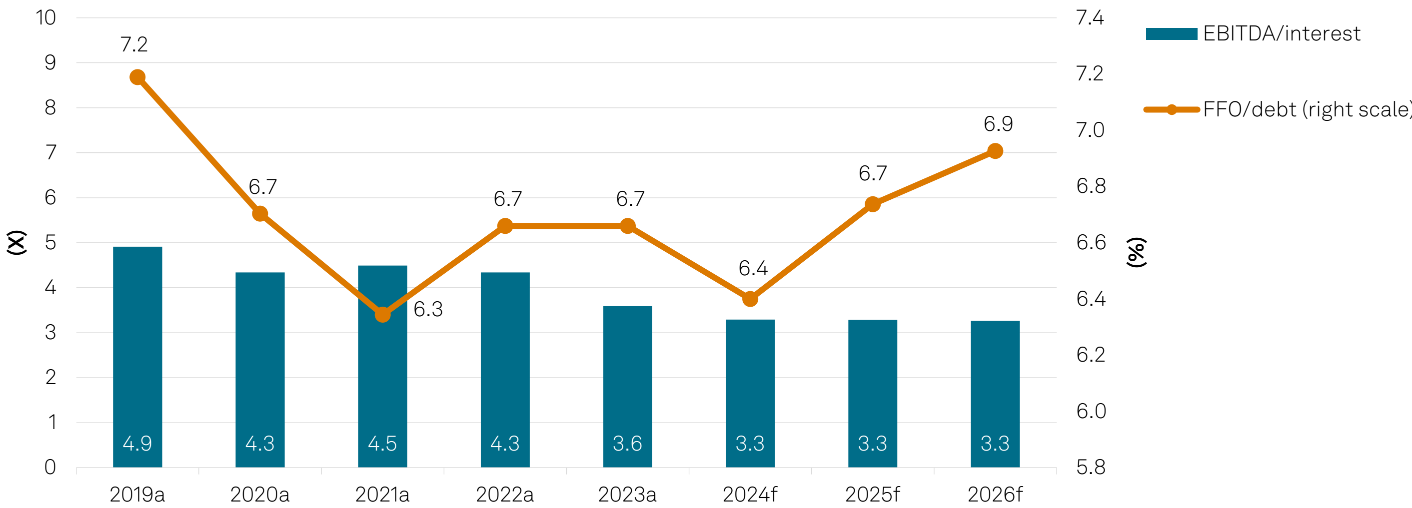
Credit metrics and financial policy

Interest coverage ratios (ICRs) will have bottomed out for 62% of issuers by the end of 2025. We expect average ICR will stabilize around 3.3x in 2025 from 4.5x in 2021 (chart 7). This is because companies' debt profiles are highly hedged or fixed with staggered debt maturities and lower absolute debt. Funding conditions are improving, with yields and REITs' spreads decreasing sharply since the beginning of 2024 ahead of likely rate cuts by the ECB. This is helping real estate companies refinance their debt maturities at more moderate rates than in 2023; it also benefits those exposed to variable rates.

Chart 7

ICR stabilizes, and FFO to debt improves

Average ratios for rated REITs in EMEA, as of Dec. 17, 2024



a—Actual. f—Forecast. Source: S&P Global Ratings.

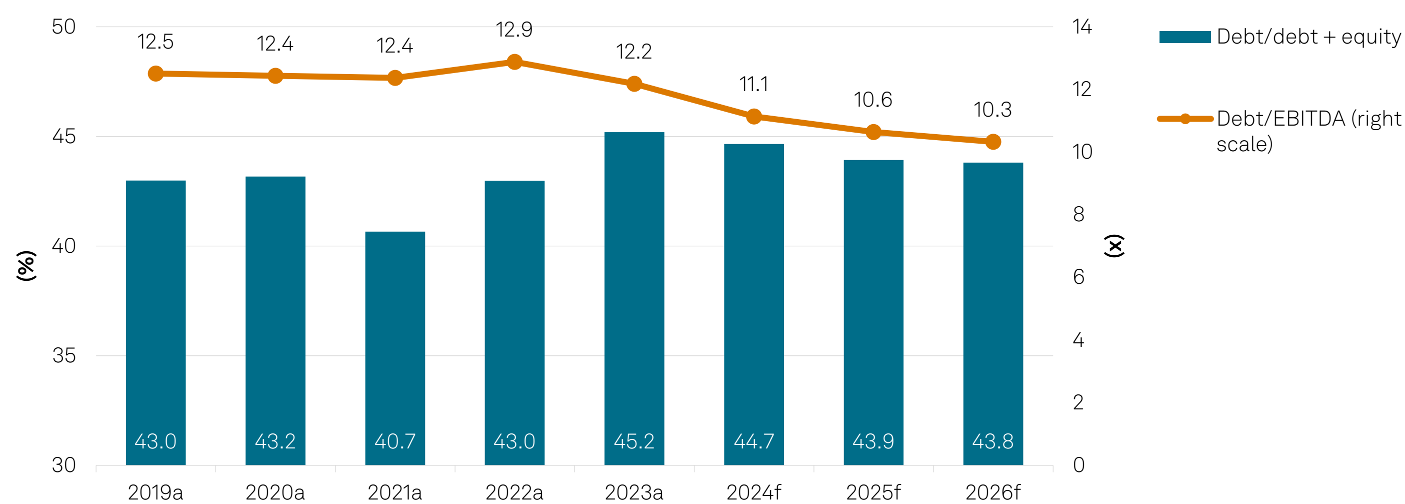
At the same time, rental income growth remains robust across most segments because of the lasting tailwinds from inflation indexation and the low supply. We therefore estimate that 47% of companies have already seen their ICR reach the bottom in 2024, and another 10% will do so this year. We anticipate the remaining 43% will see ICR bottom out in 2026 or later, though the pace of decline will be more moderate.

Debt to debt and equity will decrease by 0.5-0.7 percentage points (ppts) every year, on average, after peaking at 45.2% in 2023 (about 5 ppts higher than 2021; see chart 8). This is due to our expectations of stabilizing asset valuations and some deleveraging effects. Renewed appetite for investments as market conditions improve could temper the improvement in this ratio.

Chart 8

Both debt to EBITDA and debt to debt and equity should improve

Average ratios for rated REITs in EMEA, as of Dec. 17, 2024



a—Actual. f—Forecast. Source: S&P Global Ratings.

Debt to EBITDA will likely continue to improve because we expect revenue will continue to grow on a like-for-like basis and most debt-funded investments have been halted in recent years. We anticipate more free operating cash flow (FOCF) in 2024 than in the past five years.

Funds from operations (FFO) to debt is remarkably resilient despite rising funding costs. Robust rental income growth continues to offset more elevated interest burden, such that the ratio will likely increase steadily.

Key risks or opportunities around the baseline

1. Resumption of acquisitions and dividends may jeopardize deleveraging targets.

Some opportunistic transactions may arise for REITs, particularly for stronger players. Dividends could also resume following strong operating performance.

2. Geopolitical risks could delay the sector's recovery.

This could disrupt investors' appetite and affect government yields, which ultimately could limit asset valuations' recovery. Any negative impact to economic sentiment, job market, or consumption could also erode tenant demand.

3. Growing environmental requirements would weigh on capex.

Tighter regulation around properties' energy performance would require REITs to further increase renovations capex while the cost of capital remains high, and most REITs are still focused on deleveraging.

Opportunistic acquisitions and dividends could delay deleveraging targets. Following the weakening of LTV and ICR, REITs have been focused on deleveraging to comply with long-term ratio guidance. This mostly occurred through capex and dividend cuts.

However, the strong improvement of funding conditions and the stabilization of some REITs' capital structures could prompt companies to resume opportunistic acquisitions. Property yields have increased, and some well-funded acquisitions could even improve ICRs. Most companies reported strong operating performance lately, and revised their guidance upward, suggesting dividend distributions could normalize.

Geopolitical developments could delay the recovery of the property sector, by limiting investments. Increasing pressures on governments' budgetary decisions could also affect government bond yields. Higher yields due to perceptions of greater sovereign risk would, in turn, weigh on asset revaluations as property appraisers use these yields as risk-free rates in their property yield assumptions.

A more hostile and uncertain global environment could further erode Europe's economic security, weigh on consumer confidence, and bolster savings at the expense of consumption and growth. Stagnating growth would be detrimental to corporate credit performance and could imply lower demand for commercial real estate.

Growing environmental requirements could weigh on REITs' balance sheets. European REITs are progressing toward their decarbonization targets for this decade, but longer-term goals remain challenging and will involve significant investments. Buildings are responsible for about 40% of energy use in the EU, which aims to fully decarbonize buildings by 2050. The revised Energy Performance of Buildings Directive, which took effect in May 2024, will likely lead to a wave of renovations.

Industry Outlook: Asia-Pacific REITs

Ratings trends and outlook

The outlook on Asia-Pacific (APAC) rated REITs and real estate landlords remains predominantly stable (87% of the portfolio), which we expect will continue in 2025. That said, credit quality and ratings trends remain divergent across Asia-Pacific region. The region's divergent interest rates and vacancy trends, coupled with potential disruption from planned asset sales, could translate to continued pressure to credit quality.

The credit metric buffers of landlords and REITs remains thin. That said, credit metric deterioration is slowing, but subdued market conditions will delay meaningful improvement. REITs that embark on debt-funded acquisitions or fail to execute their asset divestment plans could see meaningful pressure to their credit metrics. Tepid asset sales, lower transaction activity, and slower U.S. dollar interest rate cuts could hamper landlords' asset sale plans. Credit metrics trends will remain divergent among different commercial asset classes.

Office landlords will face more asset value declines. Valuation pressures remain for major Australian cities and Hong Kong due to oversupply and weak tenant demand. Vacancy rates in Hong Kong could rise further into 2025 as supply remains ample. The higher-than-historical-average vacancy rates and limited financial buffer will hinder landlords' ability to grow and sustain the quality of their asset portfolio.

Main assumptions about 2025 and beyond

1. Refinancing risk remains manageable for landlords.

Banks remain supportive of prime commercial assets in key Asia-Pacific gateway cities, allowing landlords to refinance their debt with longer tenors.

2. Landlords consider all available capital-management levers to bolster credit metrics.

Asset divestments, distribution payout reduction, deferral of nonessential capex, and equity fundraisings are the most common capital initiatives employed by Asia-Pacific REITs to improve credit metrics and stave off rating pressure.

3. Vacancy rate of commercial office assets in key gateway cities could rise further.

Vacancy rate of commercial offices in key Chinese cities, Hong Kong, and Melbourne, Australia could deteriorate further through 2025.

Credit metrics and financial policy

Pacific: In 2024, office Australian REITs (AREITs) protected credit metrics through asset divestments and debt reduction. We expect these capital management strategies will continue in 2025, with further potential asset sales. We also expect companies will reduce distribution payouts, raise new equity, and access third-party capital. Signs of stabilization in asset valuations in Sydney—Australia's largest office market—and the likely moderation of increases in interest and capitalization rates in 2025, will likely support future asset sales. We note office landlords will seek to balance the undertaking of asset divestments with the potential adverse impact this would have on their asset portfolio's scale and competitive position.

Despite subdued consumer confidence and cost-of-living pressures, our rated retail landlords continued to report robust shopper footfall and retail sales in 2024. In 2025, we expect increased consumer spending, real wage growth, and contained inflation will offset cost-of-living concerns. We forecast this will underpin continued retail growth, particularly in nondiscretionary segments and benefit retail AREITs. This has prompted the recent pickup in transactional activity as equity investors look to deploy capital in the sector.

We expect vacancy and incentive rates in the industrial sector will continue increasing in 2025, albeit from a relatively low base. Given subdued economic conditions, we expect retailers will more prudently manage inventory levels and space utilization in distribution warehouses. That said, we expect credit metrics of industrial AREITs to remain stable because they have a significant exposure to high quality, well located, and highly diversified industrial assets with long leases.

Hong Kong: We expect the credit metrics of rated REITs and landlords in Hong Kong will be pressured in 2025. Weak office leasing demand and rising supply will continue to further push up vacancy rates and suppress rents. The decline in retail sales is also contributing to weaker retail rents, pressuring landlords. Rated landlords are in a better position, because they own quality assets in prime locations with good diversification across office, retail, and hotel.

We do not expect any sizeable debt-funded acquisitions because owners will seek to sell assets to reduce debt levels. While interest rates appear to have peaked, they remain high relative to previous levels. As a result, we expect our rated issuers' interest coverage will slightly increase from 2024 levels. We believe our rated issuers will maintain lower dividend payouts and retain cash flow to meet their fixed obligations.

China: In general, office leasing demand is weak due to waning business confidence. Companies are reducing rents to limit vacancy levels. Office vacancy rates in key cities are at 20% or above as of September 2024, with Guangzhou's vacancy rate slightly lower at about 18%. The retail landlords are displaying some resilience, though slowing retail sales indicate more weakness in the coming year. As a result, we forecast Yue Xiu Real Estate Investment Trust's (BBB-/Negative) credit metrics will be constrained in 2025 despite its quality assets in tier-one cities. We also expect to see more asset divestments from the broader market. This could be through direct sales or setting up additional REIT platforms, encouraged by government policies. There will be limited appetite for acquisitions.

Japan: We expect the credit metrics of rated Japanese REITs (JREITs) and landlords will remain stable in 2025. As the supply of office space in Tokyo increases in 2025, we expect the improvement in central Tokyo's office vacancy rate to hover around 5%. The vacancy rate improved from 6.0% at the end of 2023 to around 4.5% in 2024. The average office rent increased in 2024 due to limited new supply and strong corporate performances. The performance of rated issuers will be supported by their high-quality, well-located portfolios, which we expect will remain resilient.

We expect retail store sales will grow steadily due to increased tourism. We also predict condominium rents will grow steadily following the return of population growth in Tokyo. This is also supported by higher condominium sales prices due to limited land supply and higher construction cost for condominiums.

Rated issuers will continue to fund investments through debt, equity, and proceeds from asset divestments to maintain credit metrics consistent with their financial policies. We expect strong interest-coverage ratios, long average debt durations, and a high proportion of fixed-rate debt for rated issuers to underpin their credit quality.

Singapore: We expect the credit metrics of most rated Singapore REITs (SREITs) to remain stable in 2025. This is supported by sound portfolio quality and our expectation that most REITs will manage their debt usage in a prudent manner. That said, most rated SREITs have limited headroom for sizeable debt-funded asset acquisitions and enhancements.

We expect commercial office leasing conditions will weaken because rent has become stagnant amid higher vacancies. This is particularly true for older and lower quality offices. On the retail front, improving tourism activities will improve performance at downtown malls, though manpower shortages and high operating costs may limit retailers' ability to pay higher rents. Continued rise in business and leisure travel to Singapore will underpin higher occupancy and average room rates of hospitality assets.

Key risks or opportunities around the baseline

1. Landlords fail to monetize assets to deleverage on a timely basis.

Higher-for-longer interest rates in Australia could keep purchasers on the sidelines, stymieing landlords' efforts to deleverage. Sales of office assets at depressed prices will exert further downward pressure on office valuations.

2. Average funding costs stay high for longer, hindering recovery in credit metrics.

Landlords may face higher funding costs at the next fixed-rate debt reset. Faster-than-expected interest rate hikes in Japan and sluggish revenue increases could dent Japanese landlords' credit metrics.

3. Return-to-office-initiatives could improve office demand in the medium term.

This would increase physical office usage and ease the trend for tenants to downsize their space requirements. Australia would benefit the most in the region given their higher adoption of hybrid working.

Pacific: The ability of office AREIT landlords to execute on asset divestments in a timely manner is a key risk. With elevated interest and capitalization rates, office landlords are pursuing asset sales to reduce debt and shore up weakened credit metrics. Asset sales proceeds applied to debt reduction will repair the credit metrics but could also weaken the business risk assessments of office AREITs.

Beyond fiscal 2025, we forecast new developments will be limited across our rated office landlords as they balance higher construction costs and uncertain tenant precommitments. Landlords will need to balance asset divestments with a diminishing asset portfolio.

Hong Kong: A prolonged weakness in office leasing demand is a key risk for REITs and landlords in Hong Kong. Due to weaker-than-expected economic recoveries in Hong Kong and China, tenants may downsize their existing space requirements. This will make it difficult for the market to absorb the 7.9 million square feet of new, grade-A office space available by the end of 2026. Our rated issuers are responding to this surplus by offering smaller floor plate configurations to capture pockets of demand from insurance and asset management companies. They also continue to upgrade base building services to obtain green certificates to attract tenants. These improvements have helped them maintain low vacancy rate of below 10% relative to the industry average of above 13%.

Structural changes in Hong Kong's retail sector will present challenges for retail landlords. Retail sales are under pressure as tourist arrivals have yet to recover to pre-pandemic levels and Hong Kong residents are increasingly travelling overseas or across the border to China. Hong Kong retail sales have dropped by 7.6% in the first nine months of 2024 and the trend is unlikely to improve.

China: We expect office REITs and landlords in China will face pressure as the uncertain economic outlook in China weighs on business sentiment. Potential higher trade tariffs on China's imports to the U.S. is adding more uncertainty and will likely suppress economic growth. As a result, office leasing demand will remain weak, which will pressure rent and vacancy levels over the next year. However, issuers will be resilient because their assets are in tier 1 cities with less new supply.

Slowing retail sales could be another risk, and a rising number of shopping malls will lead to more competition for tenants.

Japan: Larger-than-expected interest payments, operating costs, and capex among Japanese REITs would decrease profitability; increasing net operating income and improved occupancy rates would not be able to offset the effect. It would also undermine rated issuers' portfolio asset values and reduce their interest coverage ratios.

Because rated landlords are focusing on profit growth and improving capital efficiency, more aggressive investments or shareholder returns could increase their debt burden relative to cash flow, and financial buffers would be thin. Rated landlords could see higher volatility in earnings if their real estate development and sales business contributes more to their profits.

Singapore: Rated SREITs could seek to expand their portfolio or pursue asset enhancement initiatives to upgrade their portfolio quality. Investments could be funded by asset recycling, on an opportunistic basis, or with debt. Debt-funded growth will stress credit metrics. While REITs can decrease leverage with asset sales, execution risk can delay or limit balance sheet repair.

Industry Outlook: Latin America Real Estate

Ratings trends and outlook

The outlook on Latin American (LatAm) rated real estate operators remains predominantly stable (78% of the portfolio), which we expect will continue in 2025. We expect a relatively stable operating environment for REITs, with decreasing interest rates in most countries, except for Brazil, although our current economic forecasts consider a slowdown in consumption and investment in the region.

Trade uncertainty threatens growth, especially for industrial portfolios in the region. This could stall the nearshoring trend, which incentivized higher capital expenditures and acquisitions. Though an increase in trade protectionist policies by the U.S. poses a downside risk to our projections, our base case assumes no new tariffs on LatAm. Funding needs for industrial operators will likely decrease, although financing is available and committed in most cases.

We expect retail portfolios will perform relatively well due to resilient consumption trends, and office properties are slowly gaining back occupancy after high vacancies during the COVID-19 pandemic. We expect this trend will continue, although our rated portfolio in the region has little exposure to office properties. We believe that retail and office operators' funding needs will be low, like last year, given the absence of significant gross leasable area (GLA) growth in these asset classes.

Main assumptions about 2025 and beyond

1. U.S. trade protectionism will discourage growth.

Though we assume no tariffs for LatAm countries, we expect news headlines will stall demand, especially for industrial assets, which are mostly geared toward manufacturing of goods for export.

2. Office properties have bottomed.

Office properties have high vacancy rates of close to 20% (roughly double pre-pandemic levels); however, we expect some improvement in 2025 as some businesses bring employees back to the office.

3. Moderate rental income growth for retail properties.

We expect occupancy rates for retail properties will modestly grow in 2025 because these assets have almost fully recovered to levels within 90%-95%. We estimate rental income will continue to grow, at uneven paces within the region.

Trade uncertainty will lead to lower growth and some deleveraging. We do not anticipate universal tariffs by the U.S., or changes to the United States-Mexico-Canada Agreement (USMCA) before the scheduled July 2026 review. However, we believe news headlines will discourage new investments in the region, making development pipelines more selective. We expect this will translate to lower financing needs and modest deleveraging.

We estimate acquisitions and capex will decline in 2025 for Mexican entities, following a strong expansion in 2024. These were funded with a mix of debt and equity, leading to a relatively neutral credit impact on the companies. Moreover, for new properties, we expect a stabilization period will lead to high-single-digit percent EBITDA growth. We also expect some noncore asset divestments due to high industrial property valuations, with proceeds used mostly to pay down debt.

Portfolio growth in Brazil will mostly come from industrial portfolios because we forecast a greater reliance on debt to finance development projects in 2025. However, we expect incremental leverage will be moderate, largely offset by rental income and EBITDA growth, supported by stronger operating indicators.

Rental income for retail assets will grow at uneven paces. With the increasing adoption of e-commerce among Brazilian consumers and retailers, we anticipate these entities will achieve average revenue growth in the high-single-digit percent. This contrasts with expectations in Mexican and Peruvian entities, where we expect revenue will grow 0%-5%, given lower inflation, slow consumption, and little GLA growth. However, because roughly 90% of rental income comes from fixed rent agreements, we don't anticipate a sharp contraction even if consumption drops.

Most financing activities will be related to rolling over existing debt. The weighted-average debt maturity profile of the LatAm portfolio is close to four years, with short-term debt maturities comprising around 10% of total debt. Access to capital remains fluid, resulting in very low refinancing risks. Moreover, although we expect interest rates will continue to decrease, financing costs remain above levels from two to three years ago. Nonetheless, we expect coverage ratios will modestly improve, because we estimate EBITDA growth will outpace pro forma refinancing costs.

Credit metrics and financial policy

We expect deleveraging during 2025 and steady coverage ratios. Industrial REITs deployed relatively high levels of capital in 2024, using debt and equity proceeds to fund development projects and acquisitions. We expect lower activity in 2025. Stabilization of newly constructed properties and asset divestments from acquired large portfolios will likely lead to deleveraging of rated entities in Mexico.

In Brazil, we expect some debt-funded developments in industrial assets, though we expect rental income and EBITDA growth will offset incremental debt. For retail and office portfolios, we expect an improvement in rental income, mostly among Brazilian entities, which don't have major projects in the pipeline, thereby keeping leverage metrics relatively stable.

On average, we expect rated LatAm real estate entities will maintain solid credit metrics for 2025, with debt to capital of 30%-35%, EBITDA interest coverage of about 3.9x, net debt to EBITDA in the 5.0x-6.0x range, and funds from operations (FFO) to debt of about 20%-25%.

Key risks or opportunities around the baseline

1. More aggressive U.S. protectionist measures will slowdown nearshoring.

The incoming U.S. administration has been vocal on potentially imposing tariffs on Mexico, Canada, and Brazil, which would impact industrial portfolios in the medium term.

2. Reflation concerns grow in Brazil.

Fiscal risks facing Brazil may impact the profitability of retail portfolios through erosion of purchasing power.

3. Geopolitical risks remain high, looming over global supply chains.

The geopolitical climate supports the relocation of supply chains, in favor of regional manufacturing hubs. This remains an opportunity for LatAm, especially Mexico, given its closeness to the U.S. consumer end market.

Crosscurrents at industrial assets. The current baseline scenario is that the U.S. won't impose tariffs on imports from LatAm countries. Nonetheless, we acknowledge the high level of uncertainty. The risk of any type of tariff materializing, even if only temporary, is a significant demand headwind for industrial assets. This is especially true in Mexico, where there are large industrial portfolios completely integrated within supply chains that produce goods for the U.S. market. Moreover, although we don't expect an immediate effect in outstanding lease agreements, potential renegotiations or terminations are a clear knock-on effect for real estate operators.

In our view, this uncertainty will take a toll on the development pipeline until there's more visibility on the U.S.-Mexico trade front. However, we'd expect the short-term impact to be relatively mild because most of the rated portfolio has lease agreements beyond three years, sometimes close to 7-10 years and largely dollarized, reducing any risk from further MXN-USD exchange rate depreciation. However, the imposition of tariffs has the potential to decrease occupancy rates in the medium term.

The reshoring of supply chains is an opportunity for Mexico. The need to reshore closer to the U.S. end market has increased over the past years, given global supply chain disruptions, geopolitical conflicts, and the U.S.-China decoupling. This strongly positions Mexico to continue capturing some of these investments. In the past two years, we've seen lease spreads around 20% on an annual basis (30%-40% in premium locations), while occupancy rates remain around 98% and with several sold-out submarkets in northern Mexico, reflecting high net absorption rates.

As businesses navigate these crosscurrents—balancing tariff-induced challenges with the strategic advantages of regional manufacturing—the outlook for industrial real estate assets in Mexico and LatAm remains complex for 2025. We expect greater financial prudence regarding the use of debt and capital deployment this year.

Fiscal risks facing Brazil may exert upward pressure on the country's inflation. This could negatively impact the purchasing power of the Brazilian population, posing a risk to retail portfolios, because declining sales tighten retailers' capacity to cover operating expenses—such as leases—heightening the risks of default and vacancy. Despite macroeconomic challenges, companies have intensified their investments in the expansion and revitalization of certain assets in recent years. Additionally, they own premium assets and have focused on enhancing service offerings and events in their shopping centers, which improved the attractiveness and quality of these assets, thereby partially mitigating macroeconomic risks.

Industry Outlook: Other Regions

Gulf Cooperation Council (GCC)

The outlook for this region remains positive despite escalating conflict and potentially declining oil prices. A key reason is increased government spending; for example, Saudi Arabia is implementing Vision 2030, which carries sizable upfront costs, but the country expects it will lead to longer-term social and economic benefits. In the United Arab Emirates (UAE), the governments continue to invest in infrastructure, tourism and entertainment, and regulation. Qatar, by contrast, is still dealing with excess supply across all real estate segments.

Saudi Arabia: We forecast economic growth, which benefits from strong non-oil growth that compensates for softening oil prices. Given the high level of government spending, there are opportunities for international businesses and services to enter the Saudi market. Therefore, the office segment is experiencing robust demand, with year-over-year rental growth of 11%-18% and low vacancy rates in Riyadh and Jeddah. We expect new supply in 2025 will be 10% of current stock, which will likely ease rental rates in the next 12 months.

Tourism comprises about 4% of GDP and has significant potential for growth. With easing of visa norms and expanding entertainment and sports events, we expect the country's hospitality sector will thrive. However, the retail real estate segment is struggling given changing consumer preferences to e-commerce and omni-channel shopping. While Riyadh's malls posted stable rents and vacancy below 5%, other parts of the country experienced a mixed performance. We expect future stock will be disruptive to the market as older and simpler offerings will be replaced by those with a better asset quality and shopping experience.

United Arab Emirates: We forecast strong GDP growth in 2025; 3% for Dubai (unrated), 5% for Abu Dhabi (AA/Stable/A-1+), 4% for Ras Al Khaimah (RAK, A/Stable/A-1), and 2.7% for Sharjah (BBB-/Stable/A-3). Dubai continues to be a favorite for international investors. RAK is gaining significant momentum due to the construction of the Wynn Al Marjan Island (WAMI) integrated resort (expected to open in 2027), which was awarded a commercial gaming operator's license—the first to be granted in the UAE. This has spurred hospitality projects and residential and service apartments projects in the emirates.

Dubai's overnight visitors increased to 14.96 million for year-to-date October 2024, which is 8% growth compared to the prior year period. This supports the hospitality and retail sector given Dubai's reputation as a shopping destination. Luxury retail in Dubai experienced disproportionate growth, as did the super-regional malls that house the brands. Regional malls that cater to domestic needs had stable rents. We expect this trend will continue in 2025; however, with no major supply expected, we could also see some small growth for regional malls.

Rental growth in the office segment in Dubai is increasing by mid-teens percent and by 9%-11% in Abu Dhabi. We expect economic opportunities, UAE's reputation as a safe haven within the GCC, and its low tax regime will sustain its attractiveness for global investors. Office vacancy is about 5%, which is lowest it's been in several years. However, we expect some new stock will enter the market and increase competition.

Qatar: The real estate market slowly recovered in 2024 from the correction related to oversupply created for the World Cup in 2022. The office segment continues to be supported by government-related leases while retail real estate struggles despite significant growth in food and beverage (F&B). Rentals rates have been stable over 2024. We do not expect significant recovery over the next 12-24 months.

Israel

Ongoing political and geopolitical risks are weighing on the credit quality of Israeli real estate companies, as evidenced by the substantial increase in negative outlooks, which increased to 20% from 10% in 2022. The Israel-Hamas war has weakened the country's high-tech industry, which drives demand for domestic office space. This has been exacerbated by the domestic economy's slowdown, an increase in office supply, and work-from-home trends; all of this contributed to a decline in demand for office space, lower rent levels for new contracts, and a mild decrease in occupancy rates, even in Tel Aviv, which previously saw record prices and occupancies.

Currently, these factors do not have a significant impact on the occupancy rates of rated real-estate companies, which mainly operate in high-demand areas with high-quality properties and a strong, diverse tenant base. In fact, office real estate companies have generally reported an increase in net operating income (NOI), primarily because of long-term contracts that are price indexed and result in relatively stable occupancy rates. However, filling new properties is proving difficult, especially in less central locations.

We anticipate increasing pressure on rent levels and occupancy rates due to our revised, weaker macroeconomic forecast for Israel. Additionally, we expect new, high-quality office space in the coming years will further erode rental rates and occupancy, particularly in areas already experiencing oversupply.

Strong growth in the turnover of shopping center tenants supports the performance of retail real estate companies. Despite the ongoing war, the leading companies in the sector reported significant growth in shopping center tenants' revenues, ranging from 9%-12% during the first nine months of 2024. This contrasts with modest growth of about 2% in 2023, following the disruption in the fourth quarter from the outbreak of the war.

The CPI-linked rent contracts have also supported solid operating performance, with companies in the retail sector growing 2%-6% in same-property NOI and maintaining very high occupancy rates. However, there are increasing risks of a slowdown in consumer spending due to expected tax increases, budget cuts, and weaker macroeconomic performance. These factors could reduce tenants' profitability and eventually erode rental rates.

Pressure on real estate companies' profits continues as interest rate cuts are delayed due to inflation. In the first nine months of 2024, most income-producing real estate companies reported positive revaluations due to rent increases. These revaluations were largely influenced by CPI, but also reflected a real rise in rents. However, we expect high interest rates will persist at least through the first half of 2025, increasing the risk of asset devaluations. Still, we do not anticipate asset devaluations for our rated companies, given rent indexation and the high quality of assets in central locations. If devaluations occur, they are likely to be more significant for low-quality assets or those in less-central areas, where pressure on occupancy rates and rents is higher.

Related Research

- European Real Estate Companies: Not Yet Fixed, But Improving, Jan 9, 2025
- Real Estate Brief: How Political And Geopolitical Risks Could Affect European Commercial Real Estate, Dec. 18, 2024
- EMEA Office REITS: How Credit Stories Have Evolved, Dec. 17, 2024
- U.S. Office Real Estate Investment Trust (REITs) Portfolio How Credit Stories Have Evolved, Dec. 11, 2024
- FAQ Examines Whether Operators Can Navigate Pitfalls In Asia-Pacific's Data Center Boom, Sep, 17, 2024
- Build To Rent: A Credit Perspective On Australia's Housing Future, Jul, 21, 2024
- Most European REITs Valuations Should Bottom Out In 2024, July 10, 2024

Industry Forecasts: Real Estate

Chart 9

Debt to capital (adjusted)

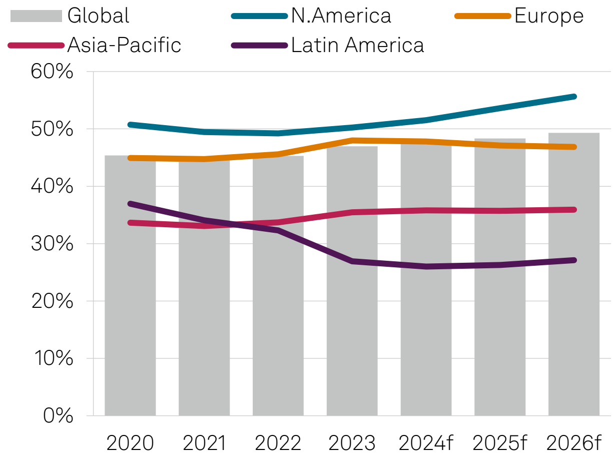


Chart 10

EBITDA interest coverage (adjusted)

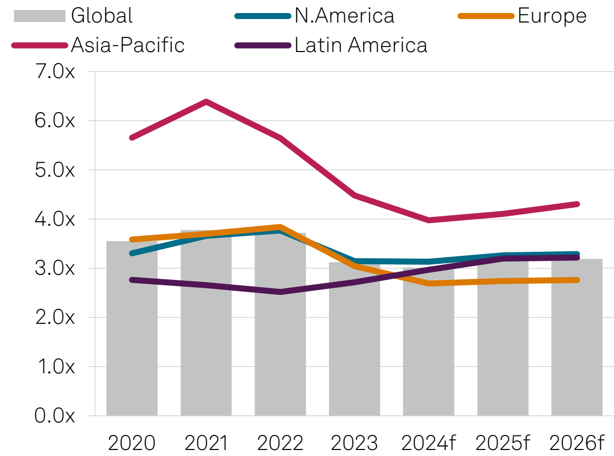


Chart 11

Debt / EBITDA (median, adjusted)

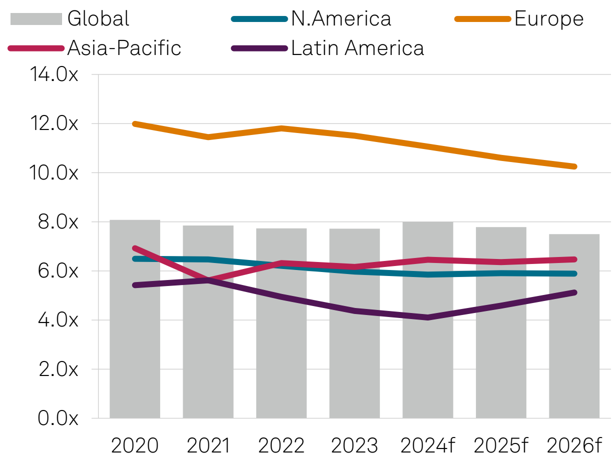
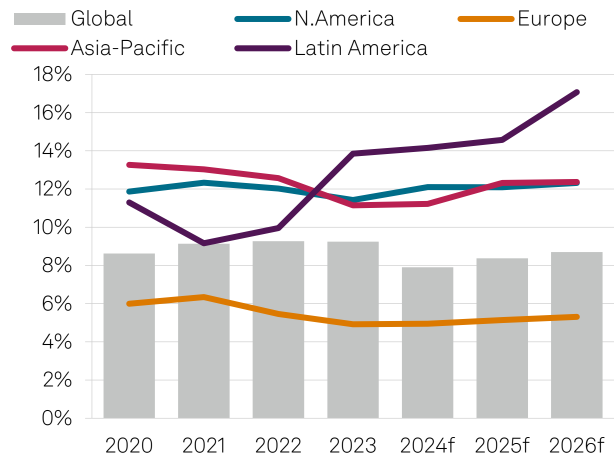


Chart 12

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
All data converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Real Estate

Chart 13

Rental revenue growth

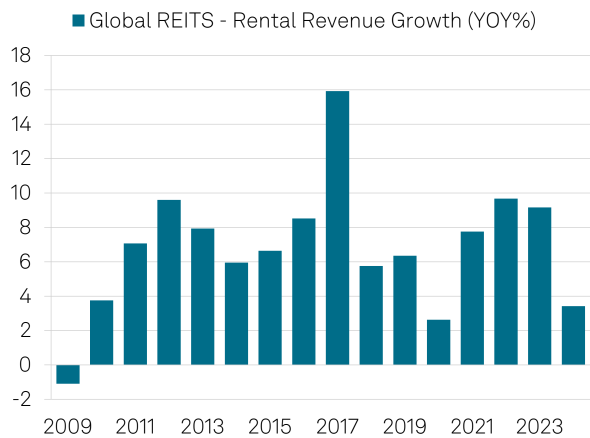


Chart 14

Return on capital employed

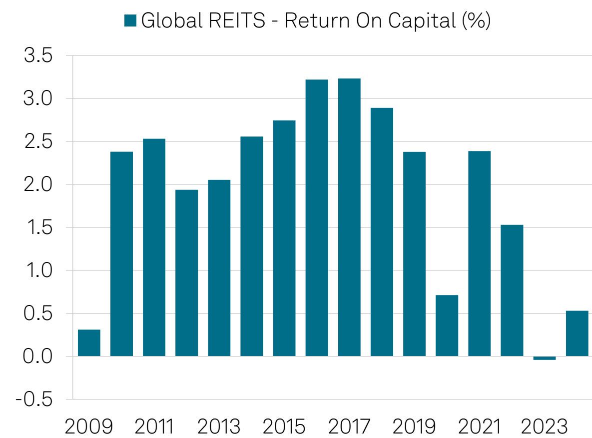


Chart 15

Fixed- versus variable-rate exposure

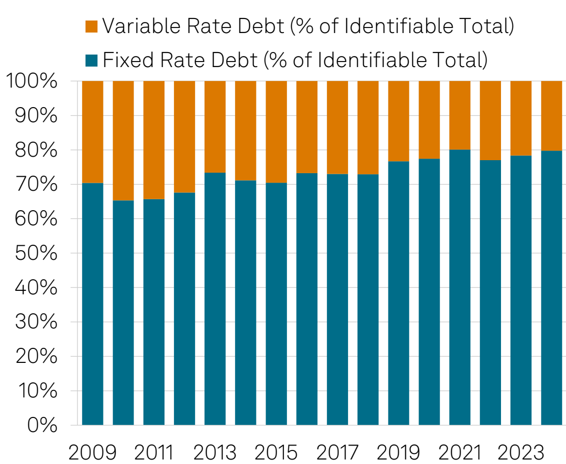


Chart 16

Long-term debt term structure

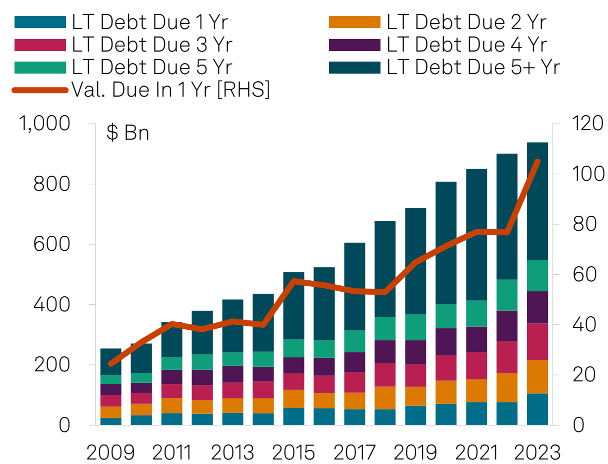


Chart 17

Cash and equivalents / Total assets

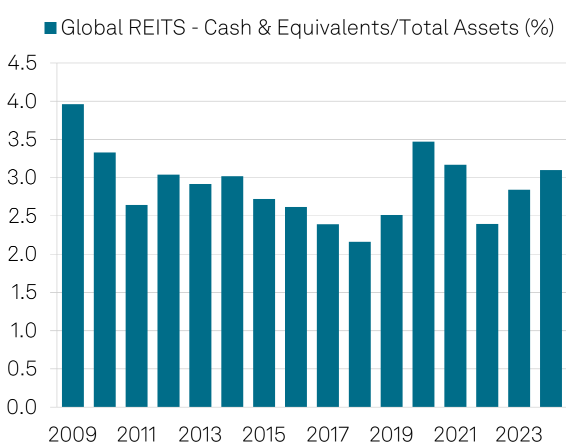
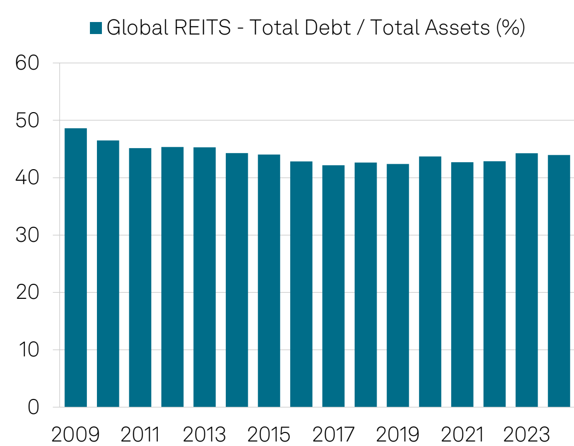


Chart 18

Total debt / Total assets



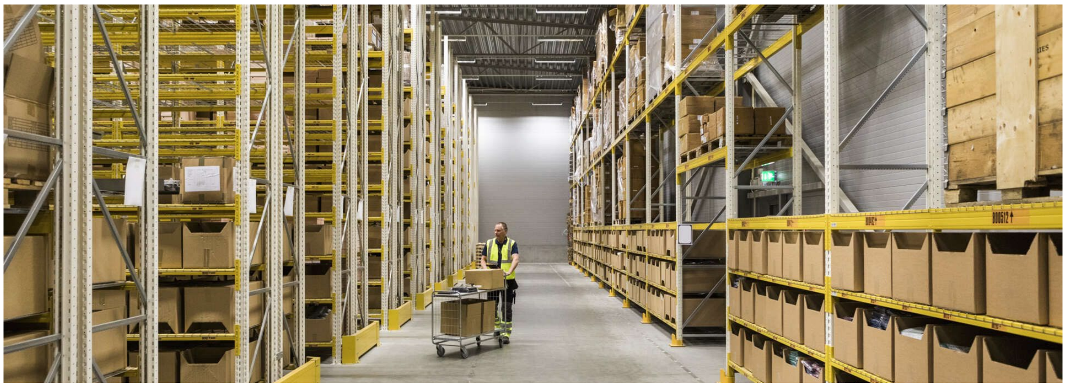
Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Retail and Restaurants

Cautious consumer discretionary spending persists

January 14, 2025

This report does not constitute a rating action.



What's changed?

High prices are sticky despite lower input costs. Retailers have not lowered prices on goods across the board, but strategically promote to retain market share or drive traffic.

Increased tariffs and geopolitical risks. Higher tariffs could spur inflation, trade wars, and supply chain constraints. Geopolitical conflicts and tensions could weaken consumer sentiment.

Consumers remain cautious. They are deferring discretionary spending and trading down. Larger retailers gain market share with their value propositions and continued e-commerce growth.

What are the key assumptions for 2025?

Household budget pressures persist. Interest rates remain high and credit card delinquencies are rising. Consumers will continue prioritizing staples like food over discretionary items.

Costs remain high and cost cutting continues. Elevated input and labor costs limit margin expansion and will require store closures. Companies will struggle to pass along price increases.

Financial policies remain consistent. We expect prudent financial policies within a weak consumer backdrop, and opportunistic mergers and acquisitions (M&A) in certain segments.

What are the key risks around the baseline?

Tariffs trigger inflation and potential retaliatory trade wars. Retailers will likely try to pass along higher costs to an already stretched consumer, which could hurt demand and profits.

Inventory levels rise by purchasing ahead of anticipated tariffs, elevating leverage, pressuring cash flow, and increasing overhang or obsolescence risk if demand stays weak.

Interest rates remain higher for longer, which will hurt consumer spending. Highly leveraged issuers may struggle to refinance upcoming debt maturities or default.

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Ratings Trends: Retail and Restaurants

Chart 1

Ratings distribution

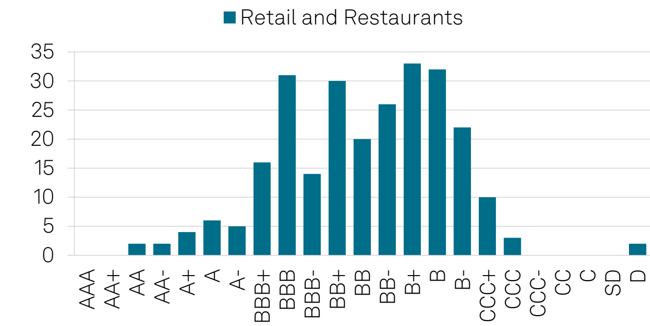


Chart 2

Ratings distribution by region

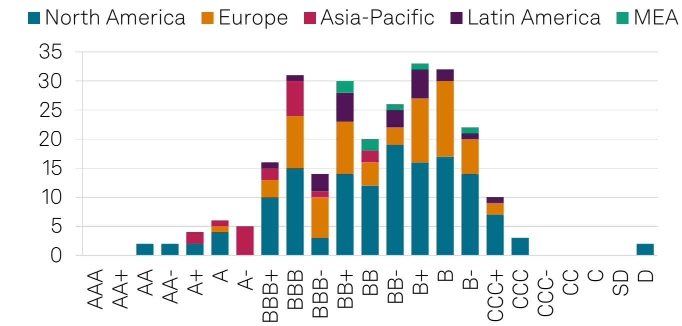


Chart 3

Ratings outlooks

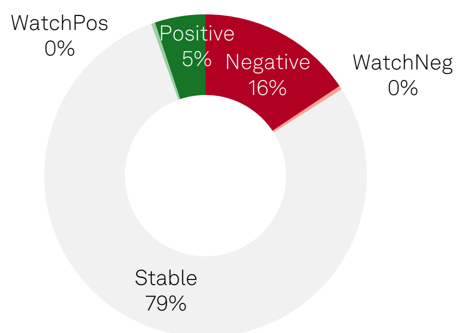


Chart 4

Ratings outlooks by region

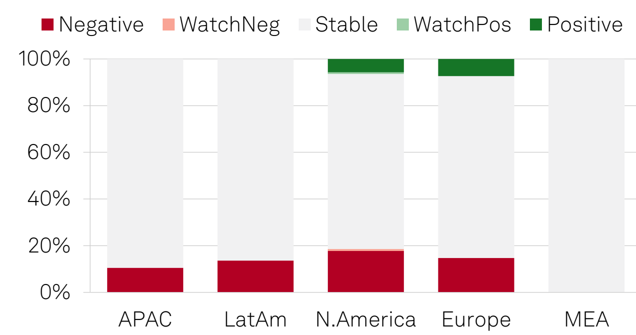


Chart 5

Ratings outlook net bias

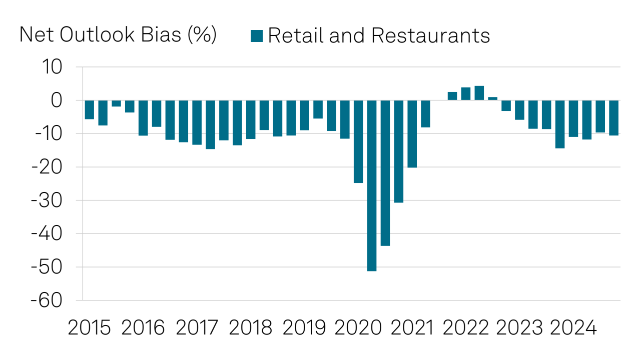
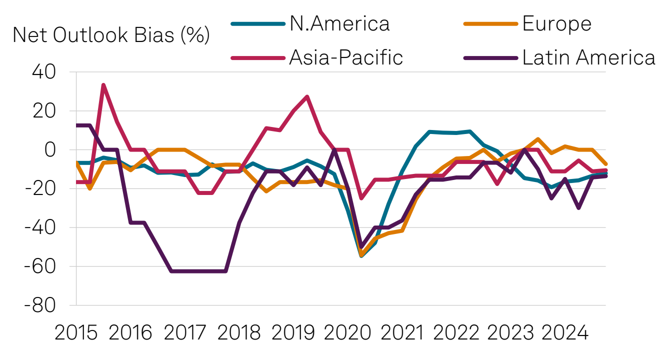


Chart 6

Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

Global retail and restaurant rating actions remained negative in 2024 because consumers in general have less buying power due to lingering high prices. Still, the consumer remained relatively resilient as recessions in the U.S. and Europe were averted. About 16% of global retail and restaurant issuers had negative outlooks in 2024 compared with 22% in 2023. Only 5% have positive outlooks, the same as in 2023.

As expected, downgrades were most pronounced in the 'B' category and lower. While gradual rate cuts allowed for some refinancings, some of these issuers will remain challenged, and issuers in the 'CCC' category, most likely in North America, could default or restructure their debt in 2025, especially as liability management transactions become increasing prevalent.

In the U.S. we expect negative ratings trends in 2025 due to stagnant discretionary spending. The consumer remains stretched between high prices and interest rates. The lower-income consumer is most impacted. This is starting to weigh on sales, as indicated by real restaurant sales tracking down and sales of value brands and staples like food. Real income growth is running behind real spending growth since mid-last year. The household savings rate is at a two-year low, and the delinquency rate for credit cards and autos are above pre-pandemic levels and trending higher. Walmart, Amazon, and Costco outperform their industry peers because they provide unique value propositions.

About 80% of U.S. retail and restaurant ratings are speculative grade. In 2024, negative rating actions outnumbered positive by a ratio of 1.5 to 1. Heading into 2025, 27% of ratings have a negative outlook while only 8% have a positive outlook or are on CreditWatch with positive implications. The highest negative outlook bias is in the subsectors most exposed to discretionary spending. Of the negative outlooks, about 13% are investment grade.

In Canada, high interest rates and the cumulative effect of inflation have caused consumers to limit spending. With unemployment forecast to be higher in 2025 and shelter expenses remaining high, we expect Canadian consumers to be less focused on discretionary spending. Our 2025 Canada GDP forecast indicates a slow-growth macroeconomic environment with higher unemployment levels. Even though we forecast CPI will stabilize around 2%, elevated inflation, interest rates, and shelter costs will force consumers to manage spending prudently.

Price- and value-conscious consumers will continue to benefit Dollarama's sales, particularly the sale of consumable items, while home-goods retailers such as Canadian Tire will have to balance between promotions and operating efficiency to defend EBITDA margins. However, given the mostly investment-grade nature of the Canadian retail portfolio, we expect a combination of financial flexibility and management's focus on balance sheets will support the stable outlook on Canadian ratings.

In Europe, consumers have been quite resilient as declining inflation and strong labor markets have supported spending. This also reflects retailers' stronger operating performance on the back of carry-over price pass-throughs to the end consumer, with only a moderate impact on trading volumes, as well as improved cost control and tight management of operating expenses. In this context, about three-quarters of the rated Europe, the Middle East, and Africa (EMEA) retail and restaurant portfolio have a stable outlook, about 14% have negative outlooks, and 9% have a positive outlook. We also assigned nine new ratings, of which there were two new investment-grade ratings (El Corte Ingles S.A. and ITM Enterprises, the financing subsidiary of

Société Les Mousquetaires S.A.S.). Nearly half of the rated companies in the EMEA retail and restaurant portfolio are rated in the 'B' category and below.

In Europe, upgrades and downgrades were balanced. There was one fallen angel with ELO (Auchan Holding) downgraded to 'BB+' in March 2024, and then to 'BB' in August 2024, due to its significant exposure to the challenging hypermarket store format in France. The other downgrades in Europe were on speculative-grade retailers and restaurants, and two of them led us to lower the ratings to 'CCC+'.

There were 17 outlook changes, but only five were outlook revisions to negative. These trends are indicative of the growth in real incomes because of disinflation and resilient labor markets across the European economy. We expect the pickup in real disposable income will boost consumption and support the European retail sector in 2025.

Overall, our forecast for low-single-digit percent top-line growth and slightly better margins in 2025 reflect our broadly stable outlooks. While we expect inflation will continue to moderate amid relatively slow economic growth, the extremely competitive retail landscape will prevent European retailers' margins and cash flows from meaningfully improving in 2025 and 2026, thereby limiting their rating headroom. Higher labor costs in Europe, especially in the U.K. with the rise in minimum wages and employers' national insurance contributions, will continue to be a drag on the profit margins.

All rated retail and restaurant companies in Europe except one have adequate liquidity. Barring a handful of companies rated 'B-' and below, we expect limited near-term refinancing pressure for most of the rated portfolio and a sound ability to bear the interest burden. As is natural after a period of prolonged cost headwinds and higher-for-longer interest rates, most companies have tight headroom under our downgrade thresholds, especially for free operating cash flow (FOCF) after leases and EBITDAR coverage.

In China, we expect retail sales to expand 4%-5% in 2025, similar to 2024. Government subsidies through a targeted trade-in program supported retail sales growth in 2024. Home appliances and electronics such as computers and, to a smaller extent, smartphones have been the key beneficiaries. While the program ended in December 2024, the government is guiding to an extension, possibly with expanded categories. We see a high likelihood for an additional stimulus—given ongoing property weakness and the potential U.S. tariff hikes to hurt exports—and have assumed a similar level of stimulus as in 2024 in our 2025 China retail outlook.

Still, consumers have been cautious. Impulse purchases were down in 2024. Big drops in average selling prices for retailers and restaurants that we saw in the first half of 2024 started to ease in the second half, and we believe prices aren't likely to fall materially in 2025 as consumer confidence stabilizes and competition among merchants turns more rational. Small areas of retail (such as niche apparel) might see higher growth, driven by perceived quality and value. Otherwise, low prices on everyday items will prevail.

Credit health for the sector is bifurcating. Smaller retailers are losing share and exiting the market as costs rise. Lower gross profit margins from discounts and a higher portion of value product in the mix, along with increasing fulfilment costs from higher returns and refunds, have hurt performance. Meanwhile, larger retailers with stronger balance sheets have more resources to prefund subsidies or discounts to gain market share; they also have the scale and ability to improve operating efficiencies to maintain or grow margins.

In Japan, we expect ratings to remain stable. Prices of everyday items and utility costs remain high, likely leading to slow domestic consumption in 2025. Headline inflation was 2%-3% in 2024, hitting a 40-year high, which also curbed consumer spending. We expect continued trade-downs from price-sensitive consumers, which will pressure top lines. An increase in operating costs, including labor, will pressure profits for retailers. Cost-saving initiatives may mitigate pressure on earnings for some retailers, as will selling more private-label products and revamping sales floors and store networks.

In Australia and New Zealand, consumer sentiment is gradually improving, albeit from a low base. We attribute this to a resilient labor market, recent tax cuts, and government stimulus that was targeted to alleviate inflation pressure. Retail spending in Australia grew steadily during 2024, with total annual seasonally adjusted retail turnover rising 3.4% as of October 2024. Decreasing interest rates in New Zealand and anticipated rate cuts in Australia will improve household purchasing power in 2025, increasing consumer spending.

With cost-conscious consumers gravitating toward private-label and discount products, retailers are competing aggressively. We expect promotional activities to remain high. Amid recent regulatory focus on market power and supplier treatment, companies with significant market share may have a limited ability to pass promotional expenses onto their suppliers.

We also anticipate wage costs will remain elevated, pressuring earnings margins. We expect union actions in Australia during late 2024 will not deter retailers from implementing cost-efficiency programs and investing in productivity enhancements.

In Brazil and Chile, we anticipate real GDP growth of approximately 2% in 2025, which we expect will contribute to a continued recovery in the retail sector, following similar trends observed in 2024. While we forecast both economies will maintain relatively controlled inflation, interest rate trajectories will differ. We project Brazil will keep its policy rates elevated for longer, whereas rates in Chile will decrease. We believe this will facilitate growth in both revenue and profit margins, enabling some debt reduction.

Traditional retailers are increasingly challenged by pure e-commerce competitors and evolving consumer preferences. Digitalization will be key for retailers in the coming years, with e-commerce and omnichannel in the center of the companies' strategy. During 2024, we revised the ratings outlook on a few retailers to stable from negative, notably Falabella (BB+/Stable/--) in Chile due to a recovery in its profitability and reduced leverage, Magazine Luiza (brAA-/Stable/--) due to its strong sales performance and sustained profit margins throughout the year, despite a still challenging macroeconomic environment, and Grupo SBF (brAA-/Stable/--) due to an improved FOCF generation and liquidity position.

In Mexico, we expect a stronger slowdown in consumption in 2025 than what we saw last year, in line with our GDP growth expectations of 1.2%. For our rated portfolio, we expect revenue to grow about 7% in 2025, similar to 2024 levels; nonetheless, we believe a weaker product mix will lead to slight contractions in EBITDA margins. We expect real wage growth will continue to back up consumption to a certain extent. We forecast this, along with a lower fiscal deficit, will cascade into lower disposable income for households. Moreover, we believe the recent depreciation of the MXN/USD exchange rate will also affect the pricing of imported goods.

Omnichannel capabilities remain key to serve and attract customers given the growth of Chinese online retailers in the country, which have gained popularity quickly, especially in soft-line categories.

Main assumptions about 2025 and beyond

1. Consumer spending will remain slow, although sentiment is rebounding.

Consumers will continue to seek value by waiting to buy during promotions and buying less, shrinking their average ticket purchases. Retailers with distinct value propositions will gain market share. Consumer sentiment has rebounded in recent months due to a resilient labor market and cooling inflation (see chart 7).

2. Margins will remain flat to modestly improved.

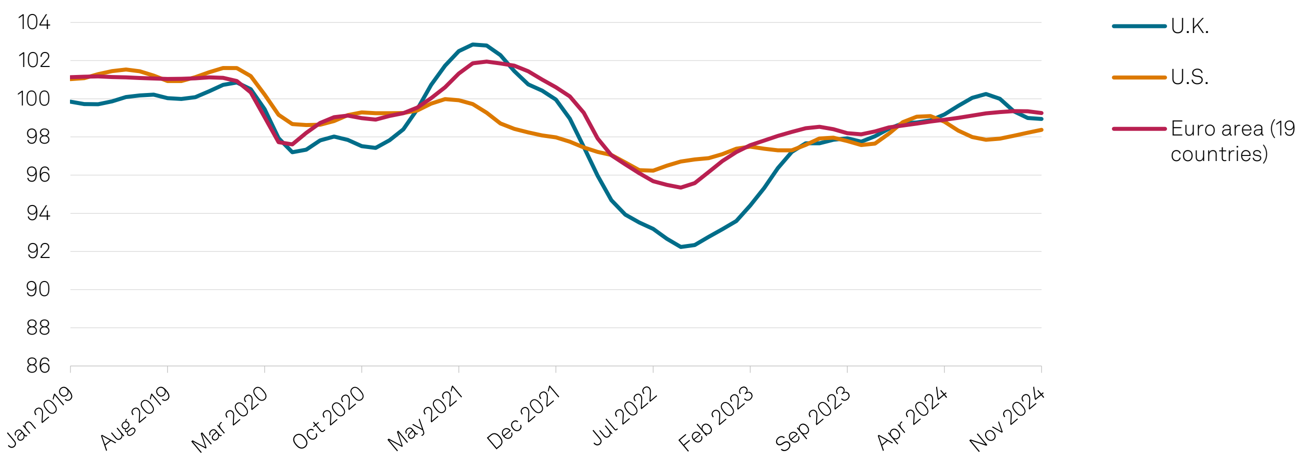
Input costs will remain manageable but high labor costs are sticky. Lower commodity, shipping, freight, logistics, and warehousing costs will continue to benefit gross margins, partially offset by higher promotions. Ongoing cost-savings measures will mitigate high wage costs and lower demand to preserve margins.

3. Cash flow and capital allocation priorities will remain steady.

Companies will continue to manage tight inventory levels to preserve solid cash flow. Higher tariffs are the biggest risk to cash flow if companies decide to buy in anticipation of price hikes on goods. Investment-grade issuers will maintain their financial policies, and large M&A will be opportunistic. Lower rates could help speculative-grade issuers refinance but higher rates for longer could trigger more downgrades or defaults.

Chart 7

Consumer confidence index



Sources: OECD, S&P Global Ratings.

North America

Big box: In 2024, big-box retailers navigated a challenging environment marked by constrained discretionary spending and persistent, though easing, inflation that has continued to pressure household budgets. In response, many retailers recalibrated their inventory strategies to address potential supply chain disruptions. Notably, companies such as Walmart, Target, and Costco outperformed their purely discretionary counterparts, primarily due to their strong presence in grocery and essential categories. Walmart significantly outperformed in the third quarter in the U.S. across both grocery and general merchandise. In contrast, Target reported a modest decline in comparable sales along with lower guidance due to softer-than-expected sales in discretionary categories, resulting in elevated inventory levels and higher-than-expected supply chain costs.

Looking ahead to 2025, we expect big-box retailers to grow revenue at 3%-7% and continue performing relatively well as consumers seek ways to stretch their budgets. We expect a very slight uptick in margins amid expected stable performance. While supply chain issues have largely diminished, elevated inflation and uncertainty regarding future interest rate cuts will continue to impact U.S. shoppers. Consequently, we expect a shift in the sales mix toward consumables, which typically yield lower margins. We also expect the larger big-box retailers to continue fending off pressure from Amazon by refining their omnichannel strategies and leveraging their physical store networks as a competitive advantage. Although Target and Costco have traditionally focused on brick-and-mortar sales, both reported significant growth in their e-commerce businesses, with segment revenue increasing in the double-digit percent area. In the near term, we foresee an emphasis on optimizing e-commerce platforms and real estate assets to improve delivery speed and operational efficiencies.

Specialty: Sales dipped across many specialty retailers in 2024 as consumers pared spending on discretionary categories and prioritized essentials. While customer traffic varied across the sector, comparable sales were challenged by many retailers lowering prices to highlight value to budget conscious consumers without seeing an offsetting increase in basket size. We believe the current macroeconomic environment continues to favor big box, discount, and online retailers that offer broad selections and low prices. However, in our view, specialty retailers that can provide unique, on-trend merchandise with convenience and good service will have a better opportunity to grow market share in a highly competitive marketplace.

We expect pet retailers to generate modest top-line growth in 2025, averaging 3%, led by stabilizing industry trends and company-specific initiatives around merchandising and services. Pet ownership continues to increase, and we expect pet humanization trends will continue. Online pet retailer Chewy (not rated) recently noted that pet adoptions are up in the high-single-digit to low-double-digit percent range year over year. Still, we expect consumers will remain value-focused in 2025, likely concentrating spending around consumables and keeping overall price increases limited. We expect margins will improve modestly following meaningful compression in 2024 as merchandise mix headwinds ease and cost reductions and sales leverage benefit earnings. Petco's ability to execute on its initiatives of improving merchandising, customer service, and efficiency will be key to driving traffic and improving conversion at its stores in 2025. PetSmart is investing in price and digital to strengthen performance, but margins may be pressured through 2025 if sales don't inflect or offsetting cost reductions aren't enough.

Industry conditions for home-focused specialty retailers remain challenging. Headwinds including elevated interest rates, the shift of consumer spending toward services and away from goods, and low housing turnover have led to tepid demand for home categories, including décor, flooring, improvement, and furnishings. We expect many of these headwinds to stabilize throughout 2025 but still expect industry demand to remain soft as housing affordability continues to be a challenge. Still, companies with sharp execution stand to grow market share regardless of overall industry performance. On the cost side, we believe there is less room to cut and fewer opportunities for additional supply chain savings. Additionally, the risk of incremental tariffs could delay stabilization.

Hobby retailers, including arts and crafts-focused Michaels and fabric-centered Joann will remain challenged in 2025. Both companies are in the midst of leadership transitions and are contending with ongoing soft demand and the risk of higher tariffs. Both also have customers that are loyal but price-sensitive, limiting additional price increases and basket building next year.

We expect the soft performance trends of 2024 to carry over through the first half of 2025 for aftermarket auto part retailers. Constrained budgets of lower-income consumers continue to weigh on do-it-yourself (DIY) industry sales, while sales to professional customers remain relatively solid. We anticipate maintenance or repairs that have been deferred in 2024 will gradually be addressed in 2025. Additionally, the relatively inelastic demand and normalizing inflation will support modest price increases this year. This, in addition to ongoing new store development, will lead to low- to mid-single-digit percent revenue growth in 2025. We forecast

EBITDA margins will remain roughly flat as sales leverage is offset by investments in store operations and labor.

Department stores: Throughout 2024 most department store operators faced secular declines, prompting them to implement operational changes and turnaround strategies. Kohl's continues to struggle with operating performance and leadership transitions, with its CEO stepping down in January 2025. The company also significantly lowered its full-year guidance, highlighting an uncertain holiday season for the department stores, as competitors like Walmart and Amazon attracted more value-conscious customer. While Macy's reported stronger-than-expected preliminary results for the third quarter, it delayed release of its full quarterly results due to erroneous accounting over several quarters. Capri also announced leadership changes at its Michael Kors brand to turnaround performance.

As we move into 2025, we expect department stores to continue experiencing pressure on discretionary demand, relying on increased discounts to drive customer traffic and manage costs. We forecast revenue growth of negative 1% to positive 2% and relatively flat EBITDA margins for the sector in 2025. To mitigate volume declines and promotional pressures, department stores will likely focus on tighter inventory management, enhancing sell-through rates, and implementing cost-saving measures. We expect companies to prioritize capital expenditures toward strengthening supply chains, refreshing stores, and enhancing omnichannel capabilities, with minimal expansion of store footprints. Additionally, we expect store closures to persist as companies streamline their operations to better align with market conditions. Consequently, we expect limited M&A after the Saks and Neiman Marcus transaction (expected to close in early 2025), along with modest share buybacks aligned with broader capital allocation and leverage targets. There is also continued interest from activist investors and pressure to creatively structure balance sheets to leverage real estate assets, reflecting a focus on short-term returns over the long-term health and flexibility of the retail operations.

e-Commerce: More retail spending is set to shift online in 2025 as short-term pressure from cautious consumer spending is offset by longer-term secular trends of increasing consumer adoption. Total U.S. e-commerce sales rose 8.1% through the 12 months ended Sept. 30, 2024, outpacing total retail sales growth of 2.4% for the same period according to Census data. We expect e-commerce penetration will continue to expand as wallet share grows, more consumers shop online, and retailers increase their digital capabilities. We forecast revenue will increase roughly 6% on average across our U.S. e-commerce issuers in 2025, with companies more exposed to discretionary categories facing softer top-line prospects. Margin performance will vary next year, but we anticipate companies experiencing weaker top-line demand will pull cost levers to keep earnings growth intact.

We believe Amazon will absorb further market share as its wide product offering, competitive prices, and fast delivery draws more customers to its platform. Amazon's regionalized inventory placement and expanding same-day fulfilment centers are strengthening customer loyalty, leading to bigger baskets and greater purchasing frequency. Wayfair meanwhile is navigating a weak sales environment for the home goods category. Although stabilizing housing starts and the prospect of additional federal rate cuts could spur growth in the housing sector, we expect demand for home categories to remain soft in 2025. EBay returned to positive gross merchandise volume growth in 2024 as consumers have been responding to the company's investments in its focus categories. We expect eBay to generate modest low-single-digit percent top-line growth in 2025 as consumers seek out value and unique merchandise across the company's marketplace amid a choppy macroeconomic environment.

Rising competition from Chinese e-commerce players, including Shein and Temu, also poses a risk to both traditional and online retailers. These marketplaces, which specialize in low-priced goods, are expanding categories and lowering merchant fees to bring more merchandise to their platforms. Price-sensitive consumers may increasingly make the trade-off between quality and slower order fulfilment in return for deeper savings.

Restaurants: We expect low- to mid-single-digit percent sales growth and modest margin improvements in 2025. Casual diners that provide value will likely win in 2025. As food-away-from-home inflation continues to exceed food-at-home inflation (the opposite held true through all of 2022 and part of 2023), we expect traffic levels to be dictated by operators' ability to draw in value-seekers. While promotions will be part of the equation, value-promoting advertising, menu innovation, loyalty programs, and digital sales will play large roles in driving transactions. We believe higher wages will be offset by the positive impact of improved labor retention rates, leading to 2025 margins moving in a narrow band compared with 2024, with cost efficiencies essential to preserving margins.

Quick service restaurants (QSRs): We expect 0%-1% same-store sales growth in 2025, slightly lower than average but improved from 2024. We believe the investment in value offerings across the second half of 2024 will continue in 2025 and reestablish the perception of fast-food restaurants as a source of good value, especially with lower-income consumers. That said, we expect continued competition from fast-casual restaurants like Chipotle, Five Guys, or Jersey Mike's, which generally offer higher-priced but still high-value meals. Casual restaurants are also offering discounted meals to compete directly with QSRs. This also reflects a shift to dining at home, which is still above historical averages. We expect QSR franchisors to continue to invest in advertising and limited-time offerings, which we believe will result in similar or slightly improving margins for the year. At the restaurant level, we expect continued targeted discounting with combination meals priced at $5-$7, given these deals have generally resulted in higher overall ticket size. We believe restaurants with better perceived relative value will continue to outperform, including Taco Bell, Dunkin', and Tim Hortons.

Grocery: We expect low-single-digit percent sales growth in the U.S. grocery sector in 2025 as we expect food-at-home inflation to stay near the expected 1% 2024 levels in 2025 and the industry is two years removed from the fast-paced inflationary days of 2022 (11.8%; 5% in 2023; U.S. Department of Agriculture). As a result, we expect margins to be relatively flat for the industry next year. At the same time, vendors have attempted to curtail a soft volume environment by providing elevated levels of trade dollars (to fund, for instance, promotions). We expect both conditions to remain at these levels through at least the first half of 2025, the combination of which portends flat to slow growth for grocers. A bright spot for the industry continues to be private label, with those that possess a robust offering poised to benefit from significantly better margins. With Kroger Co. and Albertsons Cos. Inc. terminating their merger, the two will now go it alone as they try to stem share losses to nontraditional players like Walmart and Costco.

Retail pharmacies: Overall in 2025, we expect mid-single-digit percent revenue growth primarily from drug inflation. At the same time, we expect modest EBITDA declines, primarily driven by pressure from branded pharmaceutical reimbursement (including GLP-1s), below-average generic approvals, and front-of-store weakness from a cautious consumer. Additionally, we expect some incremental pressure from competition of non-brick-and-mortar delivery pharmacies but believe this is less impactful than reimbursement dynamics. We forecast pharmacies will offset these pressures by closing unprofitable stores, reducing costs, improving working capital, and paying down debt to right-size capital structures in the challenging operating environment. We also expect pharmacies will work to improve contracting terms with suppliers and pharmacy benefits managers to improve the predictability of reimbursement and dispensing fees, but this will likely be a multiyear initiative.

Canada: Canadian grocers will continue to operate in a steady fashion, and we expect low-single-digit percent revenue growth in 2025. Consumers' shift to discount, increasing private-label penetration, and the expanding scope of services at drug stores all support top-line growth, with Loblaw and Metro benefitting most out of the big three Canadian grocers. Like the U.S., promotions from vendors and loyalty programs continue to bring in foot traffic. We expect margins to remain steady as high-margin pharmacy operations and an increased focus on operations (e.g., automated distribution centers) support profitability. However, U.S. competitors' (Costco, Walmart) continued investments in Canada have paid off, and following the pandemic, they are at 20%-25% of the Canadian grocery market share.

Europe

Grocery: Although this sector remains extremely price competitive, credit prospects for Europe's food retail industry are stable. The incumbent mainstream retailers face significant competition from discounters in all the major European markets. European grocers with an investment-grade rating ('BBB-' or higher) are typically the largest among peers and hold a strong market position in their home markets, with advanced private-label propositions and geographical diversification.

We downgraded ELO (Auchan Holding), which operates hypermarkets and supermarkets in 11 countries and is the fifth-largest retailer in France, to 'BB+' in March 2024 and then to 'BB' in August 2024. ELO's core French retail operations are the main drag on its profitability and cash generation due to its significant exposure to the structurally challenged hypermarket store format. Meanwhile, we upgraded two food retailers: Co-operative Group Ltd., the U.K.'s largest consumer co-operative and the seventh-largest food retailer, to 'BB' on improved profitability and lower financial leverage through effective pricing investments and membership offerings; and France-based fresh food retailer ZF Invest, which owns and operates within traditional covered-market operator Grand Frais, to 'B' due to its differentiated business model translating into strong operating performance amid difficult market conditions.

We expect the grocery sector to grow its absolute EBITDA in 2025 from volume recovery driven mainly by higher price promotions and continued growth in private-label offerings. EBITDA margins for the sector dipped meaningfully in 2022. After some recovery, we expect them to gradually rise in 2025, but we do not expect them to reach their pre-pandemic levels due to higher labor costs. Because of declining input costs, there are opportunities for retailers with established private labels to increase and cement their market share by providing greater value to their consumers. Strong competition will continue to force smaller and mid-sized supermarkets such as Eroski in Spain and Esselunga in Italy to compete more aggressively on prices.

The rating upside is limited by thin operating margins and high investment requirements in store refurbishment, network expansion, IT infrastructure, and logistics. While FOCF generation remains relatively robust, deleveraging for many listed companies in the sector is constrained by shareholders' expectations of regular dividends and ongoing share buybacks. We do not anticipate market consolidation other than opportunistic acquisitions of pockets of stores given that, overall, our rated retailers, especially those that are well capitalized, already have substantial market shares.

Apparel retail: High competition and lukewarm consumer demand will constrain the growth plans of many European apparel retailers in 2025. We expect many rated companies will need to substantially increase promotions to boost volumes as unit prices remain elevated. While e-commerce and mobile commerce will remain the main engines of growth, we anticipate brick-and-mortar stores will see a resurgence in footfall as consumers seek a more immersive in-store experience. Retailers with a strong omnichannel presence and a robust marketplace offering such as Next PLC and Marks & Spencer PLC in the U.K. will continue to outperform their competition. We also expect Primark, with its low-cost model providing value-focused clothing and a unique store experience, will continue to experience strong demand in 2025.

On the other hand, H&M lost some global market share compared with competitors like Zara, Fast Retailing, and Primark, which all reported higher growth. To revamp and grow its core H&M brand, the group will increase marketing costs and capex to launch various initiatives to strengthen its brand. We expect an increase in both marketing costs and capex to launch various initiatives to strengthen branding including new advertising campaigns, larger flagship stores, improved digital experience including social media content and interactions, and large events in core cities. Hugo Boss is also hindered by a challenging economic environment, and the group is looking to expand its top line, supported by marketing campaigns driving up brand visibility and the ongoing and successful reshaping of its retail network, while increasing the in-store digital experience.

We consider the global mass-market apparel industry to be very competitive, extremely fragmented, and subject to fashion risk and continuous innovations. In this context, new niche brands, including pure online platforms, continuously threaten incumbent players. Fierce competition, together with exposure to weather and consumer cuts in discretionary spending, make the earnings and inventories of mass-market apparel retailers more volatile and unpredictable than those of less-discretionary retail sectors. Further initiatives to improve profitability are being constrained by geopolitical challenges, which weigh on cost structures, including higher freight costs due to prolonged disruptions in the Red Sea.

Specialty retailers: Operating prospects vary greatly across these nonfood retailers from a range of subsectors, such as value, travel, beauty, DIY and home improvement, and electrical retailers. Other than the value retail segment, most of the European rated retailers in this group have high exposure to discretionary spending. That said, specialty retailers in the jewelry segment such as Pandora A/S and Goldstory SAS, Italian cosmetic retailer Kiko Milano, and pet care retailers such as Fressnapf Holding SE and Agrifarma S.p.A. are benefiting from continued consumer demand despite strong prices and have been able to operate at attractive margins. We expect these retailers will continue to raise their profitability as they have comparatively smaller operating scale and room for accelerated growth thanks to strong brand appeal and broad assortment, but also inherently lower fixed costs for their specialty goods. We expect the European pet care market to continue to grow steadily, driven by a shift toward higher-value products, primarily due to secular changes in customers' attitude toward their pets and an increasing willingness to improve their living conditions.

The recovery in global travel retail and significant improvements in its scale, geographic diversification, and product mix following the successful merger between Autogrill and Dufry should enable Avolta, a leading travel retailer and operator in the food and beverages space, to continue to strengthen its credit metrics. Value retailers such as B&M European Value Retail S.A., Pepco Group N.V. Action Holding B.V. and the newly rated Bubbles Bidco S.p.a. (Acqua & Sapone), should see strong demand as they remain popular with price conscious consumers. They are responding by expanding their product assortment and store footprints. We expect these retailers to continue increasing their revenue while benefiting from robust EBITDA margins.

On the other hand, many rated retailers, particularly in the electrical, home goods, furniture, DIY, and home improvement segments have seen volume pressure following significant price inflation. Operating performance is typically highly dependent on key trading seasons especially in the second half such as the summer months, Black Friday, and the winter gift-giving season. Capex investments in technology and logistics will have to be prioritised in 2025 to ensure fulfilment and service capabilities remain comparable to competition, which include large and well invested global e-commerce leaders such as Amazon and eBay. These retailers need to maintain a continued focus on proactive cost and working capital management that are critical to protect profitability and FOCF from material deterioration.

Restaurants, pubs, and food service: We have moderated our expectations of the earnings growth and deleveraging prospects of the rated restaurants, pubs, and food service companies in Europe, owing to unfavourable demand fundamentals and intense competition. All the rated restaurants in EMEA are in the 'B' rating category and below, and, apart from PAX Midco (Areas), the No. 3 global player in the travel food and beverage concession catering industry, all have a business risk of weak. We believe the dine-in segment will continue facing difficult demand dynamics, thereby creating a challenging environment to turn around operations amid intense competition. Weak FOCF for many operators also constrains the financial flexibility for expansion or capex.

We lowered our rating on PizzaExpress, one of the largest pizza restaurant chain operators in the U.K., to 'CCC+' on persistently weak cash flow. The cost pressure from higher wages and sizable lease payments will largely offset benefits from the cost-control measures that several companies have already put in place. The U.K. based restaurants and pubs are particularly exposed given the rise in minimum wages and employers' national insurance contributions.

China

Big-box/grocery: Big-box retailers in China are gaining market share from supermarkets as consumers emphasize value. With even higher volume, big-box retailers are gaining incremental bargaining power against suppliers (consumer product makers) to tailor product specification and more favorable inventory terms.

Specialty department stores: Chinese department stores continue to face pressure from rival channels and category exposure (jewelry, luxury, mid- to high-end segments), with store traffic remaining soft. As such, department stores operators are focusing on growing core membership through more personalized experiences for shoppers, including tailored shopping services to hosting offline events at the malls.

Apparel retail: As a discretionary category, this channel is performing weaker than general merchandise. Returns and refunds have surged materially, which is adding fulfillment cost to retailers, resulting in a mild decline in margins.

Restaurants: Demand for high-end restaurants has tapered off and remains low, while demand for more affordable meal options has increased. Concurrently, consumers are opting for cheaper food options and increasing smaller meals (such as night-snack) and average spending per customer has been falling. Meanwhile, the delivery market that has been in late-stage growth will likely see high-single-digit percent growth into 2025, down from double-digit percent growth in 2024.

Japan

General merchandise stores (GMSs): We expect GMSs to increase revenue in the low-single-digit percent area over the next one to two years. Competition is intense with other channels such as specialty stores. Rising labor costs will continue to depress operating profits. Retailers are accelerating efforts to improve the efficiency of store operations to improve profitability. Some retailers including Ito Yokado, one of the largest GMS in Japan, is accelerating closing unprofitable stores.

Department stores: We expect department stores to increase revenue in the mid-single-digit percent area over the next one to two years. This category has posted 10%-20% same-store sales growth in the last 12 months. Domestic consumption among the wealthy has been solid. In addition, incremental consumption from increasing foreign tourists is supporting sales growth for stores in the larger cities in Japan. In contrast, rural area department stores will continue to close due to population declines.

Apparel retail: We expect apparel retailers in Japan to maintain solid revenue growth of 2%-3% over the next one to two years thanks to ongoing improvement in mobility for locals and higher tourism spending. Demand is shifting to lower-priced goods and casual and functional products.

Convenience stores: Operating performance of domestic convenience-store business is likely stable thanks to solid merchandising operations, with 1%-2% of same store sales. However, there could be market share shifts from top player Seven Eleven Japan to the other two giants, Family Mart and Lawson, given that consumers remain price conscious and seek value, which makes competition for market share even tougher.

Grocery: Price competition will pressure supermarkets' top lines. An increase in operational costs, including labor costs, pressures profits for the grocery retailers. Competition is fierce against discount stores. In response, retailers have increased private-label offerings, revamped stores. Some have made acquisitions to maintain competitiveness and increase scale in the mature market. Increasing investment burden amid weak profits could narrow creditworthiness headroom.

Australia and New Zealand

Grocery: Food retailers experienced easing inflation in categories such as shelf stable and fresh protein in 2024. We expect low- to mid-single-digit percent same-stores sales growth, driven by higher volumes. The largely nondiscretionary nature of supermarket spending should support earnings resilience. We believe retailers with established private labels are well positioned to benefit as budget-conscious consumers increasingly trade down and prioritize value for money. Ongoing regulatory scrutiny into the sector will continue to limit retailer pricing flexibility. We anticipate increased promotional activities and ongoing cost pressures will weigh on EBITDA margins for fiscal 2025. Nevertheless, most entities retain comfortable ratings headroom while executing on their growth strategies.

Brazil and Chile

Department stores: In 2024, department stores demonstrated good recovery following a challenging 2023. The most successful effectively integrated a robust e-commerce platform with an omnichannel strategy, responding to customer demands for greater flexibility. We anticipate consumption trends will maintain positive momentum in both Brazil and Chile through 2025. However, in Brazil leverage remains a concern due to ongoing high interest rates. In contrast, we expect the macroeconomic environment in Chile to continue improving, with stable credit availability.

Apparel retail: This is one of the fastest-growing areas in retail, particularly driven by casual and sports apparel. The performance of apparel retail was strong throughout 2024 and is expected to remain positive in 2025. Artificial intelligence (AI) is increasingly important for making preference-based recommendations, and companies are advancing in their use of data to identify trends and streamline the production of more targeted collections.

Grocery: This is generally a more resilient subsector in Brazil, less affected by rising interest rates. The performance in 2024 has been relatively good, particularly driven by the increasing popularity of the cash-and-carry model and higher food inflation, which has outpaced overall consumer inflation. Additionally, digital sales are rapidly gaining significance, a trend we expect to accelerate as consumers seek more practical and flexible shopping experiences for groceries.

Mexico

Department stores: We expect lower economic growth in 2025 will weigh on consumption of discretionary goods, resulting in revenue growth from department stores slightly above inflation level. Companies with more advanced omnichannel capabilities and improved customer experience will have a competitive edge over peers amid the surge of pure online retailers and the growth of private labels across several categories.

Convenience stores: We expect convenience stores will outpace overall consumption in the country in 2025, given the nondiscretionary nature of most of product offerings, along with initiatives to digitalize customers and improve omnichannel capabilities. We expect sales to grow 7%-10%, driven by both pricing strategies and store opening.

Credit metrics and financial policy

We expect issuers to adhere to prudent financial policies in 2025 with uncertain government policy changes that could spur higher costs. If inflation remains benign and interest rate cuts continue, we expect cash flow profiles and refinancing prospects for speculative-grade issuers to improve. We expect credit metrics to remain largely in line with 2024, with slight improvements to interest coverage and debt leverage ratios as EBITDA modestly improves with relatively flat demand and modest improvements in profitability.

M&A may increase if rates continue to decrease and a favorable regulatory environment in the U.S. spurs action. We believe dividend policies will remain consistent and share buybacks will be relatively modest. In Europe, we anticipate share buyback activity will be mainly limited to large food retailers with strong FOCF generation like Carrefour, Tesco, and Ahold-Delhaize. In our downside scenario, we see reduced rating headroom if companies return to expansive financial policies and shareholder-friendly activity before a sustainable recovery in credit metrics.

Key risks or opportunities around the baseline

1. Inflation.

Proposed tariffs could spur inflation, forcing companies to pass along cost increases to consumers, dampening demand and consumer spending. Rate cuts will likely be delayed, hurting the housing market.

2. Consumer spending and the labor market.

Consumer spending figures continue to surprise, remains relatively positive, and the unemployment rate remains low. Consumers could continue to show strength. Labor supply could fall sharply, leading to sustained higher wages in the market.

3. Leveraged credits default or enter liability management transactions.

We expect some credit deterioration for noninvestment grade issuers in 2025. Speculative-grade issuers with upcoming maturities could be forced to refinance at higher rates, continuing to constrain cash flows. They may default or seek alternative restructurings.

Inflation is reignited and rates stay higher for longer. The proposed tariffs under the Trump administration could spur inflation, forcing companies to pass along cost increases to consumers. This will dampen demand and further weaken consumer spending. With renewed inflation, rate cuts will likely be delayed, hurting the housing the market and consumers reliant on credit card debt. Shelter and labor costs remain high, and increased tariffs could keep prices and interest rates elevated. Further erosion of consumers' purchasing power will lead to lower confidence and spending.

Consumer spending and the labor market are stronger. Consumer spending figures continue to surprise, remaining relatively positive, and the unemployment rate remains low. Consumers could continue to show strength if they still have savings and wage growth continues. With potentially tighter immigration policies in the U.S., labor supply could fall sharply, leading to sustained higher wages in the market. Still, with sticky high prices, consumers could continue to reign in discretionary and big-ticket purchases.

Leveraged credits default or enter liability management transactions. We expect credit deterioration for non-investment-grade issuers in 2025. If rates stay higher for longer, speculative-grade issuers with upcoming maturities will be forced to refinance at higher rates, continuing to constrain cash flows. Those issuers who cannot improve performance or address their capital structures may default or seek alternative restructurings such as distressed exchange or liability management exercises that are becoming increasingly relevant.

Related Research

- China Retail 2025 Outlook, Jan. 7, 2025
- CreditWeek: How Festive Will The Holiday Season Be For Retailers In The U.S. And Europe?, Nov. 21, 2024
- Retail Brief: European Retailers Set Out Their Stalls For The Golden Quarter, Nov. 21, 2024
- U.S. Holiday 2024 Sales Outlook: Consumers Will Trim Trees And Spending This Season, Nov. 12, 2024
- Peer Comparison: Top European Food Retailers' Business Strength Benefits From Operating Resilience, Aug. 19, 2024

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Industry Forecasts: Retail and Restaurants

Chart 8
Revenue growth (local currency)

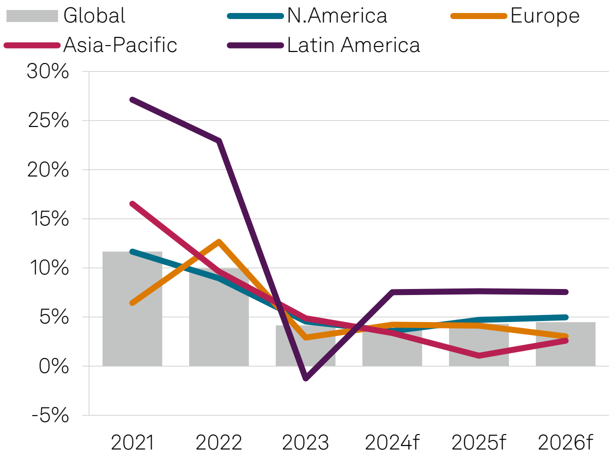


Chart 9
EBITDA margin (adjusted)

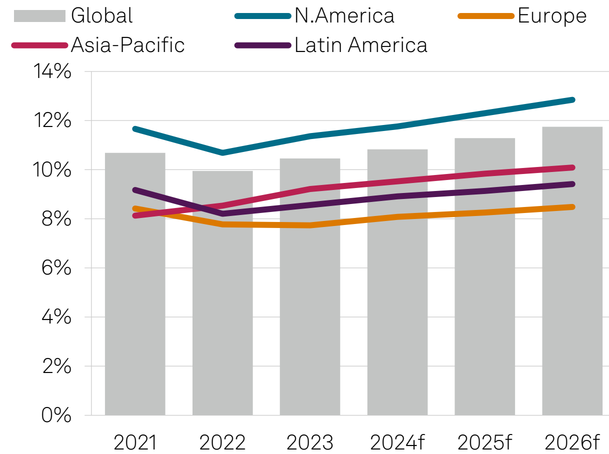


Chart 10
Debt / EBITDA (median, adjusted)

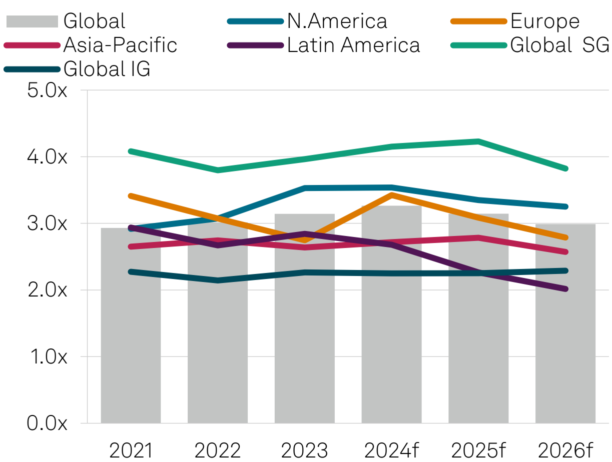
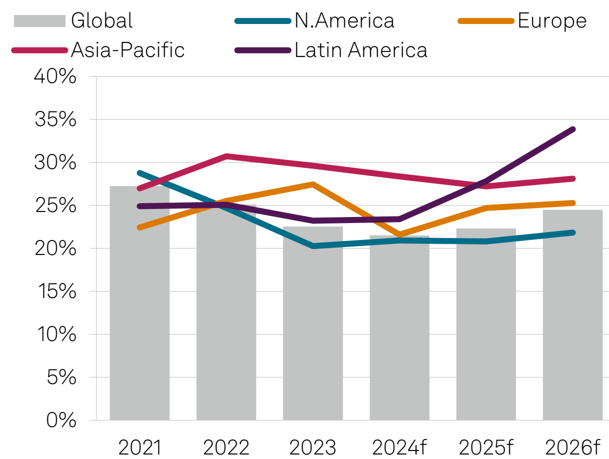


Chart 11
FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Retail and Restaurants

Chart 12

Cash flow and primary uses

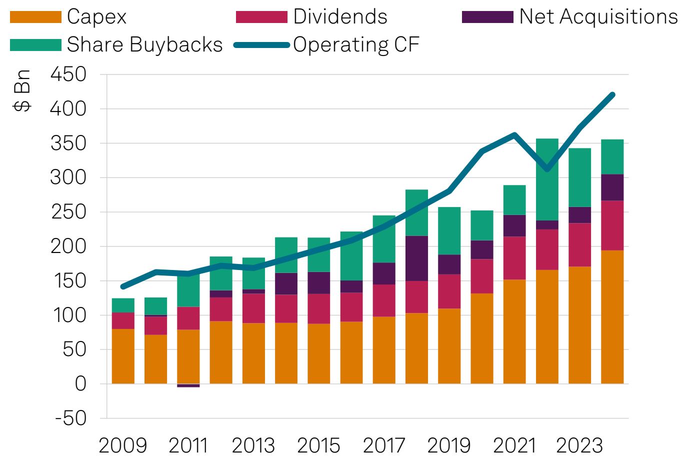


Chart 13

Return on capital employed

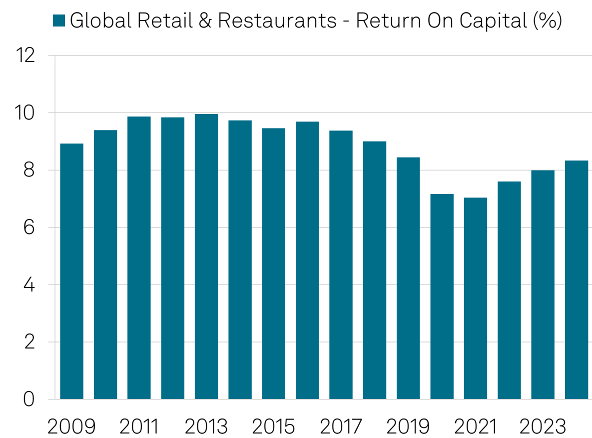


Chart 14

Fixed- versus variable-rate exposure

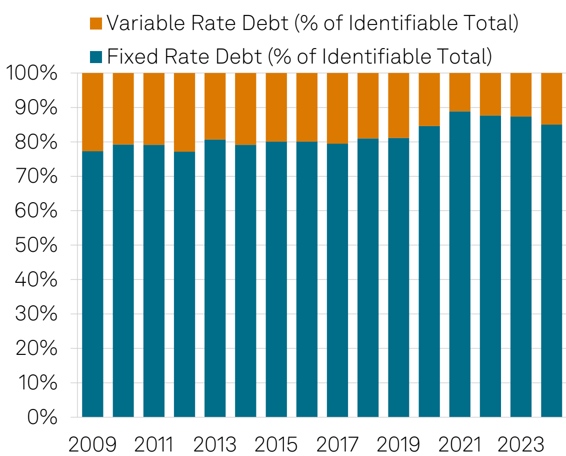


Chart 15

Long-term debt term structure

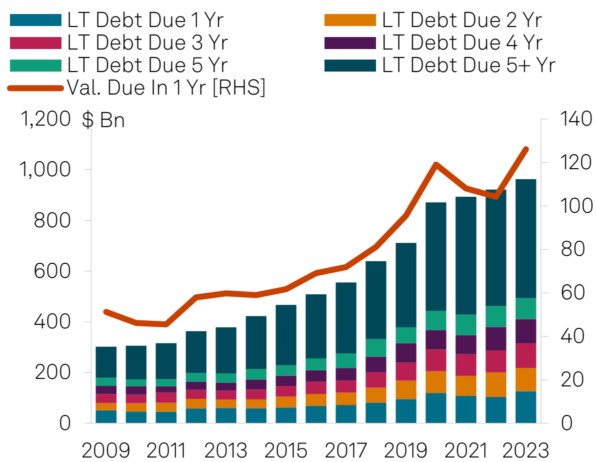


Chart 16

Cash and equivalents / Total assets

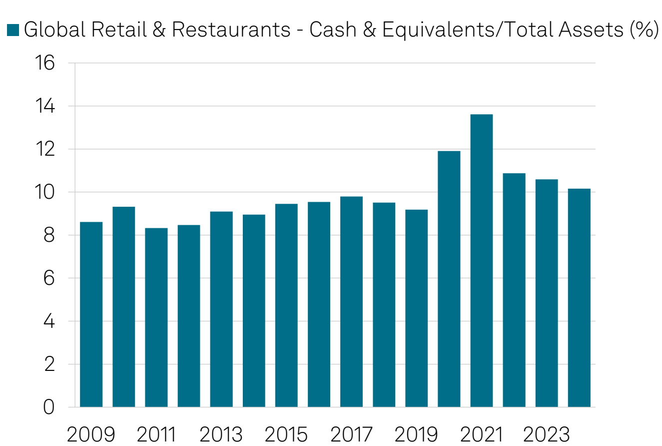
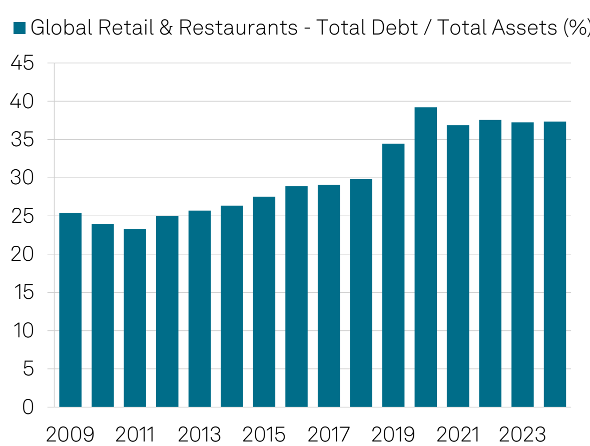


Chart 17

Total debt / Total assets



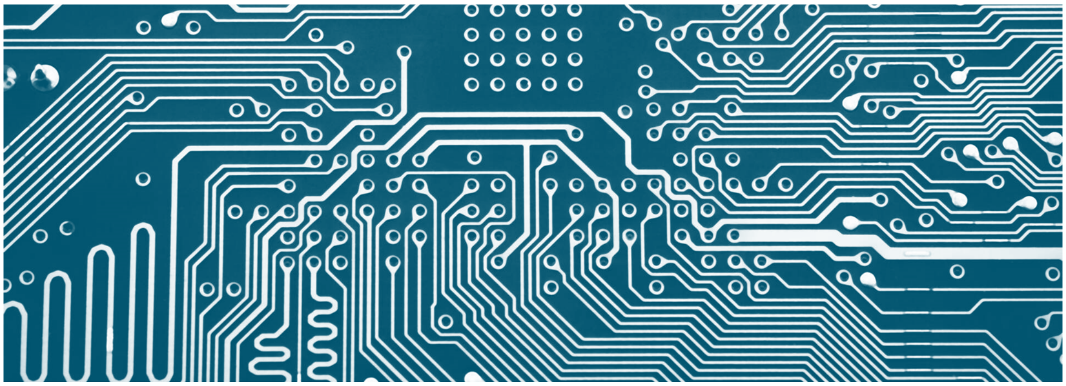
Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Technology

Tech demand is strong but subject to U.S. trade policy

January 14, 2025

This report does not constitute a rating action.



What's changed?

Tariff. U.S. tariff on tech imports, should they be implemented, could seriously affect IT consumption from consumer-focused PCs and smartphones to enterprise hardware demand. The tech industry is diversifying its supply chain but is still heavily dependent on China.

What are the key assumptions for 2025?

IT spending growth. We forecast IT spending to grow 9% in 2025, up from 8% in 2024, supported by continued AI infrastructure buildout and improvements in non-AI hardware segments and resilient software and IT services demand.

AI investments are strong in 2025. We expect sustained AI investments throughout 2025 given industry comments regarding robust AI demand and hyperscalers' announced capex plans, benefitting rated semiconductor and hardware issuers.

What are the key risks around the baseline?

Higher for longer. Inflation and policy rates have likely peaked, but interest rates may take longer to decline given caution among central banks in cutting rates too soon. This will stress companies in the 'B' ratings category with floating rate debt while keeping enterprise spending subdued.

AI investments will be volatile longer term. AI spending, while robust today, has the potential to turn the tech industry more volatile longer term should AI-related revenue growth fail to meet expectations and hyperscalers "pause" new infrastructure buildouts.

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Ratings Trends: Technology

Chart 1

Ratings distribution by subsector

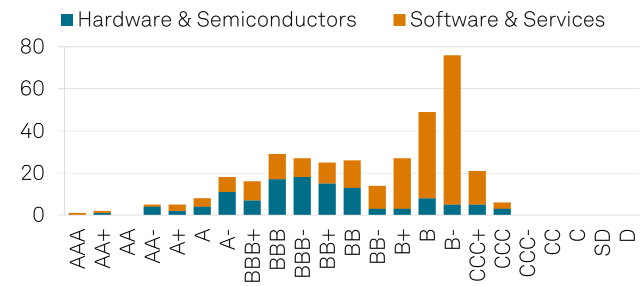


Chart 2

Ratings distribution by region

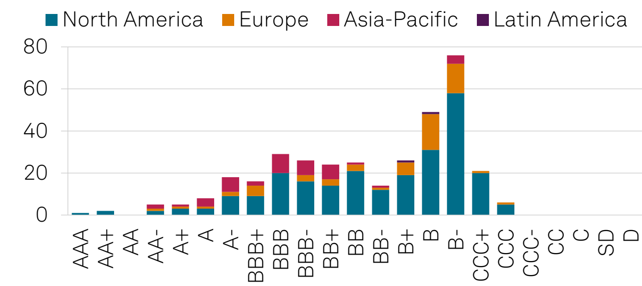


Chart 3

Ratings outlooks by subsector

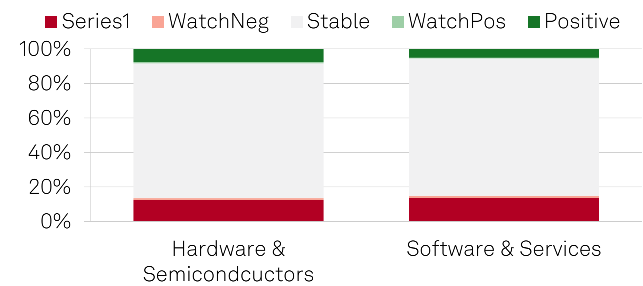


Chart 4

Ratings outlooks by region

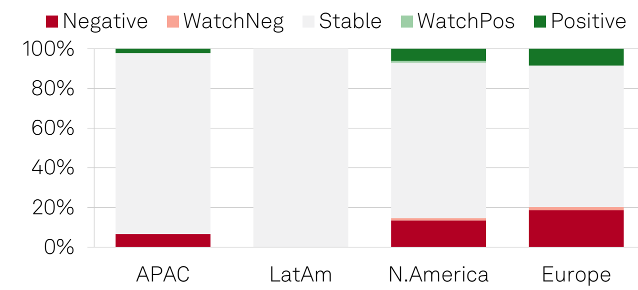


Chart 5

Ratings outlook net bias by subsector

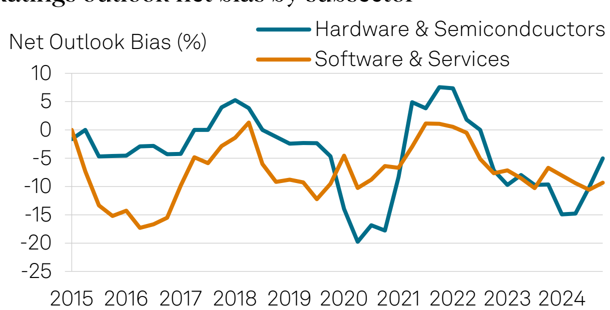


Chart 6

Ratings net outlook bias by region

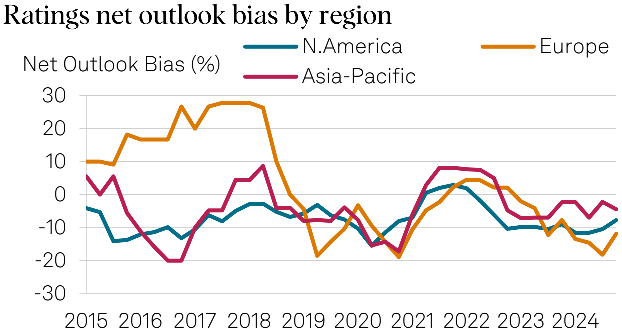


Chart 7

Ratings outlooks

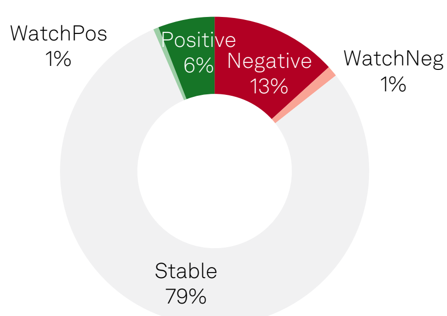
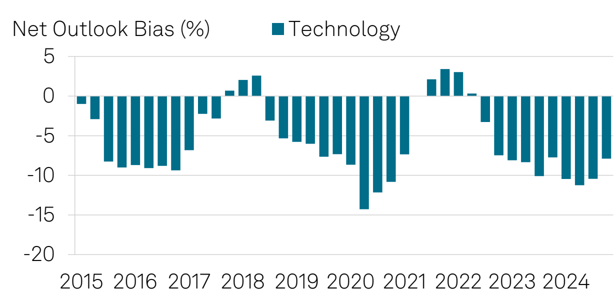


Chart 8

Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

North America: While the uneven global macro backdrop is a risk to demand, the majority of U.S technology issuer ratings have been stable. We expect this trend to continue in 2025, particularly in the investment-grade category, where approximately 85% of our issuer ratings have stable outlooks, while speculative-grade credits face heightened downside risks.

Non-stable outlooks (e.g., positive or negative) generally precede rating actions, but upgrades or downgrades from stable outlooks are possible. We see ratings upside in AI-exposed semiconductor companies seeing strong demand. Supportive financial policies, high business quality, and solid cash flow profiles across the investment-grade tech sector will provide a cushion for ratings; however, transformative acquisitions could be a catalyst for rating or outlook changes, as seen in the cases of Broadcom Inc. and Hewlett-Packard Enterprises (HPE).

Select investment-grade credits have non-stable outlooks and may experience rating changes over the next 12 to 24 months. Uber Technologies (BBB-/Positive/--) was the sole rising star in 2025, with the potential for further rating upside as profits and free cash flow scale. ON Semiconductor (BB+/Positive/--) is also a candidate in 2025 based on our assessment of its improved product portfolio and meaningful margin expansion that is likely to be sustained. Other credits with positive outlooks include Advanced Micro Devices (AMD), Analog Devices, Cadence Design, and Marvell. Corning and HPE remain on negative outlooks.

We took positive rating actions on AI hardware and infrastructure beneficiaries including AMD, NVIDIA, and Marvell during 2024. Broadcom received an upgrade to 'BBB' with a stable outlook on its acquisition of VMWare and our view of its improved business profile. We took the unusual step of downgrading Intel Corp. three times in 2024 given its continued operating challenges and significant capital spending to support its foundry strategy.

Despite pockets of weakness in the automotive and industrial semiconductor sectors, we maintained our ratings on Texas Instruments (A+/Stable/--) and NXP Semiconductors (BBB+/Stable/--). We revised our outlook on Analog Devices to positive from stable in August 2024, reflecting our view of the company's strong business quality and low leverage, despite weakness in these end markets.

Higher-quality speculative-grade credits in 'BB' category may see positive rating momentum but spec-grade ratings will likely carry a more negative bias in 2025 considering the high number of credits in the 'B' catergory and below. Credit quality certainly deteriorated for those carrying significant variable interest rate debt, most prevalent among 'B' or 'B-' rated issuers, as the elevated interest rate environment persisted. Most speculative-grade ratings have stable outlooks, although approximately 18% are on negative outlook or CreditWatch negative as of year-end 2024. Negative rating actions, including downgrades and negative outlooks, slightly outpaced positive rating actions in 2024 by 1.2:1 ratio. Apart from three issuers--Xerox (B+), Lumentum (B), and Maxlinear (B)--all other downgrades were from the 'B-' category and below. Western Digital (BB) is on CreditWatch with negative implications.

The prospect of slower rate cuts could push out cash flow improvements we expect in 2025 for some companies. For instance, we revised our outlook on Solera (B-; Polaris Parent) to negative from stable due to liquidity pressures and our expectation for free operating cash flow (FOCF) pressures stemming from significant interest expenses. Additionally, we downgraded companies facing idiosyncratic business challenges and nearing debt maturities. We downgraded Veritas (SD; selective default) on its debt exchange transaction to address its 2025 maturity. Verifone's credit deterioration, following a inventory correction in point-of-sale hardware and its upcoming maturity, led us to downgrade the company to ‘CCC+’ with a negative outlook.

Most of the Canadian tech sector maintains stable ratings; however, some companies may face downgrades in 2025. Currently, two issuers have negative outlooks: We downgraded Mitel Networks to ‘CCC’ and and assigned a negative outlook due to anticipated liquidity pressures amid challenging conditions in the unified communications market. Similarly, we hold a negative outlook on Alludo (B-; also known as Cascade Parent Ltd.) because of reduced demand and weakening earnings and cash flow. Canadian tech companies are experiencing trends similar to their U.S. counterparts. For instance, CGI plans to invest C$1 billion over the next three years in AI-based services and solutions as more customers seek AI solutions. Celestica is benefiting from increased growth and spending at hyperscalers, providing high-performance switches and custom computing solutions. In the expanding human capital management (HCM) market, Dayforce continues to thrive due to its scalable infrastructure and capability to perform human resource operations across multiple jurisdictions, while also targeting larger businesses and moving upmarket to serve large enterprises and global clients. Despite these positive developments, smaller software companies are experiencing low- to mid-single-digit revenue growth, with high leverage and rising interest rates continuing to exert pressure on their credit metrics.

While the uneven global macro backdrop is a risk to demand, the majority of U.S technology issuer ratings have been stable. We expect this trend to continue in 2025, particularly in the investment-grade category, where approximately 85% of our issuer ratings have stable outlooks, while speculative-grade credits face heightened downside risks.

Europe: We expect steady credit performance for European tech issuers in 2025, with 73% of our rated issuers holding a stable outlook. The remaining issuers have a negative bias, with 20% on negative outlooks or on CreditWatch (CW) with negative implications, while 7% carry positive outlooks or are on CreditWatch with positive implications. The majority of the negative outlooks are on ‘B’ or ‘B-’ rated financial sponsor-owned issuers, characterized by very high leverage or liquidity pressure.

In 2024, rating actions exhibited a negative bias, with six downgrades compared to four upgrades, and six negative outlook revisions versus two positive outlook revisions. Atos (SD; selective default) alone accounted for four downgrades during the year while we downgraded both ams-OSRAM AG (B/Stable/--) and Poseidon Bidco (B-/Negative/--) by two notches due to difficult market conditions that led to declines in EBITDA and increases in leverage. On the other hand, we upgraded Infineon (BBB+/Stable/A-2) at the beginning of the year, following several years of strong growth, creating the scale needed to absorb downturns in the cyclical semiconductor industry. The remaining three upgrades were of software companies that demonstrated solid operating performance and gradual deleveraging: Precise Midco (B/Stable/--), Almaviva (BB/Stable--), and Unit4 Group (B-/Positive/--). We also assigned four new ratings during the year: the Dutch advanced packing provider BE Semiconductor Industries (BB+/Stable/--), the Italian high complexity PCB manufacturer Castello (BC) Bidco Sp.A (B/Stable/--), the U.K.-based AI-powered cyber security provider Luke Midco II Ltd. (Darktrace) (B-/Stable/--), and the integrated payments processor AI silk Midco Ltd (Planet) (B-/Stable/--).

We expect that market conditions for technology hardware issuers in Europe will continue to present challenges, although we anticipate an overall improvement compared to a difficult 2024. We expect stabilization in most end markets, stemming from a normalization of customer inventories, which had depressed demand in 2024 following a post-COVID-19 buildup in 2022-2023. That said, we expect that the auto-exposed semiconductor companies we rate will continue to be affected by flat levels of auto production and stagnating electrification in the automotive sector in Europe and North America, leading to a low-single-digit revenue decline in 2025. By contrast, we expect a return to growth for our telecom equipment makers in 2025 following two years of consecutive revenue decline, reflecting expanding 5G coverage in developing markets and capacity investments in more mature markets.

Increased geopolitical conflict and trade tensions could prompt governments to impose additional tariffs or trade barriers on global supply chains, and some governments could take actions that favor local suppliers. The impact on European issuers resulting from the potential policies of the new U.S. administration and possible reprimands from other governments remain uncertain. However, we note that many of our issuers have sizable exports to both the U.S. and China, which could be directly or indirectly affected in various ways. At the same time, we generally consider our technology hardware issuers to be relatively diversified both in terms of customer and supplier bases.

We believe that software and IT services providers have strong growth prospects that will support stable ratings. The efficiency and competitive advantages of their cloud migration and digitalization offerings will likely spur demand for their products, which we expect will remain resilient. At the same time, we note that many of the companies we rate are grappling with persistently high restructuring costs related to business transformations and acquisitions, leading to pressure on profitability and FOCF generation. Although we expect a gradual decline in interest rates during 2025, we foresee that companies rated in the ‘B’ category (approximately 66% of European technology ratings) will continue to face high interest costs, especially given the high ratio of floating rate debt, which will likely result in lower FOCF generation and weaker credit ratios.

Asia-Pacific: More than 90% of the APAC issuers in the hardware and software sectors maintain a stable outlook thanks to a recovery in end-market demand despite tepid macroeconomic conditions. Most tech companies we rate possess substantial financial buffers to support their high capital expenditures needs. We expect these companies, particularly in Japan, will continue making aggressive investments and pursuing large acquisitions, some of which will be in non-tech areas such as entertainment and health care. These efforts aim to diversify their business portfolios and seek growth opportunities primarily in overseas markets; however, such aggressive investments and acquisitions may narrow the rating headroom for some Japanese tech issuers.

The AI super cycle is expected to continue boosting sales in product categories such as high-bandwidth memory and AI servers, despite U.S.-China trade tensions. This trend will benefit Korean DRAM manufacturers and companies involved in the supply chain for AI-related products. AI features and new models of smartphones and PCs are driving replacements in the premium segment. On the other hand, the increase in sales prices for AI-enabled PCs may introduce higher demand uncertainty and inventory risks within the sector. Additionally, the rising costs of AI-enabling components will pressure hardware margins for smartphone companies, although this may be partially offset by cost savings in other areas.

The APAC IT services sector is likely to continue benefiting from strong growth in digital transformation (DX) and automation. We anticipate this trend will support the earnings and profitability of Japanese and Indian IT services issuers over the next one to two years. Robust cash flow, supported by multiyear projects, diversified downstream market exposure, and solid financial foundations—often close to a net cash position—will continue to underpin their creditworthiness, even as they increase growth investments in areas such as DX and AI.

Latin America: Our base-case outlook for Latin American issuers reflects a positive momentum for business expansion; however, volatile macroeconomic conditions and high investment needs in the region may hinder our growth forecast for 2025.

We expect that online marketplace and fintech platform MercadoLibre Inc. (Meli; BB+/Positive/--) will maintain its leading market position in the region and continue to achieve strong growth. This growth aligns with the increasing digitalization of commerce and financial services in the region, which still lags other developed markets. While we believe Meli may face renewed competition from new foreign entrants, particularly Chinese platforms, its extensive footprint, superior user experience, and robust shipping capabilities provide it with significant competitive advantages. These factors, combined with its comfortable capital position, should enable Meli to grow while maintaining relatively conservative leverage metrics.

In Brazil, economic uncertainties continue to affect the retail and services sectors. Elevated interest rates may pose challenges for certain companies within the credit market. Despite this environment, we maintain our stable outlook on the Brazilian technology companies Agasus S.A. (brA-/Stable/--) and Positivo Tecnologia S.A (brA/Stable/--). We believe these companies will continue to see enhanced performance metrics over the coming years, even in a highly competitive and volatile exchange rate environment. In addition, we anticipate that sustained effective management of working capital will facilitate cash generation for the companies, thereby contributing to a gradual reduction in their debt levels.

Main assumptions about 2025 and beyond

1. IT demand set to accelerate but is subject to U.S. trade policy.

We forecast IT spending growth will improve to around 9% in 2025 versus 8% estimated for 2024, supported by a turnaround across the hardware segments which will cascade to a continued strong semiconductor demand. Software sales will remain resilient while IT services will grow meaningfully, partly due to ongoing public cloud migration. Our outlook incorporates a partial implementation of proposed Trump policies, including tariffs on China, but how these policies evolve will affect IT spending across the globe.

2. Hyperscalers betting big on the future of AI.

The global AI investment landscape is rapidly expanding, with spending projected to reach $630 billion by 2028 per IDC. Hyperscale data centers from Microsoft, Alphabet, and Meta are increasing capital expenditures, while semiconductor makers like NVIDIA and TSMC lead the beneficiaries. Software companies are still exploring monetization strategies, integrating AI into products and experimenting with revenue models as the industry evolves.

3. High uncertainty to China's technology spending in 2025.

The Chinese government's recent stimulus measures to boost consumption pulls forward some demand and will lead to slower growth in smartphone and PC shipment in 2025. The semiconductor sector in China faces overcapacity due to new capacity additions and softening end demand, although the government push to localize some tech supplies may alleviate the pressure. Large technology companies in the country will likely continue to spend on imported and domestic AI chip solutions for long-term competitiveness, after already significantly increasing their AI-related capital expenditure in 2024.

IT demand set to accelerate but is held hostage to U.S. trade policy. AI was all the rage in 2024. Despite global macroeconomic and geopolitical uncertainties and cautious enterprise IT budgets, hyperscalers continued their relentless march toward building out their generative AI infrastructure. While these companies have yet to meaningfully monetize their AI investments, their cloud revenues still grew in excess of 20% as enterprise customers continued their migration to the public cloud, keeping overall IT services growth near 7% in 2024 (see table 1). Software spending, despite its perceived backseat to the AI buildout, remained resilient, growing near 9% (see "Solid IT Demand Bodes Well For Technology Credits In 2025", published Jan. 8, 2025).

The PC and smartphone industries finally turned the corner in 2024 after two years of a significant downturn. Global server shipment grew an estimated 7% in 2024, but industry revenues jumped more than 40% to nearly $200 billion, according to IDC as the more expensive AI-enabled server shipments nearly doubled. The semiconductor industry was the biggest AI beneficiary, growing nearly 19% in 2024 due in part to massive spending on AI-related infrastructure including GPUs and high bandwidth memory (HBM). In all, we estimate global IT spending grew near 8.3% on a constant currency basis in 2024, higher than the estimated real GDP growth of 3.3% (nominal growth near 6%).

Our 2025 global GDP forecast calls for a 3.0% growth (nominal growth near 5%). U.S. GDP growth will slow gradually to the 2% area in 2025, incorporating a partial implementation of proposed Trump policies and consistent with a soft landing, while the Eurozone will continue its gradual recovery, growing 1.2% versus 0.8% in 2024. China's growth will slow toward 4.1% as the U.S. tariffs weaken exports and investment. That said, our global macroeconomic outlook is hostage to the policy implementation of the new U.S. administration. Potential changes in fiscal, trade, and immigration policy from the U.S. are significant unknowns at this juncture. Specifically, it is unclear to what extent campaign promises will translate into policy, and when. Given the size of the U.S. economy, policy action on any of these fronts can move the IT spending outlook among all regions.

Table 1

Global IT growth forecasts

	2023	2024e	2025e
Macro			
Global GDP growth (real)	3.5%	3.3%	3.0%
U.S. GDP growth	2.9%	2.7%	2.0%
Eurozone GDP growth	0.5%	0.8%	1.2%
China GDP growth	5.2%	4.8%	4.1%
Global IT spending (nominal)	**3.9%**	**8.3%**	**9.0%**
Revenues			
IT services	6.0%	7.0%	8.0%
Software	10.0%	9.0%	10.0%
Semiconductors	(8.0%)	19.0%	12.0%
Network equipment	7.0%	(11.0%)	7.0%
Mobile telecom equipment	(11.0%)	(10.0%)	3.0%
External storage	(2.0%)	2.0%	4.0%
Shipments			
PC	(14.0%)	1.0%	3.0%
Smartphone	(3.0%)	5.7%	2.4%
Server	(19.0%)	7.0%	4.0%
Printer	(3.0%)	(5.0%)	(3.0%)

e—Estimate. Source: S&P Global Ratings.

Despite the uncertainty that lies ahead for global trade, we forecast global IT spending will grow a robust 9% in 2025, higher than in 2024 and much greater than our expectations for global GDP growth. We note our forecast has a high degree of variability. In our economic forecasts, we assume President-elect Trump will use his executive powers to impose targeted tariffs on China by raising the bilateral (weighted average) effective tariff rate on Chinese imports to 25%, from an estimated 14% currently, and that Beijing would likely reciprocate with equivalent barriers on American exports to the country. We further assume that such tariffs could be managed over time by most hardware providers by passing on much of the incremental costs to end users and through supply chain reallocation, albeit gradually. Conversely, we do not assume any potential upside in U.S. enterprise IT spending should corporate tax cuts be implemented in 2025.

Hyperscalers will continue to generate revenue growth well above 20% in 2025, partly supported by gradual monetization of AI investments, and contribute to an overall strong IT services growth near 8%. The software segment will continue to outpace the overall IT industry, with a modest acceleration to around 10%, although some investment-grade issuers may exceed that level. While AI-related gains are nascent overall, we believe the continued strong growth among software vendors validates their strategy of providing productivity gains and lowering customers' operational costs.

Enterprises are entering 2025 with an improving IT spending view as they continue their transition to the cloud and slowly ramp up their investments in generative AI projects. We believe hardware spending will improve materially in 2025. Server shipments should grow near 4% but revenue growth will be much higher given high AI server ASPs. We expect network equipment and mobile telecom equipment makers to return to growth while storage sales should grow around 4%. PC and smartphone shipments should grow in the 2%-3% range but industry revenues should be higher given modest infusion of AI-enabled devices.

We forecast the semiconductor industry, already the biggest beneficiary of the AI arms race, will outgrow the overall IT industry again, at near 12% growth, largely driven by continued adoption of AI compute (GPU, HBM, among others) as well as a rebound in non-AI-related demand. We estimate that industry revenues, excluding memory and NVIDIA, will grow in the mid-single-digit percentage area after experiencing a similar decline in 2024.

Hyperscalers betting big on the future of AI. The AI investment landscape is poised for significant growth, building upon the extraordinary momentum established in 2024. IDC projects that global AI spending will surge to a staggering $630 billion by 2028, a nearly 30% compound annual growth rate from 2023. Financial services, software and information services, and retail are expected to account for 45% of anticipated AI spending over the next five years. Fast-growing use cases include claims processing, digital commerce, sales planning, smart factory floor, and product design.

We estimate capital spending by large data center players Microsoft, Alphabet, and Meta Platforms will increase about 50% in 2024, followed by more than 20% in 2025. This marks an incremental $30 billion expansion in 2025 on top of nearly $50 billion growth in 2024 amid a significant build-out of data center structures to be filled with equipment later. Management comments support a continued robust investment environment. Last quarter, Microsoft CFO Amy Hood noted that demand continues to be higher than the company's available capacity, despite rapid investment growth; Amazon reported similar constraints. Google's CEO Sundar Pichai has said that the risk of underinvesting is greater than the risk of over investing.

The clearest beneficiaries of AI investment spending at this point are the semiconductor makers. Far and away, first among them is GPU-provider NVIDIA Corp. followed by its manufacturing partner Taiwan Semiconductor Manufacturing Corp (TSMC). The memory chip makers are benefiting from high-bandwidth memory necessary for AI servers as are the custom chip providers like Broadcom and Marvell that help the large public cloud providers build their own chips like Google has done with its Tensor Processing Units and Amazon with its Trainium chips. AI server makers such as Dell and HPE will get a boost as enterprises build out on-premises or private cloud AI capabilities because of data governance and security requirements.

The platform providers–Amazon, Microsoft, Google, and Oracle–that rent AI data center capacity to model builders and to a lesser extent enterprises running AI workloads, are gaining revenue growth but are also paying for it with unprecedented levels of capex measured in the tens of billions of dollars annually for each company. The frontier model providers like OpenAI are being rewarded with large valuations but are reportedly still losing billions annually as they keep plowing cash into training the next mode. This keeps getting more expensive as these companies add more and more compute to make advances, while also try to invent new training techniques as model improvements are slowing.

Software companies are the furthest behind in monetization. They are investing in building their own models to integrate into their products–creating revenue for the platforms–but the industry remains in the early stages of monetization. Companies are experimenting with revenue models. Some are charging subscription fees for specific AI capabilities, while others are pursuing a more general strategy, infusing AI into their existing products to make them more competitive. Early examples include Microsoft’s Copilot assistant that is integrated into its Microsoft 365 suite, Salesforce’s Agentforce, which provides agents that can handle tasks like customer support without human intervention, and Adobe’s integration of AI tools to support content creation and data analysis. We expect more progress from software companies on AI monetization in 2025 as investors seek returns on investment spending.

High uncertainty to China’s technology spending in 2025. China accounts for more than 20% of the worldwide hardware and semiconductor spending. A potential slowdown in its domestic market poses significant risk to the overall health of the global IT industry. Recent stimulus measures implemented by the Chinese government, particularly the subsidies for trade-in of used consumer electronics, significantly bolstered consumer spending of smartphones, PCs, home appliances, and other products in late 2024, pulling forward some demand from 2025. Without effective further stimulus or an economic recovery, we expect the spending surge to subside in 2025. We expect China's smartphone and PC shipment growth in 2025 to slow to low-single-digit and mid-single-digit growth, respectively.

China's semiconductor market for mature nodes will continue to grapple with overcapacity, although the government's initiative to localize chip and technology supply production may alleviate some of this pressure. The Chinese government’s push for technology companies to invest in chip manufacturing and the country’s significant surge in purchasing semiconductor equipment from ASML in the first half of 2024 amid concern over further trade restrictions has resulted in overcapacity. We anticipate softening consumer electronics demand in 2025 and the commissioning of new capacity, albeit at a slower pace than in 2024, to lead to reduced utilization rates and ASP for companies in this sector. The Chinese government is focused on enhancing the localization of technology supplies, particularly smartphone components and semiconductor components for electric vehicles (EVs). This strategy may help mitigate the effects of declining demand for mature node semiconductors due to the country's slowing economic growth.

Large technology companies in China will continue to invest heavily in AI infrastructure in 2025, as falling behind in AI risks hurting their future competitive positioning in their core businesses. Large Chinese internet companies such as Alibaba and Tencent doubled their capital expenditures in 2024, mostly for investments into AI-related infrastructure. Much of the spending in 2023 and 2024 were to stock up on advanced AI chips from the U.S. prior to the effective date of U.S. export restrictions. However, we believe Chinese companies will continue to buy AI chips with China-specifications, as well as homegrown AI chips to continue the buildout of their AI capabilities.

Credit metrics and financial policy

With policy rates slowly falling, significant refinancing achieved in 2024, and a solid industry growth outlook in 2025, we expect a favorable credit environment over the near term. The technology sector has already seen solid earnings growth in 2024. Supportive financing conditions and lower interest rates allowed more than three-quarters of U.S. corporate speculative-grade bond and leveraged loan issuance in 2024 for refinancing or repricing. Inflation and policy rates have likely peaked, but interest rates may take longer to decline given caution among developed market central banks in cutting rates too soon for fear of reigniting inflation. We expect the U.S. federal funds rate will average about 3.9% in 2025 before declining to the neutral rate of about 3.1% in mid-2026.

We expect credit metrics to improve for most of our investment-grade companies given supportive top-line growth expectations and stable to improving margin profiles. We expect heightened share repurchases and acquisition activity in 2025 but do not think this will affect the credit profiles of most of our investment-grade issuers.

However, amid the U.S. political transition, the prospect that materially higher tariffs will reignite inflation and force the Federal Reserve to halt—or even reverse—its cycle of monetary-policy easing poses a significant risk. Investors could demand higher-risk premiums amid slowing economic growth, rising policy uncertainty, and increasing market volatility. Borrowers, especially those at the lower end of the ratings scale, would face more challenges servicing debt or refinancing under this scenario.

We expect financial policy will remain relatively consistent in 2025 for rated technology issuers. M&A deal flow was relatively quiet in 2024, except for Synopsys' acquisition of ANSYS for $35 billion in January 2024, Cisco's acquisition of Splunk for $28 billion in March 2024 (closed), and HPE's acquisition of Juniper Networks for $14 billion. Synopsys and Hewlett Packard Enterprise deals remain on hold due to anti-trust issues. Other sizable deals included Cohesity's (B/Stable/--) acquisition of Veritas' data protection business to form a company valued at $7 billion. The transaction included a $2.3 billion debt financing. Other notable transactions included IBM's acquisition of HashiCorp. for $6.4 billion and Thoma Bravo's acquisition of Darktrace for $5.3 billion.

We expect deal-making to pick up in 2025. While rates are likely to stay higher for longer, an end to the Federal Reserve's hiking cycle should improve the outlook for buyers and sellers. The Trump administration's potential friendlier stance on M&A should also spur deal-making, at least for smaller transactions that do not require Chinese regulatory approval.

Through the 12 months ended September 2024, technology companies repurchased a total of $246 billion of stock, up 24% from the prior year. We see a broader pickup in buyback activity into 2025 led by Apple, Alphabet, Meta, and NVIDIA, the four largest share repurchasers within S&P 500 Index through September 2024. With the recent Fed fund rate cuts, and the market's current expectations for more, companies may be more willing to increase their share buybacks. We expect lower-rated investment-grade companies, especially those in hardware and semiconductor industries, to exercise caution with shareholder returns in 2025 given tariff issues.

Key risks or opportunities around the baseline

1. Incremental trade restrictions may prove more disruptive than prior rounds.

While the technology industry has weathered trade conflict well to date, incremental restrictions from a second Trump administration could prove more painful. Tariffs and restricted entity lists have affected hardware and semiconductor companies the most, and a further escalation could lead to more disruptions, particularly in the production of smartphones and PCs, which are heavily concentrated in China. The industry is diversifying supply chains outside of China, but this process is slow and expensive.

2. AI is transforming the technology industry in ways that will create winners and losers.

The technology industry is on the cusp of a massive wave of spending on AI, with companies poised to spend over $230 billion in 2024, primarily from the largest technology companies globally. While this presents opportunities for infrastructure providers, it also poses risks, including margin pressure across the software landscape and the potential for an "AI winter" if the current level of enthusiasm proves to be oversold. Over the near term, we continue to see benefits accruing to providers of compute infrastructure and the core backbone models, while traditional—even cloud native—software providers will need to remain nimble to see benefits from this wave of investment.

3. Rising rate uncertainties pose risks to lower-rated issuers.

Our economists expect diverging global macro conditions and potential growth effects of U.S. policies will lead to inflationary pressures and a possible Fed rate cut pause at some point. They now expect the Fed rate to end 2025 at 3.6% versus 3.1% previously. A more stable backdrop may spur M&A activity while higher-for-longer presents downside risk for lower quality issuers that didn't refinance in 2024.

Incremental trade restrictions may prove more disruptive than prior rounds. The global technology industry has navigated the challenges of trade tensions, expanding tariffs, and restricted entity lists over the past eight years, growing impressively despite these multiple headwinds. Nevertheless, we view a second Trump administration as creating substantial uncertainty around U.S. trade policy, with the potential to cause significant disruption to the tech industry. Our current base-case macroeconomic forecast assumes raising the effective weighted average tariff rate on Chinese imports to about 25% from 14%, with comparable retaliatory tariffs imposed by Beijing. While we believe that the broader industry should be able to weather this level of incremental trade barriers without major disruptions, the eventual course of U.S. policy may vary substantially, and we view potential trade hurdles as a key source of downside risk to our base-case forecast.

Trade restrictions—particularly those focused on China—have been a major factor in the technology industry over the past two presidential administrations, and the technology industry enters 2025 having already adapted to a less free-trade oriented world. Hardware and semiconductor vendors have made initial steps to diversify supply chains away from China, and substantial industrial policy in the western world—including the CHIPS Act in the U.S.—has spurred substantial investment in domestic semiconductor manufacturing.

Notwithstanding these adaptations, substantial risks remain should the incoming administration pursue an even more aggressive restrictive policy than we currently expect. One area of exposure is smartphone and PC production, which remains heavily concentrated in China. China accounts for 60% or more of global production for these products, particularly for PCs and Android smartphones. This makes such products susceptible to increases in U.S. import tariffs and is a meaningful risk for PC and some smartphone manufacturers. Though we expect smartphone and

PC manufacturers can pass off some of the cost of higher tariffs to U.S. consumers and enterprises, sharply higher prices for such products could stifle demand and slow replacement cycles.

Restrictions on the export of advanced chips and their manufacturing equipment could also further exacerbate technology supply chain risks. While current U.S. export restrictions have been narrowly focused on the highest-performance chips used in AI and other advanced applications, these chips are a much larger share of semiconductor industry revenues than they were four years ago. Thus far, these restrictions have mostly impacted a handful of vendors selling advanced chips and wafer fabrication equipment (WFE). We expect these restricted entities to grow in scope—the U.S. added over 140 new entities to its restricted list in the third round of export controls this past December. If these restrictions continue to exclude a growing and increasingly important sector of the semiconductor industry from China, we see the risk of increasingly aggressive retaliation that could affect the broader technology sector.

We expect the industry to continue to pursue supply chain diversification outside of China and East Asia more broadly to mitigate some of these risks but view this process as slow and expensive. The CHIPs Act, which boasted roughly $280 billion of incremental funding for U.S. semiconductor research and manufacturing, has only begun to reverse a decades-long consolidation and will need to be followed by many similarly scaled actions if supply chains are to be meaningfully rebuilt. If growing U.S. budget deficits limit political appetite for further subsidies, the technology industry could find itself unable to rebalance capacity in the face of growing trade challenges.

APAC technology suppliers have responded to the threat of additional tariffs by investing in capacity outside of China. Initially downstream assemblers were the first to invest in overseas capacity, but midstream technology suppliers are now following suit. This is a notable trend considering that midstream suppliers tend to be asset heavy, rely on skilled labor, and require proximity to upstream suppliers and downstream customers making it difficult to shift such capacity elsewhere. Such investments are likely to continue over the next two years, somewhat reducing the financial buffer for these companies.

Nonetheless, smartphone and PC production remain heavily concentrated in China, making these products susceptible to increases in tariffs and a meaningful risk for Asian manufacturers.

AI is transforming the technology industry in ways that will create winners and losers. Generative AI and the broader universe of machine learning technologies pose both substantial opportunities and risks to technology companies and represent the greatest unknown risk facing the technology sector over the next five years. We currently expect companies globally to spend over $230 billion on AI investment in 2024, representing nearly 7% of total IT spending, a figure we expect to grow to over $300 billion in 2025. This massive wave of spending, primarily undertaken by five of the largest technology companies globally—Amazon, Alphabet, Microsoft, Meta, and Oracle—has largely benefitted infrastructure providers to date. As most of the investments so far have been focused on building out the core compute hardware needed to train large models, initial beneficiaries have been providers of “picks and shovels” to these hyperscalers rather than model owners and operators themselves.

While general optimism for this technology remains high and we don’t see signs of a pullback in spending so far, we see several ways in which growing adoption of AI could create disruption and increase credit risks among technology companies. For example, as enterprises have increasingly made AI an area of focus in their IT budgets—overall spending levels have not risen in step with this and we have heard comments regarding longer software sales cycles and pressured budgets in any area outside of AI or IT security. While software companies have pushed to add AI-enabled features in their offerings—such as SalesForce’s Agentforce—these enhancements are in early stages and we have not seen substantial adoption outside of applications in design (Adobe) or coding (Microsoft Co-Pilot). We see risk that this could lead to margin pressure across the software landscape if providers of models and inferencing infrastructure are able to capture most of the incremental value added, while any marginal pricing power is competed away.

Although a smaller risk, we also see potential risk to companies if the current level of enthusiasm for AI proves to be oversold. Despite hundreds of billions already spent and hyperscalers' push to pour more money into this technology, no "killer app" has yet emerged to create profitable broad adoption. Past cycles of heavy tech capital investment without a clear use-case have proven painful. While most of the heavy spending to date has been undertaken by the largest and best-capitalized companies in the sector that would certainly be able to weather an AI winter, we think an unexpected pullback could prove painful for several sectors of the semiconductor industry, which have largely relied on HBM and AI-enabling advanced logic chips to fuel the current market recovery.

Rising rate uncertainties pose risks to lower-rated issuers. The incoming Trump administration's policy changes and calls for higher tariffs increase downside risk of stubborn inflation data and higher interest rates for longer in 2025. Although a declining interest rate environment is widely expected, the increasing probability of less aggressive rate cuts will not bode well for companies with vulnerable businesses or high debt leverage (see table 2). Our economists expect diverging global macro conditions and potential growth effects of U.S. policies will lead to inflationary pressures and a possible Fed rate cut pause at some point. S&P Global economists now forecast a gradual move in the Fed policy rate to reach 3.1% by fourth-quarter 2026 from fourth quarter 2025 under their previous forecast (see "Global Economic Outlook Q1 2025: Buckle Up," published Nov. 27, 2024).

Table 2

Less aggressive rate cuts will likely weigh on lower-rated entities

U.S. technology sector - Average interest cover and FCF to debt by rating category

	B		B-		CCC+ and below	
	2019	2024	2019	2024	2019	2024
Interest cover (x, adjusted)	2.79	1.57	1.85	1.32	1.62	0.68
Interest cover (x, reported)	1.98	1.55	1.15	1.24	0.88	0.47
FCF to debt (%)	8.2	4.1	2.6	1.5	1.9	-3.0

FCF—Free cash flow. These metrics represent simple averages by rating category, are not adjusted for new issuers and withdrawn ratings, and exclude outliers and pre deal periods. Source: S&P Global Ratings.

With this uncertainty settling in, a flurry of lower rated borrowers experiencing good operating performance rushed to reprice loans in 2024 and may continue into 2025. For example, Cloud Software Group (B/Stable/--) came to market several times to issue and opportunistically reprice its debt, including in November 2024 when it repriced more than $6 billion of term loans, reducing the spread 25 to 50 basis points on its floating rate coupon. We view the refinancings positively considering the company's capital structure—comprising $16 billion of funded debt.

The repricing is a story of have and have-nots, as we witnessed some borrowers feeling the pinch of higher rates and become more vulnerable now that the trajectory of rate cuts is becoming uncertain. Underperforming credits have struggled to address capital structures amid weak operating performance and free cash flow generation. For example, in April 2024 we revised our outlook on Solera (B-/Negative/--) to negative from stable based on its reducing liquidity buffer and significant interest expense burden. While we expect self-help to expand EBITDA, the change in rate trajectory expectations raises downside risk for Solera.

Related Research

- Solid IT Growth Forecast Bodes Well For Technology Credits In 2025, Jan. 8, 2025
- Global Economic Outlook Q1 2025: Buckle Up, Nov. 27, 2024

Industry Forecasts: Technology

Chart 9

Revenue growth (local currency)

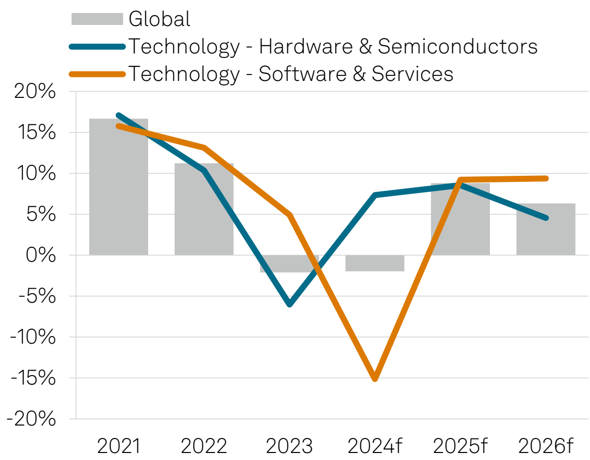


Chart 10

EBITDA margin (adjusted)

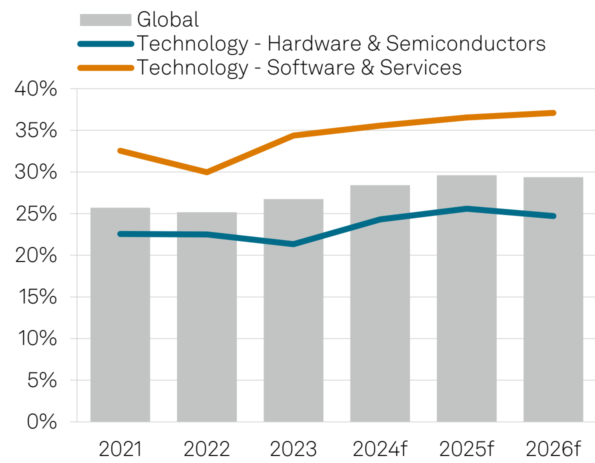


Chart 11

Debt / EBITDA (median, adjusted)

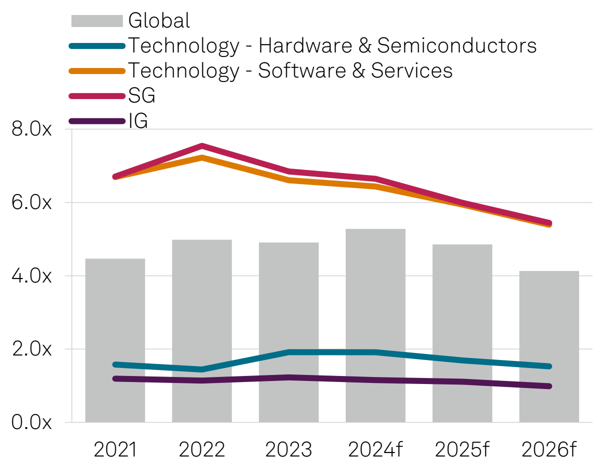
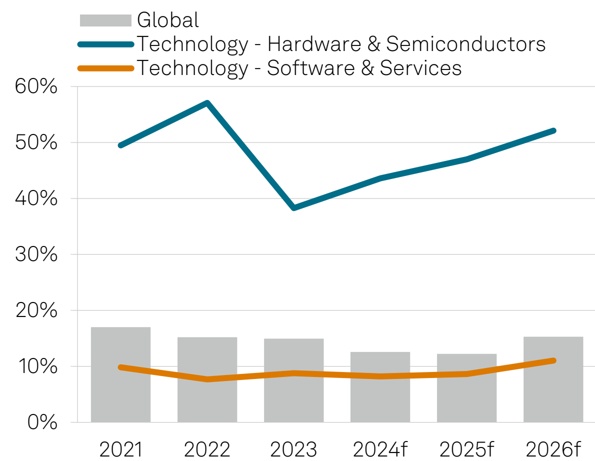


Chart 12

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Technology

Chart 13

Cash flow and primary uses

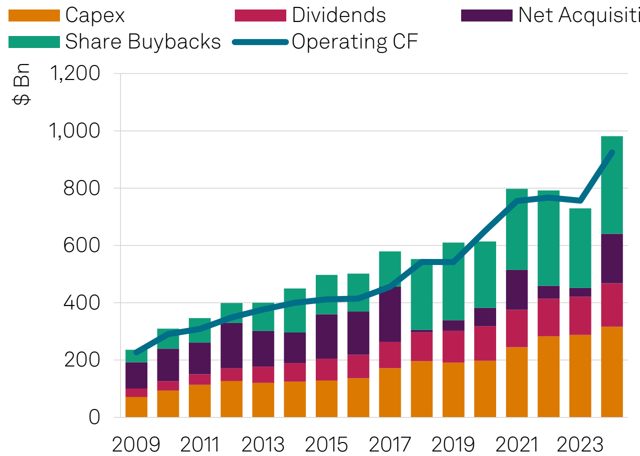


Chart 14

Return on capital employed

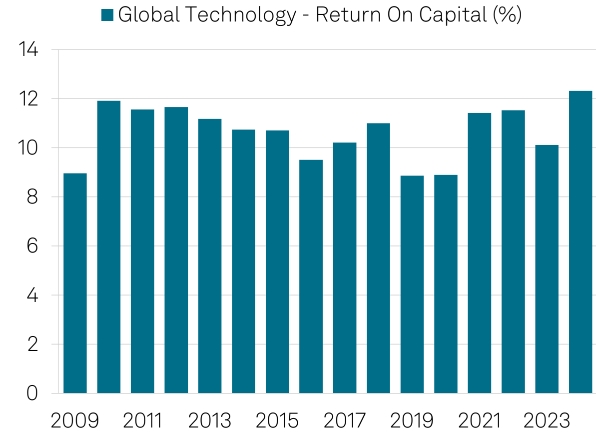


Chart 15

Fixed- versus variable-rate exposure

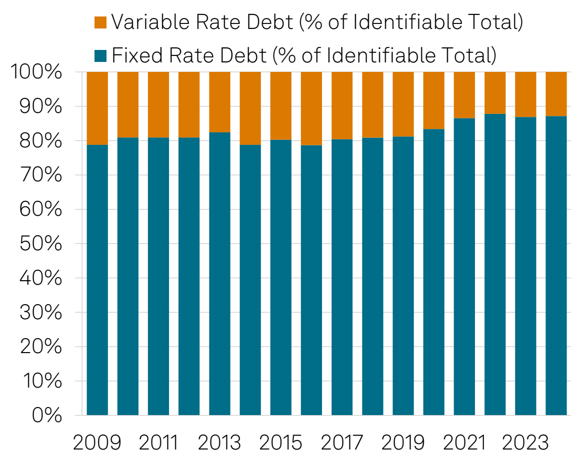


Chart 16

Long-term debt term structure

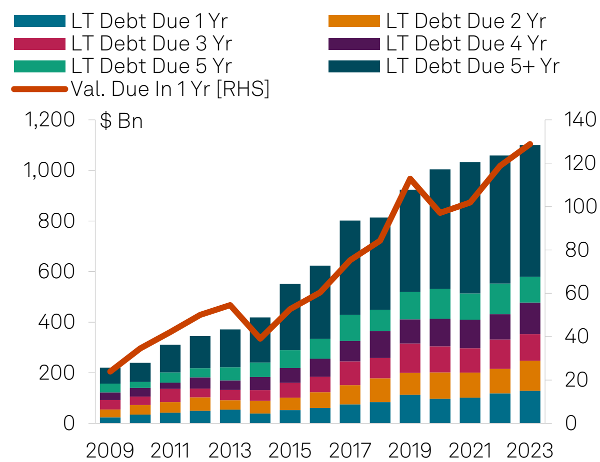


Chart 17

Cash and equivalents / Total assets

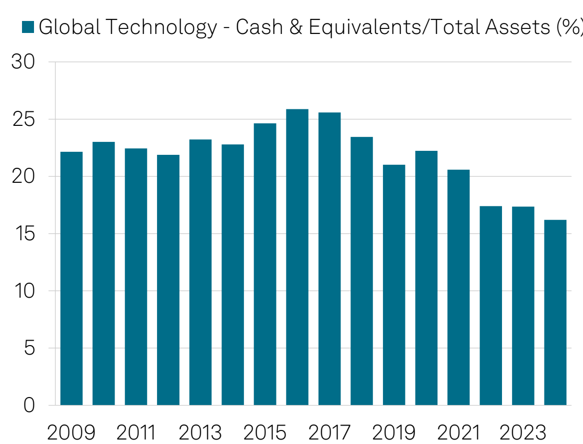
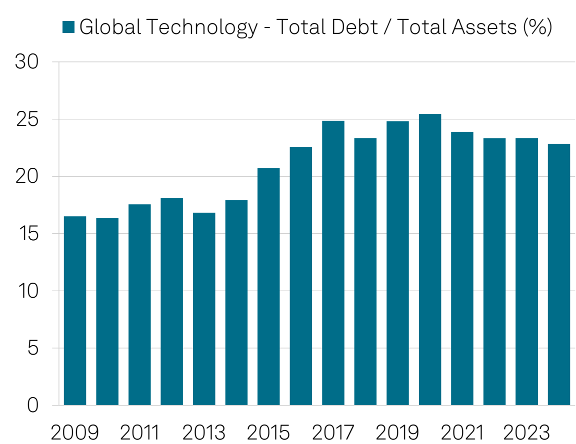


Chart 18

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Telecoms

Stronger signals for the sector

January 14, 2025

This report does not constitute a rating action.

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What's changed?

More favorable market and financing conditions, including slowing inflation, which has eased margin pressure, while moderating interest rates have improved capital market access.

Mergers and acquisitions (M&As) have increased. Telcos are seeking consolidation in Europe, Latin America and Asia-Pacific to ease competitive pressure, and JVs in the U.S. for fiber access.

The satellite segment has suffered as a growing orbit of LEO players are crowding MEO- and GEO-dependent players out of traditional business with services backed by superior broadband.

What are the key assumptions for 2025?

Steady earnings growth for 2025. Average telco revenue growth north of 2% and EBITDA growth of 3% through 2026, supported by steadily rising demand and upselling opportunities.

Digital infrastructure investment is spiking. Interest in data centers, fiber, and telecommunications towers will provide asset monetization opportunities for integrated telcos.

Capital expenditure (capex) will continue to decline. Capex will decline in markets with highly developed infrastructure, improving free cash flows.

What are the key risks around the baseline?

Consolidation M&A could improve market dynamics. If markets consolidate through M&A, competition could ease, improving business conditions.

However, competition still remains the key risk for operators. Competition has eroded more-for-more strategies, pressuring pricing, the top line, and return on capital, and remains a key risk.

Increasing investments or shareholder returns could limit credit metric improvements.

Ratings Trends: Telecoms

Chart 1

Ratings distribution by subsector

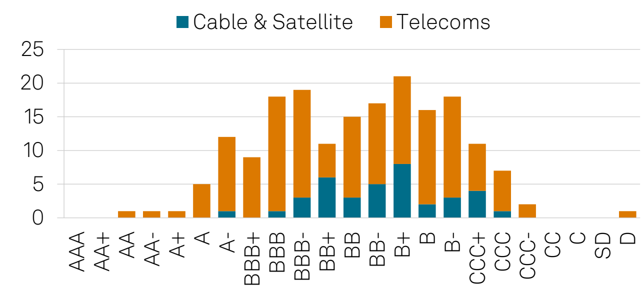


Chart 2

Ratings distribution by region

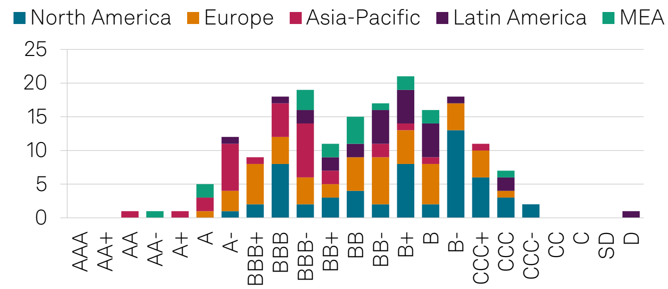


Chart 3

Ratings outlooks by subsector

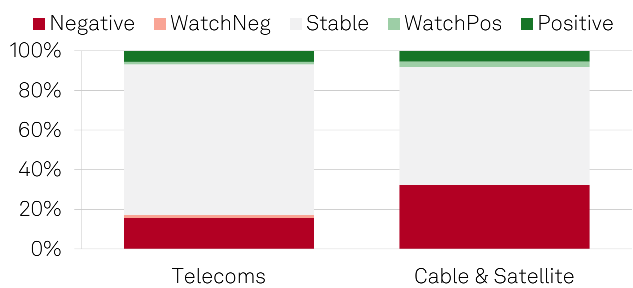


Chart 4

Ratings outlooks by region

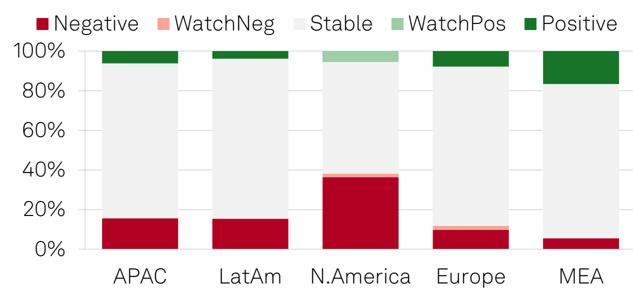


Chart 5

Ratings outlook net bias by subsector

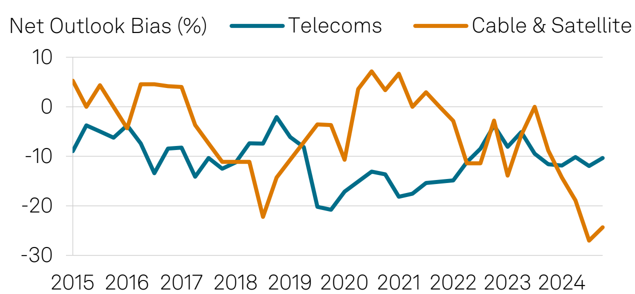


Chart 6

Ratings net outlook bias by region

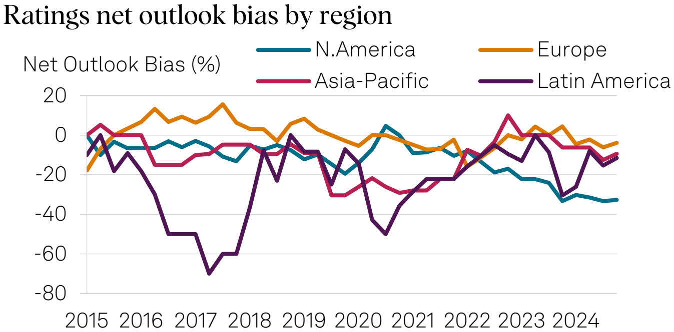


Chart 7

Ratings outlooks

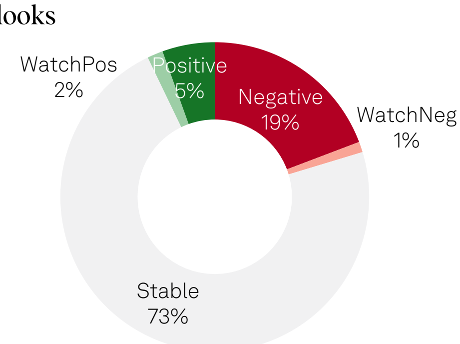
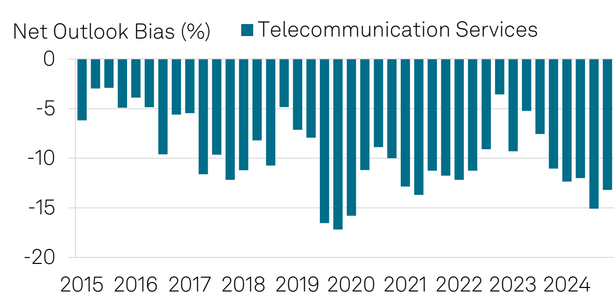


Chart 8

Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook: Global

Ratings trends and outlook

While telecom ratings have a clear negative bias at 13% globally, this is mainly driven by North America, where the negative bias is above 30% on a large proportion of speculative-grade issuers, with high leverage and increased interest rates pressuring cash flow and debt sustainability. For the rest of the world, the negative bias averages below 10%.

Despite the negative bias, conditions have generally been improving in the telecoms industry. Our positive revenue forecast is supported by significant demand for telecommunications products—including premium fiber and 5G services—an increased normalization of regular price increases, and moderating competition in many regions that is partly aided by consolidation.

Main assumptions about 2025 and beyond

1. Steady earnings growth for 2025.

Revenue growth north of 2% and EBITDA growth of 3% for telecommunications companies (telcos) through 2026. This is supported by steadily rising demand and upselling opportunities for more widely available premium products, but with exceptions in some markets facing more intense competition.

2. Digital infrastructure investment is spiking.

The focus on data centers is particularly acute, but there is also steady interest in fiber and towers. This will extend asset monetization opportunities for integrated telcos and increase the scale and number of players in this more stable telecoms segment.

3. Capex will continue to decline overall.

We forecast declining capex on 5G and fiber in markets with highly developed infrastructure, in contrast to markets with lagging rollouts. However, we expect the bulk of the free cash flow made available will go toward shareholder remuneration rather than debt reduction, limiting positive credit rating outcomes.

We estimate that earnings will remain steady for 2025. Overall, we expect top-line growth for telcos will remain stable across regions. We expect growth to average above 2% in most regions for 2025, reflecting stable demand for telecom services despite strong competition. Meanwhile, a focus on cost efficiency measures should support slightly faster earnings growth at 3%.

In the U.S., wireless service revenue is likely to grow by about 3% in 2025 due to price increases on legacy plans, customer migration to more expensive 5G plans, and growth from fixed wireless access (FWA). For cable operators, we expect similar growth in 2025, reflecting a rise in broadband average revenue per user (ARPU), improving wireless economics, business services, and an expansion of operating coverage or ‘footprint’.

In Europe, we expect top-line growth to average 2%. Despite slowing inflation, more sustainable levels of competition should allow continued contract-based price increases on postpaid subscriptions and reduced promotional discounts for new customers. Combined with margin improvements, we think earnings are poised to grow by 2%-3%.

In Latin America, we also forecast positive revenue growth, at about 4%, broadly in line with our expectations for the region’s economic growth.

In Asia-Pacific, we expect revenue growth of about 3%-5% for 2025, given increased mobile data traffic and fixed broadband adoption.

The quality of markets varies widely. We expect better performance in countries with three or fewer operators and balanced market share. Such markets, sometimes as a result of consolidation, tend to be more stable and have lower churn levels. If supported by a predicable regulatory framework and higher interest rates suppressing unsustainable pricing, competition can become and remain more moderate, raising prices and improving growth prospects.

Conversely, lower-quality markets typically feature four or more players, new and aggressive entrants, highly imbalanced market share with subscale players willing to sacrifice pricing for subscriber growth, and aggressive wholesale regulatory requirements. Telecom operators in such markets may struggle to maintain pricing while retaining market share in these conditions and experience higher churn. This can spur such companies to cut prices and extend promotional packages, further lowering ARPU and perpetuating a vicious circle of zero-sum price wars that can drag down profitability and earnings for all operators.

Digital infrastructure investment is spiking, and we expect asset sales to continue during 2025. Telcos started selling tower portfolios over a decade ago and have been selling data centers and fixed-network assets more recently. Telcos have seen improved financial flexibility as a result of the proceeds and have reduced capex requirements by sharing the burden with partners or by pushing the capex off balance sheet altogether, boosting FOCF. But this trend may be compromised if sales of strategic assets impair telcos' business profiles—a risk we consider to be higher with fiber sales.

Capex is down overall but varies regionally. Capex intensity will largely depend on the state of 5G and fiber rollouts by telcos. Investment is falling in Europe, the Middle East and Africa (EMEA), Asia-Pacific (APAC), and Canada as fiber rollout nears completion for many markets in these regions, and 5G spending has slowed after extensive investments in initial rollouts. However, capex in the U.S. is flat to up and remains high in Latin America, in both cases because of network upgrades.

We expect average capex intensity in EMEA will fall to about 16% of revenue over the next three years, down from its 21% peak in 2021, which should continue to improve cash flow and financial flexibility.

The same approach has been evident in Canada, where we expect telcos will continue to ease capital intensity, bolstering free operating cash flow (FOCF) in 2025.

U.S. capex is flat to up due to fiber rollouts replacing declining 5G spending. This investment may enable the U.S. to start catching up with other advanced markets in terms of fiber and convergence.

Latin America remains in the rollout stage for 5G, and capex will therefore remain elevated. We believe that incumbent players are more likely to be the main 5G providers due to their greater financial flexibility, with higher profitability margins and stronger liquidity positions allowing for larger investment in the new technology.

In Asia-Pacific, capex will continue to decline as the first wave of 5G investment is over. Companies are now more focused on spending on network quality, including opportunistic fiber rollouts to increase market share.

Credit metrics and financial policy

We expect modest improvement in credit metrics throughout 2025, but any positive rating momentum will require clearer financial policy commitments. Most operators are generating modest EBITDA growth and cash flow because of cost-cutting initiatives and lower capex. As a result, we expect some improvement in FOCF and increased financial flexibility. However, our forecast of relatively low growth, persistently high interest rates, and lingering inflation (especially in wages) means that financial policies will need to prioritize debt reduction to translate better cash flows into rating upside. This will be especially true when debt refinancing takes place and capital structures reset at higher rates.

Key risks or opportunities around the baseline

1. If accepted by regulators, continued consolidation M&A could materially improve markets.

Market consolidation through M&A could lead to cost savings, shared infrastructure, and cross-selling opportunities, ultimately improving business strength and easing competition.

2. Competition remains a risk for operators.

Competition is not only a risk in challenging markets like Italy, Colombia and Chile; as we've seen in Canada, a single aggressive player can push peers into making their own price responses. This can rapidly devolve into a price war with negative consequences for all players, even in hitherto higher-quality markets.

3. Increasing investments or shareholder returns could limit credit metric improvements.

If companies start dedicating more resources to higher shareholder returns or accelerated investments, credit metrics could deteriorate.

Consolidation M&A could significantly improve the operational fortunes of the sector. By merging with other operators in the same market, companies can achieve cost savings, shared infrastructure, and cross-selling opportunities, ultimately enhancing their business strength and competitive position. Such consolidation can also lead to a more stable market environment, reducing the risk of price wars and improving the overall profitability of the sector. As seen in Spain and the U.K., recently approved consolidations with relatively light regulatory remedies may indicate a recalibration of competition concerns and a more open regulatory environment for M&A.

Competition remains the key risk for operators, one that can lead to price wars and negatively impact profitability. This is particularly evident in markets with multiple players, such as Italy, Colombia, and Chile, where a single aggressive player can push peers to respond with price cuts. Furthermore, slow macroeconomic growth in Europe could exacerbate this risk, leading to a softening of the enterprise customer base and increased consumer price sensitivity.

Price competition typically increases customer churn and weakens ARPU and revenue as companies lower prices and bundle packages to retain customers. Telcos may choose to add premium services for retention purposes rather than lower pricing, but this can cannibalize some of their own customer base from higher-priced packages. This can also result in slower upgrades to higher-priced plans, especially in price-sensitive and predominantly prepaid markets, effectively mortgaging future growth potential.

Increasing investment or shareholder returns could limit improvements in credit metrics. We think companies will maintain financial discipline amid current economic uncertainties. In regions where moderate EBITDA growth and declining capex are improving cash flow and financial flexibility, we expect a balanced approach to deleveraging, investments, and shareholder returns. However, if companies come under pressure for higher shareholder returns or accelerated investment in assets with low predictability of returns, especially in the case of debt-funded M&As, their credit metrics could weaken and ratings pressure could mount.

Industry Outlook: North America

Ratings trends and outlook

Despite capital market conditions improving, 2024 was a difficult year for the U.S. telecom and cable industry due to high borrowing costs and increasing competition for broadband services, which hurt many operators' credit quality. As a result, ratings downgrades exceeded upgrades by almost 3 to 1 and over 25% of our ratings are now 'CCC+' or lower compared with 20% a year ago. Furthermore, we tightened our ratings triggers for most cable operators during the year due to a more competitive environment.

In 2024, S&P Global Ratings revised the outlook on Rogers Communications Inc. to stable from negative and upgraded Videotron Ltd. to 'BBB-', as both these companies exhibited consistent deleveraging as they integrated 2023 acquisitions and showed consistent growth. On the other hand, Bell Canada Inc. (BCE) was downgraded to 'BBB', its elevated leverage reflecting tepid revenue growth and high dividends, while Cogeco Communications Inc.'s outlook was revised to negative following a debt-financed share repurchase transaction with Rogers. Given the elevated leverage in the Canadian telecom industry and increased competition, the 2025 outlook for the sector is challenging.

Main assumptions about 2025 and beyond

1. We expect M&A and shareholder returns will limit credit metric improvement for U.S. telcos.

Despite our expectation of growing EBITDA and healthy FOCF, we assume that M&A and shareholder returns, including stock buybacks, will limit credit metric improvement in 2025 and 2026.

2. Convergence takes shape, resulting in increasing competition for in-home broadband and wireless.

Cable operators have an advantage due to their ability to bundle broadband and wireless across a larger customer footprint, and it will take several years for the telcos to approach the size of cable's existing footprint.

3. AI offers new benefits for U.S. telcos and cable operators but is unlikely to be a meaningful contributor to profit growth in 2025.

We expect AI will be used to improve network optimization and streamline back-office operations, which could drive incremental revenue, improve customer satisfaction, and enable margin expansion in the longer term. However, we do not expect it to contribute meaningful profit growth in 2025.

M&A and shareholder returns will likely limit credit metric improvement in the sector in 2025. In 2025, we expect capex to increase modestly for Verizon Communications Inc. to support its fiber-to-the-home (FTTH) builds and wireless network upgrades. For T-Mobile US Inc., we expect the acquisition of US Cellular, to be completed in the second half of 2025, will result in modestly higher capex and integration expenses.

Verizon: We forecast that capex will increase by about $500 million-$1 billion in 2025, in part due to an increase in FTTH 'passings' (establishment of infrastructure close to a property) to about 650,000 from 500,000 in 2024. We expect FOCF to decrease modestly in 2025 but remain at about $18 billion.

AT&T: We forecast that AT&T Inc.'s capex will be relatively flat as lower vendor financing payments are offset by an expansion of its FTTH passings to about 2.6 million-2.7 million from 2.3 million in 2024. We expect FOCF to decline to about $16 billion, primarily reflecting the loss of distributions from DirecTV, although this is partially offset by payments from TPG to buy the remaining stake of DirecTV that it didn't own.

T-Mobile: We forecast a modest increase in T-Mobile US Inc.'s capex, reflecting the incremental spending from US Cellular in the second half of 2025, but it should remain at about $9 billion-$10 billion. We expect FOCF to increase to about $18 billion-$18.5 billion in 2025, about 7%-9% higher than 2024.

Notwithstanding our expectation of growing EBITDA and continued healthy FOCF, we assume that M&A and shareholder returns, including stock buybacks, will limit credit metric improvement in 2025 and 2026. For example, we expect Verizon's adjusted leverage to decline to about 2.8x in 2025 from 3.0x in 2024. However, its proposed acquisition of Frontier Communications Holdings LLC will likely push leverage back up to 3.0x in 2026. Furthermore, Verizon indicated at its sell-side analyst day that it had increased its net unsecured debt-to-EBITDA target to 2.00x-2.25x from 1.75x-2.00x and that it would consider share repurchases once it hit 2.25x, which we estimate is about 2.8x-2.9x on an S&P Global Ratings-adjusted basis.

T-Mobile indicated at its analyst day that it has $80 billion of capacity for investment and shareholder returns. It has already allocated $10 billion to the acquisition of US Cellular and the JVs to acquire Lumos and MetroNet. It also plans to return up to $50 billion in dividends and share repurchases through 2027, leaving about $20 billion available for additional investments, debt reduction, or shareholder returns. However, we still expect T-Mobile to remain within its net leverage target of 2.5x (about 3.3x on an S&P Global Ratings-adjusted basis), which is supportive of the 'BBB' rating and stable outlook.

We expect FOCF at the three largest Canadian companies to improve, as peak capital spending on fiber is now complete. However, given elevated debt leverage at these three companies, weaker earnings growth in 2025 combined with dividend increase that exceeds EBITDA growth will provide less of a cushion to our downside rating thresholds. BCE paused its dividend growth and implemented a dividend reinvest plan (DRIP) to manage the balance sheet while acquiring Ziply. Telus Corp.'s DRIP has been in place for a few years, but the compounding growth of its dividend continues to pressure discretionary cash flow. Rogers' focus remains on deleveraging, and we don't anticipate additional shareholder returns in the next 24 months.

2025 will be a transitional year for the Canadian telecom sector, as the incumbents pursue different strategies to offset slowing revenue growth due to intensifying competition. This is a new growth challenge for Canadian telcos following the 2023 Rogers-Shaw and Videotron-Freedom transactions amid slowing population growth, market maturity, and commoditization of services. As a result, despite a near-record 3.2% year-over-year increase in Canada's population in 2023—reflecting net growth from approximately 1.27 million largely economic migrants—prices, and ARPU, for wireless services softened. Such conditions could continue, in our view, over the next year.

A softer Canadian economy amid a rising cost of living—including higher debt service costs—is feeding into value-seeking consumers' increased propensity to change carriers (we estimate about 60% of wireless users are not under contract), particularly as perceived service differentiation narrows among the big three providers. We expect growth in the highly profitable wireless and fixed-broadband services segment, which accounts for over 70% of the sector's combined telecom and video revenue, to remain modestly positive in 2025, given the carry-over effect from the population surge in the second half of 2023 and first half of 2024. However, we believe industry revenue gains could slow through 2025, faced with additional headwinds of regulatory actions over the last couple of years and the Videotron-Freedom merger conditions, which appear to favor greater competition.

Following the acquisitions, Rogers and Videotron are focused on sustained revenue growth to support their deleveraging aspirations and value creation. As revenue and EBITDA growth slows, Rogers is looking to maintain its deleveraging momentum, reducing by 0.5x annually, by exploring a JV structure whose proceeds of about C$7 billion will be used to repay debt. During their third quarter conference calls, both BCE and Telus provided guidance of 2025 revenue below their 2024 guidance. To address the slowing growth momentum, BCE is expanding into the U.S. through the C$7 billion acquisition of Ziply, focusing on growth opportunities in its core areas. We think Telus will likely defend its market share against Rogers, as delivering industry-leading growth is a key tenet of its deleveraging capacity and capital return aspirations. However, weakness in the non-telecom segments and Telus Digital are pressuring Telus' top line and could slow deleveraging.

Convergence has long been part of the customer experience in many markets outside the U.S., including several European countries, in both fixed and mobile. This is due in part to smaller regions that easily enable telecom operators to cover an entire footprint with both mobile and fixed-line infrastructure. In the U.S., bundling connectivity services has proven more difficult since the wireless market is essentially nationwide, whereas fixed-line broadband services are more regional. The largest two cable providers, Charter Communications Inc. and Comcast Corp., cover about 58.3 million and 63.4 million passings, respectively. Both providers are able to bundle in-home broadband with wireless service using a mobile virtual network operator (MVNO) agreement with Verizon. While the terms of the MVNO are not public, the economics of the perpetual wholesale agreement are reportedly favorable due in part to the scale benefits and origins of the agreement, which date back to a 2011 spectrum sale. We estimate that Comcast will generate about $587 million of wireless EBITDA in 2024, while Charter turned a profit for the first time in the third quarter of 2024 and will likely generate more wireless EBITDA in 2025.

At the same time, the two largest wireline telcos, AT&T and Verizon, cover about 28.3 million and 18 million passings, respectively. Including the proposed acquisition of Frontier, which is scheduled to close in 2026, Verizon will cover about 28 million passings, with plans to reach 30 million by 2028. Similarly, AT&T plans to cover 45 million customers and another 5 million through its JV agreement with Blackrock by 2029. T-Mobile announced two JVs with private equity sponsors to acquire MetroNet and Lumos with the aim of partially funding their planned fiber builds to cover 12 million-15 million passings by 2030.

Investment in generative AI fueled unprecedented capex at hyperscaler customers in 2024, and we expect spending to increase even more in 2025. AI algorithms already consume a lot of data that is transmitted over telecommunication networks, aiding in the development of this nascent technology. We think the issuers that are most likely to benefit from AI-related bandwidth demand from hyperscalers (large-scale data centers offering cloud computing and data solutions for businesses) in the near term are telcos with fiber-rich networks such as Lumen Technologies Inc. and Zayo Group Holdings Inc. as well as data center operators. However, the adoption of AI by enterprise customers has been constrained for some time by smaller operating budgets, as corporate IT spending remains depressed, although early indications are of a rebound in 2025 as inflationary pressures subside. This could help improve top-line trends from business customers, a segment that has been in secular decline for the larger telcos with significant exposure to legacy products.

In the second half of 2024, Lumen announced a series of transactions valued at over $8 billion with hyperscalers including Microsoft, Google Cloud, AWS, and Meta to provide access to the Lumen network as well as the installation of fiber on new and existing routes to support connectivity between data centers for AI-related bandwidth demand. In addition, the company stated that there is likely another $4 billion of new deals in the pipeline that will improve its financial flexibility. As a result, we placed Lumen's ratings, including the 'CCC+' issuer credit rating, on CreditWatch with positive implications, implying the potential for a one-notch upgrade. We expect similar deals for Lumen and other telecommunications providers will likely materialize over the next couple of years.

Credit metrics and financial policy

We expect U.S. telco leverage to be stable in 2025. Notwithstanding our expectation of solid earnings growth and healthy FOCF, we think telcos will prioritize shareholder returns and M&A, which will constrain leverage improvement over the next couple of years.

Verizon: We previously forecast adjusted leverage to decline to 2.9x in 2024 from 3.1x in 2023. However, Verizon took a $1.7 billion charge, which we include in our EBITDA calculation, in the third quarter of 2024. Leverage is therefore likely to be about 3.0x, slightly worse than our previous base-case forecast. In anticipation of its proposed acquisition of Frontier, we expect Verizon to increase its financial capacity through FOCF. Coupled with EBITDA growth of about 3%, we expect leverage to decrease to about 2.8x in 2025 before increasing back to about 3x in 2026 to accommodate the purchase of Frontier.

AT&T: We expect leverage of about 3.4x in 2024, down from 3.6x in the prior year. In 2025, we expect AT&T's FOCF to decline by about $1.5 billion, due primarily to the loss of distributions from DirecTV, but remain healthy at about $16 billion. However, we also assume the company will repurchase about $3.5 billion-$4 billion of common stock and pay about $8 billion in dividends as part of its new three-year capital allocation program so that leverage improves only modestly to about 3.3x during the year.

T-Mobile: We expect T-Mobile's leverage to decrease to 3.1x in 2024 from 3.4x in the prior year. However, we assume that leverage will likely remain in the low 3x area over the next couple of years as the company issues debt to fund M&A and stock buybacks.

Key risks or opportunities around the baseline

1. Consolidation and a predictable competitive environment bode well for steady wireless service revenue growth.

Despite mature industry conditions, aggressive competition and market share gains by the cable providers, the U.S. wireless industry remained healthy in the first three quarters of 2024, and we expect this to continue in 2025.

2. U.S. wirelines are reaching an inflection point, and demand for fiber assets is robust.

Wireline operators are expanding their FTTH footprint and are growing overall broadband revenue through a combination of higher ARPU and the addition of new fiber customers across their footprints.

3. Starlink will continue to disrupt the industry, and Amazon enters the market in 2025.

Starlink has taken market share from incumbent operators in recent years, and we believe the company will continue to be a formidable competitor, particularly as it continues to add depth and capacity to its constellation.

We expect wireless service revenue growth to continue slowing somewhat. We forecast industry postpaid phone net subscriber additions of about 8.7 million in 2024, down by about 4% but stronger than previously, when we had expected industry postpaid phone net adds to decline by 7%-9%. We expect cable will take about 38% of net subscriber additions, which is lower than our previous forecast of over 50%, while price increases should support healthy service revenue growth for the telcos. Furthermore, bundling and the lack of new compelling handsets have reduced the level of switching activity, contributing to healthy earnings growth.

We expect this trend to continue in 2025, although the introduction of new AI-capable handsets could result in increased promotional activity, more handset upgrades, and margin compression. In 2025, we expect service revenue growth of about 3% for the telcos, down from 3.6% in 2024, which includes some of the following assumptions:

- Very modest 0%-1% postpaid ARPU growth due to the adoption of higher-end plans and rate increases, partially offset by a greater mix of lower ARPU business customers.
- Industry postpaid subscribers to increase by about 2%-3% in 2025.
- Postpaid phone net subscriber additions of about 7.8 million in 2025, down by about 10% from 2024 due to mature industry conditions. We also assume that cable will take about 37% of the postpaid phone net adds, comparable with 2024.

U.S. wireline operators are pursuing cost reduction initiatives, in addition to expanding their FTTH footprint and growing their ARPU and fiber customer base, while an increasing shift to higher-margin fiber broadband bodes well for improving cash flow. As a result, while revenue is still declining in some cases, EBITDA appears to have reached an inflection point, and we expect most of these issuers to record EBITDA growth in 2025. That said, wireline operators need to demonstrate more progress in stabilizing revenue that will establish a more realistic path to sustained EBITDA growth.

In addition, the market demand for fiber assets is growing as these companies increase their penetration of homes passed. In addition to Verizon's acquisition of Frontier, Canadian telco BCE announced it would acquire Ziply Fiber for $3.6 billion as it looks to get a foothold in the U.S. fiber market. T-Mobile also announced it will enter into JV partnerships with private equity sponsors to acquire Lumos and MetroNet with the aim of expanding its FTTH footprint to cover 12 million-15 million passings.

While Lumen does have a residential business, unlike its peers' it only accounts for about 20% of the company's revenue, and management has chosen not to invest its capex dollars to build fiber. Its main focus is providing communication and networking services to larger business customers. This segment is in secular decline as customers migrate to less expensive, software-defined networking technologies, and we expect revenue to decline by about 5%-9% in 2025.

That said, recent business wins from hyperscalers and other technology companies to provide connectivity for AI data demand could prove material for Lumen's path to repairing its balance sheet. Lumen has secured about $8 billion of these deals to provide custom fiber networks that include dedicated access to existing fiber in the Lumen network and the installation of new fiber on existing and new routes, enabling them to support increasing demand for AI workload. These PCF sales come at an opportune moment given that its core business is in decline, as they will bolster the company's liquidity position and give it greater financial flexibility to integrate its network and IT systems over the next couple of years. Furthermore, management stated that there are about $3.5 billion worth of potential new deals still being negotiated that could provide Lumen with additional leeway to execute on its turnaround strategy

For Canada, we estimate a lower immigration target could reduce wireless net additions, to below 1.5 million in 2024 and to about 1 million in 2025 and in 2026 from just under 1.8 million in 2023. This implies wireless unit growth for the big three telcos could slow to about 2.5% from about 5% in 2023. Our estimate assumes that the increase in ongoing wireless subscriber penetration is limited to about 2% annually in the current tepid macroeconomic environment amid high market penetration, which we estimate at about 90%-94% of population presently.

Residential fixed-broadband subscriber growth is more indexed to new housing availability (largely a function of prior starts or conversions) given the relatively high penetration in most urban markets. It should therefore track the steady, albeit below potential, supply of new available homes, which we estimate in the 240,000-plus annual range in the current environment of high interest rates and weak affordability.

Although we expect slower unit growth, we recognize that carriers have some opportunity to upsell to customers, bundle new services, and manage promotions, discounting, and annual price adjustments to mitigate ARPU pressure. Furthermore, in the longer term, we think the generational effects of younger, immigration-led population growth, new home formation of potentially over 400,000 annually, and greater affordability should lead to new service adoption and pricing acceptance and support stronger growth.

Starlink has a competitive advantage in residential broadband with its low-latency service, but it has also been more successful than we previously anticipated in in-flight connectivity, maritime, and the government sector, and we expect these trends to continue. The primary limitation of the network is capacity constraints in high-traffic areas, given the uniform nature of low earth orbit (LEO) capacity. However, we believe this can be at least partly overcome with the launch of more satellites, which deep-pocketed Starlink plans. Furthermore, Amazon Kuiper plans to roll out a commercial service in 2025 with a mesh network of more than 3,000 satellites when fully deployed by 2029. Amazon could take a similar approach to Starlink once launched, with affordability as a key principle of the constellation. We believe this could reduce incumbent satellite operators' long-term growth prospects in mobility and place increasing pressure on its in-home broadband segment in the coming years.

Furthermore, Elon Musk's relationship with President-elect Trump increases uncertainty. Starlink owner Elon Musk may be able to influence decision-making at the federal level in several respects. First, Starlink could be better positioned to receive government subsidies to build out into rural America as part of the $42 billion Broadband Equity Access and Deployment (BEAD) program or others such as the Rural Digital Opportunity Fund (RDOF). Secondly, the Federal Communications Commission could act quickly to approve applications to launch new satellites. There could also be spectrum policy changes that benefit Starlink to allow for faster speeds and an even more competitive service. Finally, it's possible that government contracts may increasingly favor Starlink technology.

Industry Outlook: EMEA

Ratings trends and outlook

We expect continued stable ratings in 2025; 77% of rated telcos currently have a stable outlook (compared with 78% a year ago), and EMEA has the strongest regional balance globally. Our sector forecast is supported by incremental revenue and profitability gains, and lower capex. Revenue tailwinds from inflation have subsided after the last round of increases in early 2024, but moderate price hikes should continue with the introduction of fixed, in-contract escalator clauses in some markets and relatively relaxed promotional activity pressure. We expect EBITDA growth and lower capex will continue to improve cash flows and financial flexibility, as well as rating headroom potential, but we think this will only be sufficient for rating upside in a few cases.

We enter 2025 with negative outlooks and CreditWatch placements on 13% of our ratings (up from 6% a year ago). This is partly offset by positive outlooks and CreditWatch placements, resulting in a negative bias of about 4% (down from a 10% positive bias a year ago). The slight negative bias reflects weakened credit ratios (Proximus S.A., Swisscom AG, and Bouygues S.A. due to M&A, and Optics BidCo SpA due to its aggressive dividend policy) as well as refinancing and sustainability concerns for several ‘B-’ and below issuers (PrJSC VF Ukraine, Tele Columbus AG, and Altice International S.a.r.l.). Positive outlooks have fallen to 9% from 16% a year ago and stem from improving credit metrics (Zegona Communications PLC, Bite, United Group B.V. and TransteleCom Co. JSC), and revised sovereign outlooks that cap our ratings (Saudi Telecom Co. and Telkom SA SOC Ltd.).

We took a large number of rating actions in 2024, with 12 upgrades, 11 downgrades, and four new telecom ratings, but this belies relatively stable conditions. Downgrades were concentrated on a few companies, with multiple negative actions on TalkTalk (four downgrades on its path to default), Eutelsat and Altice France S.A. (two downgrades each for a weakening business position for the former, and weak cash flow prospects and sustainability concerns leading to restructuring talks for the latter). Similarly, the vast majority of upgrades did not stem from improved performance but from multiple upgrades of sovereign caps (Turk Telekom and Turkcell, three times and twice respectively), emergence from restructuring (TalkTalk and Tele Columbus), and the completion of M&A (e& PPF Telecom Group, Lorca Telecom Bidco S.A.U., and Telecom Italia SpA).

Main assumptions about 2025 and beyond

1. Revenue will grow despite lower inflationary price increases, and earnings will rise due to margin growth.

We expect revenue growth to average 2% over the next two years, an improvement on last year’s forecast as lower competitive pressure and ongoing fiber migration will translate into better ARPU. Cost control from efficiency programs and the realization of M&A synergies will increase margins and EBITDA gains, despite labor costs continuing to climb, albeit at a slowing rate.

2. Capex will decline to a sustainably lower level through 2026, improving cash flow.

We think capex to support fiber and 5G mobile rollouts peaked in 2021 at 21% and will decline to about 16% in 2026 from 18% in 2023. This new level should be sustainable, improving FOCF. We expect variation around the average based on the degree of buildout progress in various markets, and the need for additional 5G investment if new use cases drive greater capacity needs.

3. Improved cash flow will increase financial flexibility and improve financial ratio ratings headroom, but without material rating upside.

Revenue and margin growth and lower capex should strengthen cash flow and financial flexibility for many operators. Credit impact will depend on financial policy and management's capital allocation decisions.

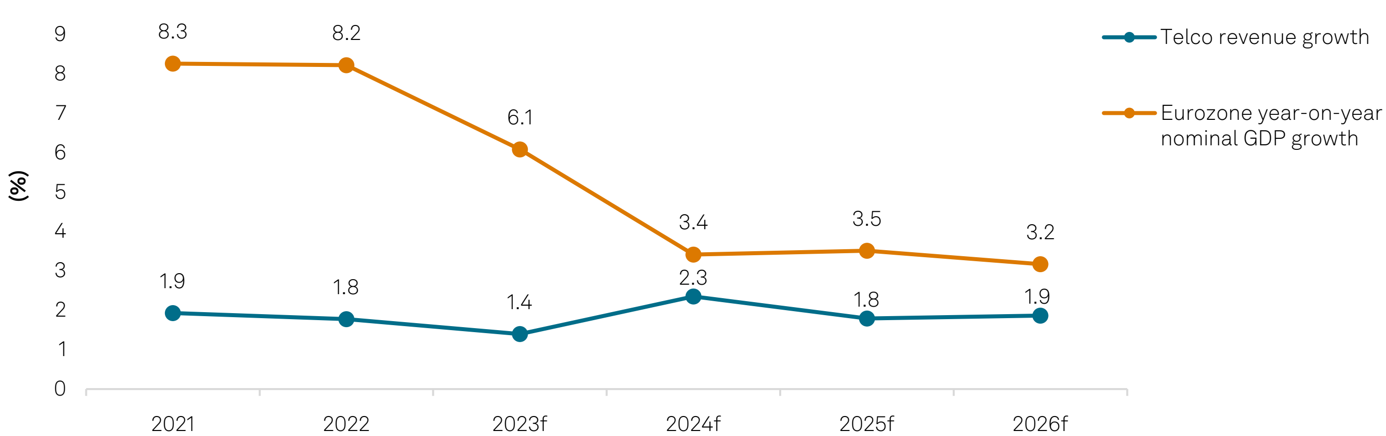
We expect revenue gains will continue, despite moderating inflation. Consolidation in Spain and the U.K., convergent M&A in Italy, and the effects of lighter-touch wholesale regulation should provide European operators with relief from excess competition. Annual price hikes should continue to lift the back book (prices for existing customers), though increasingly at a lower rate and via fixed, rather than inflation-linked, indexation. Relatively higher-for-longer interest rates should also temper the aggressiveness of challenger telco offers, curbing promotional offers and tit-for-tat price drops, which should lift the front book (price plans for new customers).

Unless interest rates move unexpectedly lower, we think this could remain a durably beneficial environment for telcos as more of the debt maturity wall begins to come due in 2026. As leveraged challengers refinance their capital structures at higher borrowing rates, greater debt service costs may widen cash flow shortfalls and the timeframe to break even. Among more aggressive price players, this could force a strategic reconsideration of market exits or a shift to higher-margin, higher-ARPU offerings to shorten the time to generate cash flow.

Service revenue trends have broadly turned favorable since 2021 (see chart 9). We expect this will continue to support top-line revenue growth of just under 2% on average for 2025-2026. Given our base-case assumption of over 3% annual nominal GDP growth in the eurozone for this period, we forecast that telecom revenue growth will lag inflation and remain slightly negative in real terms, but should be much better than in the prior three years.

Chart 9

European telcos will continue modest revenue growth in 2025-2026



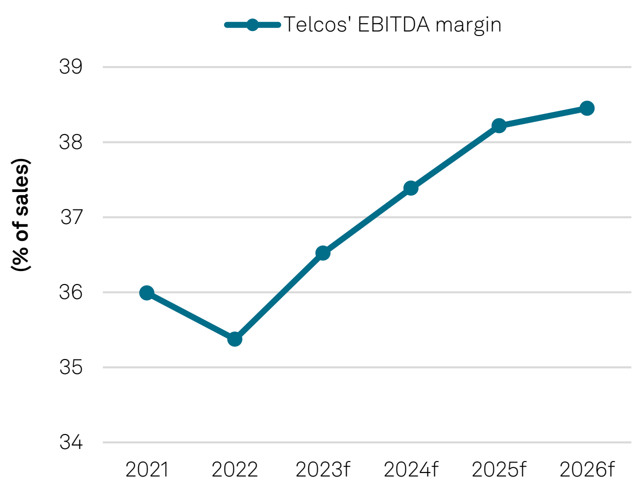
f—Forecast. Source: S&P Global Ratings.

Growth rates will vary across markets and operators, but growth should be the norm. Countries with more intense competition and challenging market structures, such as Italy, will continue to see weaker-than-average telecom performance. We also forecast weaker-than-average, though still positive, growth in the U.K. and Spain. Both markets have recently seen consolidation without strong regulatory requirements, and we anticipate a moderation in competition. However, we do not yet assume a material recovery in the market, which could take up to two years to manifest and remains subject to strategy shifts by the remaining players. There is therefore upside to our base case in these markets, but we will look for a positive track record before revising our forecasts.

We expect an incremental rise in margins. We forecast that European telcos will realize modest profitability gains, pushing EBITDA margins up by about 1 percentage point through 2026 (see chart 10). This should result in earnings growth that exceeds revenue growth. Drivers include efficiencies from traditional cost-cutting (such as Telia's 15% workforce reduction in the second half of 2024) and M&A synergies, and gradually declining maintenance operating expenditure (opex) as networks migrate to fiber. Labor costs grew in 2024, but we expect wage inflation will moderate in 2025-2026, helping shield margins from further pressure.

Chart 10

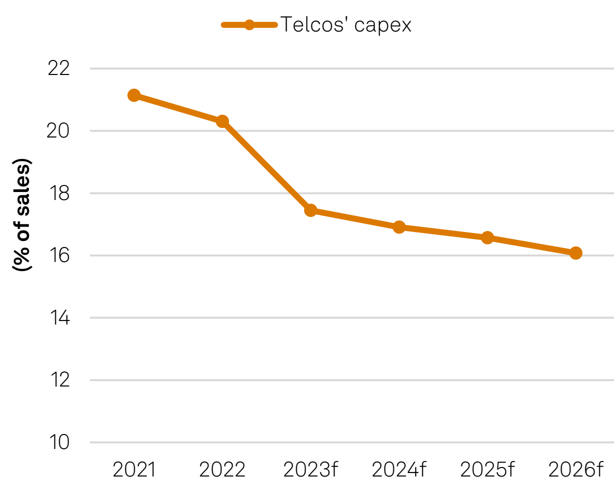
We expect European telcos' margin to increase...



f—Forecast. Source: S&P Global Ratings.

Chart 11

...while capex will fall



f—Forecast. Source: S&P Global Ratings.

Capex will likely shrink to a sustainably lower level for the next few years, improving cash flow. After remaining chronically elevated for a decade due to 4G rollouts and long-term densification, and then fiber and 5G rollouts, capex dropped sharply in 2023, to between 17% and 18% of revenue. We expect the fall will continue through 2026 to about 16% (see chart 11). However, the trend is uneven among markets. The drop is mainly due to fiber rollouts nearing completion in large markets like Spain and France, and, to a lesser extent, to a slowdown in 5G spending after the peak of the initial rollouts in many markets.

We expect incumbents like Orange S.A. and Telefonica S.A. will lower capex intensity across their operations to below 15% and about 12%, respectively. As operators decommission their copper networks, the lower maintenance capex associated with passive fiber networks should allow them to further reduce investments. On the other hand, with fiber rollouts in the U.K., Germany and Belgium—three markets that are significantly behind in fiber coverage—now in full swing, capex in those markets will remain high. We forecast 18%-19% capex intensity in Deutsche Telekom AG's German market over our forecast period, 21%-21% for Proximus in Belgium, and that British Telecommunications PLC will have at least 22% capex intensity through to 2026. In aggregate, however, falling capex intensity is good news for telcos' cash flows and credit metrics.

Credit metrics and financial policy

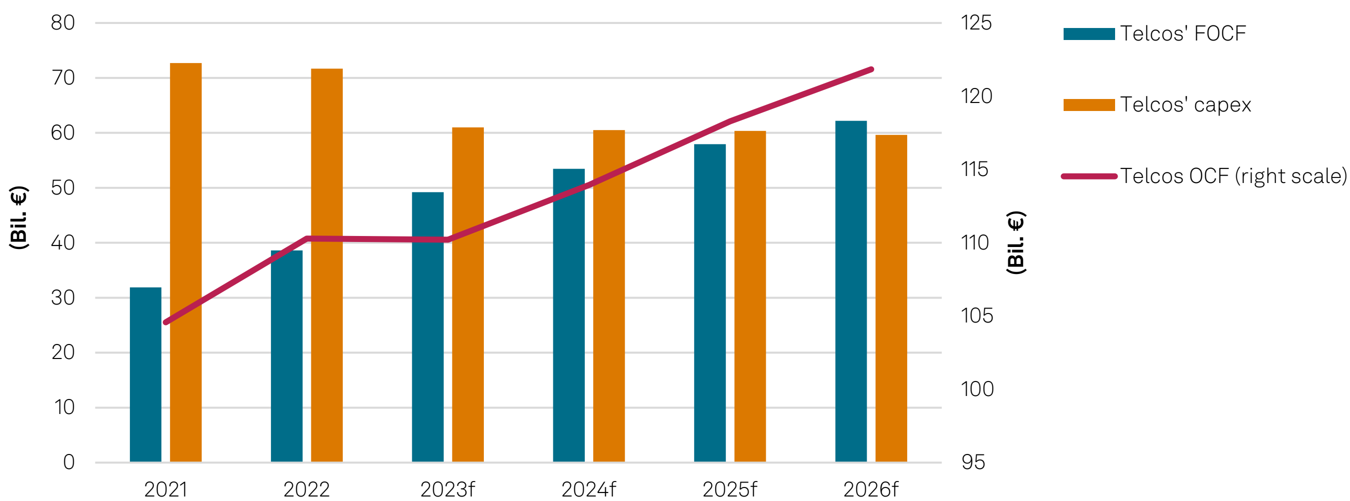
We expect stable core ratios with an opportunity for modest headroom improvement in leverage ratios by about 0.1x in aggregate per year through 2026, driven in part by improving FOCF.

Improved cash flow will raise financial flexibility, but without material rating upside, unless supported by conservative financial policies. We forecast that recent expansion in FOCF will continue, doubling by 2026 from the 2021 level (see chart 12). This, along with EBITDA expansion, should give telcos the financial flexibility to reduce leverage, improve their credit ratios, and increase rating headroom amid tighter funding conditions. However, we expect financial policies favoring shareholder returns, which should limit rating upside. In Gulf Cooperation Council (GCC) countries, for example, we have seen announcements of progressive dividend policies, such as e&'s increase of UAE dirham (AED) 0.03 annually for the fiscal years 2024, 2025, and 2026. We've also seen potential special dividends, depending on performance and strategy.

Chart 12

European telcos' FOCF looks set to steadily increase

European telcos' operating cash flow (OCF) breakdown



f—Forecast. Source: S&P Global Ratings.

Capital allocation priorities will be particularly important for highly leveraged speculative-grade telcos facing higher interest rate, and, to a certain extent, for investment-grade names such as Cellnex, for which our ratings incorporate a commitment of further deleveraging. Decisions to prioritize shareholder returns over debt reduction have contributed to recent downgrades at speculative-grade companies, increasing high leverage in some cases and liquidity risks in others. This has included VMED O2 UK Ltd., which is at least temporarily prioritizing dividend distributions over deleveraging targets, and Altice France, which has removed proceeds from asset sales from the restricted group despite upcoming maturities.

Key risks or opportunities around the baseline

1. A new wave of investment interest in digital infrastructure.

The infrastructure-like characteristics of telecom fiber, towers, and data centers is drawing interest from investors. This creates monetization opportunities at relatively attractive multiples for telcos, but also raises the risk of selling the crown jewels that support their business profile.

2. The re-intensification of competition remains a key risk.

Excess competition, while keeping prices low for consumers, has eroded more-for-more strategies, pressuring pricing, topline revenue, and the return on capital over the last decade. In countries like France, fragmentation and an imbalanced market share could reignite price competition. In markets like Spain, Belgium, and Portugal, new operators could disrupt the market.

3. Further consolidation and financial policy will be key credit determinants as companies decide what to do with increased cash flow.

Consolidation could extend cash flow and financial flexibility improvements, but the credit effect will depend on how management teams prioritize debt reduction, accelerated investment, M&A, and shareholder returns.

Telcos have steadily sold off infrastructure assets since the mid-2010s, starting with mobile tower portfolios. More recently, asset sales have transitioned to fiber network and data center sales. Buyers are typically interested in the critical nature of the assets; towers and data centers have a strong demand profile supported by contracted offtakes, while the regulation of fiber can be a significant credit strength when it limits competition and provides for stable revenues. Valuation multiples for these assets can be more than three times that of integrated telcos, making them an attractive monetization option.

But selling such assets can pose risks for the business, depending on the uniqueness and extent of the assets sold. For example, we view an incumbent's sale of all its fixed-network assets as likely to put its business profile under stress, with our assessment of it likely resulting in a downward revision by about one category. The impact could be less if a challenger telco sells off its network; if the network is overbuilt by competitors and is not a unique, differentiating asset; or if the operator retains other differentiating assets in the market or has diversified exposure to other markets.

To date, we have only a few rated examples of a fixed-network spin-off and its business impact on the telco. First was an integrated telco, Telcom New Zealand Ltd., renamed Spark New Zealand Ltd. after it split off its fixed network, which was named Chorus. The split led to a downgrade of Spark to 'A-' and a one-notch downward reassessment of its business risk profile to satisfactory from strong. Another example is TDC's split between its retail business (Nuuday) and its fixed and mobile networks (TDC Net). The split led to a one-notch downward reassessment of Nuuday's business risk profile to fair from satisfactory. And most recently, we raised the rating on Telecom Italia to 'BB/Stable/B' after it completed the sale of its fixed-line network to private equity firm KKR and deleveraged to 3.5x-4.0x. This was despite the weakening of its business profile, which we reassessed to fair from satisfactory.

Constructive market dynamics could disappear if competition reignites. Consistent service revenue growth has been challenging for the sector, particularly in Europe, given high fragmentation and competition. Despite increased data traffic, which has required sustained levels of relatively high opex and capex, operators haven't been able to regularly raise prices, leading to a long-term deterioration in return on capital (see chart 14 in the appendix). Competition has been a key reason for this, leading to lower prices to the benefit of consumers. The inflationary spike in 2022 and 2023 finally gave operators common cause to raise prices, while more aggressive operators found it riskier amid rising interest costs to make countervailing price cuts to increase market share. While return on capital has edged upward in the last two years, the threat of excess competition remains if conditions change.

Weaker macroeconomic conditions or a recession in Europe would ratchet up competition risk. We would expect an initial softening in the enterprise customer base resulting from reduced headcount, particularly among small and midsized enterprises. For retail consumers, steep drops in disposable income may not result in mass cancellations of contracts, but it could increase consumer price sensitivity. Customers looking for better value are more likely to switch providers, incentivizing low-price competition by carriers that can depress front book pricing, lowering ARPU and revenue. In such a scenario, markets that we view as most at risk to a flareup in competition include those with:

- An aggressive price challenger focused on growing to scale;
- A competitive market structure, typically four or more players, and a poor track record of price improvement; and
- Weak barriers to customer churn, including a high prepaid customer base and a low degree of convergence.

European operators have long sought market consolidation to relieve competitive pressure, which is the key risk to telcos' credit quality, in our view. Regulators have effectively denied market consolidation for most of the past decade, with the exception of in the Netherlands (a smaller market) and Italy, where stringent regulatory requirements resulted in a new and ultimately destabilizing entrant (Iliad S.A.). Recently approved consolidations in Spain and the U.K. with relatively light remedies potentially indicate a recalibration of competition concerns and the balance regulators are willing to strike between incentivizing investment and protecting consumers. This could encourage further consolidation attempts in Europe’s more challenging or structurally competitive markets, such as Italy or France.

While agreements and approvals are still far from assured, further consolidation could relax competitive pressure and add tailwinds to improving earnings and cash flow trends. However, companies are facing competing priorities, and the credit impact will depend on financial policies and relative prioritization between deleveraging, accelerated investment, M&A, and shareholder returns. We expect an emphasis on shareholder returns, partly reflected in standout European telecom equity performance this year. This could restrict broad-based, material improvements in credit metrics, limiting rating upside or even creating ratings pressure if financial policies become too aggressive.

Looking at the overall structure of the European telecom market, we still believe that the ambition to create ‘European champions’ through extensive crossborder M&A remains unlikely to come to fruition. While the prospect of rationalizing Europe’s highly fragmented market (compared with the U.S.) would allow for greater economies of scale, crossborder M&A lacks the typical synergy benefits for participants of in-market consolidation. Since separate countries’ markets are effectively siloed, participants don’t gain better positioning through combined market share and spectrum, rationalization of duplicate cost structures (outside of centralized corporate functions), and better infrastructure and capacity utilization. Furthermore, we do not anticipate reforms that could catalyze greater crossborder consolidation benefits, such as crossborder spectrum harmonization, anytime soon.

Industry Outlook: Latin America

Ratings trends and outlook

We expect ratings performance in Latin America to remain broadly stable. Revenues and EBITDA will likely continue to grow, despite our expectation of modest economic growth in the region. About 80% of outlooks are stable, up from 70% a year ago.

Main assumptions about 2025 and beyond

1. We expect moderate revenue growth.

We expect revenue growth of about 2.5% for 2025 thanks to 5G deployment and a greater focus on postpaid customers in the mobile business.

2. 5G rollout continues in the region.

We think the leading players will continue to deploy 5G technology to enhance the speed of data transmission and reduce churn rates.

3. Capex will remain high.

Investments will remain high in Panama, Costa Rica and Colombia, given the need for 5G rollout, but we expect them to be lower in Brazil.

Revenue growth will likely remain moderate. We expect revenue growth of about 4% in 2025 (excluding the effects of hyperinflation in Argentina), reflecting the 5G deployment by most of the companies in the sector. Across the mobile business, operators are primarily focused on migrating prepaid customers to higher-value postpaid contracts, strengthening recurring revenue streams, and reducing churn.

In Brazil, this growth aligns with a trend observed among companies that acquired slots in the 5G auction held in late 2021. In Argentina, amid the sharp deceleration in inflation, we expect revenues to resume positive real growth, after two years in which tariff increases have lagged well behind inflation. Furthermore, ARPUs in dollars should improve considerably as the Argentinian peso continues to appreciate. The lower inflation scenario should also allow for EBITDA margin improvements as costs in Argentina are largely indexed. The Caribbean region's mobile and fixed operations are also benefiting from a rebound in tourism, although certain cyclicality persists, with the fourth quarter typically the strongest period of the year.

Regarding independent infrastructure operators in Latin America, we continue to see favorable growth prospects for tower companies in the region as underpenetration remains a driver for investment. Although the adoption rates have been slower than originally expected, we continue to regard 5G as a boost for potential expansions in countries such as Colombia and Peru. We believe that independent infrastructure operators in Latin America continue to benefit from high cash flow predictability and relatively low substitution risk as a result of built-to-suit sites, price inflation-linked escalator clauses, and an overall long-term average maturity of contracts.

5G deployment continues in the region. Overall, telecom companies in the region continue to increase data transmission speed through 5G coverage. In Central America, countries such as Panama and Costa Rica are at the early stages of 5G rollout; spectrum auctions are scheduled for 2025, and initial nationwide deployments are expected to start in the latter half of that year and beyond. By contrast, in the Caribbean, 5G investments are likely to lag, given the limited footprint of the islands; hence, operators are prioritizing network improvements and the expansion of

FTTH services within their fixed-line segments. In Mexico, America Movil has increased 5G coverage, resulting in higher subscriber additions and reduced disconnections, currently with an average churn rate of about 3%.

Internet service providers (ISPs) in Brazil made progress in implementing 5G in 2024, albeit at a slower pace than in 2023, since most formal regulatory requirements will only take effect in 2026. Brisanet Participacoes S.A. has constructed its own towers in northeast Brazil and significantly expanded its coverage to reach 200 cities in the region. Meanwhile, Unifique Telecomunicacoes S.A. has also launched its 5G service in the South region, currently covering eight cities, but it has opted to utilize capacity from existing tower companies rather than invest in its own infrastructure.

Capex will differ across Latin America regions, and investments will vary depending on the capex cycle. We believe that the forthcoming 5G spectrum auctions in Costa Rica and Panama could shape long-term strategic planning. However, we anticipate a limited immediate effect on 2025 capex, given that meaningful development activity would likely commence in the second half of the year or later. In the meantime, we expect capex to focus on completing ongoing network upgrades, integrations, and expansions. In Chile, we expect intensity to remain elevated as the country is undergoing a technology transition both to 5G in mobile and to FTTH in the fixed-line business.

However, the ISP market in Brazil saw a slowdown in infrastructure investments during 2024, with a focus on increasing customer takeup, partly due to challenging macroeconomic conditions. Looking ahead to 2025, we anticipate a continued slowdown in investment pace, as companies have once again lowered their capex guidance to focus primarily on connecting existing homes and technology.

Credit metrics and financial policy

We expect companies will reduce leverage, despite higher expected investments to develop 5G. This will mainly depend on companies' ability to increase subscribers' growth and reduce churn rates to strengthen EBITDA generation and margins.

While the expansion will require further material investment, we expect companies will continue to access to bank and market debt funding. This should allow companies to continue to benefit from inorganic growth if opportunities from market consolidation or further spinoffs from carrier-owned assets materialize. While issuers with refinancing needs in 2025 may face a constrained market due to the overall competitive telecom environment in the region, we continue to view their long-term prospects for access to markets as more favorable than those of integrated carriers.

Key risks or opportunities around the baseline

1. Competition remains a challenge for telecom operators.

We expect competition to remain strong in the region, particularly in Colombia and Chile.

2. Currency risk could weigh on earnings and leverage.

A mismatch between revenues generated in local currency compared with foreign currency debt could have a negative impact on earnings and leverage.

3. Expected market consolidation will trigger M&A activity.

The need for cost reductions, shared infrastructure, and the creation of synergies between competitors will lead to M&A activity in the region.

Competition remains a risk. Fierce competition in Colombia remains a challenge for operators' ARPU and profitability, which is still translating into high investment needs for companies to enhance their services and thus maintain their competitive position. While this continues to hinder companies' ability to maintain solid liquidity positions, Colombia Telecomunicaciones (Coltel) intends to offset this through increased cash flows after spinning off its infrastructure assets in Colombia. At the same time, the collapse of players such as Wom S.A. in the country could provide some opportunities to recover some competitive ground.

We expect the industry to remain highly competitive in Chile. Wom S.A's announcement that it had reached a restructuring agreement under the Chapter 11 process in early December 2024 eliminates possibilities of further industry consolidation in the short term. This means there are at least four to five carriers competing both in fixed and wireless services in an already highly penetrated market.

The Central America and Caribbean telecom markets remain highly competitive, generally supporting four or five carriers per market. Within this landscape, one or two operators typically assume incumbent positions. For companies such as Cable & Wireless, we expect 2025 performance to be somewhat better than 2024 levels, driven by the completion of integration initiatives and network upgrades.

Telcos in the region could face some currency risk pressures. Companies with U.S. dollar-denominated debt could face increased foreign exchange rate volatility risk in 2025 if the local currency depreciates. Such exposure to exchange rate volatility remains a key risk for telcos in the region, given that the revenue model in local currency doesn't necessarily fully protect them from this exposure. Significant local currency depreciation would have a negative impact on cash flows on a dollar basis and therefore damage Latin American telcos' credit metrics.

M&A activity in the region will likely continue. We expect to see consolidation in some Latin American telecom markets because of the need for cost reductions, shared infrastructure, and the creation of synergies between competitors.

In Mexico, America Movil announced the consolidation into its ongoing business with ClaroVTR in Chile, as well as a nonbinding offer to acquire Wom S.A.'s assets in a joint participation with Telefonica S.A., with a purchase potentially occurring in 2025. In Brazil, we had anticipated more consistent M&A activity in 2024, but this was again hindered by macroeconomic conditions. Following the merger of Vero and America Net in late 2023, only smaller transactions have occurred, which have had minimal impact on metrics. However, we expect M&A activity to increase in 2025 as competition and professionalization constrain organic growth. Nevertheless, we foresee credit remaining a barrier in an environment of persistently high interest rates throughout 2025, contrary to our expectations at the start of 2024.

Industry Outlook: Asia-Pacific

Ratings trends and outlook

We expect generally stable ratings in 2025. Overall, the region's telcos have coped well with the capex wave of recent years. They have done so by means of strategic M&A to boost competitiveness and ease price pressure, implementing cost-cutting measures, and divesting non-core assets and businesses. In our view, our rated telcos in Asia-Pacific continue to have measures they can take or at least plans to manage leverage.

Our base case assumes moderate earnings growth, spurred by increasing mobile data traffic and fixed broadband adoption. These factors, combined with our view that infrastructure sharing is set to rise, support our growth expectations for the tower company industry in Asia-Pacific.

Rating actions will likely be driven by idiosyncratic factors. Similar to 2024, we expect any upside or downside to ratings to result from entity-specific circumstances rather than sector-wide issues.

Among our publicly rated issuers, 2024 saw the improvement of Taiwanese telco Far EasTone Telecommunications Co. Ltd.'s stand-alone credit profile and the revision of our rating outlook on India-based telco Bharti Airtel Ltd. to positive from stable. Both actions reflected lower leverage.

However, we also revised our rating outlook on CAS Holdings No. 1 Ltd., which controls telecommunications businesses including Hong Kong Telecommunications (HKT) Ltd., to negative from stable. This revision reflects the risk of leverage at PCCW Ltd. (CAS' parent) creeping back up, even after the recently announced asset divestment, due to persistent shareholder returns.

We think ad-hoc merger, acquisition and divestment activity will continue to be a risk to ratings, both on the upside and downside.

Main assumptions about 2025 and beyond

1. Modestly rising earnings with moderate revenue gains and cost-cutting efforts.

The EBITDA of Asia-Pacific telcos will, on average, rise by 3%-5% in 2025. Increased mobile data traffic and fixed broadband adoption will continue to bolster the top line. Cost-cutting, supported by AI adoption and simplified business structures, remains a common theme in the sector.

2. Less network capex and more infrastructure sharing.

Investment in 5G has waned for now. There are, however, pockets of rising fiber capex in some markets to capture market share amid increasing fixed broadband adoption. Both passive and active infrastructure sharing is likely to increase. In addition to tower sharing, players in some markets have proposed or entered into network sharing agreements for cost and capex efficiency.

3. Step-up in spending in high-growth segments, with AI investment increasing.

Divestments of non-core businesses and assets provide balance sheet capacity to undertake such investments.

We expect earnings to grow, albeit modestly, in most markets, supported by increased mobile data consumption. Price hikes in markets such as India and Australia add an extra boost to telcos' topline trends. In some South and Southeast Asian markets, we also see increasing fixed broadband adoption contributing to rising earnings.

Active cost-cutting will remain a common theme as Asia-Pacific telcos continue to navigate inflation-linked rising costs. It is rare for prices of mobile plans in this region to be linked to the consumer price index (CPI) or other inflation measures. Therefore, Asia-Pacific telcos tend not to have a direct mechanism to pass inflation on to consumers, instead relying on ad-hoc execution of price changes. Among Asia-Pacific telco markets that we analyze, we only saw mobile plans explicitly linked to CPI in Australia. However, these too have now ceased following the removal by Australia's leading telco Telstra Group Ltd. of CPI-linked price increases on all mobile post-paid plans in May 2024.

AI adoption will increasingly be used as a cost-cutting tool. We expect telcos could use AI, for example, to aid customer service and improve targeted marketing. In addition, more telcos may streamline their business structures to gain synergies and cost efficiencies, as companies including Telekom Malaysia Bhd and Singapore Telecommunications Ltd. (Singtel) have done.

Competition is likely to ease following consolidation in several markets. The last 12-18 months have seen consolidation either announced or implemented in Indonesia, Sri Lanka, Taiwan, and Thailand.

In the case of Taiwan, we expect greater pricing discipline in the market following the merger of Far EasTone Telecommunications and Asia Pacific Telecom Co. in December 2023. In Indonesia, the proposed merger between XL Axiata Tbk. PT and Smartfren Telecom Tbk. PT follows a 2022 merger between Hutchison 3 Indonesia PT and Indosat Tbk. PT, creating a predominantly three-player market.

Capex intensity dips as 5G spending wanes for now. We believe telcos are now more cautious about investing further without the availability of significant monetizable use cases. This sentiment was apparent in the muted appetite for spectrum at the June 2024 auction in India, despite issuing some of the region’s most expensive spectrum licenses in the past. The three largest Indian telcos bought Indian rupee (INR) 113 billion of airwaves. This amount contrasts starkly with the INR1.5 trillion that the three main telcos jointly spent on 5G spectrum in 2022.

In the meantime, we expect telcos to improve their 5G network quality based on adoption rates. This could mean strengthening 5G coverage in dense cities and central business districts ahead of less populated areas.

In contrast to easing 5G capex, there are markets where fiber network investments have picked up, particularly where there is lower fixed-line broadband penetration and uptake. For example, Philippine-based PLDT Inc. and Thai telco Advanced Info Service Public Co. Ltd. are both accelerating fiber rollout to capture a larger share in their respective underpenetrated fixed broadband markets.

As a result, we project average capex intensity (capex as a percentage of revenue) for rated Asia-Pacific telcos to ease slightly to 19%-21% in 2025 and 2026, from an estimated 21%-22% in 2024.

Infrastructure sharing is set to rise. In particular, telecom tower sharing will likely increase, boosting the development and earnings of the region's independent tower company industry. This comes after a wave of tower sales by the region's mobile network operators (MNOs) in the past three to five years, especially in Australia, New Zealand, and the Philippines. Many telcos regard such assets as less of a source of competitive advantage as network coverage improves. Tower sharing will allow MNOs to improve coverage more quickly and at a lower cost.

Regulators have also encouraged tower sharing, with a common objective of a faster improvement in the market's network quality. Regulations promoting or mandating tower sharing can help to improve network accessibility for rural areas, for example. The Philippines, Australia and Bangladesh are some of the markets that have policies encouraging tower sharing nationwide or in rural areas.

In addition to tower sharing, more Asia-Pacific telcos could be open to network sharing arrangements, as some players in the region have entered into. Such agreements range from the sharing of selected terrestrial and submarine fiber-optic cable assets in the Philippines to the exchange of spectrum use for network service provision in Australian regions.

In our view, the need to recoup significant network investments and cost savings are key factors driving increased infrastructure sharing. We expect telcos will be more cautious about sharing active network assets than passive infrastructure. This is because active infrastructure assets are typically more central to telcos' competitiveness, especially if they are extensive or unique to the telco in question, as this could then weigh on their business strength. In determining the implications for telcos' credit profiles, we will consider factors such as the assets' importance to competitive advantage, the level of control retained in these assets, and any change to leverage.

Non-core asset sales are likely to continue, supporting balance sheet strength and ratings. Proceeds from the sale of assets that are not key to a telco's competitiveness can create balance sheet capacity for capex and investment in new growth areas.

Singtel, for example, announced that it has identified a Singapore dollar (S$) 6 billion asset monetization pipeline. This comes after a spate of asset monetization by the company in the past two years that has resulted in greater financial flexibility at its current rating level. Other telcos have used asset disposals to preserve ratings. For instance, PCCW group (which includes HKT) has disposed of various assets in the past few years to manage leverage. This includes HKT's disposal of a minority stake in its wireline business, announced in 2024.

We expect investments in cloud, data centers and AI to remain high as companies try to boost long-term earnings potential. If funded by debt, such investments can reduce rating headroom, as these new revenue streams take time to ramp up.

Partial divestments in such new growth engines are likely to continue, particularly to introduce strategic partners. In addition to lowering the leverage burden, this could help telcos reduce exposure to execution risks. For example, PLDT Inc. is looking to sell up to 49% of its data center unit.

Credit metrics and financial policy

We expect credit metrics in 2025 to be flat overall, despite our expectations of moderate improvement in earnings and continued divestments. We estimate that the average debt-to-EBITDA ratio for Asia-Pacific telcos will be about 2.9x in 2025, similar to our estimate for the full year 2024. This is because continued investments in new growth engines will use up balance sheet capacity. In addition, a number of telcos in the region also tend to distribute special dividends from divestments, diluting any deleveraging benefits that such actions could otherwise bring.

Active leverage management, including timely divestments, is key. With rated Asia-Pacific telcos mostly at investment grade, our focus is on financial policy. For instance, our rating on Spark New Zealand incorporates our expectations that the company will take prompt action to bring credit metrics back to levels commensurate with its current ratings.

We expect that telcos will continue selling non-core businesses and passive infrastructure assets to fund investments in new growth engines, as well as managing their leverage.

Key risks or opportunities around the baseline

1. Macroeconomic uncertainties could weigh on earnings and debt, especially in emerging markets.

More persistent inflation and a decline in consumer sentiment could translate into slower upgrades by consumers to pricier plans and weigh on telcos' ability to execute on price increases. Macro headwinds could also weaken demand from enterprise customers. Entities with exposure to emerging markets with weakened currencies could face lower earnings and greater balance sheet pressure arising from foreign currency-denominated debt.

2. Mergers, acquisitions, and divestments could present a mixed bag of credit impact.

Market consolidation could ease market competition and result in more competitive, larger companies. However, it could come at the expense of other credit factors such as higher debt. Similarly, divestments could aid deleveraging but could weaken business strength.

3. Sporadic spectrum purchases, and, in the longer term, the need to fund another round of capex.

Telcos that have rolled out non-standalone 5G may face another investment wave as they move toward stand-alone 5G. Sporadic spectrum buys and renewals could also add leverage stress.

Earnings and deleveraging momentum could be disrupted, owing to a possible decline in retail and enterprise customer confidence, as well as currency woes. We have yet to see trading down to lower-priced plans amid inflationary pressure, due to the relatively persistent nature of data consumption. However, higher and persistent inflation could lead to slower upgrades to pricier plans. At the same time, macroeconomic uncertainties could hurt business sentiment and spending by enterprise customers.

Earnings of some of the region's rated issuers could be hit by currency weakness, particularly in South and Southeast Asia. In addition to the impact on earnings, currency weakness can be a double whammy for a company's leverage, particularly if it has significant unhedged debt denominated in foreign currency .

Strategic actions often have an opposite, unequal impact on business and financial strength. We expect mergers, acquisitions and divestment activity to continue in 2025. Business combinations usually improve business strength and give rise to synergies, including cross-selling opportunities and cost efficiencies. A more consolidated market also typically translates into an easing of competition.

However, these benefits come at a cost, such as higher leverage from funding the acquisition. In other cases, a merger could lead to weaker earnings quality. We see this in Malaysia-based Axiata Group, which is pursuing a merger in Indonesia. In our view, the deterioration stems from the loss of direct control over the merged Indonesian entity, even though it is larger.

Similarly, while divestments can help to bring down leverage, the sale of assets or businesses that play a strategic role in a telco's competitiveness can weaken its business position.

Another round of capex could pose a risk. In our view, telcos with non-standalone 5G may need to fund another capex wave as they move toward standalone 5G. However, this risk lies in the medium term.

Sporadic spectrum auctions, especially in regions where spectrum licenses are expensive, pose an event risk. In 2025, spectrum auctions are slated to be held in some markets, including Thailand and Indonesia.

Related Research

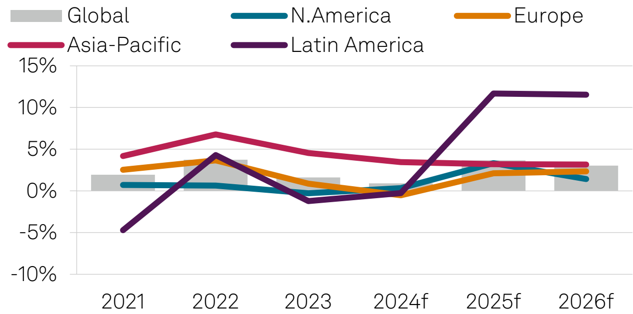
- ESG Credit Brief: Telecommunications, Dec. 4, 2024
- Spanish Telecoms Outlook: Consolidation Unlikely To Reduce Competitive Pressures, Nov. 26, 2024
- Cross-Practice Views On Rating European Digital Infrastructure, Nov. 14, 2024
- Satellite Providers Pulled Into Starlink's Orbit, Nov. 7, 2024
- The Canadian Telco Squeeze--The Need To Compete Will Lower Returns, July 30, 2024
- Asia-Pacific Towercos: More Construction, Colocation and Consolidation Ahead, May 9, 2024

Industry Forecasts

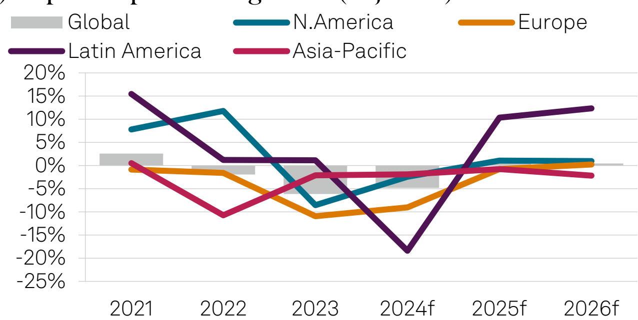
Telecoms - Fixed and Wireless

Chart 13

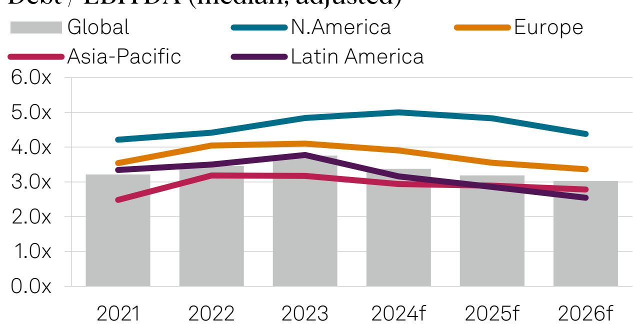
a) Revenue growth (local currency)



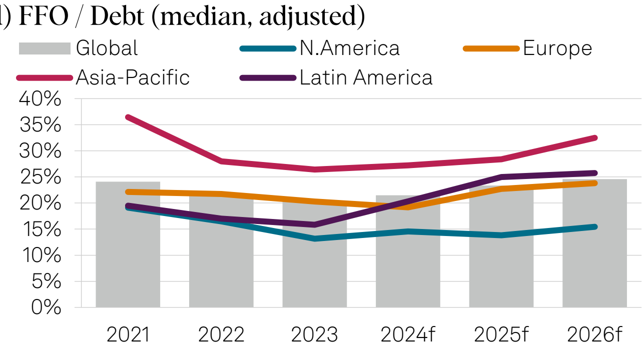
b) Capital expenditure growth (adjusted)



c) Debt / EBITDA (median, adjusted)



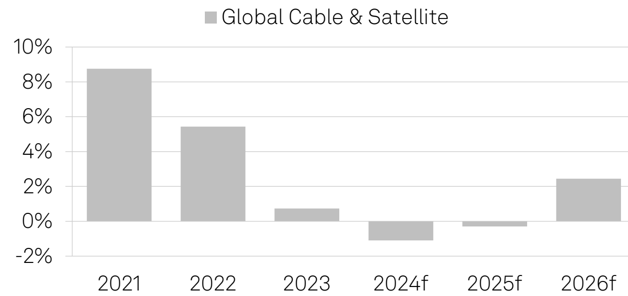
d) FFO / Debt (median, adjusted)



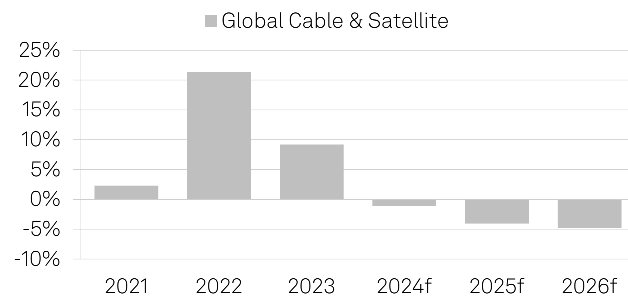
Cable and Satellite

Chart 14

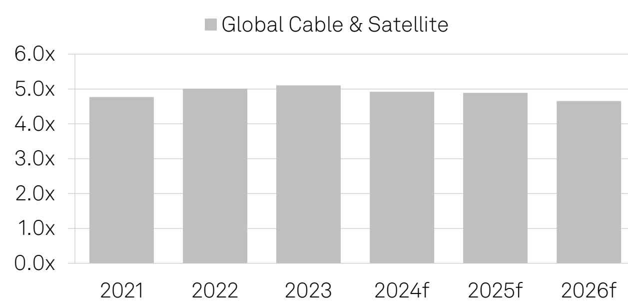
a) Revenue growth (local currency)



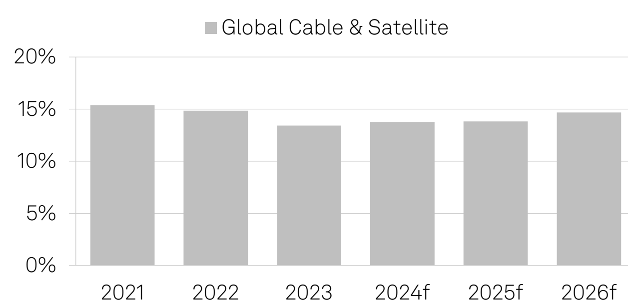
b) Capital expenditure growth (adjusted)



c) Debt / EBITDA (median, adjusted)



d) FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Telecoms

Chart 15

Cash flow and primary uses

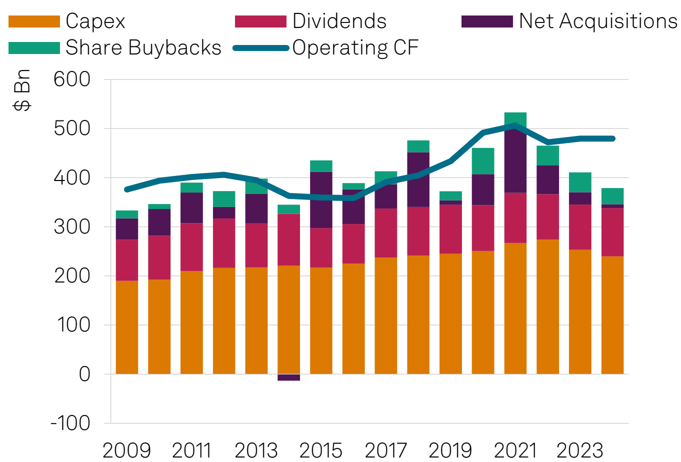


Chart 16

Return on capital employed

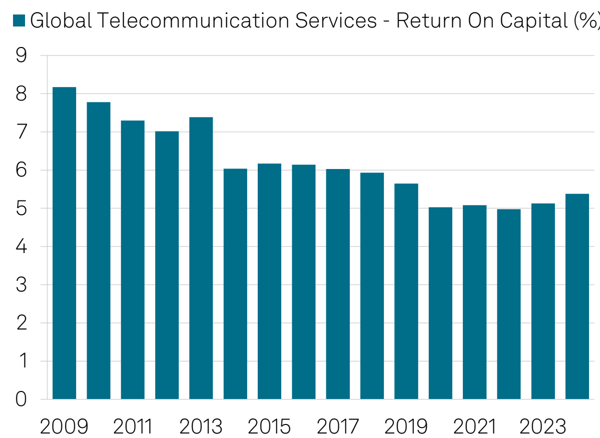


Chart 17

Fixed- versus variable-rate exposure

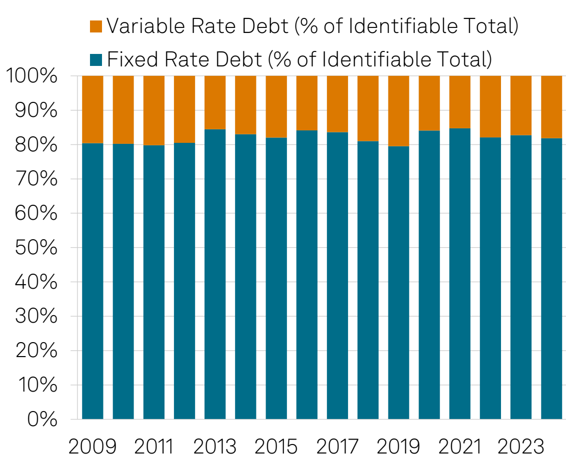


Chart 18

Long-term debt term structure

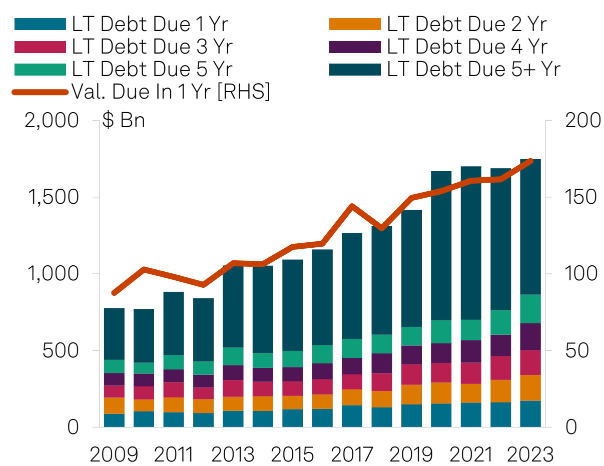


Chart 19

Cash and equivalents / Total assets

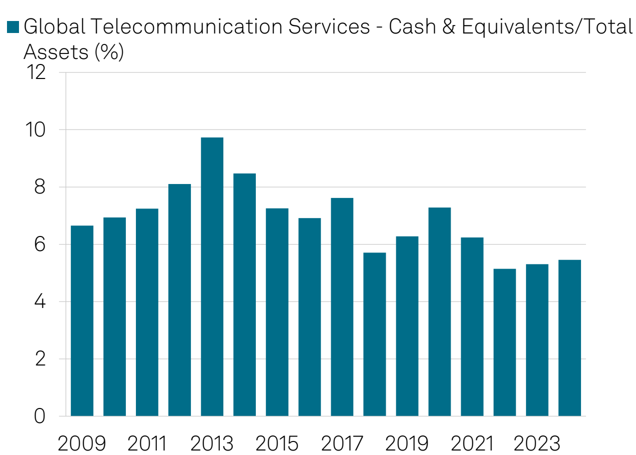
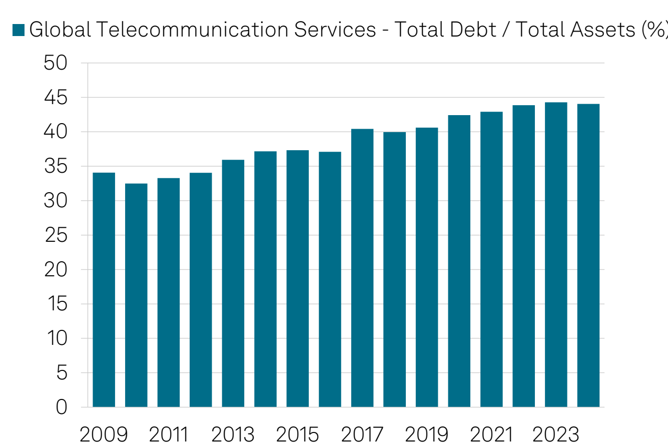


Chart 20

Total debt / Total assets



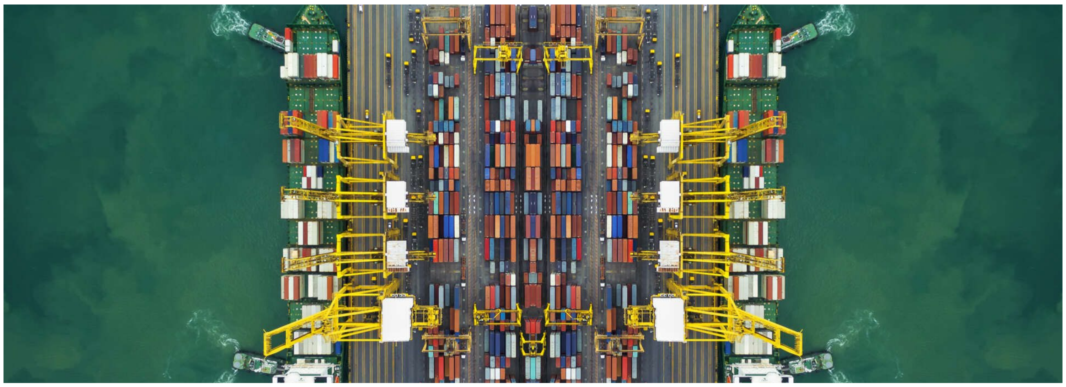
Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

Transportation

High fares and rates cover high costs, for now

January 14, 2025

This report does not constitute a rating action.



What's changed?

Geopolitical tensions worsened. The protracted Russia-Ukraine conflict and current conflicts in the Middle East brought greater unpredictability and disruption to supply chains.

Structurally higher labor costs. Given tight labor markets and wage agreements ratified in 2024.

Container shipping freight rates surged. Continued attacks on commercial ships in the Red Sea and robust trade volumes supported maritime freight rates well above our previous forecasts.

What are the key assumptions for 2025?

Sturdy consumer spending. Forecast robust global economic expansion of 3%, underpinned by resilient labor markets and easing inflation, should support demand.

Oil prices will remain relatively high. This comes after prices shifted downward in 2024.

Sluggish aircraft deliveries. Persistent new order delays and engine issues will continue to affect airlines' capacity growth and defer operating efficiency improvements.

What are the key risks around the baseline?

Geopolitical tensions spillover. Supply chains could be further disrupted, oil prices could be even more volatile, and the demand for travel could be diminished.

Mixed effects from a second Trump term. Increased tariffs on all goods imported to the U.S. could dampen trade volumes on key trade routes. Short-term inflation could increase and negatively affect consumer spending. Stimulation of U.S. oil production could cut fuel costs.

Softening airfares. A small decline in yields could have a significant effect on airline earnings given the high operating leverage inherent in the industry.

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Ratings Trends: Transportation

Chart 1

Ratings distribution by region

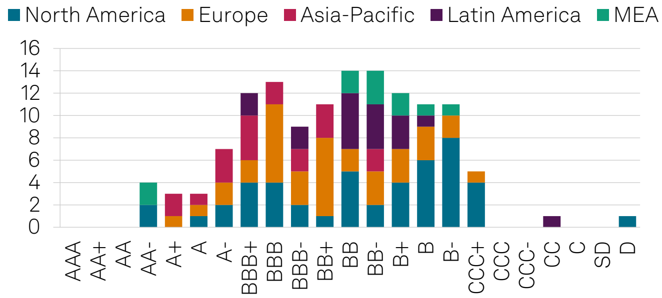


Chart 2

Ratings distribution by subsector

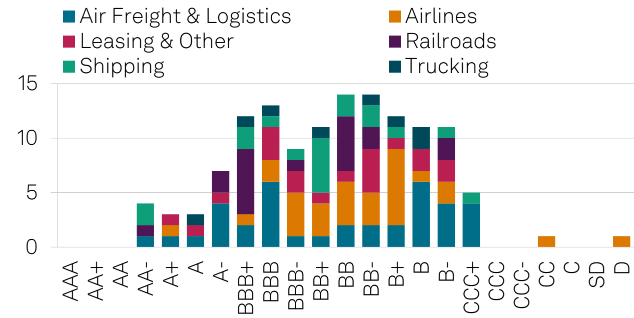


Chart 3

Ratings outlooks by region

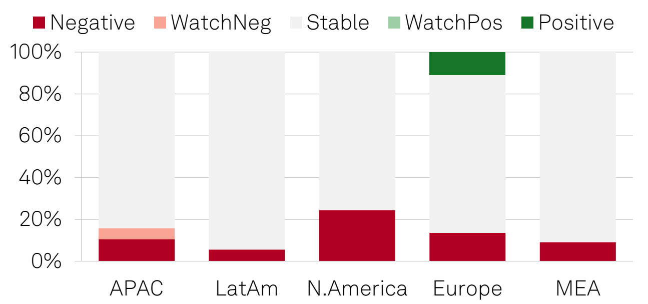


Chart 4

Ratings outlooks by subsector

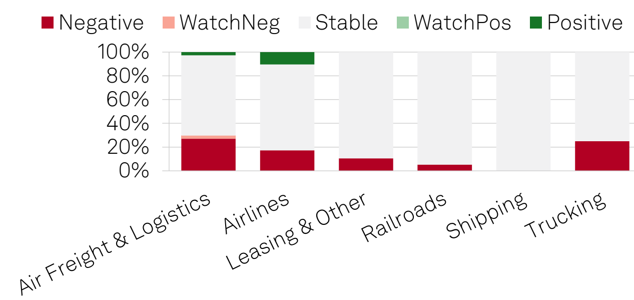


Chart 5

Ratings outlook net bias by region

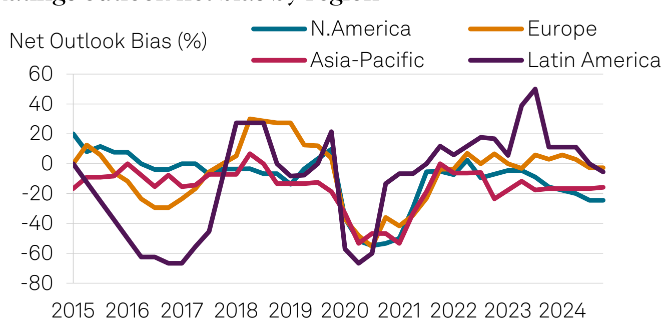
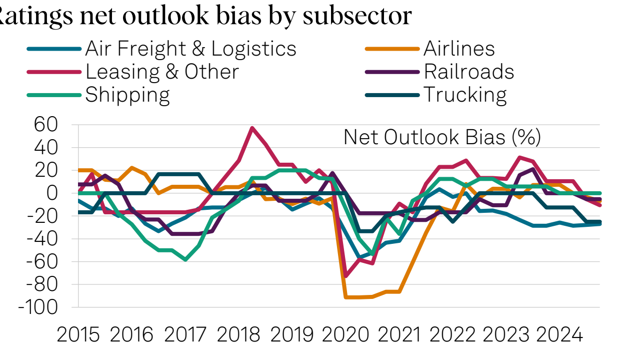


Chart 6

Ratings net outlook bias by subsector



hart 7

Ratings outlooks

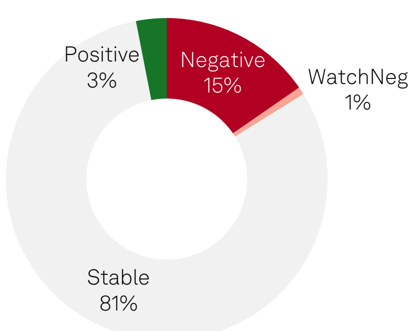
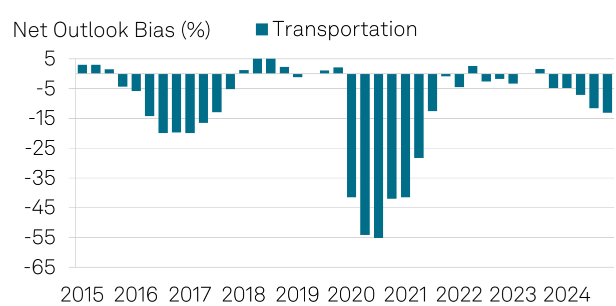


Chart 8

Ratings net outlook bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook: Airlines

Ratings trends and outlook

We think air passenger demand will remain healthy. This will drive continued revenue growth in 2025. Demand for leisure travel will endure, particularly in the premium leisure segment. We think that cost inflation—particularly on the labor and maintenance side—will be compensated by passenger growth and flat to modestly higher ticket prices for the most part. However, profit margins could come under pressure if yields soften as additional capacity comes online. The Boeing Co. delivery delays, which have lasted longer than we had previously anticipated, are likely to result in some further deferral of the heavy capital expenditure (capex) we had forecast for the sector in 2025. This will limit the pace of expansion for some and present a source of near-term incremental cash flow adding to financial flexibility for others. Furthermore, fleet renewal toward more fuel-efficient aircraft brings substantial future cost savings. We also expect airlines to continue shifting their product offerings toward more profitable premium seats, a trend that appears now to be structural.

A relatively upbeat credit outlook should support airlines. Consumer spending is forecast to rise, with a bias toward experiences, like travel, rather than goods. However, high geopolitical uncertainty presents a potential earnings headwind, alongside unpredictable oil and jet fuel prices, which trended lower in 2024. As such, we expect a relatively measured approach to rating actions in 2025.

Main assumptions about 2025 and beyond

1. Strong growth in air passenger volumes.

We think air passenger demand will continue to increase, led by strong momentum from the Asia-Pacific and Latin America regions, with Europe and the U.S. also showing positive trends. We note that international traffic operated by Asia-Pacific airlines demonstrate extraordinary growth but is still recovering (it was about 10% below 2019 levels in September 2024 as per the International Air Transport Association [IATA]). This contrasts with the impressive expansion from Latin American carriers (up over 14% in September 2024 compared with 2019 as per the IATA).

2. Structurally high labor costs.

Labor cost inflation was higher than expected in 2024 and has added pressure to margins. Many airlines have settled wage agreements, which should constrain further wage pressure in 2025, but labor costs will remain high. We currently forecast stable oil prices for 2025 and beyond of $75 per barrel (/bbl) for Brent and $70/bbl for West Texas Intermediate. The crack spread (the difference between crude oil and jet fuel prices) has also reduced (to below $20/bbl). However, jet fuel prices could become more volatile, particularly for airlines that do not hedge, given elevated geopolitical tensions.

3. Sluggish aircraft deliveries.

We expect the effect of new aircraft delivery delays (from Boeing, and, to a lesser extent Airbus SA) to persist in 2025 affecting carriers' capacity and related operating efficiency improvements. Increased expenses will also stem from additional leasing of aircraft and older aircraft utilization. Conversely, delays in spending could defer cash outflows and lead to slightly better issuer credit metrics in 2025.

Growth of air passenger traffic in Asia-Pacific will decelerate in 2025. This is because of the higher base. A surge in domestic travel demand in China drove most of the increase in traffic for the Asia-Pacific region in 2024. Capacity will continue to increase, despite supply chain constraints for new aircraft. Growing competition among local and regional peers, alongside high labor and fuel costs could pressure profitability.

We anticipate rational markets and healthy growth in Latin America for 2025. Growth should moderate but remain healthy after strong expansion in 2024, particularly in international traffic. In general, domestic and international traffic has comfortably surpassed pre-pandemic levels but the region remains underserved and underpenetrated, which should drive mid to high single-digit growth in capacity in the main economies of the region in the next couple of years. Delays in aircraft manufacturer deliveries and issues with engines ensure a rational market but could eventually be a downside risk to our growth prospects. In Brazil, two of the largest players (Gol Linhas Aereas Inteligentes S.A. and Azul S.A.) are still in the process of straightening up their capital structures and have a strong focus on enhancing cash flows, further reducing risks of aggressive competition.

Diversification remains helpful to earnings' stability. Airlines with significant operations outside of the passenger airline business benefit from diverging market trends. We expect maintenance and repair businesses to remain in demand in 2025 and report strong results. Air cargo demand continues to increase and air cargo yields were almost 50% above 2019 levels by the end of September 2024, driven by booming e-commerce and some shippers switching from sea to air transport because of maritime freight rate increases (as per IATA).

Credit metrics and financial policy

Credit metrics to show a modest improvement in 2025. After a remarkable recovery in the years after the COVID-19 pandemic (as demonstrated in the graphs in this report), there were clear regional differences in airlines' performance. European carriers showed better growth in 2024 than those in North America, and operators' performance in Asia-Pacific and Latin America improved even more. Historically low-cost airlines in the U.S. also struggled to generate positive earnings, as sharply higher cost bases (notably linked to labor) outpaced unit revenues and contributed to negative rating activity (including one airline filing for creditor protection in the region). However, airlines with established premium offerings (namely multiple seat classes), established loyalty programs, and international exposure have outperformed the broader industry. We expect this dynamic to persist in 2025. In Europe, there were some market indications of softening consumer sentiment and ticket pricing during 2024, particularly in the second quarter of the year, but trends improved as the year progressed.

Returns to shareholders are not yet widespread. Share repurchases and dividends have been announced by higher rated (typically 'BB' and higher) carriers. Continuing strength in demand and lower-than-previously assumed aircraft capex (stemming from original equipment manufacturer delivery delays) that facilitates growth in positive free cash flow could prompt more shareholder friendly activity in 2025. However, we think that most higher-rated issuers will remain focused on keeping ample cushion in their credit metrics, to guard against unexpected market pressure in this volatile industry.

Key risks or opportunities around the baseline

1. Spillover of geopolitical tensions.

Fuel prices will remain airlines' biggest operating expenses, and small fluctuations can have an outsized effect on airline earnings and cash flow. Jet fuel prices eased through much of 2024, but we assume prices will remain volatile and a potential headwind to profitability (particularly given the risk of further spillover effects related to the Russia-Ukraine war and the conflicts in the Middle East). Most European and Asia-Pacific carriers have softened the volatility with fuel hedges (compared with most carriers in the U.S. which typically do not hedge fuel). Furthermore, escalation of geopolitical tensions could also deter demand for travel.

2. Operating cost inflation.

Labor costs (typically the largest component of operating expenses) are now structurally higher following various agreements ratified mostly in 2024 (notably with pilots and other collective labor agreements) and expected to steadily increase annually. In addition, skilled labor shortages will likely persist, contributing to higher maintenance costs—particularly amid delayed new aircraft deliveries that require prolonged utilization of older aircraft. As capacity growth eases for many airlines, fixed cost absorption becomes more challenging. Foreign exchange volatility has exacerbated in emerging markets in recent months and could also add to cost and margin pressures, as a large share of costs are dollar-linked.

3. Softening ticket prices.

We will cautiously monitor any potential downside to airline ticket prices, as a small decline in yields could have a significant effect on earnings given the high operating leverage inherent in the industry. We assume flat or perhaps a modest improvement in prices through 2025 for most airlines, and this follows positive unit revenue guidance revisions by several airlines for the fourth quarter of 2024. That said, visibility beyond the next couple of months is typically low, particularly against the backdrop of geopolitical uncertainty. Even short periods of overcapacity can add outsized pressure to airfares. Airlines with the lowest debt leverage, or highest exposure to premium, loyalty, and international revenues are generally best positioned to withstand downside to prices but are not immune.

Carbon costs are ramping up for European airlines. Climate transition planning for airlines is still developing and relies heavily on the increased use of sustainable aviation fuels (SAF) and carbon regulations. The ReFuelEU aviation directive's requirements are much stricter than elsewhere, and mandates that all airlines use a 6% SAF blend for flights departing from EU airports by 2030 (the U.K. has set a 10% target). However, supply is extremely limited and so the current price of SAF is prohibitive. The cost of the EU's Emissions Trading System will increase again in 2025, as free allowances continue to be phased out (to zero by 2026). We think the increased cost will largely be passed onto consumers in higher airfares. Regulations outside of Europe are currently much less burdensome.

The effect of a second Trump term will likely be mixed. Given the president-elect has proposed universal tariffs on all goods imported to the U.S., as well as significantly higher charges on all goods (particularly from China), inflation could be pushed higher at least in the short term. This could affect consumer spending. Conversely, stimulation of U.S. oil production could temper oil prices and jet fuel costs, which could reduce costs. It will likely mean fewer environmental demands on U.S. airline businesses.

Cyber incidents affecting transportation groups have risen markedly. The risk of cyber attacks has been aggravated by heightened political tensions, which have provided states (and their proxies) with a fresh impetus to target transportation systems in support of military aims or in the hope of financially damaging geopolitical rivals. As such, although rated transportation companies have averted substantial credit quality damage from cyber incidents so far, we think this risk will continue to increase in the future, particularly for those with weak cyber hygiene.

Industry Outlook: Container Shipping

Ratings trends and outlook

Container shipping freight rates have surprised to the upside over 2024. Rates have surpassed 2023 levels, the pre-pandemic averages, and S&P Global Ratings' expectations. The unexpected outperformance can be traced back to a handful of factors, including, most importantly, the persisting rerouting of containerships away from the Red Sea, and stronger-than-anticipated global trade volumes and port congestion. These factors have offset both this year's record-high increase in containership capacity, which we had expected to weigh on rates in 2024, and the incremental cost of diverting ships around the southern tip of Africa.

The resultant market strength boosts operators' profitability. This includes an acceleration in rate increases in the third quarter of 2024. Rated container liners A.P. Moller-Maersk A/S (Maersk), Hapag-Lloyd AG, and CMA CGM S.A., have exceed our earlier EBITDA expectations for 2024. This is positive for their creditworthiness, which we expect will likely remain robust in 2025. Consequently, we hold on to our stable rating outlooks in the sector based on the assumption that circumventing the Red Sea and healthy global trade volumes will largely cushion the effect from new tonnage deliveries in 2025. We also factor in industry players' stringent capacity-management discipline when the Red Sea disruptions and port congestions eventually ease (releasing capacity into the network), which may not happen in 2025.

Main assumptions about 2025 and beyond

1. The Suez Canal route may not return in 2025.

The attacks on commercial vessels in the Red Sea by Houthi rebels will continue, with no signs of a sustained resolution to the geopolitical conflicts.

2. Freight rates will moderate due to additions of new tonnage.

After higher-than-expected freight rates in 2024 on the back of persisted Red Sea disruptions, robust demand, and port congestion, freight rates will likely diminish in 2025. This is because growth in global container demand will not likely match sizable new containership tonnage that is due to come online in 2025.

3. Financial health remains robust entering an uncertain 2025.

Despite record high shareholder returns and discretionary spending on acquisitions, funded from unprecedented gains, container shipping companies' balance sheets remain solid. Credit quality will likely remain within current rating thresholds in 2025, as Red Sea disruptions continue to support freight rates, notwithstanding new tonnage additions.

Traffic through the Suez Canal has reduced since mid-November 2023. This is because of attacks by Yemen-based Houthi rebels on maritime shipping in the Red Sea area. The Suez Canal is the shortest maritime route between Asia and Europe. Containership tonnage traversing the Red Sea was down 90% in the January-November 2024 period compared to the first half of December 2023, according to Clarksons Research. Most of the missing Red Sea container liner traffic is being rerouted around the Cape of Good Hope in South Africa, increasing average transit times by at least 10 days. There are no signs that a return to the shorter route is imminent. However, this may not be bad news for freight rates or container ship operators. The longer transit time boosts ton-mile demand (the distance of the trading route multiplied by the volume transported) and, along with the unexpectedly robust global container trade, ongoing port congestions have alleviated the pressure from new containership deliveries (which intensified in second-half 2024) and the capacity they add.

We expect freight rate levels to moderate. This will be because of sizable additions of new tonnage continuing in 2025. Our base case for container liners incorporates a reduction in their average freight rate of 5%-10% in 2025, noting that more pronounced, yet temporary seasonal or event-driven swings in rates throughout the year are possible. Furthermore, new vessel order books remain elevated—due to a surge in contracting in summer-2024 and despite a glut of deliveries in 2024—currently accounting for 25% of the total global fleet, compared to an all-time low of 8% in October 2020, according to Clarksons Research. Their data suggests that containerships' total capacity will increase by approximately 5% in 2025, all else being equal, following a surge of nearly 10% in 2024.

Credit metrics and financial policy

A resilient 2024 allowed rated container liners to preserve solid balance sheets. This is on the back of elevated rates. Maersk and Hapag-Lloyd have kept their net cash positions as of Sept. 30, 2024, while CMA CGM's balance sheet has returned to a net debt position as of the same date—although the net debt level remains well below the 2018-2020 levels. Companies also maintained substantial liquidity reserves as of 2024-end.

Our base-case scenario anticipates a decrease in earnings and cash flows in 2025. This is in line with moderating freight rates as significant new tonnage continue to come online. Credit metrics will remain within our rating thresholds, but with diminished headroom. Industry conditions remain volatile given the looming capacity oversupply that has been delayed rather than solved. Our forecast remains subject to uncertainty of future normalized freight rates, notably once the transit via the Suez Canal resumes (releasing tonnage into the network). This diminishes the predictability of credit-ratio projections and increases the risk that EBITDA could underperform, or that financial leverage could overshoot what can be reasonably built into our base case.

Key risks or opportunities around the baseline

1. Red Sea disruptions will decrease markedly.

The resultant release of containership tonnage into the network would see freight rates falling and container liners' results come under significant pressure. Although, this is not our base-case assumption for 2025.

2. Additional tariffs may drag on trade volumes.

Trump's second term poses a threat to global trade and may disrupt supply chains, with U.S. imports accounting for about 13% of global seaborne container trade as measured in TEU twenty-foot equivalent unit terms, according to Clarksons Research.

3. Large capex requirements will weigh on cash flows.

Container liners continue the environmental upgrade of their fleets in line with their decarbonization goals and to comply with increasingly tighter emission standards.

The economic outlook for 2025 will be marked by uneven recovery patterns. This follows the lingering effects of the COVID-19 pandemic and geopolitical instability. Interest rates are set to stay higher for longer as nations continue to struggle to contain inflationary pressures. New President-elect Donald Trump further complicates the macroeconomic outlook, as he has vowed to impose hefty tariff increases for example on all imports from Canada and Mexico and an additional increase in tariffs on goods from China and the EU. Such measures will likely suppress trade volumes on key routes as importers seek to minimize exposure to heightened costs.

The IMO's 2023-strategy is to reduce the industry's greenhouse gas emissions. The target for the International Maritime Organization (IMO) is net zero by or around 2050, which necessitates lumpy investments in new vessels, requires alternative and greener technologies and fuels, and involves higher running costs. Shipping companies are getting on board. Many are exploring the use of carbon-neutral fuels (green ammonia and green methanol) or liquefied natural gas (LNG) technology—which we view as a transitional solution. Larger players have also initiated green fleet renewal programs, for example by stipulating that newbuilds will be methanol-enabled and dual-fuel capable. There is room for improvement, however. Clarksons Research noted in its November 2024 report that 6.6% of the current global fleet can use alternative fuels, up from 5% in 2023 and 4% in 2022, and this should continue increasing. About 77% of orders (in global fleet tonnage terms) will be capable of using alternative fuels or propulsion, including LNG (about 51% of the orderbook) and methanol (about 26%), %), according to Clarksons Research.

Industry Outlook: Railroads

Ratings trends and outlook

Earnings growth and financial policies will support continued ratings stability. U.S. real GDP (2.0%) and consumer spending (2.3%) growth expectations in 2025 in the U.S. underpin our assumption for carload growth in 2025. In addition, railroads should continue to achieve prices at or above inflation, offsetting higher wages expected from new labor agreements currently being negotiated and support earnings growth. The broad diversification of railroad freight shipments is a key source of earnings stability that we assume will continue. Moreover, consistency in financial policies is anticipated to preclude appreciable change in credit metrics and we assume ratings stability in 2025.

Main assumptions about 2025 and beyond

1. Class 1 revenue expected to benefit from growth in carloads and prices.

We assume Class 1 railroad revenues will increase by about 1%-3% in 2025, following a relatively subdued 2024. We believe that carloads will increase to a modest extent, led by trend-level economic growth (in the U.S.) but still sluggish freight environment. Improvement is likely to be broadly diversified across several end markets. We also assume relatively flat surcharges and steady growth in revenue per carload (prices).

2. Reliable service has railroads primed to take share from trucks.

Service levels deteriorated during the pandemic, but increased staffing in 2023 mostly addressed service level issues by the end of 2023, with 2024 service levels remaining strong. We think that railroads are now better positioned to compete with trucks, which have gained share namely on shorter-haul routes in recent years. That said, trucking remains competitive and a material shift in transportation modes is unlikely in the absence of higher trucking rates from current near-trough spot levels.

3. No protracted work stoppages or port diversions.

On Jan. 8, 2025 the International Longshoremen's Association (ILA; which briefly went on strike in October 2024) and the U.S. Maritime Alliance reached a tentative agreement on a new contract in advance of the current Jan. 15, 2025 deadline. Both sides have agreed to continue working under the current contract until the proposed contract has been voted on. While ratification of the proposed contract seems likely, this is not a foregone conclusion (Boeing workers rejected initial contract offers agreed to by their union representation). In the event of a potential and protracted strike would lead to port diversions and reduced port capacity that could disrupt rail shipments.

Intermodal and merchandise carload will increase. Growth will be supported by stable consumer and industrial spending. We estimate an increase in carloads by about 1% to 3% in 2025, which would represent a consecutive year of growth (mid to high single-digit growth in 2024) following a weak 2023 (5% decline) linked mainly to inventory destocking after the pandemic. We expect steady industrial production and consumer demand to be key drivers of carload growth, which we assume for both intermodal and merchandise segments. In our view, lower inflation and a declining interest rate environment are notable contributors. At the same time, we do not anticipate truck prices to materially change from current low levels during the 2025 bid cycle, which likely limits the extent of truck to railroad conversions as a source of intermodal expansion (but also intermodal pricing). Excess trucking capacity has persisted longer than we had anticipated and will need to be addressed for prices to sustainably increase. For merchandise carloads—namely automotive, agriculture, fertilizer, construction products, chemicals, and other industrial commodities—we expect growth generally in line with U.S. real GDP.

Large stockpiles and low LNG pricing continue to weigh on coal carloads. We expect coal shipments to remain a headwind to railroad shipments and earnings in 2025, but not to an extent that negatively affects ratings. Lower coal volumes had an outsized effect on the western U.S.-based rails in 2024 (down about 20% year over year), but the eastern rails were also affected (down by mid-single digits). For 2025, we continue to assume lower coal shipments, but at a moderating rate of decline (particularly in the western U.S.). Moreover, while speculative, policies adopted by the incoming Trump administration could potentially result in an increased usage and higher shipments of coal.

Modest rail price appreciation to continue in 2025. We expect railroads will continue to achieve price increases at least in line with operating expense inflation, contributing to modestly higher revenues and earnings in 2025. Rail is a comparatively more cost-efficient means of transporting long-haul shipments, with limited alternatives to move certain commodities (like coal and grain) since most commodities are shipped in bulk. We assume revenue per carload (excluding fuel surcharges, which are effectively a pass-through) to increase in the low single-digit percentage area on average for the Class 1 issuers. However, railroad pricing power is comparatively weaker in intermodal (which competes with trucks) and coal (a function of benchmark coal prices) relative to merchandise shipments, which is embedded in our forecasts.

Potential labor disruptions are not expected to materially affect railroad credit profiles. The ILA agreed to compensation terms in early October 2024, with workers receiving around a 60% wage increase over six years. Automation efforts by port operators remained the larger issue, though the tentative agreement indicates a compromise has been made that satisfies both parties (details have yet to be disclosed). We think that normal allocation of freight between west and east/gulf ports has not resumed, with shippers still leery of another disruption. In the event of a protracted work stoppage (which we view as unlikely), we believe declines in total container volumes would be limited (and potentially beneficial for railroads due to a longer length of haul).

Credit metrics and financial policy

In 2025, we expect credit metrics to remain stable. These metrics are well positioned for current ratings. We expect the Class 1 railroads on average to generate low single-digit percentage growth in earnings in 2025. Relatively steady earnings should translate to another year of significant free operating cash flow (FOCF), which provides financial flexibility. FOCF has historically been allocated almost exclusively to shareholder returns, with discretionary free cash flow deficits and large partly debt-funded share repurchases. We assume this will continue but expect that any shortfall in earnings and operating cash flow will reduce (or eliminate) share repurchases to an extent that preserves credit measures at levels we view as commensurate with their respective ratings. For 2025, we estimate most of the Class 1 rails will generate funds from operations to debt and adjusted debt to EBITDA firmly in line with their respective ratings.

Financial policies are expected to remain unchanged. We believe the Class 1 railroads will remain focused on preserving their stated leverage targets. For most, this has afforded a high degree of historical ratings stability. During periods of earnings weakness, the rails have demonstrated a willingness to pause or reduce shareholder distributions to limit downside to credit measures. This was most recently demonstrated by certain U.S. railroads starting in 2023 (including Union Pacific, the largest Class 1 railroad by revenue) and Norfolk Southern (due to its well-documented derailment).

Key risks or opportunities around the baseline

1. Truck capacity could exit the market quicker than expected.

Truck overcapacity has remained stubbornly higher (and longer) than we (and the industry) had expected, and we continue to think prevailing prices are unsustainable. The supply/demand balance will eventually normalize, and prices will improve as many trucking companies are struggling to operate profitably. However, this industry dynamic has diverged in duration from past cycles, and uncertainty remains high. In the event of a near-term and meaningful price inflexion, we would expect certain volumes moving to the railroads more than our current expectations and benefit earnings and cash flow.

2. Coal production may expand from possible EPA regulatory challenges.

Trump expressed support for the coal industry during his first term, and a repeal or softening of certain U.S. Environment Protection Authority (EPA) regulations could lead to an increase in coal usage and carloads. Low LNG prices have since made LNG a viable fuel alternative to coal, and utilities have also reduced coal usage to follow EPA regulations.

3. Trump policies may undermine nearshoring efforts.

Mexico has benefited from ongoing nearshoring trends with expanded manufacturing capacity and is a notable source of rail shipments to/from the U.S. While speculative, the potential for tariffs to be applied to goods crossing the border—a Trump election platform—could negatively affect the cost of goods and, in turn, reduce demand and the amount of carloads moved by railroads.

Labor disruptions, if they occur, are manageable. The national collective bargaining process began on Nov. 1, 2024. However, certain railroads began negotiations with local unions before this, already reaching tentative agreements (some ratified) with numerous unions. This approach varies from past negotiation rounds whereby the railroads jointly negotiated at the national level. For now, negotiations do not appear to be as contentious as they were in December 2022, when Congress intervened and imposed a contract between the railroads and unions (which expires at the end of 2024). With the progress made thus far, it is likely that remaining unions will come to agreeable terms. If not, we would not rule out another Congress-imposed contract to avert a shutdown.

Related Research

- Transportation Companies Face Increasing Cyber Risks, Dec. 12, 2024
- ESG Credit Brief: Airlines, Dec. 4, 2024
- Global Credit Outlook 2025: Promise And Peril, Dec. 4, 2024
- India Aviation: Funding Needs Will Soar, Oct. 15, 2024
- Rating Airline Debt And EETCs, Sept. 3, 2024
- North American Airlines On Slow Climb To Improved 2025, Aug. 19, 2024
- Sustainability Insights: Biofuel Regulations Stoke Demand, Volatility Hits Brakes, July 17, 2024
- Global Airlines Outlook: Clear Skies, For Now, April 30, 2024
- Sustainability Insights: E-fuels: A Challenging Journey To A Low-Carbon Future, March 25, 2024
- CreditWeek: How Will The Red Light In The Red Sea Affect Supply Chains And Inflation?, Jan. 18, 2024

Industry Forecasts: Transportation

Chart 9

Revenue growth (local currency)

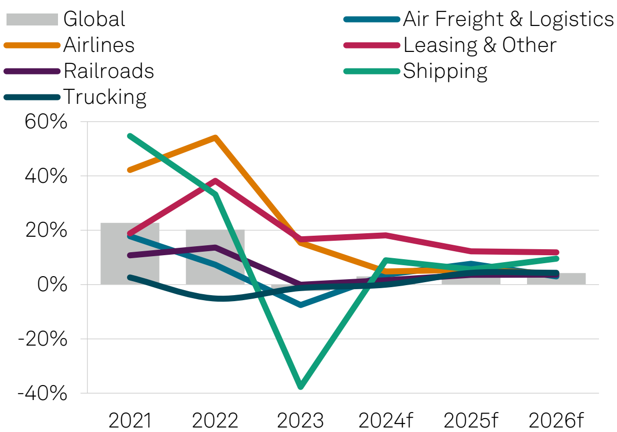


Chart 10

EBITDA margin (adjusted)

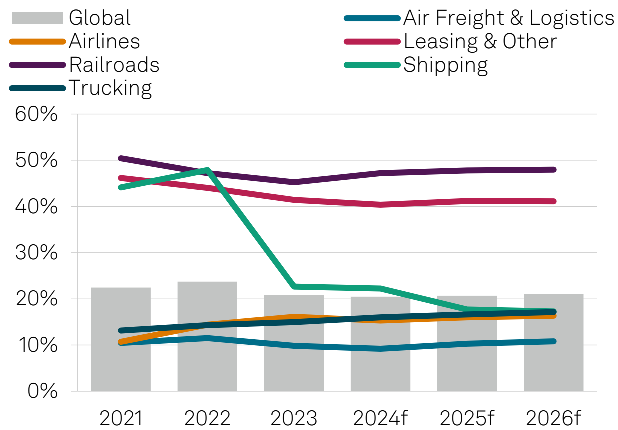


Chart 11

Debt / EBITDA (median, adjusted)

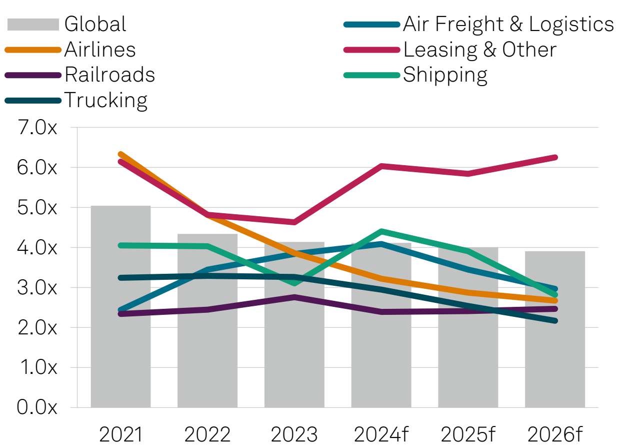
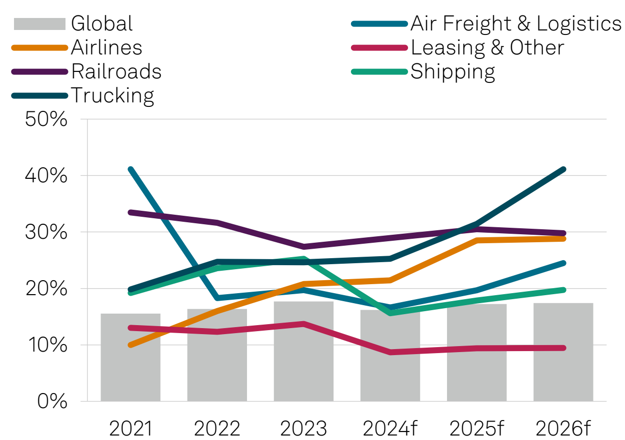


Chart 12

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Transportation

Chart 13

Cash flow and primary uses

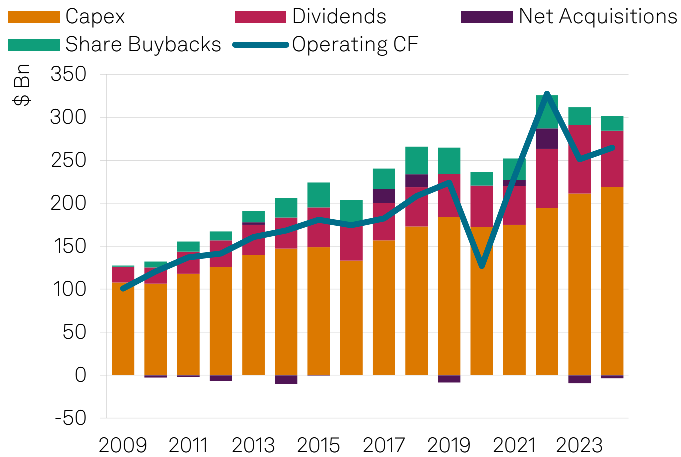


Chart 14

Return on capital employed

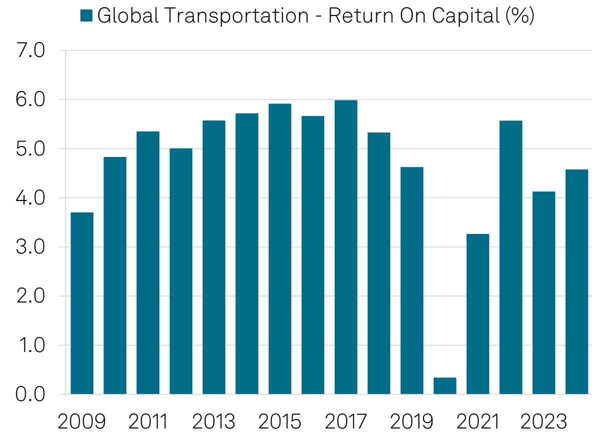


Chart 15

Fixed- versus variable-rate exposure

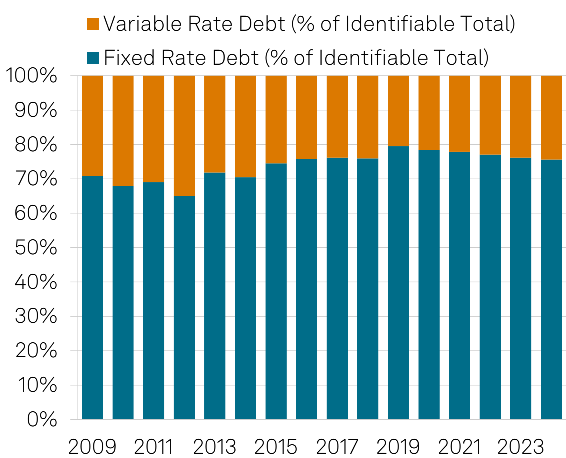


Chart 16

Long-term debt term structure

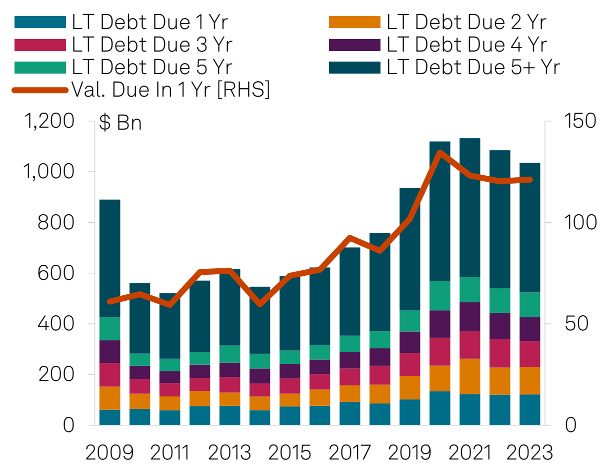


Chart 17

Cash and equivalents / Total assets

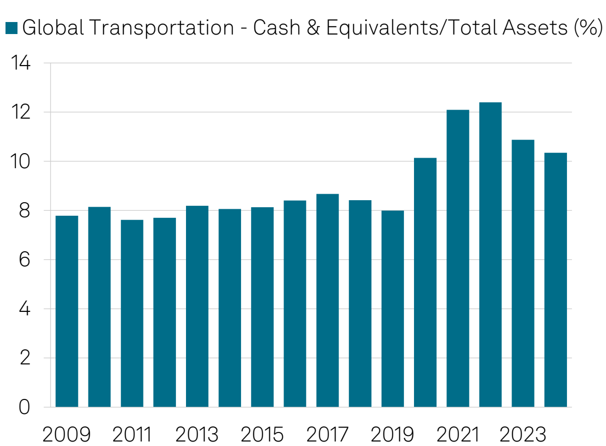
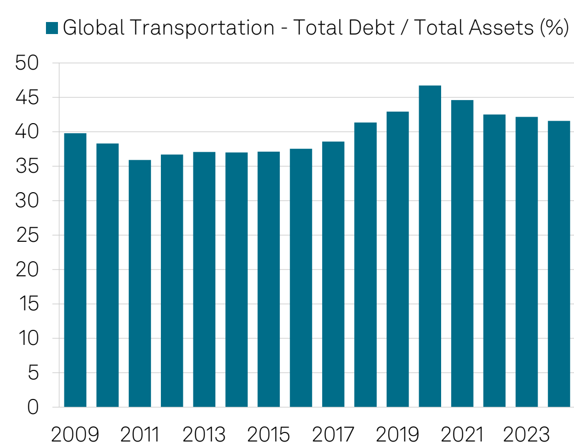


Chart 18

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

S&P Global Ratings

Asia-Pacific Utilities

Balancing a need for growth with the challenge of transition

January 14, 2025

This report does not constitute a rating action.

What's changed?

Economic outlook. South and Southeast Asian (SSEA) countries will remain Asia-Pacific's growth engine.

Interest rates. Slow pace of rate cuts may add to the burden of renewable operators.

Execution risks. Grid and storage facilities will be a bottleneck holding back energy transition.

What are the key assumptions for 2025?

Power demand to maintain growth in the mid-single digits. Power demand growth in China is slightly higher than GDP given the structural shift of consumption to the service sector. Power demand in other Asia-Pacific markets will largely follow the rate of economic recovery.

Profitability facing challenges. Debt-funded capital expenditure (capex) for renewables expansion will stay high and add to Asia-Pacific power operators' debt burden. On-grid tariffs for renewables are falling in many markets given more marketized trading mechanism and cost cuts.

Governments continue to support energy transition. Asia-Pacific countries are moving toward their climate targets, backed by supportive policies.

What are the key risks around the baseline?

Grid stability. Higher intake of renewables may affect grid stability. Utilization and operating efficiency will be affected. In China, we expect power curtailment to rise for renewables.

Technology breakthrough. Power transmission and storage facilities are bottlenecks for renewable expansion in the prevailing power systems in Asia-Pacific.

Fuel cost. Fuel cost may fluctuate unexpectedly on rising geopolitical conflicts, leading to earning volatilities for gas and coal-power suppliers.

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Ratings Trends: Asia-Pacific Utilities

Chart 1
Ratings distribution

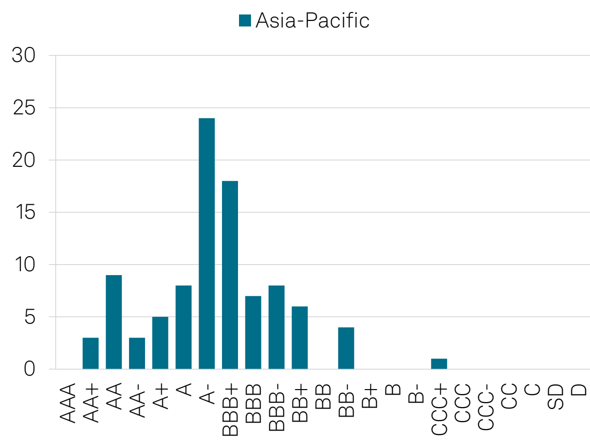


Chart 2
Ratings distribution by region

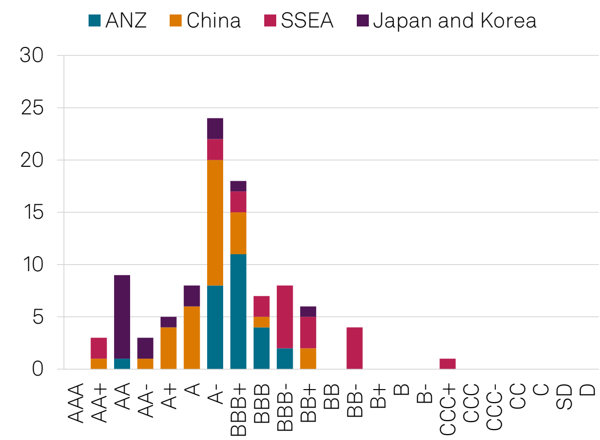


Chart 3
Ratings outlooks

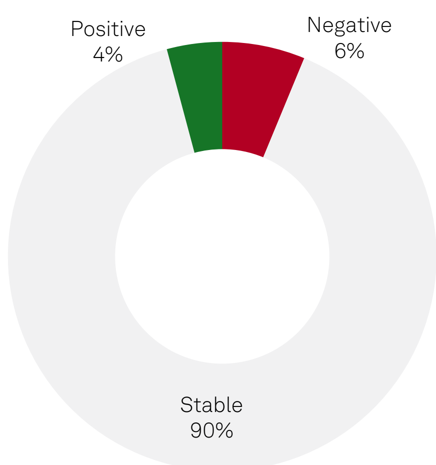


Chart 4
Ratings outlooks by region

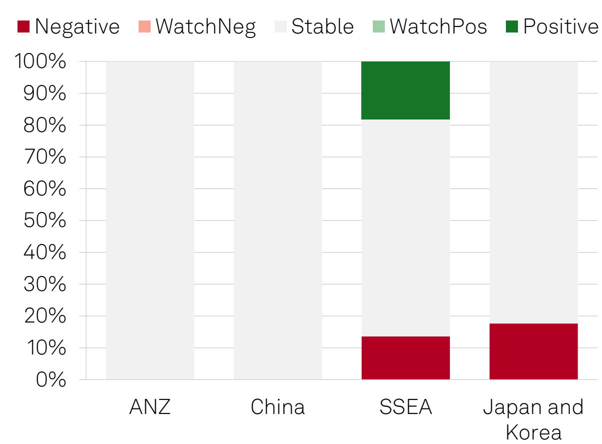


Chart 5
Ratings outlook net bias

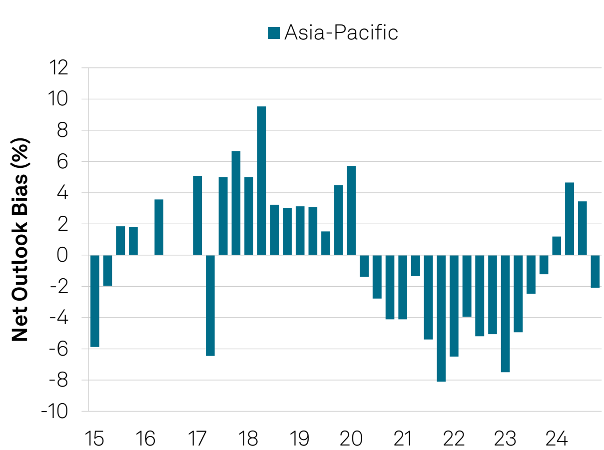
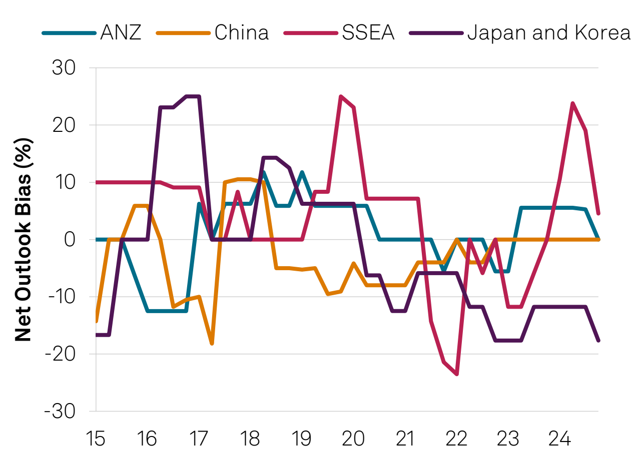


Chart 6
Ratings net outlook bias by region



Source: S&P Global Ratings.

Ratings data measured at quarter-end. ANZ—Australia and New Zealand. SSEA—South and Southeast Asia.

Industry Credit Metrics: Asia-Pacific Utilities

Chart 7

Debt / EBITDA (median, adjusted)

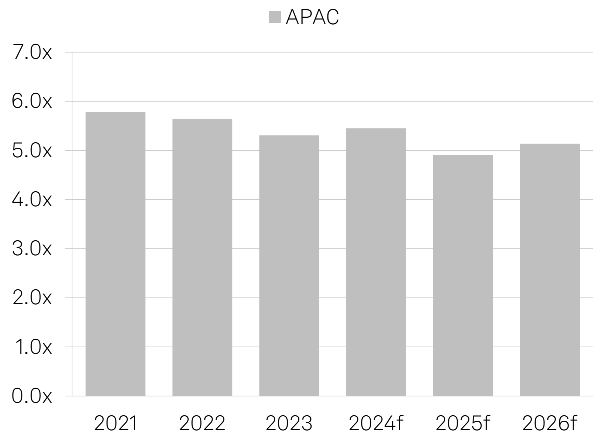


Chart 8

FFO / Debt (median, adjusted)

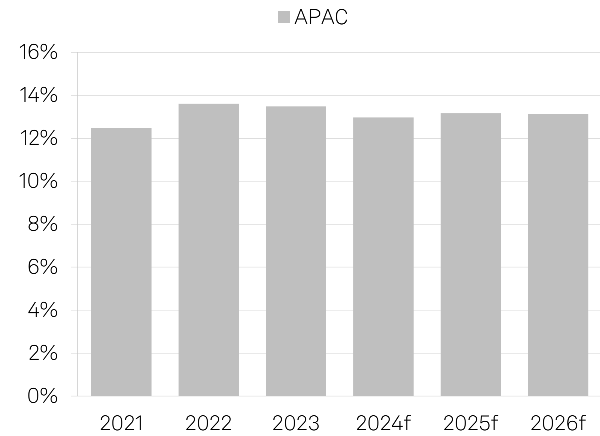


Chart 9

Cash flow and primary uses

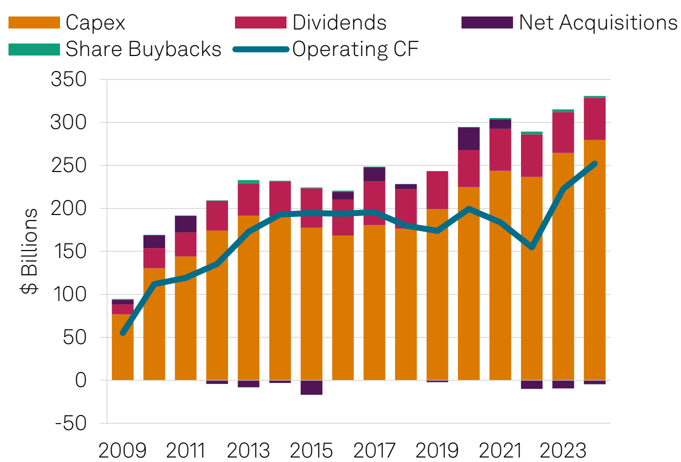
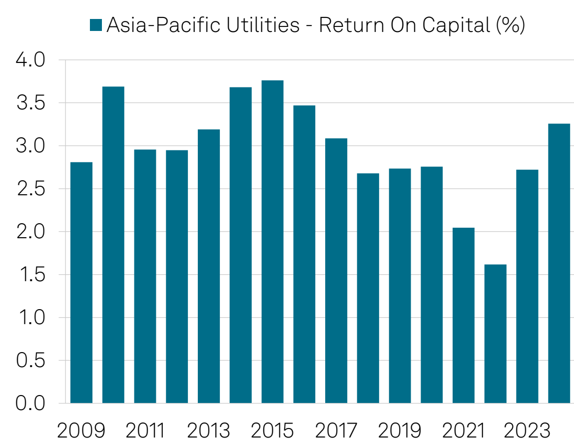


Chart 10

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2024) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: Australia and New Zealand

Ratings trends and outlook

We forecast stable credit metrics and outlook. This is supported by the adequate rating headroom of most rated entities. Regulated utilities are benefiting from high inflation-linked revenues, but higher costs will squeeze margins. Demand for electricity and gas remains flat; this trend is captured in regulatory determinations. Large transmission projects are underway, and we expect regulation and owners to remain supportive. Unregulated players in New Zealand will benefit from prudent policies on shareholder distributions during the building phase.

Main assumptions about 2025 and beyond

1. Companies will likely operate within their regulatory parameters.

Inflation-linked pricing will flow to revenues. Minimal benefit to margins due to higher costs for labor, contracts, and procurement. Stable interest rates for now in Australia and falling rates in New Zealand will ease pressure on interest costs. Softer gas demand or new connections could limit upside to gas distributors.

2. Elevated capex for regulated and unregulated operators.

Network reliability concerns with slow growth in electricity volumes due to energy transition, and new transmission projects will push up capex. This is captured in regulatory settings. The pipeline of renewable projects will increase capex for integrated merchant power. Lower shareholder distributions, or equity infusions in some cases, will support balance sheets.

3. More volatility in electricity prices due to climate effects and rising renewables.

We forecast average electricity prices will stay high, based on normal hydrology and stable demand. Downside risks include extreme hydrology or heat, rising gas prices, and strong retail competition.

Credit metrics and financial policy

In our view, the financial policies of rated entities boost credit quality. The financial metrics of the rated portfolio have reasonable headroom, which gives leeway for any unexpected variation in operating parameters. Most rated entities operate according to financial policy targets that can range from target ratios of funds from operations (FFO) to debt, risk limits, interest rate hedging, and refinancing ahead of debt maturities. All rated entities have flexibility in dividend distributions and, to some extent, for capex.

Key risks or opportunities around the baseline

1. High investment in regulated networks will increase the regulated asset base, and returns.

Higher capex and inflation will assist growth in asset bases and earnings. While there is opportunity to grow contracted (unregulated) connections for new renewable projects, these are likely to remain small.

2. Australian unregulated utilities: renewable power investments present mixed outcomes.

Construction costs, approvals, network connections, and contract arrangements will present risks to the timely execution of projects.

3. Merchant utilities in New Zealand will grow by establishing new projects.

The pipeline of projects across rated entities will increase demand for labor, materials, skilled contractors, and funding.

Cost escalation or poor project management can create risks for regulated utilities. This is particularly so for large new transmission projects given fixed-price contracts are no longer the norm. Risk can arise due to poor contractor performance, weather delays, difficult labor management or unfavorable outcomes from risk-sharing arrangements. Regulatory reopeners can reduce this risk, but this may take time and may not fully compensate for inefficiencies. We expect simple network-related projects to be managed within the regulatory allowances.

Rapid growth in renewable power will require large investments to connect them to the grid. Most of these are likely to be contracted or unregulated, and to be debt funded. We expect phased growth; however, a rapid increase in unregulated investments by regulated utilities could dilute our assessment of the business risk.

Australian unregulated utilities: Renewable power investments present mixed outcomes. Construction costs, approvals, network connections, and contract arrangements will involve steady variables and be a risk to project deliveries. Planned investments for generation and transmission are substantial, spurred by the target to reduce emissions by 43% by 2030.

Stability and reliability issues, as well as the uncertain visibility on the rollout of renewable capacity, are extending the lifecycles of some coal plants. Volatile pool prices, plant availability, and construction costs remain the biggest risk to the unregulated sector over the next one to two years.

Merchant utilities in New Zealand are investing in several new "green" projects. Cost management and execution remain key risks due to a shortage of contractors and the long lead times for equipment supply. While several large and small projects have been completed recently with no—or limited—risk to credit quality, few have seen cost escalations or delays due to weather, supply, or design changes.

Industry Credit Metrics: Australia and New Zealand

Chart 11
Debt / EBITDA (median, adjusted)

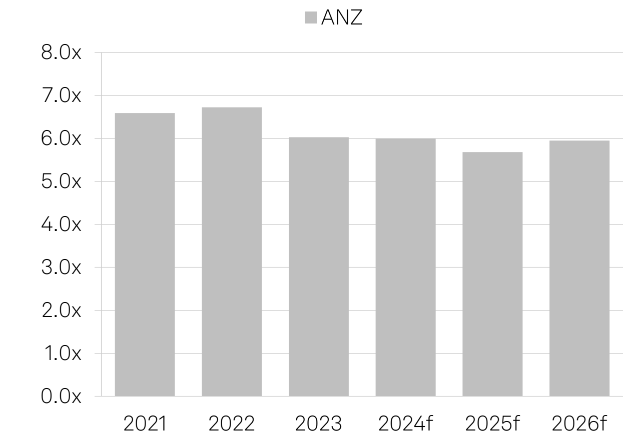


Chart 12
FFO / Debt (median, adjusted)

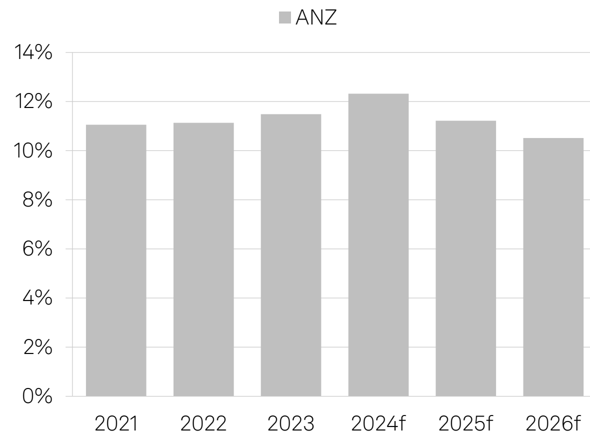


Chart 13
Cash flow and primary uses

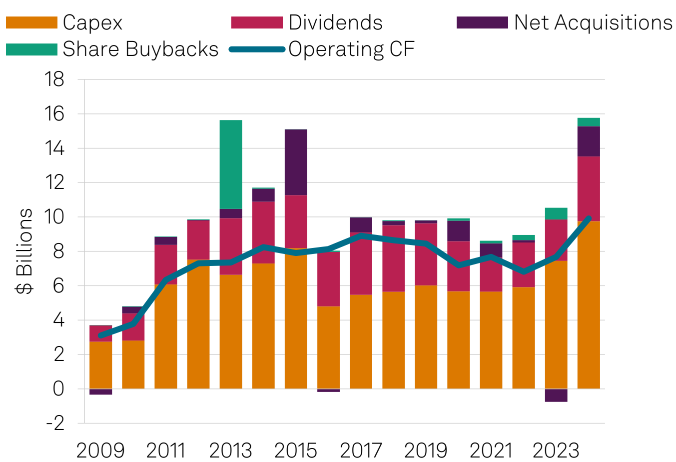
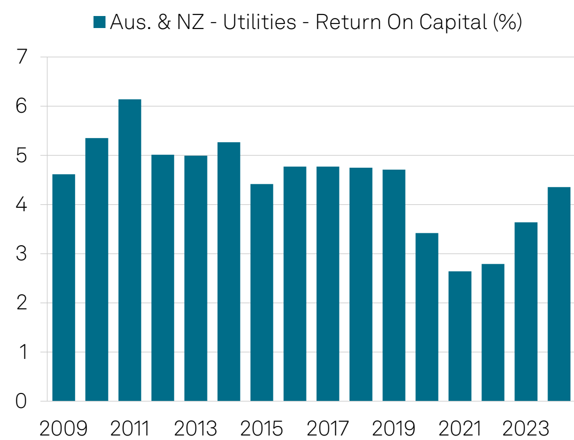


Chart 14
Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2024) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: Mainland China and Hong Kong

Ratings trends and outlook

Our stable outlook for the sector is underpinned by the continued government support in promoting clean energy usage and low interest rate environment in mainland China. Moderating fuel prices and a ramping-up of newly installed renewable capacities will support earnings growth for the independent power producers (IPPs). Tempering the financial improvement is a trend for diminished tariffs for renewable producers, and still elevated debt-funded capex over the next one-two years.

Main assumptions about 2025 and beyond

1. A breakthrough year for energy transition.

Renewable energy capacity achieved 1,250GW by September 2024, outpacing the 1,200GW target set for 2030. IPPs will continue to expand capacity but in a more selective way.

2. Deepening power market reforms to weigh on the profitability of the renewable sector.

Mainland China will further deregulate power generation by pushing all renewables into market-based trading in 2026-2029, earlier than the original guided 2030. On-grid tariffs will soften, particularly for renewable power sold through market-based contracts.

3. Deceleration of gas consumption growth reflects substitution risk and property downturn.

Government decarbonization measures and slowing GDP growth will weigh on gas demand. Income from new connection fees will continue to shrink amid the slowdown in the property sector. Gas distributors will count on dollar margin expansion and business diversification to sustain profitability.

A breakthrough in energy transition. Mainland China added 200GW of wind and solar in the first nine months of 2024. The cumulative capacity of non-hydro renewables has reached 1,250GW, handily beating a government target to create 1,200GW of such capacity by 2030. Including hydro, renewable capacity accounted for 54.7% of total power capacity, and generated 35.5% of total power in the first three quarters. We expect annual addition of non-hydro renewables to stay at about 200GW over the next one-two years.

We also expect IPPs will be more selective in project development. Priorities will be given to those in areas with more favorable local power trading policies and better demand. This is to ensure a project's rate of return meets internal requirements amid declining tariffs and potential power curtailment stemming from oversupply in certain regions.

Power market reforms to weigh on the profitability of the renewable sector. Mainland China's power market reforms advanced in December 2024, when the government outlined a three-step roadmap for establishing a national unified power market by 2029. All renewables will be traded under the marketized scheme by 2029, one year earlier than the original guidance. IPPs will face more challenges in sustaining their profitability in the near-term amid reduced guarantees on dispatching volume and declining average tariffs. The national mechanism will facilitate a fluctuation in power prices within a range, such that the price reflects real supply and demand dynamics. These measures should lead to cheaper green power, encouraging wider use.

A higher percentage of market-based trading volume will increase volatility in both pricing and operation risks for IPPs in near term. In 2023, 61.4% of national power was sold through market-based trading mechanisms, a fivefold increase from 2016. About 47.3% of power generated from renewables was sold through market-based trading; that level will likely exceed 50% by 2025. Average on-grid tariffs will continue to trend down for both coal-power and renewables over the next three-five years. The financial impact on renewables may be greater because coal-power projects are compensated for drops in utilization hours with capacity tariffs. Such compensation is absent for renewables.

Decelerating growth in gas consumption points to substitution risk and a slowing economy. We expect gas volume growth will moderate over the coming five-six years as the central government slowly deprioritizes natural gas usage in meeting its energy security and emission-cutting goals. A slowdown in GDP growth to 4.1% in 2025 and 3.8% in 2026 under U.S. trade tariffs and a persistent property downturn could also pressure gas demand in manufacturing sectors. New connections will continue to decline against the backdrop of a weak housing market. Gas distributors' average dollar margin may expand slightly, supported by a 2%-3% annual decline in gas costs following drops in the Brent crude benchmark. The rising gas storage capacity will partly mitigate supply and price risks. Gas distributors are laying the groundwork for new sources of growth including sales of gas appliances and services, transitioning into integrated energy, and pushing into renewables.

Credit metrics and financial policy

We expect credit metrics to be stable for mainland Chinese IPPs over 2025-2026. Their average ratio of FFO to debt will remain at about 9%. The improvement in profitability from lowered fuel costs and the ramping up of renewables will be partly offset by declining average tariffs and increased capex (largely debt funded).

The credit metrics of mainland China gas distributors will modestly improve over 2025-2026. Their average ratio of FFO to debt will likely increase to 24% in 2025 from 22% in 2023, while gas sales volume continues to grow, albeit at a lower rate, with some mild improvements in dollar margins. We expect capex levels of gas distributors to be broadly stable over the next few years.

Key risks or opportunities around the baseline

1. Curtailment on renewable output could be a structural issue.

The curtailment rates may keep rising in mainland China's power sector, depressing utilization rates and margins for renewables operators.

2. Grid infrastructure and energy storage to catch up.

Investment in grid infrastructure and energy storage will accelerate to equip the power system for further structural changes.

3. Geopolitical uncertainties may drive up fuel costs and depress power demand.

Natural gas distributors may face more volatility given likely geopolitical tensions and swings in the price of liquified natural gas (LNG). Rising complications in doing international trade may depress power demand from the industrial sector.

Curtailment of renewable output could be a structural issue. Massive renewable capacity may magnify oversupply issues during certain times of a day given the inevitable mismatch between the supply of natural energy sources and power demand, particularly without storage facilities and smart distribution systems. As such, power curtailment rates may increase under the prevailing system. The power grid operators are allowed to loosen the renewable power dispatching rate to 90% from 95%, implying the power curtailment rate for wind and solar projects may double from 5% to 10%.

This will translate into lower capacity utilization and even temporarily negative spot-market tariffs under market-based trading, particularly for solar projects. Participation in inter-regional market-based trading may be a way out for renewables when local grid dispatching is not assured and energy storage is insufficient.

Grid infrastructure and energy storage to catch up. Over the past decades, power grid operators have been building ultra-high voltage (UHV) transmission lines to connect areas with abundant renewable resources to those with greater energy demand, although the development pace of grids mismatches that for renewables—wind and solar capacity almost doubled over 2020-2023, while interprovincial transmission capacity only expanded by 15%. More investment into grid networks is likely, ensuring the stability and reliability of power supply as renewables gradually increase their share of power generation.

Entities will also be investing heavily in energy storage. In the first nine months of 2024, the capacity of new-energy storage projects reached 58.5GW, an increase of 86% from end-2023. Mainland China is targeting 100GW of battery storage capacity by 2030, which has the advantage of high capacity, long life cycles, lower cost, and fast response times.

Industry Credit Metrics: Mainland China and Hong Kong

Chart 15

Debt / EBITDA (median, adjusted)

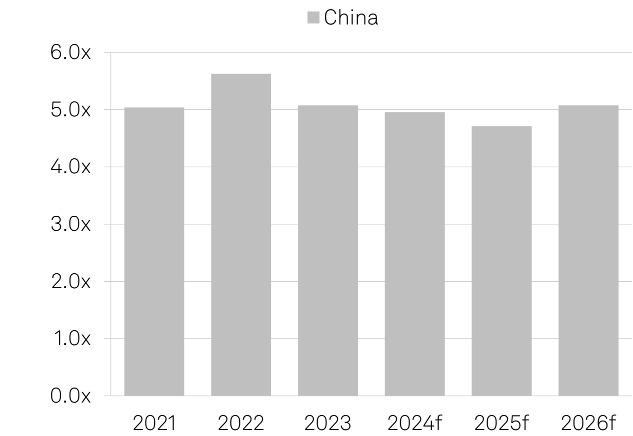


Chart 16

FFO / Debt (median, adjusted)

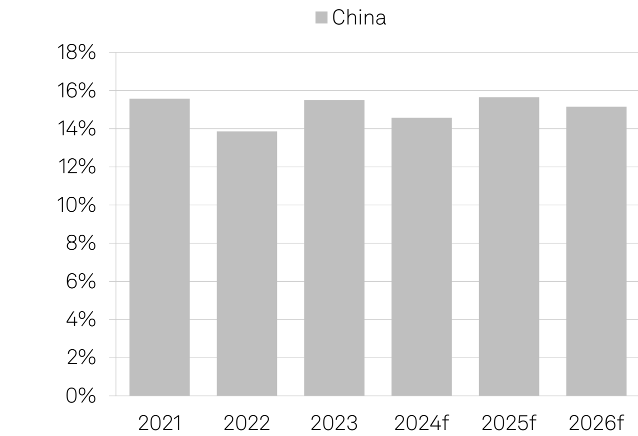


Chart 17

Cash flow and primary uses

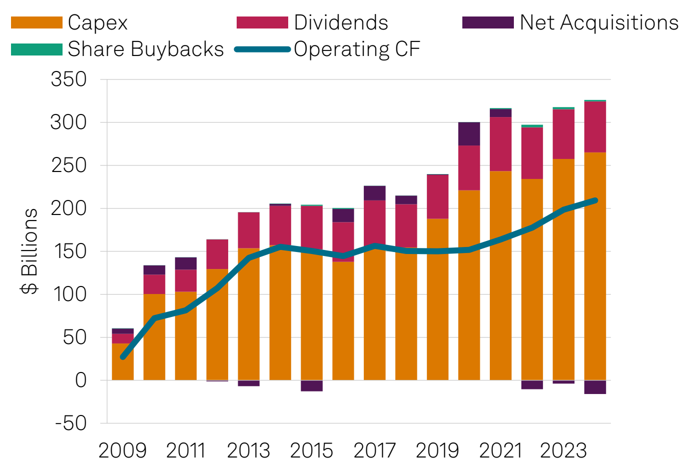
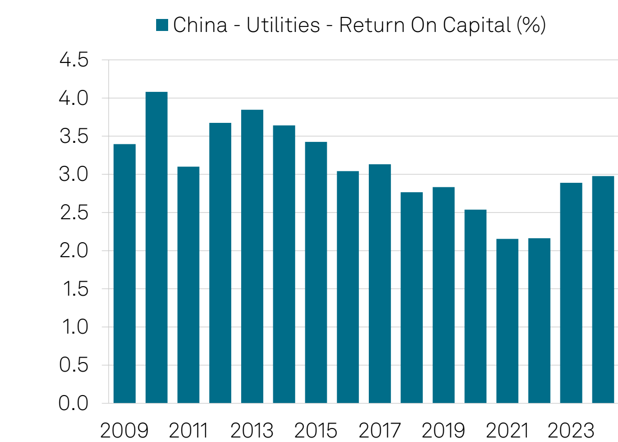


Chart 18

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2024) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: South and Southeast Asia

Ratings trends and outlook

We have a largely stable outlook for the sector, supported by increased headroom for most rated entities. This is following several positive rating actions during 2024 across some entities in India, Malaysia, and the Philippines. A positive outlook on the Indian sovereign is also driving improving rating trends. Solid operating performance and continuing regulatory support underpins cash flow predictability. Regulated utilities continue to benefit from supportive regulations, with a long record of being able to pass though full costs when needed, to alleviate periods of volatility, either through tariffs or subsidies. Rated IPPs continue to be able to pass through fuel costs under existing contracts. Leverage remains high, but under control, as rising operating cash flow offsets increasing capex, as the sector navigates energy transition.

Main assumptions about 2025 and beyond

1. Healthy economic growth to support power demand.

Relatively healthy GDP growth in South and Southeast Asian economies will drive power demand. We project around 4%-7% growth in annual power demand in fast-growing emerging economies such as India, Indonesia, the Philippines, and Malaysia. Singapore and Thailand will experience increased power demand of 2%-3% annually.

2. Increasing capex supported by higher earnings keeping leverage stable.

Rising demand and new capacity, in addition to stable returns, support the profitability of utilities. Continuing investments in renewable energy, and fossil fuel power plants as baseload power for energy security will keep capex and leverage high for rated utilities in South and Southeast Asia. Capex for utilities in India should significantly increase over the next two to three years. This is largely on account of investment in renewable assets to meet the country's targets for renewable energy and in building out transmission networks to support additional capacities. Capex for rated Indian utilities over the next couple of years will likely be 50%-100% higher than that of fiscal 2024 (year ending March).

3. Supportive regulatory frameworks to continue.

We expect the supportive regulatory frameworks in Malaysia and Singapore to continue in the next regulatory tariff reset periods of January-April 2025, without any material adverse regulatory changes. India has reset the tariff framework without any material changes until 2029. Indian utilities are investing heavily in renewable assets and transmission assets (under competitive bidding) that do not benefit from a regulated return. But these assets will not comprise a meaningful part of the total assets over the next three to five years.

Malaysia and the Philippines continue to demonstrate a long record of consistently passing through costs when needed to alleviate periods of volatility. This is despite a six-month lag following the Malaysia government's approval and ongoing delays in the Philippine regulatory tariff reset for regulated utilities.

Thailand's electricity regulatory framework remains broadly supportive, albeit with delays in the recovery of accrued revenue from electric energy sales according to the automatic tariff adjustment. These delays are due to the government's tariff caps. In our view, Thai regulations are similar to those in Malaysia, where the utilities are exposed to sociopolitical considerations, as the government may delay tariff hikes, particularly the fuel cost pass through component.

Credit metrics and financial policy

Leverage generally remains high, with the ratio of debt to EBITDA at about 4x-5x for utilities in growing markets such as India and Indonesia, because capex is growing fast. Nonetheless, leverage has improved from 5x-6x levels over the past few years. Growth in power demand and improving profits support higher spending and stable credit quality. Power majors in mature and fully electrified markets such as Singapore and Peninsular Malaysia will continue to operate around 2x-4x debt-to-EBITDA. Many of the rated utilities in the region are government-related entities with a record of high dividend payments. We believe this will continue to result in negative discretionary cash flow, especially given the large capex. However, these companies and governments have shown a willingness to lower dividends in times of stress, such as during the pandemic.

Key risks or opportunities around the baseline

1. Implementation risks with higher capex and new business/geographic areas.

Several utilities across South and Southeast Asia are investing heavily in renewable energy. Further, many Southeast Asian utilities are making these investments in markets outside their home market. While the companies have good records in project implementation, execution ability in new resources and geographies, as well as regulations, presents risks.

2. Renewable players: Transition from plain-vanilla projects to hybrid and storage-based projects.

Cost management and execution are key risks for larger and more complex round-the clock and pumped storage hydropower projects. India-based players are increasingly active in this space, and we expect experienced players with good access to funding to take on such projects.

3. Rise in corporate purchase power agreements (PPAs) could mean better counterparty credit quality and payment record despite shorter contracts.

These benefits, including the diversity in offtakers, could outweigh the shorter corporate PPA contracts as compared with typical long-term fixed-tariff contracts with government-owned utilities. Key risks to this strategy are renewal risk of contracts and the uncertainty of cash flows at time of renewal due to exposure to volatile merchant power markets if the contracts are not renewed.

Implementation risks with higher capex and new business/geographic areas. Rated Indian utilities are investing heavily in renewables. For companies such as NTPC Ltd., renewable assets could account for about 40% of total capacity by 2032 from less than 5% currently. Apart from execution risk, the profitability of new projects will be a key watchpoint, given the absence of regulated returns in the renewables business. Southeast Asian utilities have also been actively investing in renewable assets overseas. These also present risks compared to the utilities' domestic markets if the regulatory systems are weaker, macroeconomic conditions are more volatile, and currency or geopolitical risks are greater. To manage such variables, most companies will invest in a phased manner, and likely in partnership with local players.

Transmission capacity roll-out and spending is also increasing significantly in the region as major power producers are focusing on renewables. A high demand for transmission equipment and components has led to a surge in transmission costs, increasing spending for developers. Power producers are also facing execution delays for pipeline projects due to delayed delivery in transmission components. In India, we expect transmission capacity constraints in key renewable states such as Gujarat and Karnataka over the next three years. Transmission spending will need to pick up in the country to accommodate renewables expansion. That said, there are currently no curtailment issues for existing power projects in India and most of Southeast Asia. We expect regulated transmission utilities to be able to fully recover all costs with adequate returns as they invest in the transmission networks to cater to rapid demand growth.

Renewable players: Transition from plain-vanilla projects to hybrid and storage-based projects. Cost management and execution are key risks for larger and more complex renewable projects. This includes round-the clock and pumped storage hydropower projects, which are more common in India's maturing renewables space. Such projects have longer gestation periods and carry higher execution risks and capital costs. Despite the risks, returns can be higher due to less competition for bids. Other countries are also venturing into hybrids and storage-based projects, though mainly in developing solar-battery storage projects.

Rise in corporate PPAs could mean better counterparty credit quality and payment record despite shorter contracts. These benefits, including the diversity in offtakers, could outweigh the shorter contract tenors of typically between five and 10 years as compared with the typical 20-25 year fixed-tariff contracts with government-owned utilities. In India, renewables players are increasingly signing up with commercial and industrial (C&I) customers, not just state discoms with the typical long-term PPAs. Continuum Green Energy Holdings Ltd.'s differentiated focus on the C&I segment in India's power sector will continue to support its competitive position and receivables. Vena Energy, an IPP of renewable energy across Asia-Pacific, signed with C&I customers such as Amazon in Australia.

Key risks to this strategy are renewal risk of contracts and the uncertainty of cash flow at time of renewal due to exposure to volatile merchant power markets if the contracts are not renewed.

Industry Credit Metrics: South and South-East Asia

Chart 19

Debt / EBITDA (median, adjusted)

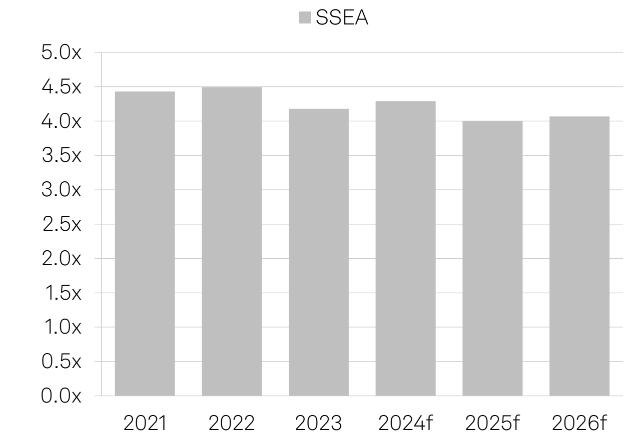


Chart 20

FFO / Debt (median, adjusted)

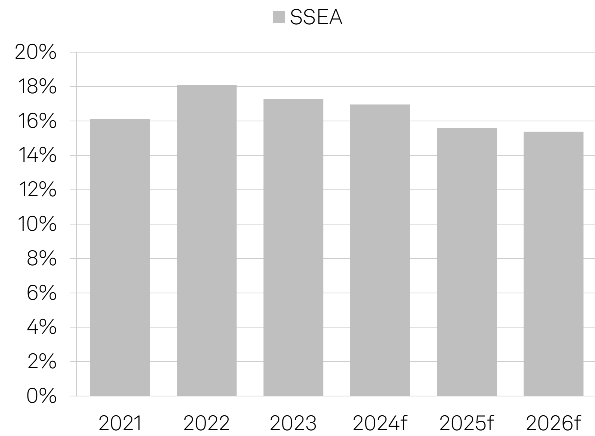


Chart 21

Cash flow and primary uses

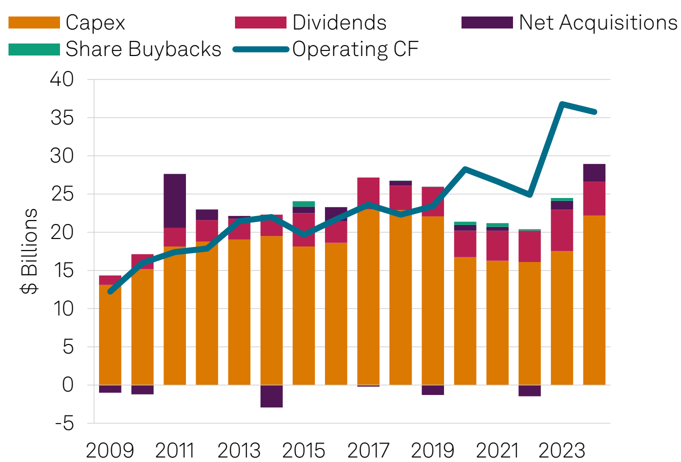
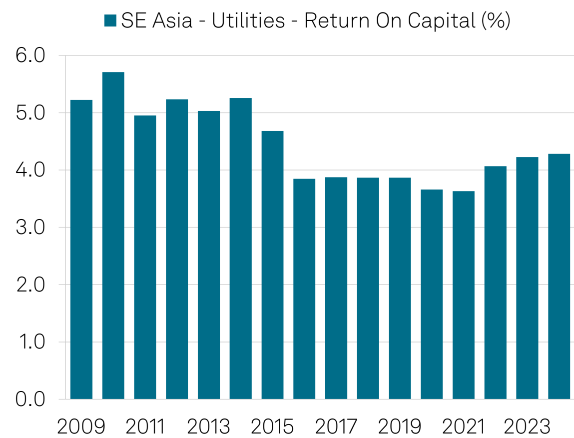


Chart 22

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.

Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2024) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: Japan and Korea

Ratings trends and outlook

In Japan, the outlook is stable for the regulated electric utilities sector but negative for the gas utilities sector. For the regulated electric power companies, multiple factors continue to support creditworthiness such as strong positions in respective supply regions, favorable regulatory frameworks, transparent pricing systems, and the possibility of extraordinary support from the Japanese government in times of need. On the other hand, for gas companies, the rising weight of its portfolio in unregulated businesses has been increasing pressure on creditworthiness.

In South Korea, the outlook is stable on utilities companies. Korea Electric Power Corp. (Kepco) and Korea Gas Corp. (Kogas) are government-related entities with an almost certain likelihood of support in times of financial distress. The ratings and outlooks are equalized with those on the South Korean government.

Main assumptions about 2025 and beyond

1. Expectations for Japanese electric utilities over the next 12 months:

Stabilizing operating performance eases a huge investment burden.

2. Expectations for South Korean utilities over the next 12 months:

Earnings and operating cash flow continue to gradually recover into 2025, but the leverage burden for Kepco and Kogas to stay elevated.

Japanese regulated electric utilities: Performance will remain firm, backed by higher rates for their end customers implemented in mid-2023, stable demand backed by a resilient domestic economy, and increased utilization of nuclear power plants. Debt growth will be mild due to stable cash flow generation, despite aggressive investments in areas including decarbonization.

South Korean utilities: We believe earnings and operating cash flow of South Korean utilities will be steady in 2025. After weak operating results and an accompanying increase in debt over 2021-2022, earnings began to recover starting in mid-year in 2023 with stabilizing raw material costs and some tariff increases.

Leverage burdens will remain elevated over next 12-24 months. For both Kepco and Kogas, the adjusted debt increased sharply over 2021-2023, and further deleveraging, if any, will likely be gradual. Also, risks remain around the limited visibility on future tariff hikes, and potential upswing in raw material prices.

Credit metrics and financial policy

Key cash flow measures for Japanese electric and gas utilities will be stable for the next two years, supported by solid performances, despite continued high debt burden. Their FFO-to-debt ratios will remain at around 10% for most of the regulated electric utilities and slightly above 25% for regulated city gas players.

Bifurcation in financial policies among the Japanese utilities will likely continue. Most Japanese electric utilities will continue with modest shareholder returns. This is because they are increasingly aware that a sufficient financial buffer is necessary to cushion capex, which will likely accelerate, amid uncertainties around operating environments including potential fuel price volatility. By contrast, we expect Japanese leading gas utilities will remain aggressive in shareholder returns than in the past years. This is because they started to prioritize improving capital efficiency (e.g., returns on equity) and may reduce capital as part of measures to achieve this efficiency.

For South Korean utilities, debt leverage will stay high, despite improving significantly from peak levels seen in 2022-2023. We forecast Kepco's FFO-to-debt ratio to improve to about 10%-12% in 2024-2026, from 2.8% in 2023. Kogas' FFO-to-debt ratio will likely improve to about 6%-8% in 2024-2026, from 4.5% in 2023.

Kepco's capex burden will likely be sizable over the next 12-24 months, driven by investments in nuclear power plants and green energy projects. Meanwhile, Kogas will face ongoing challenges in recovering tariff-related receivables, which will limit the pace of deleveraging.

Key risks or opportunities around the baseline

1. Acceleration in investments by electricity utilities.

For Japanese electric companies, downward pressure on free cash flow could grow if investments in decarbonization or safety measures to restart their idle nuclear power plants accelerate, resulting in more debt. This would add to the already very high debt levels of electric utilities due to the global energy crisis in 2022.

For Kepco, we assume rising capex in 2024-2026 from 2022-2023 levels, driven by investments in new nuclear power plants and green energy projects. This should limit the pace of its deleveraging to gradual at best.

2. Intensified competition in domestic electricity retail in Japan.

The deregulation of the electricity retail business leaves open the possibility of the industry being exposed to fierce competition. This could hit sector profitability.

3. Expansion in unregulated businesses by Japanese gas players.

Japan's largest regulated gas players are expanding unregulated domestic IPP business and shale gas development projects in North America. Higher exposure to such areas could add volatility to the earnings and cash flow of these utilities.

4. Tariff adjustment visibility remain a risk to Korean utilities.

Korean utilities companies endured a sharp spike in debt over 2021-2023, largely due to delayed and insufficient tariff adjustments. Uncertainties around timely tariff adjustments remain a key swing factor for the Korean utilities' credit metrics and deleveraging.

In Japan, a second round of competition in the electric retail sector is set to start. Liberalization of the retail electricity market in April 2016 lured hundreds of new entrants to the market. Many of them exited from the market following the outbreak of the global fuel crisis and turbulence in the electricity wholesale market in 2022. That said, competition among retail players is gradually intensifying again, in our view, because of the new standard business practice. Power generation units of major regulated power companies are now required to treat other players for power purchases on equal terms with their own retail subsidiaries. Accordingly, retail players can procure cost-competitive electricity easily and make the most of it to take retail market shares.

In Korea, we see Kepco's capital expenditure burden also increasing. We forecast its capex will increase to Korean won (KRW) 16 trillion–KRW18 trillion in 2024-2025 from KRW14 trillion in 2023 and KRW12 trillion in 2022. The increase is in large part driven by further investments in generation capacity including nuclear power plants. This should constrain the pace of debt reduction for the company, in our view, in the next 12-24 months.

In addition, delays to tariff adjustments is a risk for Korean utilities, although we have seen the companies' earnings recover over the past few quarters. For Kogas, we estimate it will take five years or more for it to recover receivables accumulated through the period when commodity prices spiked and tariff adjustments were delayed. For Kepco, although recent tariff hikes have provided some relief, they are insufficient to significantly reduce its debt stemming from substantial losses over 2021-2023.

Industry Credit Metrics: Japan and Korea

Chart 23

Debt / EBITDA (median, adjusted)

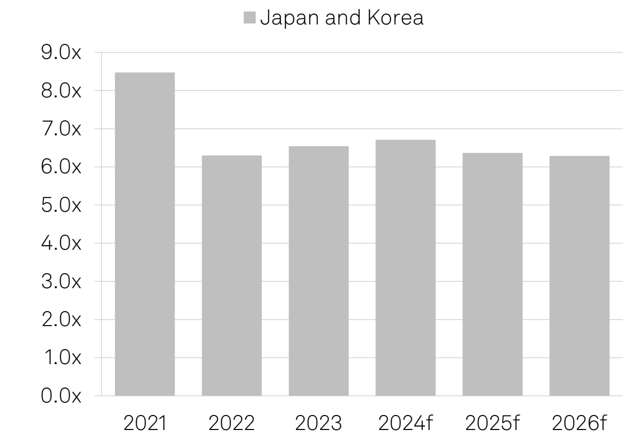


Chart 24

FFO / Debt (median, adjusted)

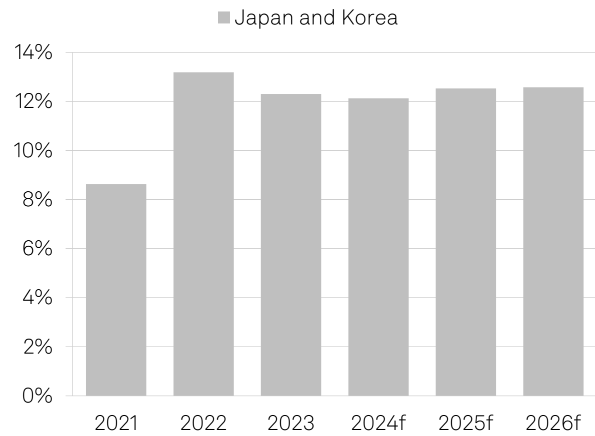


Chart 25

Cash flow and primary uses

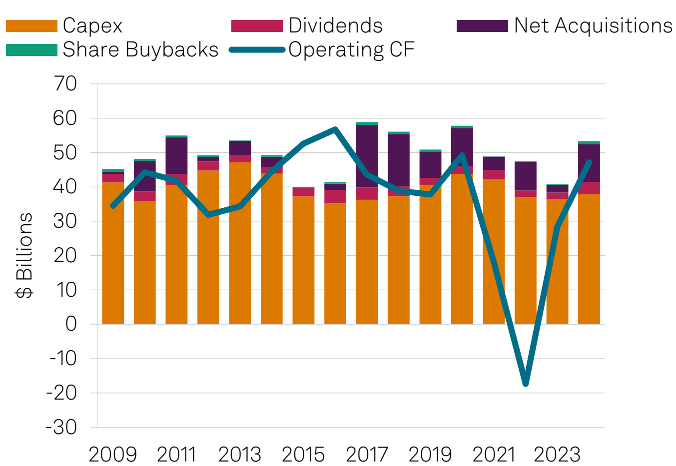
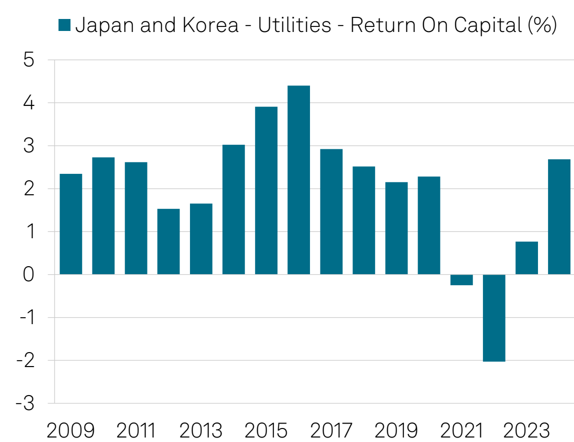


Chart 26

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.

Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2023) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

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- South And Southeast Asia Infrastructure: All Clear For Takeoff, July 2024
- Asia-Pacific Energy Transition: Adapting To Looming Execution Risks, April 15, 2024
- China Gas Distributors Can Overcome Hit To Connection Revenues, April 14, 2024
- Indian Renewables: A Deep Dive Into Operating Performance, March 7, 2024
- Assessing Project Finance As Way To Unlock India's Renewables Potential, Feb. 21, 2024

EMEA Utilities

Energy transition investments reduce rating headroom

January 14, 2025

This report does not constitute a rating action.

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What's changed?

Conditions for U.K. water companies have taken a turn for the worse following Thames Water's demise. We expect the regulator's final determination to enable continued sector investment.

Weaker economics decelerate the deployment of hydrogen and batteries and costlier nuclear and offshore wind make the transition less affordable than expected.

High interest rates and grid capital expenditure (capex) test energy transition economics. For grids, strong and adapting regulations broadly offset risks associated with considerable leverage.

What are the key assumptions for 2025?

High and volatile gas and power prices benefiting power generators, especially those with flexible production assets. Tight gas supply test affordability amid tepid GDP growth.

Caution on generation and power grid investments. Massive capex necessitate cautious financing, to be prioritized over dividend growth.

Reduced ratings headroom for power producers and integrated players. Balance sheets, while typically solid, are eroded by high and growing capex, interest rates, and dividends.

What are the key risks around the baseline?

Supply chain issues, interest rates, inflation, and regulatory and fiscal setbacks. Changes in assumptions or weak contracting could impair a utility's business risk or financial risk profile.

Political and regulatory. Making the energy transition faster and cheaper could weigh on ratings.

Cyber risk, physical sabotage, or weather, particularly for issuers with thin liquidity.

Ratings Trends: EMEA Utilities

Chart 1
Ratings distribution

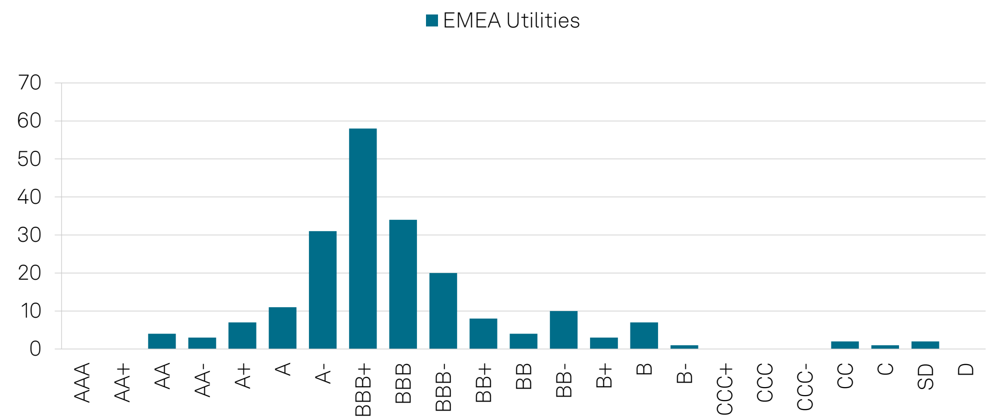


Chart 2
Ratings outlooks

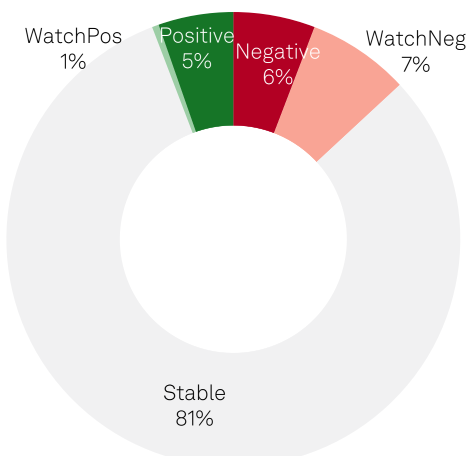
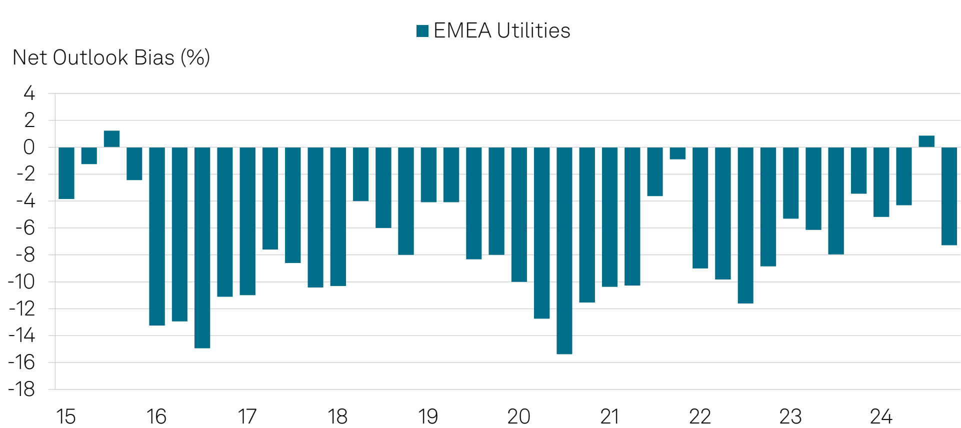


Chart 3
Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

The sector enters 2025 with a slight negative outlook bias (following a temporary net positive one in 2024), mainly from adverse credit dynamics in the U.K. water utilities sector. On the power side, business fundamentals remain solid as Europe executes its energy transition, with investment prudence needed in nuclear, offshore wind, and new technologies. For gas grids, financial discipline is crucial to preserve ratings as issuers face stranding risk. For power grids, we will look at how much regulations and disciplined financial policies preserve cash-flow-based credit metrics in the face of a capex super-cycle; for some, particularly in the Netherlands, Belgium, and Germany, we continue to expect state support to protect credit quality.

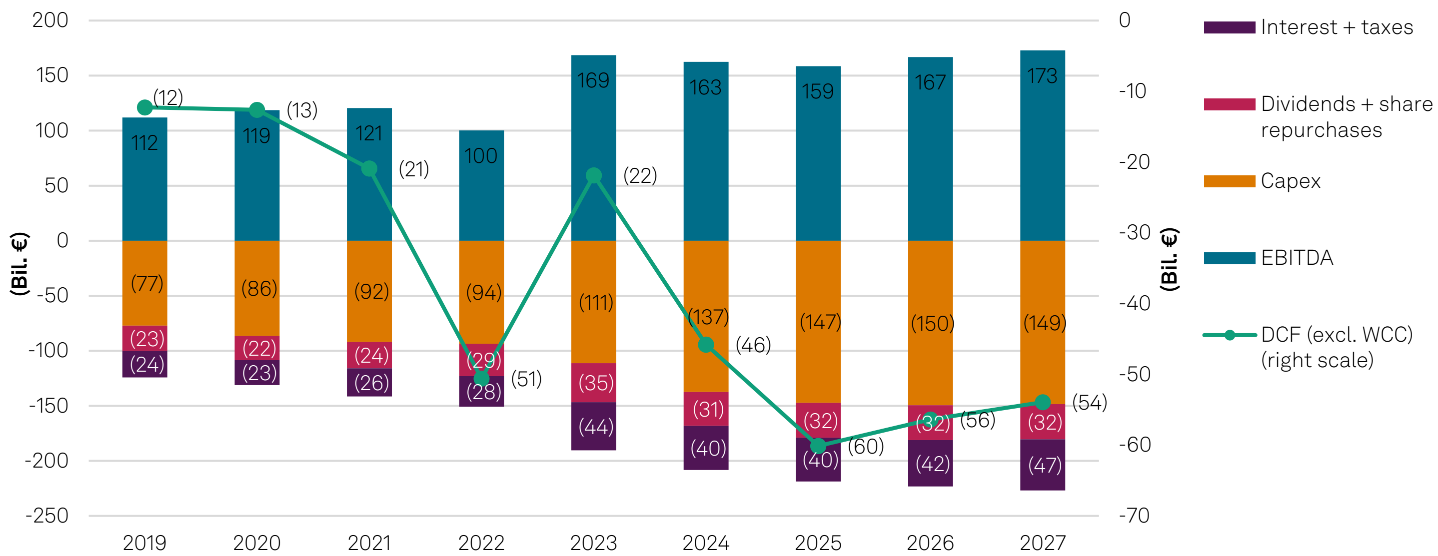
Our remaining negative bias primarily reflects the following:

- The regulatory reset risk for U.K. water companies is high, with potentially more challenging operating and financing conditions for almost all rated U.K. water utilities over the April 2025-March 2030 regulatory asset management period 8 (AMP8). The regulator's determination published Dec. 19, 2024, indicates the nature of regulatory allowances and requirements for each company for AMP8, which has significant implications for the sector's ability to invest given the significant increase in required investments over the next five years. We expect to assess the impact on our ratings on U.K. water companies in the coming weeks.
- There are risks and opportunities from gas and power prices, with prices elevated through 2026, even if much less so than in 2022; higher-for-longer refinancing rates; and continuing issues about supply-chain and sector-specific inflation, notably for offshore wind and power networks.
- For networks, in particular power, tensions are emerging on financial risk profiles from heavy capex, regulatory reset risks on the weighted-average cost of capital (WACC), and dependence on new equity.
- We expect the EU to approach, but not reach, its 2030 target of a 42.5% share of renewables in the primary energy mix, as solar capacity additions continue to offset weak wind additions amid tepid demand growth, which we expect at 1-2% from 2025 (see "Europe's Power Producers Continue Their Balancing Act As Electricity Prices Stay Low," published July 10, 2024). On the grid side, we expect Europe's power transmission and distribution network expansion over 2023-2030 to absorb €800 billion in capex. Including all generation technologies and storage, costs will likely exceed €2 trillion across Europe, about 20x the total annual capex of our top 25 rated European energy utilities by cash flow.

Against this background, we anticipate sector capex and debt to rise steadily with most rated utilities' cash flow growing in stride. This should protect credit metrics, except for companies, notably power grids, that ramp up capex so aggressively as to weaken metrics, at least for a few years. For our top 25, over 2025-2027, we project capex to represent 1.22x funds from operations (FFO) compared with about 0.9x each year over 2017-2023 (except 2022, the year of the energy crisis, see chart 4). Leverage in particular could increase for some power grids and U.K. water utilities, which face growing pressure to raise service quality. We will monitor the extent to which works in progress get sufficient remuneration and higher interest rates are effectively and timely passed on to WACCs, as some regulations are now doing. For instance, Italy's regulator has lowered its WACC remuneration for 2025-2027 by 30-60 basis points for power and gas networks to reflect lower interest rates. We had already accounted for this in rated utilities' strategic plans (see "Italian Electricity And Gas Transmission And Distribution Frameworks: Supportive," published May 14, 2024; and "WACC Revision For Italian Regulated Utilities Is In Line With Our Base Case And Shows Regulation's Consistency," published Dec. 3, 2024).

Chart 4

Top 25 European utilities: Capex will continue increasing, dragging down DCF



DCF—Discretionary cash flow. WCC—Working capital change. Source: S&P Global Ratings.

For integrated companies, we expect less rating pressure than a year ago from the dilution of regulated activities in the overall business mix as a number are rebalancing capex toward grids, translating in faster EBITDA accretion; many are also moderating renewable investments.

Financial policy and credit rating commitments support many ratings and stable outlooks in the 'BBB' band. We perceive that many managements see a 'BBB' rating category—in particular, ratings of 'BBB' or 'BBB+'—as a floor, including to preserve operating momentum and continued, competitive access to debt markets. We factor in potential new equity to the extent we think key shareholders are publicly committing to it for the near term.

Outside the U.K. water sector, we expect downgrades to be limited to one notch in 2025, similar to 2021-2024, and senior debt to remain clustered in the 'BBB+' and 'BBB' range.

Main assumptions about 2025 and beyond

1. Elevated gas and power prices until 2026 in an evolving market design.

Through next winter, Europe's gas and power markets will remain tight, resulting in still-elevated and volatile power prices. This is a price issue, because we do not foresee volume shortage for winter 2024-2025.

2. Heavier investments in power networks, and moderation in renewable energy.

Depending on the company, we expect capex for power grids to rise 50%-200% over 2023-2028, mostly to accelerate the energy transition. Many rated utilities are moderating capex on renewables.

3. Still-supportive financial policy despite often-slim buffers.

For many companies, high capex and dividends are eliminating credit-metric buffers at current ratings.

Gas prices will remain high and volatile in 2025, then moderate. This is due to Europe's supply-demand tightness following the loss of most Russian volumes (including the full cut since Jan. 1, 2025, of volumes transiting through Ukraine), supporting prices 2.0x-2.5x above pre-pandemic levels. As its energy transition goals make long-term contracting less attractive, Europe needs to continue capturing excess spot liquefied natural gas (LNG) volumes at prevailing prices.

The main European exchange-traded index, the Title Transfer Facility (TTF), remains in backwardation. Specifically, we assume it will moderate to $10 per million British thermal units (mmBtu) in 2026 from a high $12/mmBtu in 2025, equivalent to about €40 per megawatt-hour (/MWh; the levels has hovered within €40-€50/MWh since November) (see "S&P Global Ratings Revises Its Natural Gas Price Assumptions; Oil Price Assumptions Unchanged," published Sept. 10, 2024). This will depend in particular on inventories, which at 71.8% fullness opened 2025 a sixth lower than a year ago.

Power prices will remain high and volatile until 2026. We expect prices of €80-€100 per megawatt-hour outside Scandinavia, Spain and, from 2026, France. Prices for gas—notably landed LNG—will continue to drive (and support) power prices, despite fossil-fuel generation down by about a fifth in 2024. In addition, EU carbon allowance prices, the other key factor behind power prices, could somewhat support power prices if they clearly exceed the €70 per ton mark; our base-case scenario remains that in 2025 they will not, however.

Europe's power demand has weighed on electricity prices by declining in 2022 and 2023, and remaining subdued at under 1% growth in 2024, back to 2004 levels. Demand should offer some price support given data center demand growth and the gradual electrifications of electric vehicles and heat pumps. In our view, each factor is susceptible to add 20-30 basis points to average annual power demand growth and lift it to about 2% each year over 2025-2027—in other terms, while each is positive, unlike in the U.S., none is a game-changer, individually or even combined. Also, from 2028, we expect annual power demand growth to moderate to near 1%.

Looking at the 10 key markets combined, wind and solar should easily meet even 2% (under 50 TWh per year) demand growth, under normal weather conditions. These two should contribute to a record 36% of generation, based on S&P Global Commodity Insights estimates. We assess wind and solar generation to grow about 100 TWh annually. In other words, nuclear and hydro being tendentially flat, each percentage point of demand growth beyond 1% implies some 50 TWh per year less demand on electricity produced from gas and coal. We therefore expect gas- and coal-fired capacities to continue closing, also given negative clean spark spreads expected across markets (except Italy).

Beyond average baseload prices, we expect an increasing bifurcation in prices captured by the various technologies. Increasing risks, particularly on solar and wind, of capturing a low proportion of wholesale prices heighten the importance of contracting to protect generators' cash flow (see "European Electricity Producers' Credit Quality And Revenue-Support Contracts: It's Complicated," published July 10, 2024). The most flexible ones—in particular, reservoir-based hydro and combined-cycle gas turbines (CCGTs)—should be able to capture peak prices (even as CCGT economics increasingly rely on remuneration via capacity markets for CCGT plants running for ever-fewer hours). By contrast, captured prices for intermittent renewable energy should decrease even more than baseload prices, because storage and interconnections are increasing too slowly to smoothen the absorption of wind and solar generation and lack the flexibility to support renewable revenue (see "The Energy Transition, Geopolitics, And Cannibalization Are Shaping Europe's Power Prices," published Sept. 12, 2024). As a result, we expect negative prices to remain about as frequent as in the record 2024, when the Netherlands, Germany, and France recorded 350-457 such hours (and Nordic countries even more). We do not see material quantities of hydrogen for electrolysis or seasonal storage as plausible over the next decade.

U.K. water companies and power grids will increase capex. U.K. water utilities and power transmission system operators (TSOs) are increasing capex fast, both to strengthen networks and expand them to connect new renewable capacities. Some power grids are tripling their annual investments, with some rating implications. We revised our outlook to stable from positive on SSE PLC to account for the group's significant increase in its capital intensity until at least fiscal 2027 (year ending March 31, 2028), via its now £20 billion five-year Net Zero Acceleration Programme Plus.

While we see the related regulatory frameworks as strong, we monitor how regulators respond to capex stress on these sectors; tensions that might appear as users see the full impact of the increase in their energy bills (including distribution costs, which could be about double the TSO costs); and the degree and duration of credit metrics being potentially below our guidance for ratings. Financial policies then become paramount, and the ability and willingness to effectively raise sufficient new equity might be an important credit support.

In all cases, we expect funding and liquidity management to bridge discretionary cash flow (DCF) gaps. Given likely rigid capex requirements for urgently needed energy-transition projects, we assess the reliance on new equity issuance in the context of the specific ownership structure and shareholder commitment, full ownership by a single highly rated and committed sovereign being particularly credit supportive (as is the case in the Netherlands).

Gas grid prospects remain weaker than for power, given long-term stranded-asset risk. In the Iberian peninsula and Latvia, we differentiate gas networks' long-term prospects from those of power grids and we could extend this to more countries. We expect gas grid operators that do not invest significantly away from fossil fuels to accumulate balance-sheet headroom as free cash flow remains steady. In that light, financial policies and shareholder support are paramount in our prospective credit analysis.

In contrast, the Netherlands and Germany are actively preparing their transition to hydrogen. Across gas grids, we monitor closely how regulators prepare the ground, notably through sufficient remuneration of new assets and accelerated depreciation of legacy fossil-fuel assets, unless new hydrogen assets are directly subsidized by the government, as in the Netherlands.

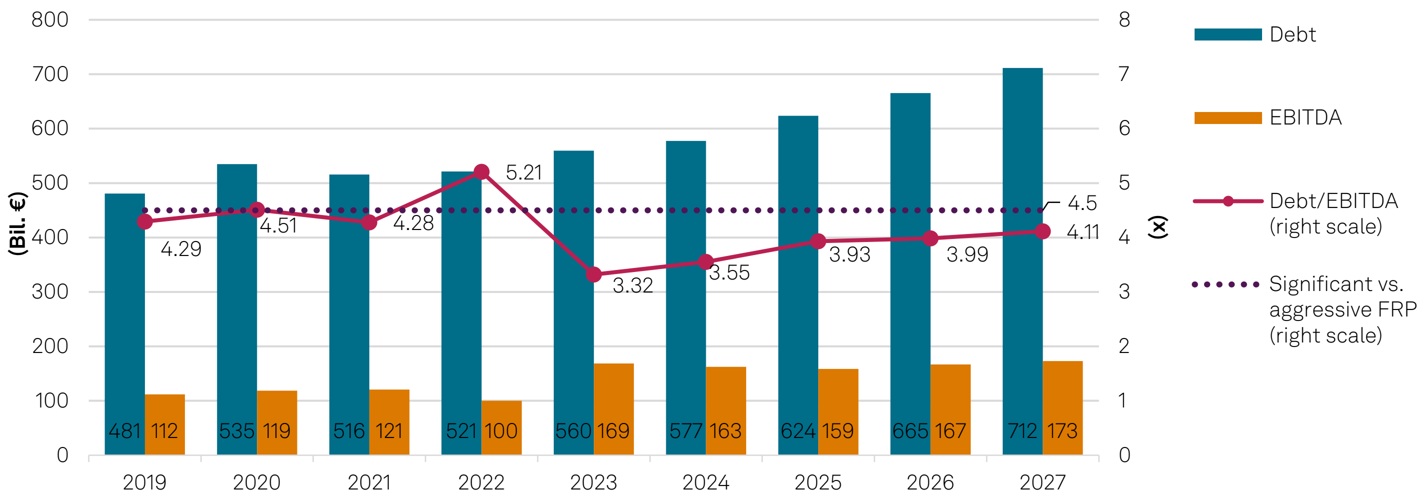
Large integrated utilities are cutting plans for greenfield renewables. We observe contrasting capex trends among integrated companies. In 2024 Iberdrola, Enel, EDP, and Orsted all reduced their targets of installed capacity, whereas SSE is pressing ahead with renewable capacity deployment. Positively, most appear to cautiously approach further investments into wind and solar, and particularly offshore wind, as they prioritize projects with the strongest economics over volume growth.

Credit metrics and financial policy

Credit-metric headroom has fallen as capex expands but the sector retains asset sale flexibility and access to capital, especially outside U.K. water. Overall, we expect the sector to keep posting metrics within expectations for the ratings. Over 2025-2027, we anticipate absolute debt to continue rising, including by a hefty €45 billion annually for our top 25 utilities combined (see chart 5); this is based on high and increasing capex and, despite moderate dividend growth expectations, continuingly negative DCF. However, existing buffers and EBITDA growth of about 2% allow adjusted leverage to be contained near 4.0x, in line with 2019-2021 levels, and FFO to erode gradually to just below 18%, from 22% in 2023. We estimate an annual increase in the sector's adjusted debt of about 7%, with a significant dispersion between those increasing debt 10%-200% (notably networks) and those we expect to stabilize metrics. At the same time, a mild economic recovery from 2025, sustained gas and power prices, and new renewables capacity should support earnings growth. Given reduced rating headroom, we expect dividend moderation and any M&A to be conservatively financed, as with Iberdrola's acquisitions of Electricity NorthWest in the U.K. and of some minorities in its key U.S. subsidiary Avanguard.

Chart 5

Top 25 European utilities: Mounting debt will likely keep leverage metrics around 4x



FRP—Financial risk profile. Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Oversized price volatility or event risks disrupt operations or liquidity.

For companies where increasing capex is depressing DCF (in particular), cyber or physical sabotage could aggravate liquidity tightness. Companies active on energy exchanges could also face liquidity squeezes.

2. Political and regulatory risks and opportunities cloud the overall investment picture.

Measures to accelerate the energy transition run against affordability constraints and limited budgetary firepower in a context of increasing risks concerning security of supply.

3. Deteriorating economics complicate low-carbon power capacity deployment.

Continuing supply-chain constraints, together with persistently high interest rates and slow inflation reduction, complicate the economics of the low-carbon capacity buildup.

Event risks can disrupt operations, liquidity, and credit quality. As for many other corporate sectors, rating risk often relates to liquidity. Some companies' liquidity buffers are thin relative to our minimal expectation at the adequate assessment, a tightness we reflect both in our liquidity and management and governance analyses. We will continue to monitor liquidity as market behavior is hard to predict, especially as power mixes and market designs evolve.

For 2025, we see event risks affecting liquidity relating to:

- Wholesale price volatility, as happened in 2022;
- Extreme weather;
- Geopolitical events, including wars and sanctions, which could foster volatility and even affect physical supply; and
- Cyberattacks.

Despite Europe's increasing exposure to extreme weather events—most recently, the Valencia floods in October—the impact on utilities' credit quality has been muted. We expect this to continue and governments to typically play a more supportive role than in the U.S., whether for existing government-related entities or companies that could become one. Still, weather conditions are expected to continue deteriorating given continued climate change.

Geopolitical events that might affect EMEA utilities—mostly energy—include wars in the Middle East and Ukraine and sanctions, such as on Russian LNG, to the extent they foster price volatility and affect physical supply.

Generally, the possibility physical sabotage cannot be excluded, particularly for offshore assets like the highly developed gas and power lines in the North Sea and the Baltics, and gas pipelines to Italy, which are difficult to continuously monitor. Of particular relevance are Norway's gas export pipes and Scandinavia's power interconnectors with their continental clients in Germany and the Baltics.

Finally, cyber risk might materialize, particularly for power grids, especially distribution; for these, digitalization is essential in optimizing the use of existing assets in the face of growing and ever-more distributed supply and demand. In turn, it may expose them to even more risk of disruption of operations than for other utilities.

Political and regulatory risks and opportunities abound, particularly where governments run budget deficits, where capex need are massive or where affordability is at risk. Measures to protect end-user affordability could erode related utilities' credit quality, notably via price caps, windfall taxes, and slowness to recognize higher interest rates and inflation in regulated revenues. These measures can prompt higher debt or lower earnings.

Still, we see a steady trend for regulators to grant stronger remuneration on new projects, as decided since 2023 for example in Germany, Italy, Belgium, and France (for gas, and possibly in 2025 for electricity (see "WACC Revision For Italian Regulated Utilities Is In Line With Our Base Case And Shows Regulation's Consistency," published Dec. 3, 2024).

Besides accelerating the energy transition, affordability is a cornerstone of Europe's REPowerEU strategy and Fair Transition Plan. Protecting citizens' purchasing power will remain high on political agendas, just as grid fees may double.

Low-carbon project economics are thornier. Supply chains, permitting, grid access, and public policies influence project pace, costs, and risks. This is especially the case for offshore wind, nuclear; batteries; carbon capture, use, and storage; and hydrogen. The latter four necessitate public support to become financially viable—for instance, the financing is still not closed for any of Europe's three major nuclear projects in the U.K., France, and the Czech Republic (see "Is Europe Ready For A Nuclear Renaissance?," published Dec. 9, 2024). New technologies are struggling even more than we expected a year ago. A number of batteries and low-carbon hydrogen products were abandoned in 2024 given weak economics and high investment and demand risks. This has been compounded by significant political uncertainty in key countries like France and Germany, further delaying the adoption of supportive regulations, for example on hydrogen-fired power generation.

Across regions, we will monitor the following:

In the U.K., progress on power generation and grid investments required to meet 2030 net-zero goals. These goals stand high in the agenda of the recently elected U.K. government, which published its clean power action plan in December 2024. The plan includes significant reforms for the country's energy systems, notably on connection queues, to speed up the planning process and changes and consultation to the government flagship Contract for Difference scheme ahead of the seventh auction, which is due to be held later this year and is critical for 2030's targets. Swift progress is needed given ambitious commitments to increase clean power sources with offshore wind, solar, and onshore wind installed capacity to 43-50, 45-47 and 27-29 gigawatts (GW), respectively, by 2030 from the current 15, 17 and 14 GW. These in turn require rapid and considerable increases in grid investments, to accommodate the new sources of renewables. The regulator, Ofgem, has enacted its accelerated strategic transmission investment framework, a fast track for major transmission projects that accelerates the funding process by up to two years via the regulator's initial list of 26 onshore transmission projects. As a result, we expect a significant uptick in transmission investment among rated utilities such as National Grid, SSE, and Scottish Power for the rest of the decade. We also monitor nuclear reactors' contribution boosts to energy security, as the recent life extensions of four reactors of up to two years mitigate the delays at EDF's new Hinkley Point C plant.

In France, important milestones for the sector. These include the publication of the TURPE 7 regulation for the period starting in January 2025 shaping the remuneration trajectory of RTE's massive investment plan; and the costing and financing arrangements for EDF's ongoing construction of six new nuclear reactors (and for the sector's back-end segment, as per the president's Feb. 26 decision to launch the Aval du Futur program). We see continued subdued demand growth and net exports remaining solid after 2024's 89 TWh record.

In the Benelux region, the execution of massive investment plans for power TSOs TenneT and Elia. We expect progress on structural solutions to Tennet's equity needs to bridge to the state's shareholder loans exceeding €20 billion, which mature by the end of 2026. We'll also monitor the decommissioning of the majority of Belgium's nuclear fleet by the end of 2025, and the initial price of the contract for difference at which Engie's two remaining reactors will operate until 2035.

In Spain, how depressed power prices weigh on generation earnings as hedges elapse. We expect limited demand growth, coupled with increased renewable generation, to affect Spanish prices through 2025. We expect the regulator to publish a draft of the upcoming regulation for power grids in first-half, potentially accelerating the pace of much needed investments on both transmission and distribution infrastructures from 2026 onward.

In Germany, political developments at the federal level possibly at most delaying the implementation of some key initiatives**.** For instance, we don't expect the Kraftwerkstrategie to be finalized before the election in February 2025, which could push tenders to later that year as several power generators expect a clear regulatory framework to take investment decisions. We see these delays as more detrimental to the country's transition than to utilities' credit quality per se. On the other hand, we expect credit-supportive updates on regulated grids to run independently from changes in government and continue to monitor how the regulatory framework adapts to the tripling capex that power transmission system operators are undergoing. In addition, the impact of the capex super-cycle on credit quality will depend on operators' funding elections, including any shareholder support. We see the ramp-up of a hydrogen supply chain evolving slower than previously expected, which could extend the transition period for gas grid operators, potentially weakening their business profiles as conventional gas grid infrastructure matures. While such a weakening depends on multiple factors, including regulatory protection, overall we view the regulatory framework for hydrogen as slightly weaker than that for gas or power networks because of residual risks operators have to bear if the hydrogen ramp-up fails. For power generators, we expect coal capacity to be retired as planned (for instance, Uniper retired 2.9 GW of coal capacity in 2024), and expect operators owning an efficient combination of dispatchable and renewable generation capacity, and particularly for integrated utilities with trading activities, to fare better than single-technology issuers.

In the Nordics, continued softening of power prices, which could pressure some generators' cash flow. In addition, we expect price volatility to remain very high for most rated entities. This should heighten the competitive advantage of the most flexible and lowest-cost assets, namely reservoir-based hydro-production, which we expect to continue to reap strong cash flow during peak periods. We expect the market in 2025-2026 to be more volatile than before, in part as renewable production in the area has been high in recent years and export capacities increased. Intra-Nordics price differences have increased markedly. Growth of generation capacity remains uncertain; offshore expansion has generally come to a halt (except for a recently announced project in Finland) due to increased costs for interconnections and in Sweden, defense-related considerations. The debate on expansions of nuclear capacity in Sweden is likely to continue over 2025-2026. The government roadmap envisages new nuclear capacity equivalent to at least two large-scale reactors by 2035 and up to 10 by 2045. It remains to be seen, however, if the financial proposal, which includes a state-loan and a two-way contract-for-difference, will be attractive enough for market participants given the massive investment needed. Such a decision would reshape and affect the Nordic power market for decades, however, given its magnitude and very long asset lives.

Related Research

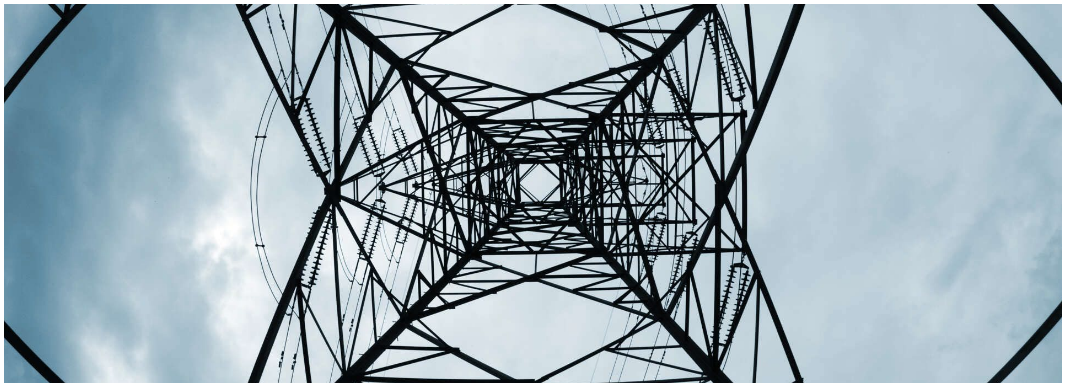
- Issuer Ranking: EMEA Utilities Issuers Ranked Strongest To Weakest, Jan. 9, 2025
- Is Europe Ready For A Nuclear Renaissance?, Dec. 9, 2024
- WACC Revision For Italian Regulated Utilities Is In Line With Our Base Case And Shows Regulation's Consistency, Dec. 3, 2024
- S&P Global Ratings Revises Its Oil Price Assumptions; North American And Dutch Title Transfer Natural Gas Price Assumptions Unchanged, Oct. 1, 2024
- Utilities Handbook 2024 | Western Europe Regulated Gas, Sept. 16, 2024
- The Energy Transition, Geopolitics, And Cannibalization Are Shaping Europe's Power Prices, Sept. 12, 2024
- Some European Power Markets Will Suffer As Renewables Put Pressure On Prices, Sept. 12, 2024
- Power Sector Update: European Offshore Wind Is Racing Ahead, Sept. 10, 2024
- Utilities Handbook 2024 | Western Europe Regulated Power, Sept. 10, 2024
- Industry Credit Outlook Update Europe: Utilities, July 18, 2024
- European Electricity Producers' Credit Quality And Revenue-Support Contracts: It's Complicated, July 10, 2024
- Europe's Power Producers Continue Their Balancing Act As Electricity Prices Stay Low, July 10, 2024
- Italian Electricity And Gas Transmission And Distribution Frameworks: Supportive, May 14, 2024
- European Utilities: The Rating Relevance Of Net-Zero Commitments, May 2, 2024
- European Utilities' Net-Zero Ambitions Face Myriad Hurdles, May 2, 2024
- Europe's Power Push: Can Project Finance Help Fund Interconnections?, Nov. 16, 2023

Latin American Utilities

Political interference, high interest rates burden the industry

January 14, 2025

This report does not constitute a rating action.



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What's changed?

Increased exposure to extreme weather events. Higher frequency and severity of climate events could represent a new challenge. We expect regulators to demand investments to strengthen the assets' resilience and mitigate the volatility of energy supply, which may not be fully recoverable under existing contractual frameworks.

Political interference. Despite the regulators' autonomous operations, we have observed an increased number of political meddling, such as the proposed regulatory changes in Chile and attempts to freeze energy rates in Colombia. Still, we continue to view regulatory frameworks as supportive, because they allow for timely recovery of operating costs and capital.

What are the key assumptions for 2025?

High interest rates and foreign-exchange volatility to constrain cash flows. Regional currencies have been weakening since the U.S. election.

Hydrology in line with the historical average. As hydrology continues to drive energy prices in Brazil, Chile, Colombia, Peru, and Panama, we expect spot prices to ease in 2025 (except for Colombia). This is because our base-case scenario currently excludes severe El Niño or La Niña events.

What are the key risks around the baseline?

A sharp rise in energy demand. The data-center boom may disrupt the historical pace in power demand growth, resulting in energy price spikes.

Curtailment. Given the rising share of wind and solar energy, its intermittency is causing the risk of curtailment to rise in Brazil, Chile, and Mexico. Batteries are a temporary offsetting factor, while new transmission capacity is deployed.

Ratings Trends: Latin American Utilities

Chart 1

Ratings distribution (including project financing)

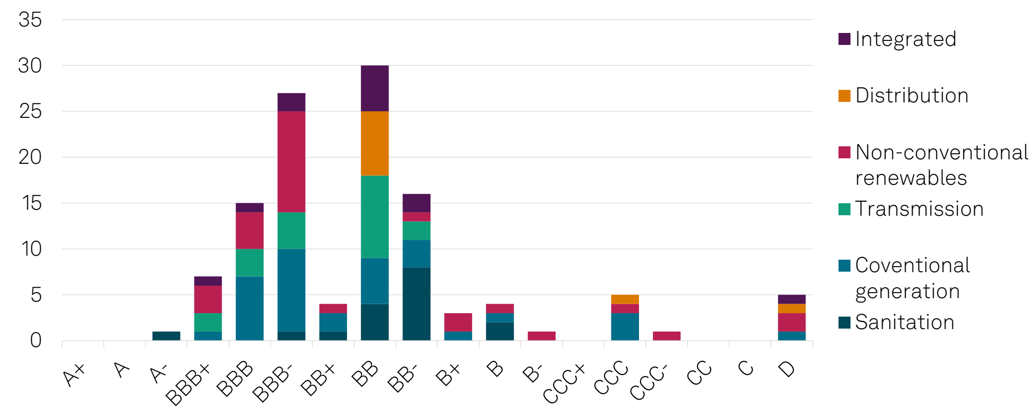


Chart 2

Ratings outlooks

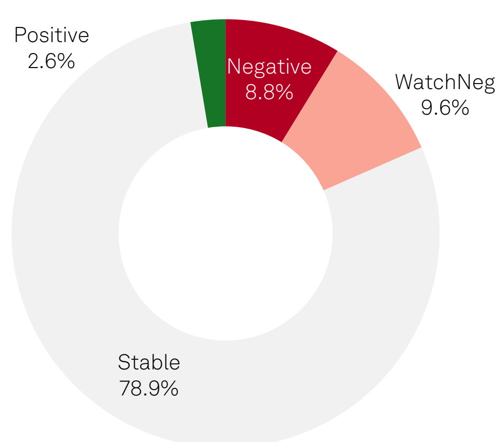
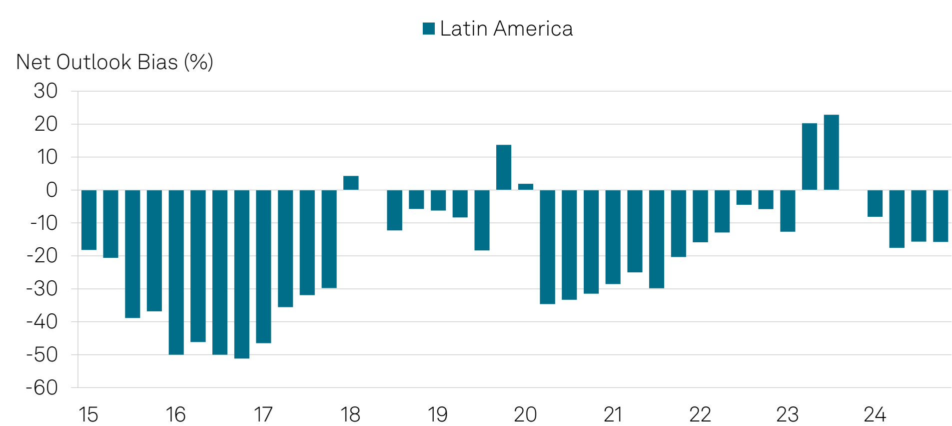


Chart 3

Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Credit Metrics: Latin America Utilities

Chart 4

Debt / EBITDA (median, adjusted)

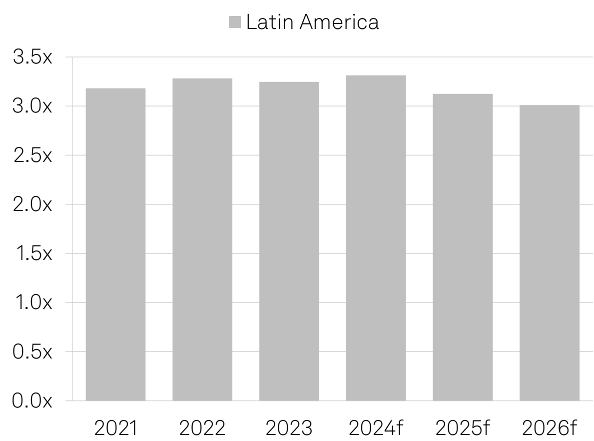


Chart 5

FFO / Debt (median, adjusted)

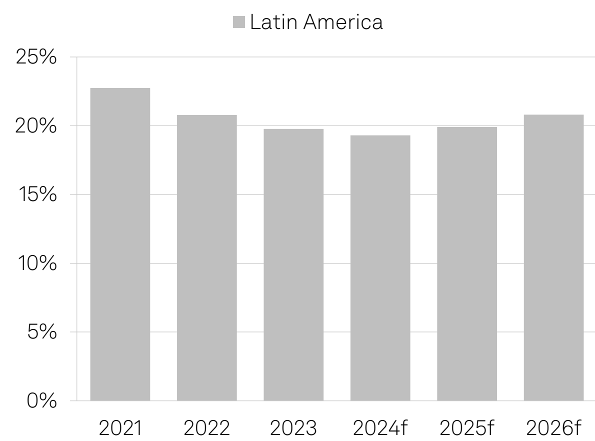


Chart 6

Cash flow and primary uses

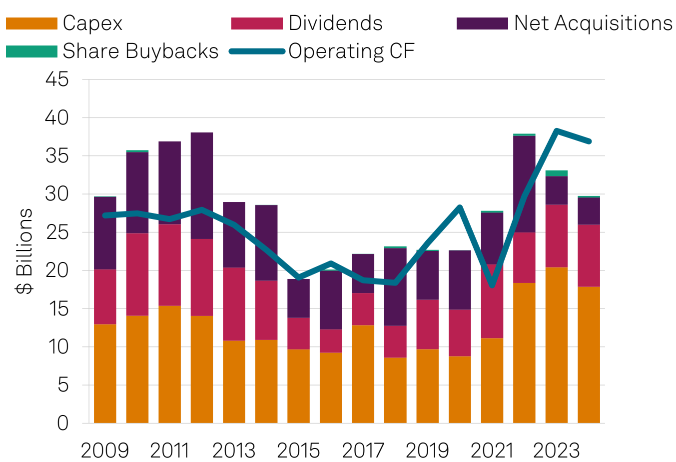
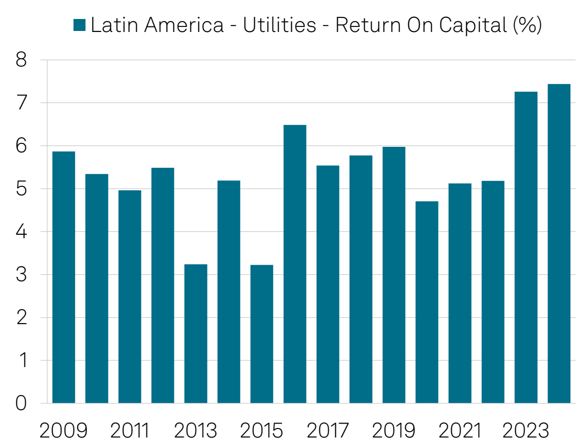


Chart 7

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.

Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2024) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook

Ratings trends and outlook

About 80% of the rated Latin American utilities have a stable outlook, most of which mirror the outlooks on their respective countries of operations. The sovereign ratings continue to determine most of the ratings on the region's largest regulated utilities.

Main assumptions about 2025 and beyond

1. Energy demand to continue growing in line with that of GDP.

We forecast the region's GDP growth of 2.1% in 2025 and 2.2% in 2026 (see table 1).

2. Drivers of energy prices.

We assume hydrology conditions, as well as oil and gas prices to remain the main drivers of electricity prices.

3. High interest rate and volatility of local currencies.

Borrowing costs are unlikely to come down soon, as the region's central banks adopt a cautious monetary approach considering the slower-than-expected pace of interest-rate cuts in the U.S. and global trade policy changes proposed by the second Trump administration. These factors have lifted volatility in the region's exchange rates and likely to tighten financial conditions.

Table 1

Macroeconomic outlook for Latin America

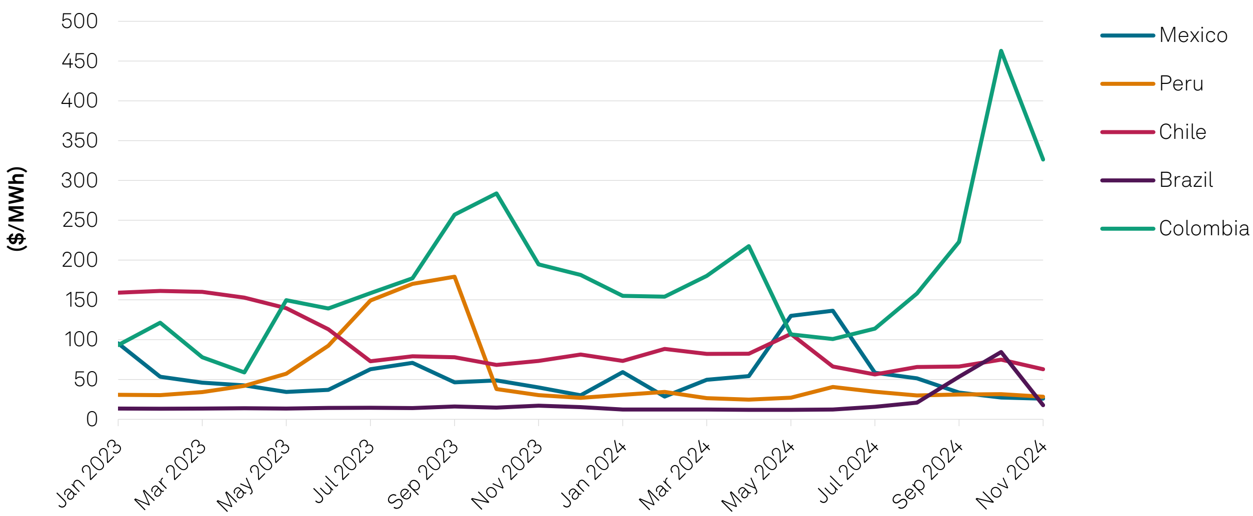
%	2023			2024e			2025f			2026f			2027f		
	GDP growth	CPI inflation	Interest rate	GDP growth	CPI inflation	Interest rate	GDP growth	CPI inflation	Interest rate	GDP growth	CPI inflation	Interest rate	GDP growth	CPI inflation	Interest rate
Argentina	(1.6)	133.5	100.0	(3.5)	226.0	35.0	3.8	65.0	25.0	2.5	40.0	25.0	2.5	32.0	25.0
Brazil	2.9	4.6	11.75	3.1	4.3	11.75	1.9	4.2	11.25	2.1	3.7	9.5	2.2	3.5	9.0
Chile	0.3	7.6	8.25	2.4	4.3	5.0	2.2	4.0	4.0	2.4	3.7	4.0	2.5	3.5	4.0
Colombia	0.6	11.7	13.0	1.7	6.7	9.25	2.5	3.9	8.0	2.8	3.4	7.5	2.9	3.1	7.0
Mexico	3.2	5.5	11.25	1.5	4.7	10.0	1.2	3.9	8.5	1.9	3.4	7.5	2.2	3.1	7.0
Peru	(0.5)	6.3	6.75	2.9	2.5	5.0	2.8	2.4	4.0	2.7	2.4	4.0	2.9	2.4	4.0
LatAm 6	**1.8**	-	-	**1.5**	-	-	**2.1**	-	-	**2.2**	-	-	**2.4**	-	-

CPI inflation data are annual averages. Interest rates are central bank policy interest rates at year-end.
e—Estimate. f—Forecast.
Source: S&P Global Ratings Economics.

Our base-case scenario assumes demand for electricity to rise in line with our GDP growth forecast. On supply side, thanks to energy transition, net capacity will continue expanding about 3% on annual basis, mainly consisting of growth of solar PV. Despite the expansion of nonconventional renewable capacity of about 10% annually in the region, hydro-based generation still represents around 10% of the installed capacity, which is the main driver of energy spot prices in Brazil, Chile, and Colombia. Meanwhile, energy price volatility linked to Henry Hub gas prices will remain, given Mexico's dependence on thermal generation. Spot prices should remain relatively low, given historical rainfall levels, as the likelihood of a severe La Niña has diminished (see chart 8). However, we continue to see high prices in Colombia, as reservoirs have yet to recover from the drought in 2024. Historically, La Niña causes dry conditions in Brazil and Chile, and the opposite effect in Colombia and Peru. Still, other effects, like peak energy demand due to heatwaves and intra-day volatility due to curtailment, may continue to burden electricity grids in Brazil and Chile.

Chart 8

Spot prices for electricity in Latin America



Source: S&P Global Ratings.

Credit metrics and financial policy

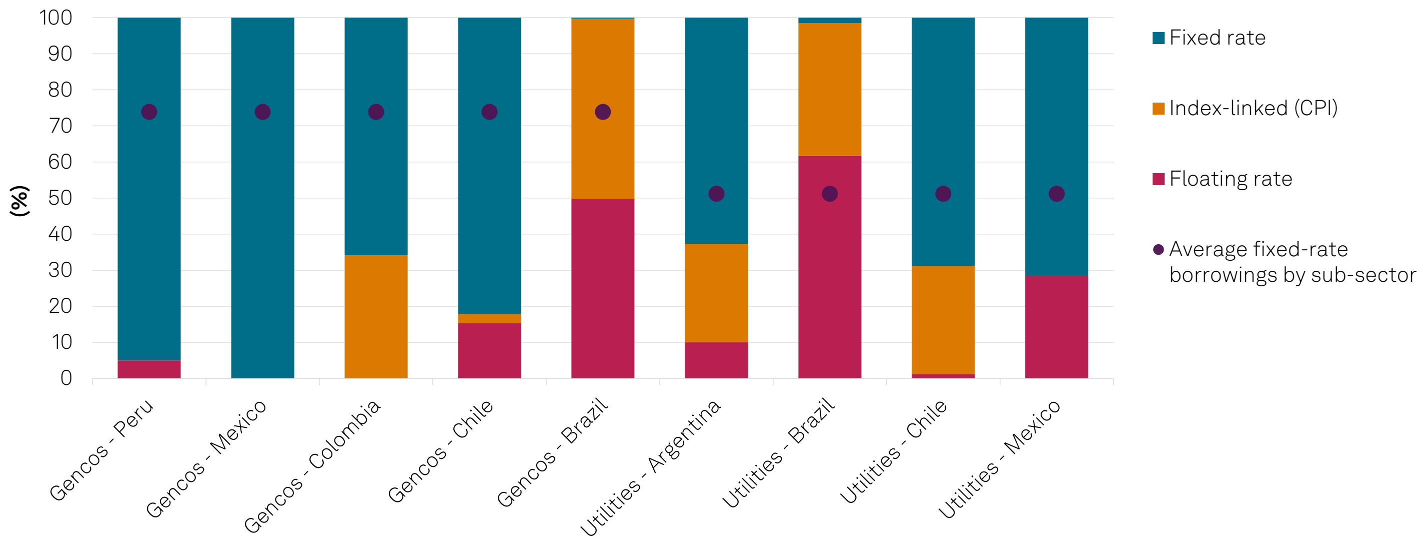
Persistently high interest rates in Latin American countries, except for Chile and Peru, should continue to heighten financing costs and debt service. The recent volatility of local currencies has also increased the operating costs of those entities with higher participation of thermal in the energy dispatch, like in Mexico. However, except for Brazil, most of the generation companies' (gencos') existing debts are at fixed rates (see chart 9). Therefore, the prospects of tightening financial conditions might limit the funding needs for capital expenditure (capex), rather than raising the debt burden, as we don’t forecast large refinancings in the sector for the next two years. Similarly, 50% of the regional utilities' total debts are at fixed rate (excluding those in Brazil that operate under a different dynamic). Although positive from an investor point of view, inflation-linked debt increases credit risk, given that credit metrics will suffer initially because of the lag between higher interest costs and the cost pass-through.

We anticipate demand for financing in the first quarter of 2025, mainly fueled by ongoing genco deals. However, we also believe that in a scenario of higher economic volatility and global uncertainties, some companies may decide to postpone capex to preserve free cash flows and cash positions.

Chart 9

Debt composition for Latin America gencos and utilities

As of September 2024



Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Surging demand for data centers could pressure energy prices.

The data center sector's boom in the U.S. could migrate to other regions, particularly Latin America, where mostly renewable-based energy mix might attract some developers.

2. Elevated curtailment risk.

The wind and solar capacity addition has outpaced that of transmission in the region. This results in operational challenges, like project cancelations, line saturation as the energy supply can't be stored, and reduced profitability due to energy spills, zero market price, and/or higher intra-day spot prices.

3. Sovereign rating limitations.

Given the utilities' regulated nature, our ratings on most of them are either linked to or limited by sovereign risk.

The rapidly rising demand for data centers, given the rapid advance in artificial intelligence, 5G, and cloud services, is already saturating the U.S. market where nearly 50% of these assets are located. We could see the data-center sector expand in other regions, particularly Latin America, given that the renewables' share of total generation of more than 50% might attract clients seeking to meet net zero targets. Power demand stemming from data centers could cause the overall demand growth to accelerate, resulting in higher prices for power purchase agreements as the energy supply is already tight in the region. Energy supply growth is marginally higher than historical energy demand, mainly driven by energy transition targets, and often constrained by transmission bottlenecks. Still, the development of data centers in the region is in its early stage.

Curtailment is already impacting the energy matrix in the region, such as the decoupling effect in Chile, intra-day spot price variation in Brazil, the cancellation of construction of new renewable assets in Colombia, and energy spills in Mexico. We have incorporated into our ratings the adverse financial impact of these factors. But the downside risk still exists, in our view, as the development of new transmission infrastructure takes about five years, in comparison to two-three years to build a wind or solar asset. We also acknowledge that temporary solutions, like the integration of hybrid facilities (combination of wind/solar with battery storage), and grid-enhancement technology can mitigate curtailment. But these factors might not be sufficient to cushion against extreme weather events and the rapid pace of distributed generation growth. For example, heatwaves result in peak demand at the end of the day when solar generation is declining, or the transmission grid's saturation stemming from fast growth of self-dispatched distributed generation (mainly solar PV parks) diminishes the operating flexibility of the energy matrix.

Except for Colombia, the ratings on the sovereigns in the region have stable outlooks. However, fiscal conditions are tight in most these countries, which could weaken their credit quality amid the risk of more aggressive trade protectionist policies, and consequently, a deeper hit to growth.

Country Highlights

Argentina

We view more positively Argentina's current rate-setting mechanism, mainly due to the reestablishment of a temporary regime of adjustments that intends to compensate for cost increases for all regulated utilities operating in the country. The new administration granted in early 2024 a one-time adjustment of about 320% for the distribution companies (discos) and 665% for gas suppliers to compensate for last year's high inflation. In addition, the government reinstated a mechanism for monthly rate updates for all energy segments, pursuing an improvement over private investment levels going forward. Still, we believe that the absence of a permanent adjustment mechanism will continue, and a monthly inflation cost pass-through could be an option for 2025 until the framework has been established.

Brazil

We continue to forecast growth opportunities for the electricity sector in the medium to long term. The sector continues to be exposed to hydrology conditions, and the risk of curtailment remains. This is because transmission expansions are planned based on demand, rather on the generation capacity, and we have seen relatively slow demand growth over the last few years.

As Brazilian integrated utilities continue to invest in nonconventional renewables, we have seen intra-day spot price variations, particularly in the Northeast System, which has higher growth potential for solar and wind plants than other grid networks. Energy Research Co. (known by its Portuguese acronym of EPE) forecasts an additional 3 gigawatt (GW) – 4 GW in transmission capacity will be necessary to connect the Northeastern and Southern Systems by 2032. This would allow the export of additional 10 GW, out of the expected 57 GW of wind and solar generation capacity. The transmission capacity auctions in 2024 and 2023 resulted in roughly R$59 billion in investments to build 17,900 kilometers (km) of transmission lines and substations totaling 20,440 megavolt amperes of transformation capacity. We expect the next three auctions, scheduled for 2025 and 2026, to continue to attract private players to bid for additional 8,000 km with estimated capex around R$20 billion. This is because they have visibility over the return of this type of asset akin to a fixed income driven by its availability remuneration framework. EPE has also started to monitor the potential demand for data centers, given requests to connect potentially 2.5 GW to the grids in the states of Sao Paulo, Ceará, and Rio Grande do Sul between 2024 and 2037.

The electricity sector is waiting for the regulatory changes that have been under discussion since 2023, which would tackle emerging trends such as the capacity payments necessary to mitigate the higher intermittency stemming from solar and wind, including large-scale batteries, the approval of regulation for offshore wind parks, and the expansion of solar distributed generation that added 8.6 GW in 2024, reaching 35.2 GW of installed capacity, and will likely add 21 GW by 2029 according to EPE.

Chile

We're monitoring closely the proposed bill to overhaul the power industry regulations, given the government's efforts to offset the sharp rise in electricity rates. The bill includes temporary rate haircuts for projects operating under the Small Distributed Generation Means framework. The bill also incorporates the fines related to quality of services on discos and additional carbon taxes.

Chile has a long track record of honoring business contractual agreements, underscoring the opinion among investors and sponsors that the country is one of the most attractive jurisdictions in Latin America to operate. This has been the case also for domestic and international infrastructure players, which sought stability and predictability in business conditions due to the long-term nature of investments in this industry. However, we have seen delays in rate-setting adjustments during the review cycle for regulated utilities, such as transmission lines. In addition, since the social unrest in mid-2019, gencos had to absorb higher working capital requirements related to the rate freeze imposed by the government, while the financial support mechanism (Mecanismo de Protección al Cliente [MPC]) took a long time to implement. In our view, these factors have prompted our reassessment of Chile's regulatory framework to adequate from strong/adequate. This revision now aligns Chile's framework with that of Brazil, where the rate-review cycle for transmission lines is implemented without long delays. Also, in Brazil, the funds to offset the harm stemming from the pandemic and the 2021 drought were disbursed quicker than those of MPC in Chile.

Finally, Chile's ambitious decarbonization plan—aiming to retire all coal plants by 2025—has been impaired by the transmission curtailment, considering that it could jeopardize the grid's security. We have also seen delays in the granting of permits to build new transmission infrastructure. Curtailments caused significant fluctuations in the spot prices depending on the energy delivery point and withdrawn point (the 'decoupling effect') and spot price variations between day and night, considering the amount of new solar projects that were connected to the grid. We believe that curtailment will end once the construction of the large transmission line Kimal- Lo Aguirre, connecting the northern (where most of the new renewable capacity is located) and the central region (responsible for most of energy consumption) is completed in 2030. In addition, an energy reform might be necessary to establish a new framework for dispatch order (considering higher generation from nonconventional renewables), and the inclusion of large-scale batteries. Still, given that Chile was the first country in the region to implement capacity payments for batteries, the country is leading the development of large-scale batteries in the region.

Colombia

So far, President Petro's attempts to impose changes to the electricity framework haven't been successful. However, the government has halted new hydroelectric projects and reduced investments in fossil-fuel baseload capacity, which may pose a risk to the reliability of the electricity grid in the future.

Furthermore, delays in granting licenses and a lack of legal and institutional certainty for unconventional projects, coupled with the need for transmission to integrate energy into the

National Interconnected System in recent years, are additional concerns. Many of the new solar developers, which won the October 2021 renewable auction, had to cancel their long-term energy supply contracts because transmission lines were not built to enable the delivery of energy to the consumption areas.

A new utility bill is underway and could change the framework for both electricity and water utilities. This, coupled with the absence of the construction of new transmission lines, could prevent the construction of new projects.

Mexico

We expect the electricity market conditions and opportunities to improve under President Claudia Sheinbaum, particularly regarding the private players' participation in the generation sector and energy transition goals. Still, we believe the new government will continue expanding the role of Comision Federal de Electricidad (CFE; foreign currency: BBB/Stable/--; local currency: BBB+/Stable/--) and Petroleos Mexicanos (Pemex; foreign currency: BBB/Stable/--; local currency: BBB+/Stable/--) in the energy sector and prioritizing the activities of these public companies over those of private players. We expect a high level of continuity from the previous administration regarding the role and importance of these state-owned companies in the energy sector, and for both companies to continue receiving support from the government. However, CFE has, in our view, limited financial room to bolster its generation capacity, while it needs to invest in strengthening the transmission network in the country.

Therefore, we are still cautious about the sector's future development. We will monitor how the government's proposed energy strategy evolves, like the recent tightening of relations between the regulator and the Ministry of Energy, because investor confidence in the Mexican regulatory framework has weakened in the past few years.

President Sheinbaum was vocal during her campaign about prioritizing fossil fuels, but also about giving more room for private investment in the energy sector, and to foster new unconventional renewable capacity, which expanded by 4.5 GW between 2021 and 2023.

The development of large-scale new renewable projects will be key to allow the country's industrial sector to expand and benefit from nearshoring opportunities, but CFE might be a roadblock, given its monopoly over the distribution network, including the transmission lines. Like other countries in the region, Mexico faces transmission curtailment, which results in price variations among the systems, and energy spills by gencos.

Peru

The driver of the economy has been the mining industry, and we expect it to fuel electricity consumption growth. The port facilities' development also indicates that additional mining capacity is underway, which could be favorable for the utilities, both in terms of additional generation capacity and transmission. After years of political instability, President Dina Boluarte, who is expected to finish her predecessor's term in 2026, has committed to economic and business stability.

Until 2016, the Peruvian electricity market suffered a prolonged period of oversupply. While consumption per capita remains at less than half of that of Latin American peers, energy demand was driven by the mining sector's expansion, large infrastructure assets—such as Lima Metro Line and the Lima Airport's expansion—and the population's greater access to electricity, given geographic constraints in the country.

We estimate that 5.5 GW in capacity will be added in 2024-2028, mostly solar and wind, to the existing 14.3 GW in installed capacity, which mainly consisted of thermal (53%) and hydro (37%) as of September 2024. For such a purpose, the government is proposing changes to the Law 28,832 to diversify the energy matrix and facilitate the development of nonconventional renewables. Changes include the setup of time slots for the sale of energy through the day and the possibility (unlike the existing law) to split the offer between capacity and energy sold in auctions for the regulated segment. We believe this should foster the development of renewables, although the law's approval and implementation may take several quarters.

Related Research

- Latin American Electric Utility Regulatory Framework: Signs Of Increased Political Interference, Jan 9, 2025
- Data Centers: Can Infrastructure Developments Keep Up With The Increasing Demand?, Dec. 4, 2024
- Economic Outlook Emerging Markets Q1 2025: Trade Uncertainty Threatens Growth, Nov. 26, 2024

Midstream Energy

Credit quality is on solid ground

January 14, 2025

This report does not constitute a rating action.

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What's changed?

Domestic and industrial energy demand is rising. Additionally, LNG export capacity is doubling, and data centers are growing, providing opportunities for gas-focused midstream companies.

More-benign regulation provides a potential tailwind. The Trump administration could create a more-favorable operating environment for midstream companies and oil and gas industry.

Credit trends are positive. Creditworthiness continues to improve across the portfolio as companies focus on strong balance sheets and smaller growth projects.

What are the key assumptions for 2025?

Industry consolidation continues. Companies continue to seek strategic assets and acquire businesses to improve scale or expand geographic footprint.

More natural gas infrastructure is developing. Spending will focus on natural gas and rich gas infrastructure in the Permian, Haynesville, and U.S. Gulf Coast regions.

Financial discipline pays credit dividends. Years of conservative financial policies have improved credit profiles. This could cause ratings among investment-grade companies to diverge further.

What are the key risks around the baseline?

OPEC+ increases supply. If OPEC defends its market share and reintroduces idled capacity, oil prices could weaken.

Renewable fuels and alternative energy could grow faster than expected at the expense of hydrocarbons, despite potential efforts to curb growth by the new U.S. administration.

Opposition to hydrocarbons strengthens. If courts or public opinion succeed further in any fights against hydrocarbon use, the industry could face more headwinds.

Ratings Trends: Midstream Energy

Chart 1

Ratings distribution

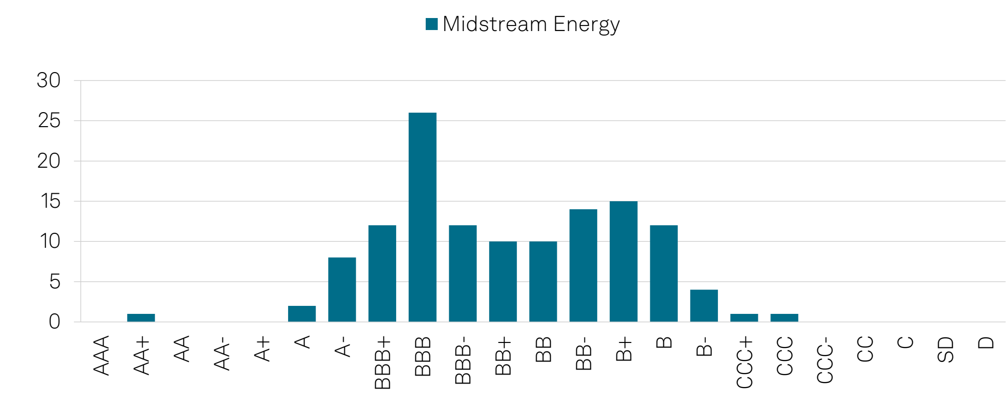


Chart 2

Ratings outlooks

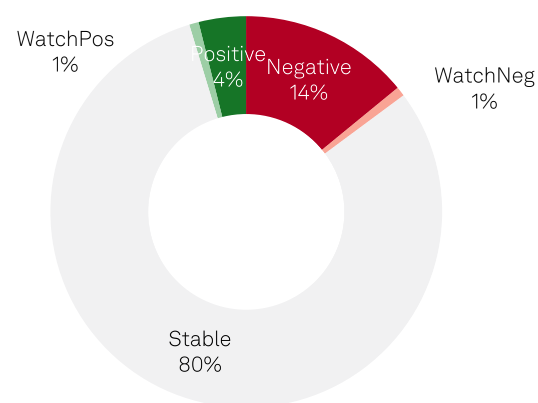
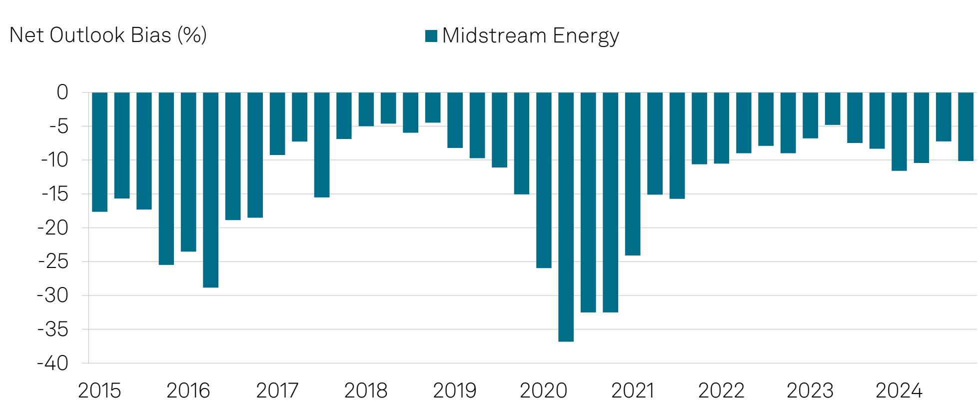


Chart 3

Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

Amid an energy evolution with fewer opportunities, the midstream energy industry has remained resilient by maintaining financial discipline, funding growth conservatively, and positioning the business to meet future demand. We expect these key credit strengths to persist in 2025. Positive milestones in 2024 include the completion of three major and long-delayed North American infrastructure projects: the Mountain Valley, Coast GasLink, and Trans Mountain pipelines. While completion of these projects will address egress issues in western Canada and the northeast U.S. the industry is unlikely to undertake similar sized projects again. In the last few years, midstream companies have approached projects smarter—by partnering with another strategic or financial party to share risk—which has kept balance sheets and credit quality strong.

Currently about 80% of midstream rating outlooks are stable, 4% are positive, and 14% are negative. Ratings improved for both investment-grade and speculative-grade companies, as highly contracted cash flows, stable prices, and growing demand led to better credit profiles. Ratings and outlooks in the sector were similar to the beginning of 2024, when 80% of ratings were stable, 5% were positive, and 14% were negative.

Main assumptions about 2025 and beyond

1. Industry consolidation could heat up.

Acquisitions will likely accelerate in 2025, with midstream companies using their strong balance sheets and equity currencies to acquire assets that make strategic sense while growing scale. Other factors may also arise, such as financial sponsors seeking exit strategies and valuations that become more attractive to buyers. Smaller speculative-grade companies could be more aggressive to scale up and survive independently or become more attractive to larger peers.

2. Rising demand for natural gas will drive infrastructure development.

Growing demand will require additional pipeline development, particularly along corridors short of egress, such as West Texas, and high demand areas, such as the U.S. Gulf Coast. Demand from data centers is a wild card that will likely provide a tailwind, but actual impact could vary widely. We estimate new data centers could require gas of 3 billion–6 billion cubic feet per day (Bcf/d) by 2030. However, industry estimates are much higher at 10-12 Bcf/d.

3. An unwavering focus on credit provides companies a chance to help the industry adapt to future challenges.

The industry's focus on keeping a strong credit profile is unlikely to change. With fewer organic growth opportunities, companies with strong credit have flexibility for tuck-under acquisitions, while balance sheet room allows for growth projects that smaller, more financially stretched peers must pass up. Stronger, more scalable companies are positioned to take advantage of business that grows out of the energy transition as it becomes economically viable.

Mergers and acquisitions (M&As) will continue in 2025. Activity was robust in 2024 as ONEOK Inc., Energy Transfer L.P. (ET), Kinetik Holdings Inc., and DT Midstream Inc. (DTM) pursued M&A (see table 1). Scale remains important to midstream companies, which will result in ongoing consolidation and growth through acquisitions. Lower interest rates, strong balance sheets, and limited organic growth opportunities will likely create a ripe environment for M&A in 2025, supporting consolidation, sponsor exits, joint ventures, and strategic rationalizing.

Continued consolidation across the ratings spectrum resulted in better scale and stronger competitive positions as most acquisitions used prudent financial policy. In compression, Kodiak Gas Services LLC acquired CSI Compressco L.P., making it the largest gas compression company in the U.S. Similarly, Archrock Inc. acquired Total Operations and Production Services LLC from Apollo Global Management Inc., improving the company's scale and market position. Kinetik purchased Durango Midstream LLC from Morgan Stanley Equity Partners, and DTM purchased three pipelines from ONEOK. These acquisitions improved scale while reducing leverage, leading to positive outlooks. Energy Transfer's acquisition of WTG Midstream LLC from Diamondback Energy Inc. improved its natural gas and natural gas liquids (NGL) business in the Permian. Sunoco L.P.'s acquisition of NuStar Energy L.P. led us to upgrade Sunoco to 'BB+' due to the increase in scale and diversity of operations and cash flow. We expect similar transactions to continue in 2025, further strengthening industry credit quality.

Table 1

M&A transactions 2023-2025

Issuer	Acquisition	Price (mil. $)	% debt funded	Consolidated EBITDA (mil. $)			Debt/EBITDA (x)		
				2023	2024	2025	2023	2024	2025
DT Midstream Inc.	OKE pipes	1,200	70	885	925-950	1,100-1,150	3.6	3.0-3.25	3.0-3.25
Energy Transfer L.P.	WTG Midstream	3,250	75	11,000	12,150-12,350	12,600-13,000	4.4	4.0-4.25	4.0-4.25
Kinetik Holdings Inc.	Durango Midstream	845	50	840	975-1,000	1,110	4.3	3.5-3.75	3.5-4.0
ONEOK Inc.	Enlink & Medallion*	5,900	100	5,156	6,000-6,200	8,200-8,400	4.2	4.75-5.25	3.75-4.0
Sunoco L.P.	NuStar Energy	7,300	0	1,001	1,750-1,800	1,800-2,000	4.1	4.4-4.6	4.1-4.4

*Excludes the acquisition of GIP's public units, which will be fully funded with equity. Source: S&P Global Ratings.

Sponsors that invested in midstream assets in 2017 and 2018 are facing exit windows and motivated to sell. Global Infrastructure Partners Inc. (GIP) demonstrated this when selling EnLink Midstream LLC and Medallion Midstream LLC to ONEOK. In 2025, this trend will continue to provide an opportunity for smaller issuers to improve scale and for larger strategic companies to increase their interests in joint ventures (JVs).

For large strategic companies that have minority interests in operational pipelines, increased interest or full consolidation could drive more activity in 2025. JVs consisting of both midstream and upstream entities, as well as financial sponsors, were behind many pipeline projects in 2024. Supported by free cash flow, larger issuers have the flexibility to buy minority interests without hurting balance sheets. We saw this in 2024 when Tallgrass purchased the 25% common interest in Rockies Express Pipeline from Phillips 66 Co., making them the 100% owner. MPLX L.P. exercised its right of first offer on BANGL LLC as part of the WTG transaction, increasing its stake in BANGL from 25% to 45%.

Large strategic companies may divest nonstrategic assets that can find better value elsewhere. Such was the case with ONEOK's transaction with DTM. TC Energy sold assets in 2024, including Portland Natural Gas Transmission System to BlackRock. However, it indicated it will not likely pursue further asset sales as part of its strategy for lowering leverage in 2025.

2024's trend of buy-ins of midstream limited partnerships (MLPs) to continue in 2025. Most refining and E&P companies have either fully consolidated their MLPs or spun them out, like HF Sinclair Corp. and Holly Energy Partners L.P. (HEP); EQT Corp. and Equitrans Midstream Corp.; and Phillips and Phillips 66 Partners (PSXP). There are not many left, notably Antero Midstream Partners L.P., MPLX L.P., and Hess Midstream Operations L.P. are still MLPs.

Alternatively, Delek Logistics Partners L.P. remains acquisitive to diversify exposure to parent Delek US Holdings Inc., which could reverse some consolidation in terms of accounting. However, it doesn't necessarily mean we'd change our view from an analytical or ratings perspective.

Midstream energy will focus on building natural gas infrastructure. With associated natural gas production in the Permian basin increasing by about 1.3 to 26.1 Bcf/d in 2025 and the construction of LNG terminals progressing through 2027, we expect demand for additional natural gas takeaway capacity to remain a key focus in 2025. Certain pipeline projects have already achieved final investment decision (FID), and we expect additional announcements from other investment-grade companies, as well as those rated within the ‘BB’ category.

While we do not expect any new, large, greenfield crude oil pipelines to be announced in 2025, midstream companies may consider more NGL pipeline and fractionation capacity in regions such as the Bakken and Permian basins. That said, we expect the industry to focus more on facilitating natural gas and NGL transportation to end markets in 2025, as the majority of growth in those commodities is associated with upstream producers drilling for crude oil in the Permian basin.

The Permian remains a key basin as upstream companies focus on drilling for crude oil there due to its low break-even costs. Midstream companies typically take a prudent approach to new pipeline construction and expansions, requiring long-term contracts from their shippers as they target a minimum high-teens percent unleveraged return on their investment.

The recently announced BlackFin pipeline, owned by Whitewater Midstream, is currently under construction and expected to add up to 3.5 Bcf/d of takeaway capacity by the end of 2025. ET also announced the Hugh Brinson pipeline, which should provide up to 2.2 Bcf/d of capacity, with Phase I in service by the end of 2026. These developments highlight the growing focus on expanding natural gas takeaway infrastructure to accommodate increasing production levels. Newly announced pipelines that have reached FID are projected to add another 7.3 Bcf/d in capacity by 2026 (see table 2).

Table 2

Permian Basin new pipeline projects

Basin/pipeline	Operator	Capacity	Status	In-service date
BlackFin (Colorado County to Jasper County, East Texas)	Whitewater Midstream	3.5 Bcf/d	New pipeline—construction	Q4 2025
Saguaro Connector pipeline and border facility (Permian Basin to the U.S.-Mexico border)	Oneok	2.8 Bcf/d	New pipeline—announced Lateral pipeline—approved	2025
Blackcomb (Permian to Agua Dulce)	Whitewater Midstream Ownership: WPC Joint Venture (70%), Targa Resources (17.5%) and MPLX (12.5%)	2.5 Bcf/d	New pipeline—approved	2026
Gulf Coast Express (GCX) pipeline expansion	Kinder Morgan	Added 570 Mmcf/d to total capacity of 2.57 Bcf/d	Expansion—approved	2026

Hugh Brinson	Energy Transfer	1.5–2.2 Bcf/d	New pipeline—approved	2026
Apex project (Permian Basin to Port Arthur, Texas)	Targa	2 Bcf/d	New pipeline—approved	2026

Bcf/d—Billion cubic feet per day. Mmcf/d—Million cubic feet per day. Source: S&P Global Ratings.

Natural gas production to increase. The U.S. Energy Information Administration (EIA) estimates that natural gas production in Haynesville will likely grow to 15.3 Bcf/d in 2025 from 15 billion Bcf/d in 2024, driven by global LNG demand and the proximity of its midstream infrastructure to LNG facilities along the U.S. Gulf Coast. Between 2025 and 2027, Haynesville will add more than 7 Bcf/d of new capacity. Notable projects include the Louisiana Gateway pipeline, which is currently under construction and should be in service by the end of 2025, and the newly announced New Generation Gas Gathering pipeline, also scheduled to be operational in 2025. These projects highlight the strategic importance of the Haynesville region in meeting rising LNG export demand. Gas prices are a key consideration for drilling activity as it is predominantly a dry gas basin.

In the Bakken region, natural gas takeaway capacity will likely increase modestly with the addition of 300 million cf/d (Mmcf/d) of capacity via TC Energy's Bison Express pipeline (see table 3). The project should be in service by 2026 and we believe will support continued drilling activity in Bakken, given the high gas to oil ratio.

Table 3

Haynesville/Bakken new pipeline projects

Basin/pipeline	Operator	Capacity	Status	In-service date
Louisiana Energy Gateway	Williams	1.8 Bcf/d	New pipeline—construction	2025
New Generation Gas Gathering (gathering system)	Momentum	1.7 Bcf/d, expandable to 2.2 Bcf/d	New pipeline—announced	2025
Bison Xpress	TC Energy	300 Mmcf/d	Expansion—approved	2026
Pelican pipeline	Whitewater Midstream	1.75 Bcf/d	Reached FID	2027

Bcf/d—Billion cubic feet per day. Mmcf/d—Million cubic feet per day. FID—Final investment decision.
Source: S&P Global Ratings.

Two new projects provided critical infrastructure and satisfied much needed transportation for the Canadian energy industry in 2024. The past year saw the long-awaited commissioning of Trans Mountain (TMX) and Coastal Gaslink (CGL) pipelines. TMX's 590,000 barrel per day (bbl/d) expansion almost tripled the crude oil capacity of the existing pipeline to 890,000 bbl/d; we assume the additional capacity will be fully contracted by 2027.

While the cost of these two projects far exceeded expectations and it is too early to predict the impact on the Western Canadian Select-West Texas Intermediate price deferential, the additional capacity provides more optionality for Canadian oil sands producers and likely a higher net-back price. The commercial in-service of CGL, which transports up to 2.1 Bcf/d, is a major step toward Canada entering the global LNG export market through LNG Canada. Although the pipeline is contracted to LNG Canada and Cedar LNG, it could prompt further LNG development on Canada's west coast. Further, despite some reports that the Keystone XL project could be resurrected, we believe those claims are based more on politics than economics.

Canadian mergers and acquisitions have only been modest—except for Enbridge Inc.'s purchase of three U.S. gas distribution utilities—with most of the activity related to specific assets. We expect this to continue in 2025, with companies shedding noncore assets purchased as strategic buys to complementary assets. We expect financial buyers will continue to be very selective and complete transactions through existing platforms, such as Pembina Pipeline Corp.'s joint venture with KKR, Pembina Gas Infrastructure, which closed several acquisitions in 2024.

While the specter of tariffs from the new U.S. administration is a potential threat, the importance of Canadian oil and gas to the U.S. and level of contractedness are strong mitigants to short-term effects. Canadian crude oil is also important enough to the U.S. refining complex in the Gulf Coast that it could deter the imposition of such tariffs. That said, to the extent that such tariffs emerge, it could somewhat disrupt the Canadian energy industry in the long term.

Credit metrics and financial policy

In 2024, North American midstream credit quality continued improving, with both investment-grade and speculative-grade companies expanding in size, reducing debt, and improving leverage metrics. The year witnessed about 10 upgrades across the midstream portfolio, primarily due to lower leverage and increased scale that enhanced our business risk assessments. Additionally, about eight issuers are currently on a positive outlook, signaling potential upgrades within the next 12-24 months.

Furthermore, a robust demand for natural gas, fueled by LNG export capacity and AI data center demand, will likely support re-contracting efforts and counterparty credit quality for midstream issuers, resulting in stable to moderate margin improvement and new expansion prospects. We foresee this positive credit momentum slowing down as leverage approaches the lower end of midstream companies' targets, prompting them to shift focus to enhancing shareholder returns or pursuing more other growth opportunities or acquisitions.

A noteworthy sector in the speculative-grade midstream space is natural gas compression, featuring Archrock (BB-/Stable/--) and Enerflex Ltd. (BB/Stable/--), alongside peers USA Compression Partners L.P. (B+/Positive/--) and Kodiak Gas Services (BB-/Stable/--), all of which are improving in scale while reducing financial leverage. Looking ahead to 2025, we anticipate that several issuers in the 'BB' and investment-grade categories will focus on expanding their asset base. Rising stars Kinetik Holdings (BB+/Positive/--) and DTM (BB+/Positive/--) recently engaged in M&A or invested in growth projects. We believe these cross-over candidates may pursue additional acquisitions while maintaining or improving leverage, potentially positioning them for an upgrade to investment grade.

The large, integrated midstream players continue to drive down leverage, and in some cases have lowered long-term debt to EBITDA target ranges. Enterprise Products Partners L.P. has the most conservative profile among the large midstream companies with a target leverage of 2.75x-3.25x, and a 'A-' issuer credit rating. However, many large integrated midstream companies are rated 'BBB', some of which have the potential for further positive ratings momentum, given a focus on more conservative financial policies and credit measures.

The Williams Cos. (WMB) is an obvious candidate to achieve a 'BBB+' rating given the current positive outlook. We expect WMB will maintain a strong balance sheet as it completes tuck-under acquisitions. We could upgrade WMB if it maintains S&P Global Ratings-adjusted debt to EBITDA of about 4.0x as it executes its organic growth program, which is focused on securing projects with long-term take or pay contracts.

Other U.S.-based midstream companies that are rated 'BBB' include ET, Kinder Morgan Inc., ONEOK, Targa Resources Corp., and Plains All American L.P. The bar to get to 'BBB+' is different for each of these companies and is dependent on the companies' business mix, size, scale, volume risk, contract structure, and cash flow diversification. We upgraded Plains to 'BBB' in November 2023 when it lowered its target leverage range, but its size, scale, and business mix limit further upside. ET and ONEOK have very large scale and have been acquisitive recently. For a positive rating action, these companies would need to meet our leverage target and have a long-term financial policy that supports a higher rating. We would also need confidence they will not undertake acquisitions that increase leverage again. Targa would have to boost its scale or sustain even lower leverage to consider a positive rating action.

Negative credit trends have largely been limited to the 'B' category with some exceptions—mainly due to issuers pursuing construction with long lead times, resulting in periods with higher leverage and refinancing concerns. We do not expect demand to drive many negative rating actions in 2025 given our supportive demand outlook for the sector. Declining interest rates should continue to support the refinancing environment for issuers looking to tap the debt markets and address upcoming maturities.

Key risks or opportunities around the baseline

1. OPEC increases production.

While most of midstream companies' cash flows aren't directly exposed to commodity prices, if OPEC and its members increase production to regain market share, it could still indirectly affect cash flow amid lower volumes for crude oil and NGL logistics providers.

2. Renewable use grows faster than we expect.

Faster adoption of renewables could make inroads on demand for hydrocarbons, which would be more of a secular change and hinder the midstream industry. While the Trump Administration has said that it will seek to unwind key parts of the Inflation Reduction Act, it has been successful in creating jobs in states that support the administration.

3. Organized opposition to hydrocarbons strengthens.

Recent court decisions that have reversed approvals of LNG export facilities and related transportation infrastructure remain a risk in 2025, despite greater federal support for the oil and gas industry. More victories from environmental groups could slow momentum for the industry and harm credit quality.

OPEC's potential production increase could hinder cash flow, although the industry is not directly exposed to commodity prices. OPEC delayed its planned output increase of 2.2 million bbls/d by three months until April 2025 and extended the full unwind of production cuts of another 3.56 million bbls/d through the end of 2026. Previously, OPEC planned to phase in almost 500,000 bbls/d each month to the global market in 2025, but it has now reduced the plan to about 190,000 barrels, which will have limited—if any—effect on global prices.

We expect producers focused on oil will remain disciplined and ignore calls for rampant drilling since the current supply seems to be more than enough to satisfy relatively weak demand growth in 2025. We believe that midstream companies focused on crude oil will have a more difficult time growing their base business, which in our view could lead to more consolidation. We expect crude oil prices of $60-$70 per barrel in 2025, with limited interference or influence from OPEC+.

The energy transition remains a long-term risk. However, it will likely only have a marginal effect on credit quality through 2030. Midstream companies focused on natural gas will have a longer runway as a bridge fuel for at least the next decade, particularly given the increased demand from AI technology and the growth of data centers. We expect LNG export capacity to double to about 24 Bcf/d by 2027.

Natural gas demand will likely increase in 2025, with the pause on new permits for LNG export projects lifted. However, the Biden administration's final report could delay the Trump administration's plans to lift the ban quickly. The final report states that the expanding LNG exports could not only increase greenhouse gas emissions, but also increase natural gas prices for U.S. consumers in the long run. The new administration will likely take up to six months to review and possibly revise the study. These delays could affect financing and contract negotiations for some projects that have yet to reach FID, but they will likely have limited impact on most of our rated issuers that have achieved operations or on shipping merchant cargoes.

The transition risk for crude oil logistics companies may be more pronounced as we approach 2030 and beyond. Electric vehicle (EV) penetration continues to make inroads at a slow pace in North America but is growing faster globally; China's EV sales are forecast to surpass internal combustion engine (ICE) vehicle sales for the first time in 2025 (12 million EVs compared with 11 million ICE cars). This could have a ripple effect for global refiners, as capacity is set to increase. Ultimately, midstream companies that provide transportation and storage services for refining companies could come under pressure.

Litigation and regulation curbing the use of hydrocarbons could intensify. The incoming Trump administration has already signaled plans to roll back stringent environmental regulations and federal policies that it believes is hindering the development of oil and gas production. However, groups opposing the expansion of hydrocarbon use have had recent success in the courts.

In September 2024, the D.C. Court of Appeals vacated the Federal Energy Regulatory Commission's (FERC's) permit authorizations to construct NextDecade Corp.'s Rio Grande LNG, along with associated pipeline infrastructure. The court ordered FERC to reconsider the environmental effects, which could require a new environmental impact statement and public comment period, making the completion of $18 billion project and its commercial operations date uncertain. While the decision has not affected the phase 1 constriction schedule, construction timing for phase 2 could be on hold as the ruling works through the courts. The decision surprised industry observers and could signal a higher risk to future energy infrastructure projects if permits can be vacated after receiving agency approval.

That said, the increasing demand for energy will likely require all sources—conventional and renewable—to meet needs within the U.S. and globally.

The midstream industry is somewhat insulated to these secular, long-term risks overall for the next few years, in our view, due to the pace of change. Companies have strengthened credit quality sufficiently through financial discipline and highly contracted cash flow streams.

Related Research

- Data Centers: More Gas Will Be Needed To Feed U.S. Growth, Oct. 22, 2024
- Industry Credit Outlook Update North America: Midstream Energy, July 18, 2024
- Credit FAQ: Will The TMX Expansion Project Move The Needle On U.S. Refiners' Credit Quality?, April 10, 2024
- Key Credit Drivers For North American Midstream Energy Companies In Q2 2024, March 20, 2024
- Issuer Ranking: North And South American Midstream Energy Companies, Strongest To Weakest, Feb. 15, 2024

Industry Forecasts: Midstream Energy

Chart 4
Debt growth (adjusted)

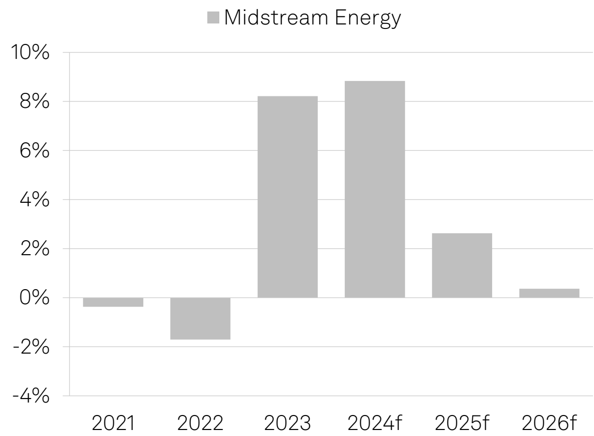


Chart 5
Capex Growth (adjusted)

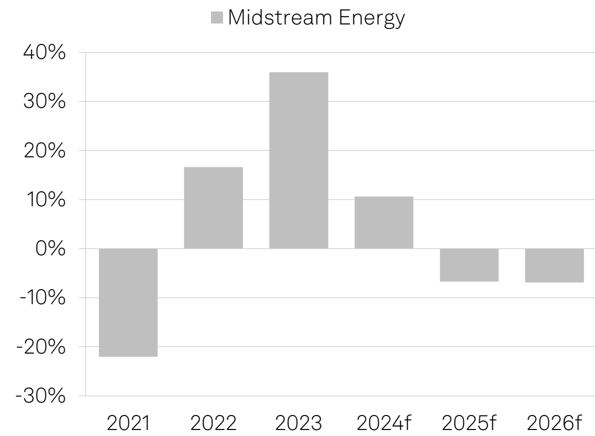


Chart 6
Debt / EBITDA (median, adjusted)

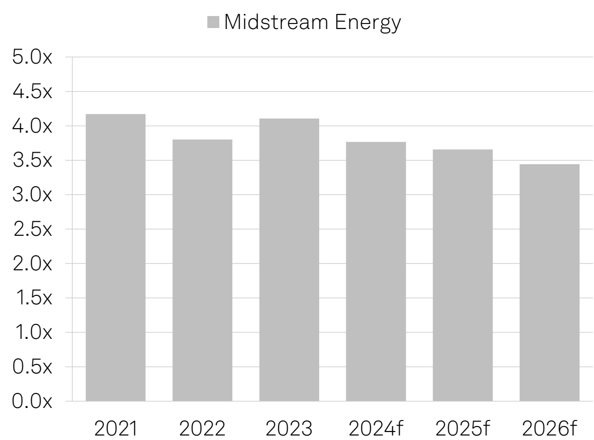
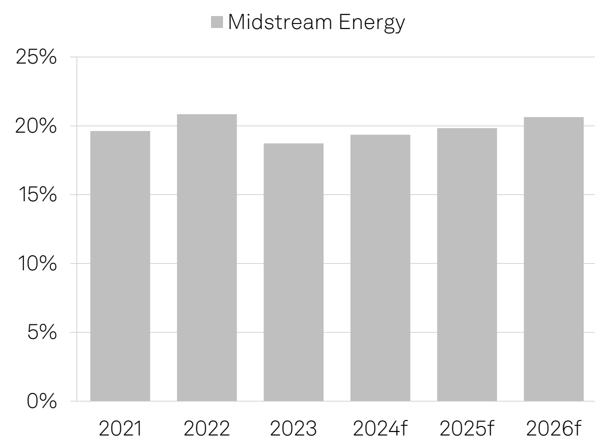


Chart 7
FFO / Debt (median, adjusted)



Source: S&P Global Ratings.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Midstream Energy

Chart 8

Cash flow and primary uses

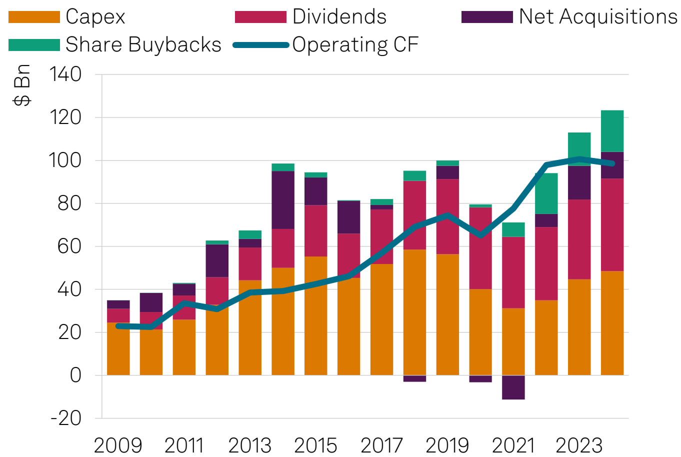


Chart 9

Return on capital employed

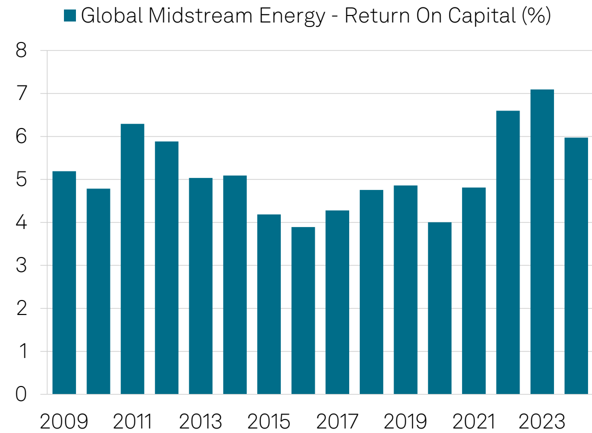


Chart 10

Fixed- versus variable-rate exposure

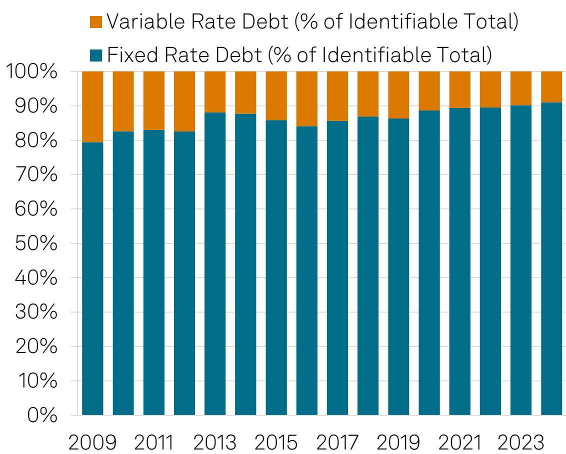


Chart 11

Long-term debt term structure

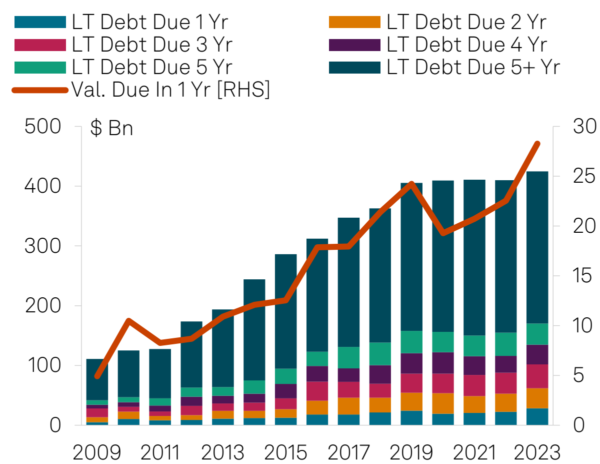


Chart 12

Cash and equivalents / Total assets

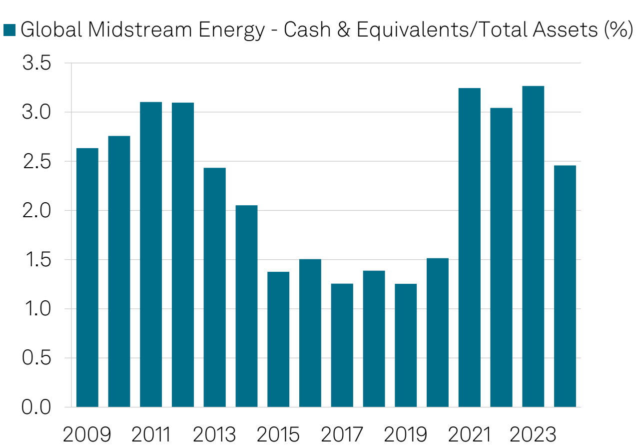
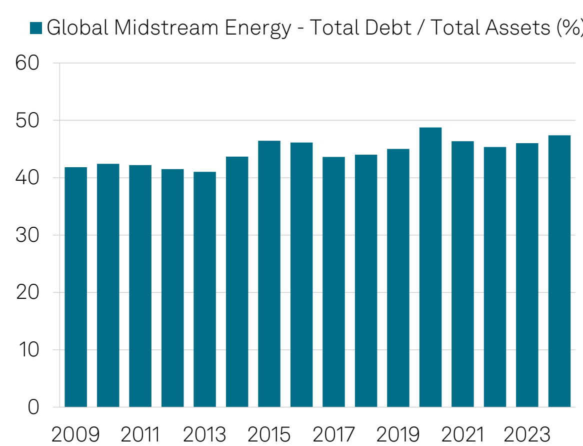


Chart 13

Total debt / Total assets



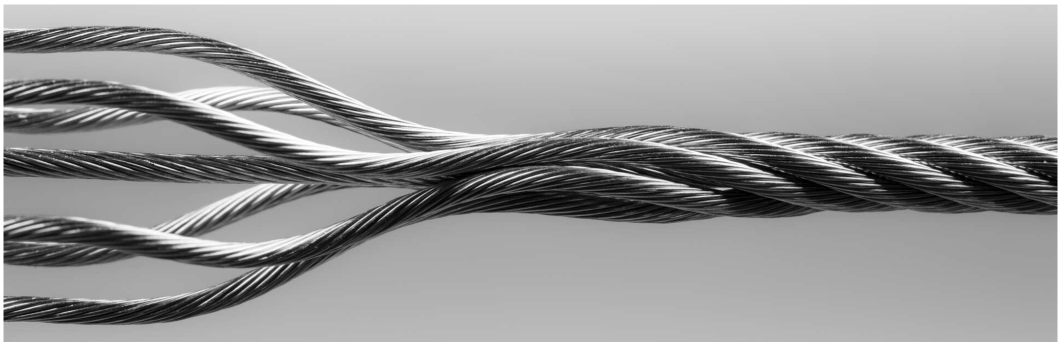
Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2024) figures use the last 12 months' data.

North America Competitive Power

Demand surge and IRA repeal risk dominate credit outlook

January 10, 2025

This report does not constitute a rating action.



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What's changed?

The tightness of demand and supply. We expect capacity markets to remain tight, and potentially tighten further, before supply catches up. Energy markets remain well supplied.

Meeting incremental demand cannot be done with renewables alone. We believe all power generators with legacy assets benefit from increased power use.

Credit quality is somewhat 'barbelled'. The competitive renewable segment is under credit pressure while conventional generation companies ride tailwinds. We may see a ratings barbell: upgrades in conventional and credit pressure for renewables.

What are the key assumptions for 2025?

Consolidation and/or incorporation. Estimates for power demand are now at over 2.5% compound annual growth rate over 2024-2030. This surge will result in asset rationalizations, some by aggregation of project finance portfolios into larger corporate vehicles.

Data center transactions. Despite FERC's unexpected ruling on Talen Energy's interconnection supply agreement (ISA), we expect more nuclear power supplied data centers. Gas-fired contracting will also follow.

What are the key risks around the baseline?

Higher tariffs on imported goods, like panels, especially from China.

Partial repeal of the Inflation Reduction Act provisions, affecting the renewable segment's growth trajectory.

Demand surge narrative could be oversold. While electrification, onshoring of manufacturing, and large load data center needs are real, the ability to deploy concomitant infrastructure is a significant concern.

Ratings Trends: North America Competitive Power

Chart 1
Ratings distribution

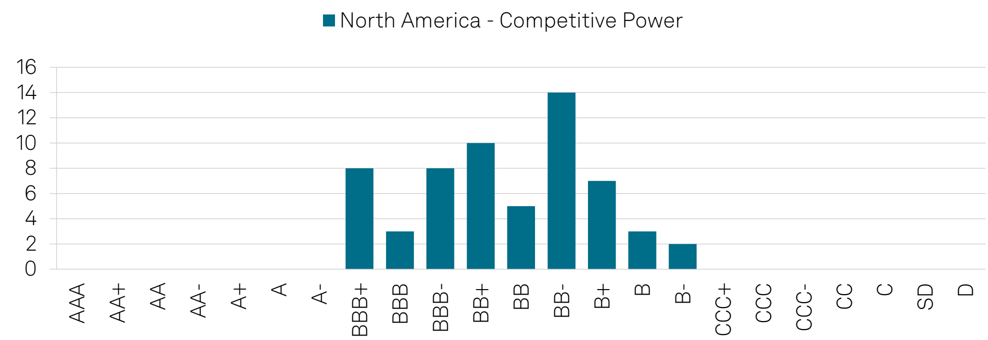


Chart 2
Ratings outlooks

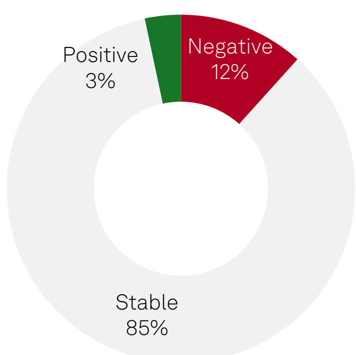
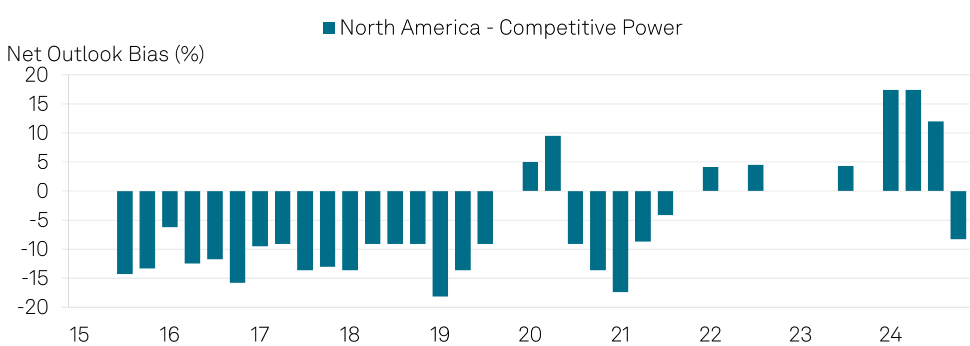


Chart 3
Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Our rating distribution in the merchant power sector has strengthened in the 'BB' category where it had moved in 2021 (average ratings were 'B+' in 2018). Partly contributing to the move is the improving credit profile of the conventional portfolios and consolidation in the industry, offset by weakening credit profile in the renewable segment. Investment-grade credit quality has also strengthened, after deterioration over the past three years. Negative outlooks, which had declined to 3% at the end of 2022, picked up to over 10% due to pressure on the Yieldco renewable sector but stay below historical levels (17% as of Dec. 2021 and 24% in Dec 2020).

Industry Credit Metrics: North America Merchant Power

Chart 4
Debt / EBITDA (median, adjusted)

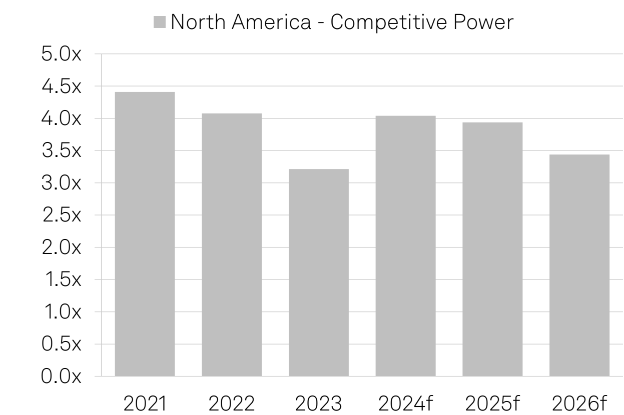


Chart 5
FFO / Debt (median, adjusted)

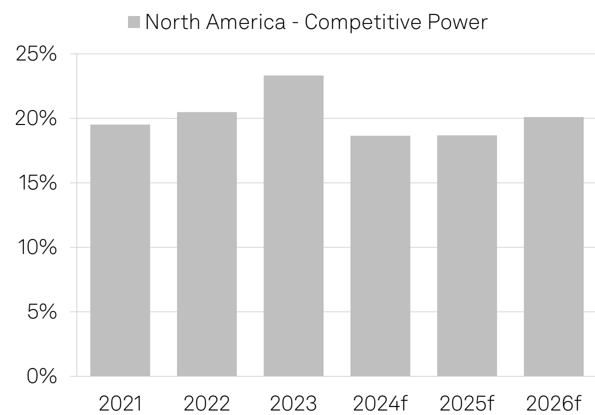


Chart 6
Cash flow and primary uses

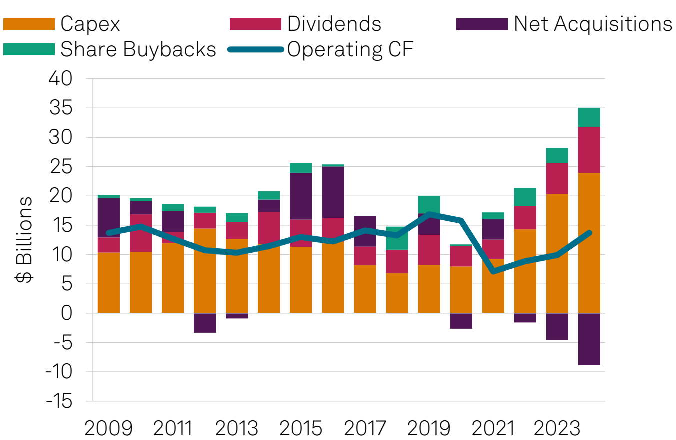
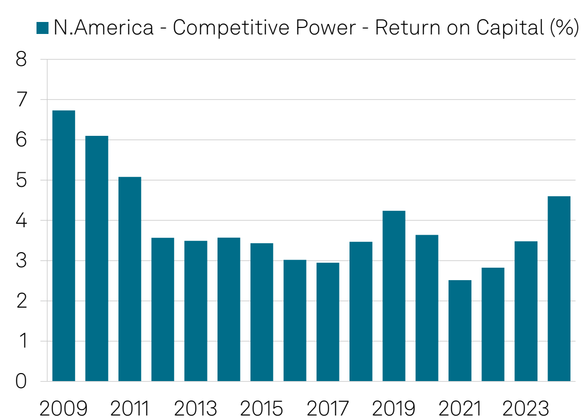


Chart 7
Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2024) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Entering 2024 we expected some Yieldcos and renewable-focused companies to grow meaningfully on the back of tax provisions of the IRA. We expected financial ratios to weaken given the growth was without issuance of commensurate equity. Past winter events had also slowed deleveraging efforts of major independent power producers (IPPs), and some IPPs had slowed their investment-grade aspirations, choosing instead to reallocate excess cash flow to share buybacks and/or acquisitions. As a result, ratios for the sector have weakened overall. In 2025, capital allocation will move to organic growth projects and acquisitions, but also to debt reduction for several IPPs. Most still target adjusted debt to EBITDA in the 2.5x-2.75x range and adjusted funds from operations (FFO) to debt above 25% on a sustained basis. We expect to see credit improvement in the IPP space.

The one segment we think will continue to see incremental leverage are the YieldCos (and unregulated renewable corporates) because of higher interest rates and a significant erosion in their share prices. Securing equity capital for growth could be harder for these companies until interest rates moderate.

Industry Outlook

Ratings trends and outlook

1. Capacity markets have tightened.

We expect elevated resource adequacy (RA) prices in California—where prices are in the low double digits ($/KW-month) through 2030—and in the Pennsylvania-New Jersey-Maryland (PJM) Interconnection, where capacity prices increased 9x in the latest auction (2025-2026) over the previous year.

2. Renewables PPA prices have more than doubled since first quarter 2021.

Market-averaged solar and wind PPAs are up 10% and 17%, respectively, year-over-year, the twin impacts of higher costs (labor, panels) as well as higher interest rates.

3. Stable ratings profile but pockets of risk.

We expect robust cash flow generation and high cash flow conversion from the IPPs, provided operating performance remains intact. Perversely, renewable companies are short equity capital for their financing needs.

Power growth is finally here. In January 2024, the PJM, the biggest independent system operator (ISO) in the U.S., increased its demand forecast to a compound annual growth rate (CAGR) of 1.7% through 2030, up from 0.8% the previous January. Revisions of growth expectations are not unusual so the news did not stand out. But then forecast revisions started accelerating. By June 2024, our affiliate, S&P Global Commodity Insights, revised its power CAGR for the contiguous U.S states to 2.1% for 2024-2030 from a CAGR of 1.2% as recently as January 2024. Compounding can be deceptive—it can hide growth—so this differential in CAGR is significant, especially when compared with demand that had stagnated.

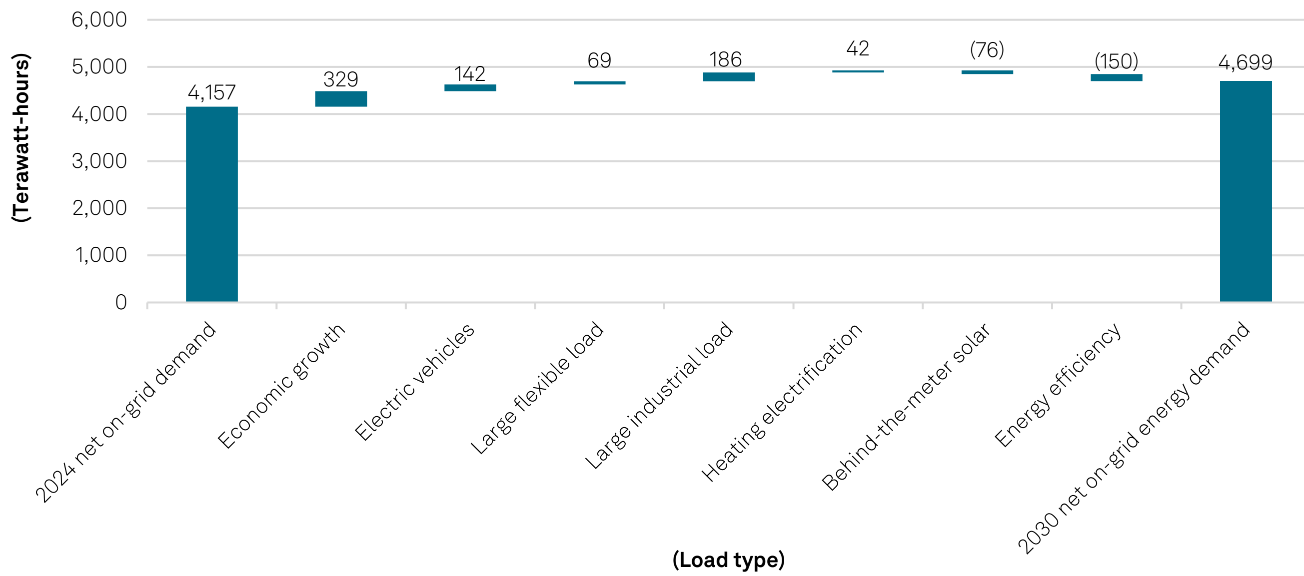
Over the past decade the increase in demand from customer growth and electrification needs was offset by energy efficiency (e.g., building codes and efficient appliances) and behind the meter solar installations. The current growth surge is spurred by large loads (see chart 8). Electric vehicles and large flexible loads (e.g., electrolytic hydrogen and industrial processes) will drive significant demand between 2030 and 2050. However, data centers may account for 20%-30% of all net new demand added between any two consecutive years until 2030.

Bottom line, in a demand growth scenario we see owning generation as a credit positive, especially if it is dispatchable, and at scale. Nuclear generator such as Constellation Energy benefits most, followed by others like Vistra Energy, Calpine Corp, PSEG Power, Talen Energy, and NRG Energy.

A major setback facing the IPP sector the past decade is the loss of the long-term investor. Wary of the asset lives around fossil fuel generation, the long investor had all but left the sector. The present demand surge has made many investors rethink how to position their holdings. We expect owners to start aggregating portfolios under a corporate structure, and expect to see new IPPs emerge. We think the critical mass that sponsors need to organize a new IPP is about 5 GW. It is not surprising that we saw the formation of corporates like Lightning Power LLC and Alpha Generation LLC in 2024

Chart 8

U.S. power demand through 2030



Sources: S&P Global Commodity Insights and S&P Global Ratings.

Capacity markets to remain tight, benefiting prices. In most parts of the U.S., generation capacity is increasingly appreciated. The explanations are similar: Over the past years, supply/demand imbalance has grown. However, a longer line of reasoning also includes long interconnection queues. There is also insufficient future transmission planning and now the problems have simply cascaded, resulting in several regional transmission organizations (RTO) short on MW capacity for power delivery. While future capacity auction outcomes are yet to be set, bilateral capacity continues to be contracted at high price levels in New York and California.

We see capacity shortages glaringly in the sharply elevated resource adequacy payments in California—which are holding steady in the low double digits through 2030—and in the last PJM Interconnection capacity market auction price (for delivery year 2025-2026), which increased 9x over prices set in the previous auction (2024-2025).

Earlier this year, PJM published parameters for the auction for delivery years 2026-2027 (that was to be held in Dec. 2024 but is now delayed). For this delivery year as well, demand and reliability requirement are higher than the July 2024 auction by 3.3 GW and 2.8 GW, respectively, and installed reserve margin is now 18.6% compared with 17.8%. All these revisions point to higher price outcomes, and there is really nothing in the latest parameters that leads us to expect prices to recede materially from the 2025-2026 levels. Based on the parameters presented, we believe the prices set in the auction would have been higher—potentially topping $300/MW-day—and higher than our current assumptions for capacity year 2026-2027.

The FERC has recently issued an order granting PJM's request to delay its 2026-2027 capacity auction by six months to June 2025. We expect parameter changes in the coming months to include reverting the reference unit back to a combustion turbine, lowering the gross cost of new entry (CONE), potentially easing upwards price pressure. We also see risk of the Talen Energy reliability-must-run units being included as generation supply in this auction (roughly 1.4 GWs of unforced capacity), which should also have a dampening effect on pricing outcome in the auction. Conversely, we see the potential for higher demand—on Nov. 25, 2024, the PJM added 1.8 GW to its 2025 load forecast but increased 2030 forecasts by 17 GW.

As a separate yet related point, we note that systemwide PJM capacity costs to load climbed to $14.7 billion in the latest auction, the highest they have been. Notably, this cost is meaningfully higher than the $2.2 billion in the previous two auctions. Therefore, we expect some political backlash given customer price impacts. The high prices will likely drive stakeholders to advocate market changes and possibly out-of-market interventions.

Renewables PPA prices have more than doubled since first quarter 2021, stalling the downward cost curve of power prices. Solar and wind market-averaged price index have increased to over $55/MWh and $65/MWh, respectively, in Q4 2024, up from $30/MWh in Q3 2020. Solar and wind PPAs both showed higher contracting prices in 2024 to reflect the twin impacts of higher costs (labor, panels) as well as meaningfully higher interest rates. We see supply chain and permitting constraints as lingering but remaining an overhang on near-term renewable development timeframes and returns. Utility scale solar and storage demand remains robust, although interconnection challenges have yet to clear meaningfully.

In April 2024 the Biden administration rolled out policies that increase tariffs on solar cells from China to 50% (more on this later). In response, many U.S. developers have stockpiled inventories of low-cost panels from south-Asian countries like Vietnam, Thailand, and increasingly India. U.S. developers can mitigate the impact of tariffs and potential snags around forced-labor and anti-circumvention/anti-dumping laws by sourcing domestic PV components, but such products bring a price premium. Meanwhile, the wind industry is still contending with challenges around land availability, community opposition, lengthy and arduous permitting and interconnection processes, and the price pressures remaining from pandemic-era inflation. Rising insurance costs resulting from increasingly common extreme weather events are adding cost pressures too.

Project delays are occurring across renewable technology types and regions for numerous reasons, typically interconnection issues, high voltage transformer (HVDC) access and lead times, permitting challenges, and module access and financing challenges. Delays on transformers broadly are now about three years, and delays for HVDC transformers are even more protracted.

We note that renewable PPA prices appear to be relatively sticky at their higher levels and we expect them to persist at these levels through 2025.

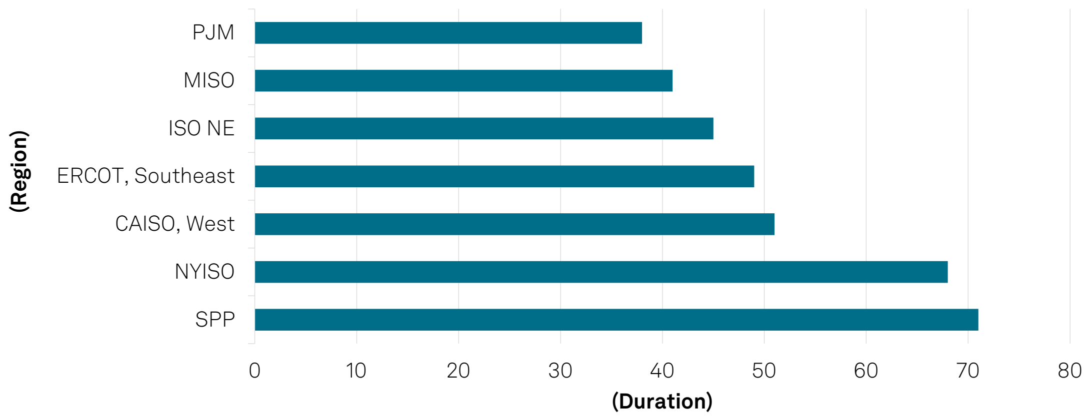
Demand cannot be met with renewables alone. The increasing need for reliable, uninterruptible power for electrification is not helpful for the sustainability story. Even as a meaningful amount of renewable power is being placed on the grid, we expect there will be significant need for natural gas-fired generation if this demand is to be addressed. Not only is gas generation needed to meet part of the demand, but dispatchable gas resources will also serve a critical balancing role as more renewable capacity enters the market.

There just are not enough renewable MWs to accommodate the demand increase, especially after incorporating their effective load carrying capability (ELCC) accreditation impact. That also means a substantial amount of MWs of gas-fired generation is needed. But this conundrum raises both a willingness and ability problem. A developer must be willing to take a 35-year directional bet on gas-fired generation in an environment pushing toward decarbonization goals (a priority for the outgoing administration).

Even if investors are somehow convinced to finance projects on the back of merchant energy revenues, new gas-fired entrants will also be delayed by the lengthy interconnection queue. Given poor results for recent new builds and weak economics, there have been no active interconnection requests for natural gas plants since 2021, a first since 1997. Besides, the expansion of transmission infrastructure assets is a long-term planning process that requires permitting and siting and is typically done at a measured pace. It requires regulatory approvals that often take many filings and considerable time. Moreover, reliance on foreign suppliers, lingering COVID-19 pandemic-related shortages, and insufficient domestic manufacturing capacity all contribute to delays in transmission project development. Given how pervasive transmission issues are, we believe, at least for now, it is all about securing generation sites that come with grid interconnection infrastructure. The time it takes for new generation capacity to go from planning to commercial operations has increased because grid interconnections are harder to find (see chart 9).

Chart 9

Interconnection queue by region



As of April 2024. Duration—Average time from queue data to proposed online date. Source: S&P Global Market Intelligence.

Competitive, long generation companies are well positioned to respond to the demand, and we believe Constellation Energy and Vistra Corp. are best positioned. We expect Talen Energy Corp. and PSEG Power LLC to benefit as well, but to a lesser extent because of their smaller generation footprints. We also expect developers such as NextEra Energy Inc., Brookfield Renewable Partners L.P., Clearway Energy Inc., and Pattern Energy Group L.P. to allocate significant capital to firming power. Pattern Energy's Sunzia project is well positioned because there can be no energy transition without transmission. This asset is under construction but needs to manage its construction costs within expected budget.

Main assumptions about 2025 and beyond

1. Path of renewable proliferation dominates power market forwards.

Renewable proliferation continues to have two drivers: 1) The need for energy to replace fossil plants retiring; and 2) a temporary increase in renewable PPA prices.

2. Supply chain bottlenecks to ease and domesticate.

Solar panel imports were delayed by geopolitical tensions and the implementation of the Withhold Release Order (WRO), the anti-dumping/countervailing duties tariffs (AD/CVD), and the Uyghur Forced Labor Prevention Act (UFLPA). In 2025 we expect the supply chain for solar panels, inverters, batteries, etc. to domesticate further.

3. The heightened risk of tariffs.

We think the increase in pricing of renewables PPA is already reflecting some of that risk.

4. Risks to provisions of the Inflation Reduction Act.

We see a surgical strike (provisions of the IRA) rather than a sledgehammer approach (full repeal) as likely. That is also the market consensus.

Path of renewable proliferation will slow in 2025. North America is poised to break its annual installations record for the second year in a row in 2024, touching the 50 GW mark for the first time, which represents a 30% year-over-year growth rate. Chinese overproduction since the passage of the IRA has flooded markets with inventory and caused average global module prices to plummet. For solar, prices have declined from $0.26 to $0.13/watt between the end of 2022 and now. Solar module inventory in the U.S. has surged over the past 18 months because of the global price collapse, resulting in nearly 50 GW of imports in 2023 and an additional 32 GW through July 2024. However, much of this inventory must be installed by the end of 2024 to avoid tariffs from the anti-circumvention investigation.

Since July 2024 the manufacturers in Vietnam, Thailand, Malaysia and Cambodia have largely halted shipments owing to the uncertainty surrounding potential tariff levels and the filing of an injunction. This injunction could trigger retroactive duties for modules shipped over the past three months if the Department of Commerce determines there was a spike in imports from these countries to circumvent future tariffs. Considering these challenges, some developers have delayed projects in 2025 and 2026 to seek alternative supply sources.

Overall, we expect solar installations to decline to about 40 GW in 2025.

Tariff risk has heightened. The first Trump administration's Section 301 review in 2017 led to tariffs on about $160 billion and $115 billion worth of Chinese products at rates of 25% and 7.5%, respectively, with additional measures under Sections 232 and 201. These tariffs, along with subsequent adjustments by the Biden administration, have reduced mainland China's share of U.S. imports from 21.1% in 2016 to 13.6% by September 2024.

While tariffs on products from China could go further up under the second Trump administration (and new ones imposed on Mexico and Canada), earlier in 2024 the Biden administration increased tariffs under Section 301. In particular, the administration increased the tariffs on electric vehicles (EVs) to 100% from 25%, solar cells to 50% from 25%, and lithium-ion batteries to 25% from 7.5% (EV batteries in 2024 and non-EVs in 2026).

Major developers have been planning on tariffs for over a year and have brought in much of the equipment they need for 2025 and 2026 projects. They are also moving increasing levels of their supply chain domestically. Some developers like NextEra have offloaded tariff risk for suppliers to bear. Finally, we note that global panel prices are now at all-time lows due to a glut of supply and improvements in the efficiency of manufacturing. However, there is a large gap between the prices in the U.S. and globally because of U.S. trade policy. As a result, there will still be potential for imports from China despite tariffs. We note that photovoltaic module prices have started to return to around $0.28-$0.32/watt for supply that is still shipping and baking tariff risk into current pricing.

Tariffs have an adverse effect on the declining cost curve of the renewable industry, slowing down growth plans of many companies. Perversely, this may help slow down growth and thereby benefit the credit profile of companies that have been aggressively utilizing debt-funded growth to take advantage of IRA tax credit provisions.

Potential repeal of sections of the IRA will likely weigh on investments. While the IRA is creating much more economic benefits in Republican states, the partisan nature of the IRA law and the need to pay for extending the 2017 tax cuts will likely result in some changes. We do not assume a sledgehammer-style full IRA repeal in our base-case but do assume a surgical strike across some provisions.

Even as we have not heard any credible calling for a broad-based repeal of any of the tax credits, we think an earlier end to premium tax credits/investment tax credits (PTC/ITC) could be a potential way to save money. The IRA increased the solar ITC to 30% from 26% and extended the credit through 2032 before stepping down to 26% in 2033 and 22% in 2034 and expiring in 2035. This ITC not only helps support incremental demand for renewables but has also become more relevant to installers and developers due to the transferability of the tax credits. The removal of these credits, should this occur, would weigh on demand through less advantageous project economics, as well as eliminate the ability of developers to monetize credits. However, it is more likely that downward revisions to the ITC would be contemplated rather than its elimination.

The consensus view in the market is that EV credits and offshore wind are areas most at risk. Given President-elect Trump's comments on offshore wind during the campaign, even if his administration does not consider outright removing wind subsidies, it is possible he can consider slowing down or halting development projects through an executive order to commence environmental studies. We see tax transferability (it has zero cost from a budget standpoint), and nuclear PTC are at least risk. That said, we note that transferability facilitates a broader arena for monetizing credits and repealing that would stunt growth, lowering future credits generated.

Wading further into the weeds, we do not see 45Q being as much of a target since this has a lot of Republican support and several traditional oil/gas firms (e.g. Chevron, Exxon) have been leaning into carbon sequestration. Our view is similar for 45X, the domestic manufacturing credits, since it supports largely manufacturing jobs domestically and in Republican districts (e.g. Ohio).

We do note that most of the large developers have safe harbored equipment for their backlogs so that they would be protected from an early end to credits. Safe harbor only requires about 5% of the project cost to be locked up (or construction to commence) and is typically good for four years. An early end to credits could initially create a wave of demand to beat the end date but then a big slowdown would likely follow.

Credit metrics and financial policy

Power prices have stayed strong because of rising demand and slower-than-expected increase of renewable generation. We note that debt reduction is still a stated objective for several IPPs. In 2021, expectations for aggregate debt/EBITDA and FFO to debt were above 4.0x and 15%, respectively. Now some IPPs have targets of adjusted det to EBITDA in the 2.50x-2.75x range and adjusted FFO to debt above 25% on a sustained basis by year-end 2025. We see tailwinds for the credit profile for the sector with more ratings at investment grade levels potentially by year-end.

Key risks or opportunities around the baseline

1. Excess cash allocation to organic growth.

We see companies deploying significant proportion of excess cash to organic investments and acquisitions. However, share buybacks continue to be a priority in 2025.

2. Interest rates will likely decline by year-end 2025.

Many companies kept operating and maintenance costs flat or down in recent years, with labor attrition and technology advances offsetting inflation. However, material costs could increase with tariffs, and supply chain shortages could influence margins in 2025.

3. Long-term contracts with large loads can improve cash flow.

While hyperscalers have focused on contracting clean energy that also offers scale, other large loads could pursue contracts with gas-fired generation for their needs.

We expect to see increasing levels of excess cash allocated to organic growth. We see a potential pivot away from share repurchases in 2025 towards growth capex. While some of its provisions could face repeal, we think the IRA provides incentives for renewables that have led some of the manufacturing base to return to the U.S. Not unexpectedly, we continue to see significant deployment of capital in new storage and renewable projects. What interests us more is the level of capital spending that companies will direct towards repowering the wind fleet. With several installations getting to their decade-old vintage, we see the repowering of wind assets as a necessity, not an option.

Interest rates will likely decline in 2025 but still present a challenge. With uncertainties relating to the expected tax cuts and growing risk of fiscal deficits, yields on 30-year treasuries reversed course and increased in recent weeks. We expect interest rates to continue to slow acquisitive growth in the sector. In particular, the Yieldco segment is heavily dependent on rates because of the need for external financing of their growth. We expect this segment to continue to lag growth expectations until rates start declining. While companies like AES corp. and NEP are contending with growth and equity needs, a company that has managed its growth relatively well is Clearway Energy. We think rising cash flow available for distributions (CAFD) and increasing internal cash flow retention limits its need for future equity.

We expect more bilateral, long-term contracts that can benefit cash flows. We have not assumed any hyperscaler contracts in our forecasts for companies such as Constellation Energy but provide some details for context. If we assume a floor price of about $45/MWh (a generator would argue they are assured of that in the wholesale market through the production tax credits, and a hyperscaler must match it) and convert the latest $270/MW-day capacity price into $/MWh at 95% capacity factor ($12.5/MWh), then add ancillaries and a premium for clean attributes and long-term contracting, we believe these PPAs would be struck at $80/MWh-$85/MWh. Also, the longer the term, the higher the price would likely be.

While nuclear assets are in the news, we think this could expand to natural gas assets. Gas fired generation provides dispatchable but not clean energy. We think many data centers' sponsors will simply ignore the sustainable part.

A recent issue has been FERC's recent order rejecting Talen Energy's amended ISA to serve Amazon Web Services' data center co-located with the Susquehanna nuclear unit. The order effectively slows down behind-the-meter colocations. However, in later November Constellation submitted a fast-tracked 206 filing arguing that the PJM tariff does not contain rules for interconnected generators to follow when seeking to provide service to fully isolated co-located load, and asked FERC to adopt a replacement rate that incorporates PJM's previously established guidance on co-located load.

We expect power prices to be range bound in 2025, but most companies are heavily hedged. We note that forward power prices have held steady despite a decline in natural gas forwards, suggesting higher demand that has increased market heat rates. The forward gas curve is still in contango but now well below $4.0 through 2026 with broad delays in liquid natural gas (LNG) supply projects as well as a mild start to the winter, pushing inventories higher. While ERCOT power is down modestly, spark spreads in the region have remained resilient and expanded as power usage has increased. For instance, earlier this year in its capacity, demand, and resource (CDR) report, ERCOT laid out negative reserve margins after factoring noncontracted load. With likely acceleration of demand in 2025-2026 and limited new gas generation in the queue, we see a strengthening power demand for generators such as Vistra Corp. and Calpine Corp. Regional natural gas demand should increase in 2027 with the latest round of LNG supply reaching in-service as adding to energy price expectations. The pressure from coal-fired retirements and reliability needs also helps power prices nearer-term.

The increase in renewable PPAs should also buttress prices. PJM's congested interconnection queue is adding uncertainty and pushing prices up in the market. Rising land and labor costs have been reported across most markets, adding to projects' capex—costs that developers are largely passing forward in PPA prices. Industry headwinds make it unlikely PPA prices will go down substantially anytime soon. At the same time, buyer demand for PPAs remains high due to pressure on corporations to decarbonize their energy usage.

Related Research

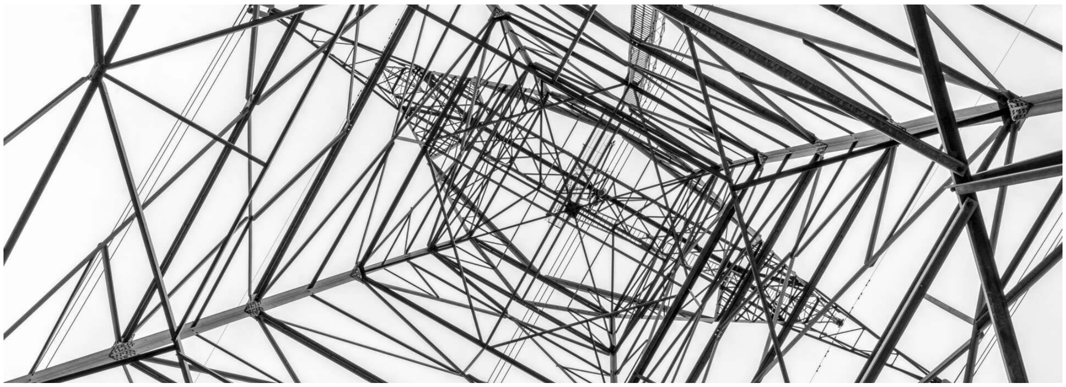
- Data Centers: Surging Demand Will Benefit And Test The U.S. Power Sector, Oct. 22, 2024
- Capacity Market Update: High, Or Low, Capacity Prices Are Their Own Solution, Aug. 28, 2024
- Sustainability Insights: U.S. Offshore Wind Projects Have Not Harnessed Their Full Potential Yet, Aug. 2, 2024
- Power Sector Update: Credit Drivers In The California And Texas Power Markets, June 18, 2024
- Power Sector Update: A Rising Tide And Other Credit Views, June 10, 2024
- Power Sector Update: The Piper At The Gates Of Dawn, Apr. 1, 2024

North America Regulated Utilities

Capex and climate change pressures credit quality

January 14, 2025

This report does not constitute a rating action.



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What's changed?

Lower ratings headroom. A high percentage of companies are operating with only minimal financial cushion from our downgrade threshold.

Rising capital spending, higher cash flow deficits, and increased wildfire risks led to downgrades outpacing upgrades for the fifth consecutive year.

Data centers spur electricity sales growth at about 1% annually, which will provide modest support to credit quality.

What are the key assumptions for 2025?

High cash flow deficits of about $100 billion, which could harm financial performance if not funded in a credit-supportive manner.

Robust dividends of about $50 billion for 2025 and at a dividend payout ratio of about 60%.

Record amount of hybrid securities. The industry issued $26 billion of them in 2024, and we expect this trend will persist.

What are the key risks around the baseline?

Rising wildfire risks stemming from climate change.

Tax legislation could weaken financial measures if the new Republican administration lowers the corporate tax rate, reduces tax credits, or eliminates their transferability.

Common equity issuance is below our base-case expectations, and has been for the last several years, leading to weaker financial measures.

Ratings Trends: North America Regulated Utilities

Chart 1

Ratings distribution

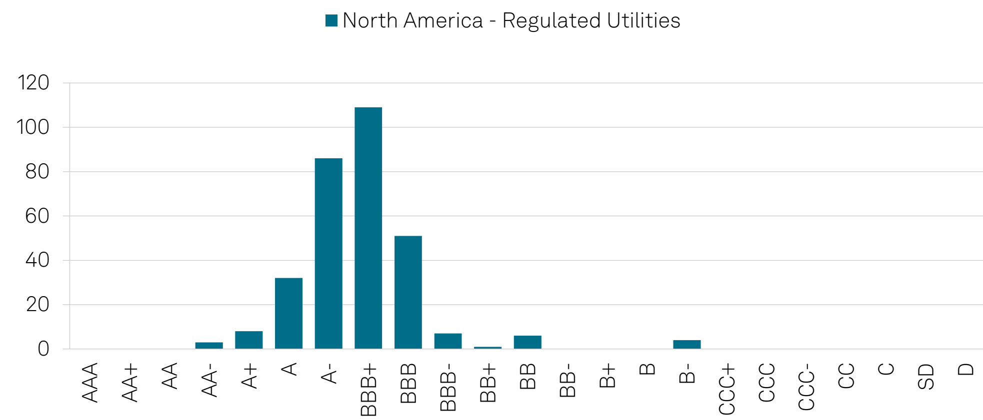


Chart 2

Ratings outlooks

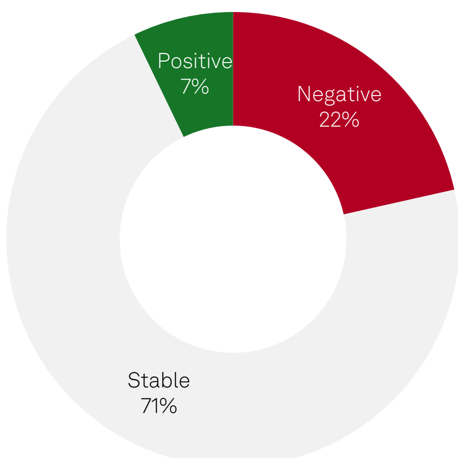
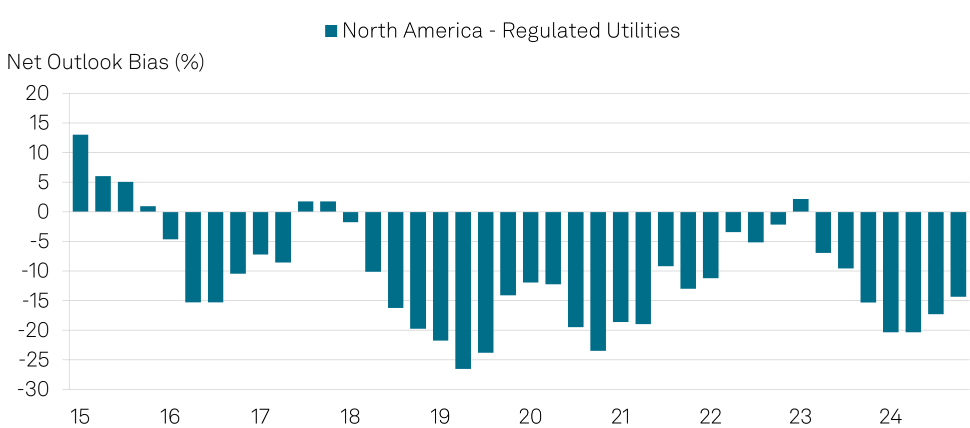


Chart 3

Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Credit Metrics:
North America Regulated Utilities

Chart 4

Debt / EBITDA (median, adjusted)

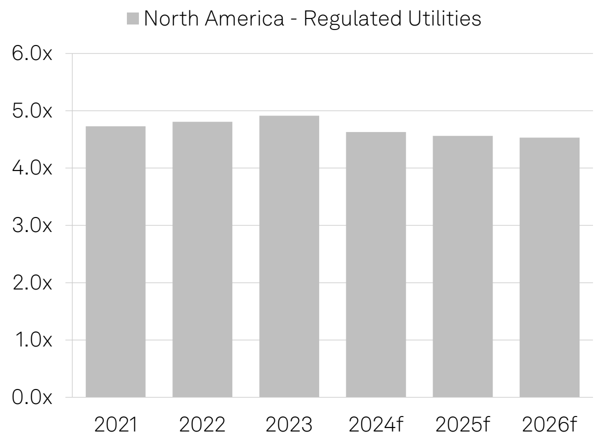


Chart 5

FFO / Debt (median, adjusted)

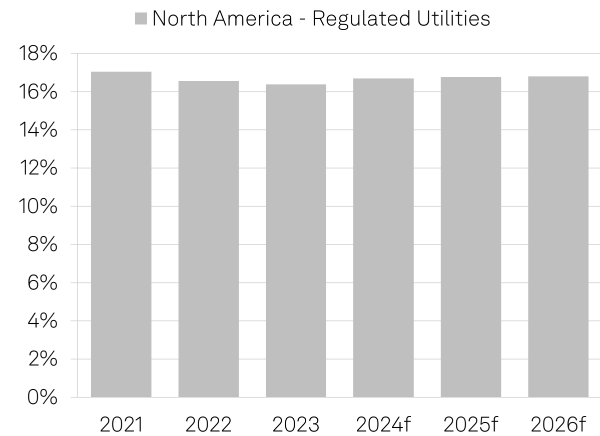


Chart 6

Cash flow and primary uses

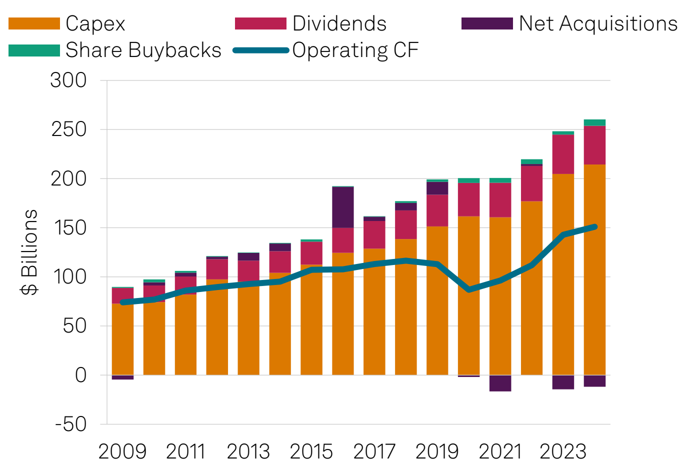
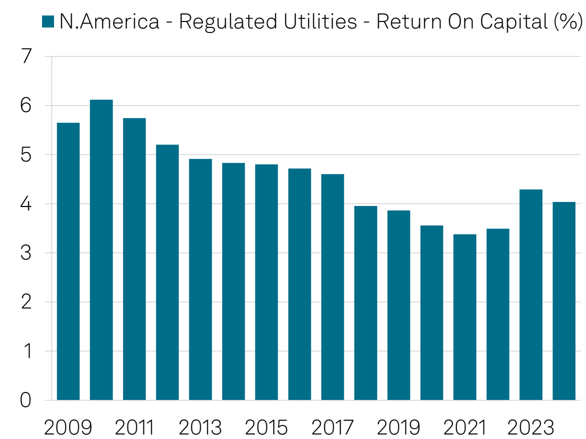


Chart 7

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2024) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

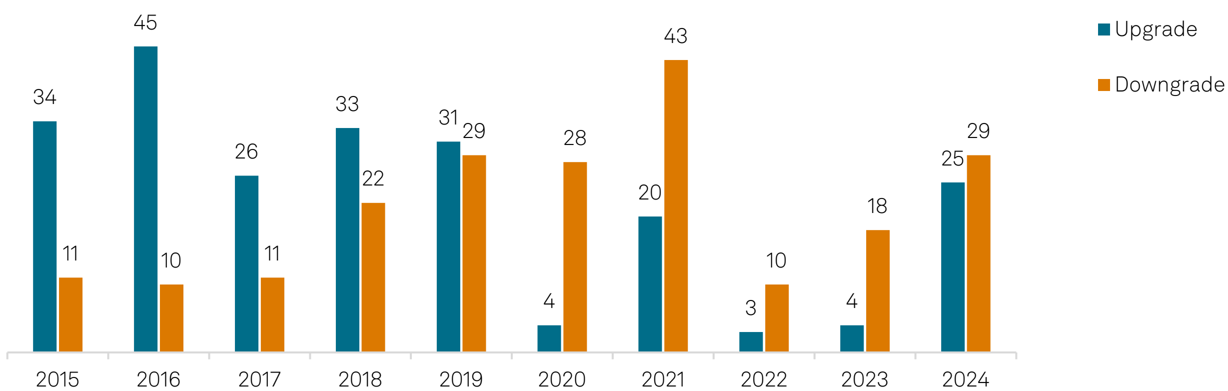
Industry Outlook

Ratings trends and outlook

In 2024, downgrades among North America's investor-owned regulated utilities outpaced upgrades for the fifth consecutive year (see chart 8). Most were directly attributable to rising wildfire risks, robust capital spending, and challenging regulatory constructs. We expect these risks will persist for 2025, further pressuring the industry's credit quality.

Chart 8

North America regulated utilities' upgrades and downgrades



Source: S&P Global Ratings.

Main assumptions about 2025 and beyond

1. Record capital spending.

The industry is heavily investing in safety, reliability, energy transition, and data centers. We expect this spending will exceed $300 billion before the end of the decade.

2. Management of regulatory risk.

This includes constructive rate case orders, minimizing regulatory lag, and earning the authorized return on equity (ROE).

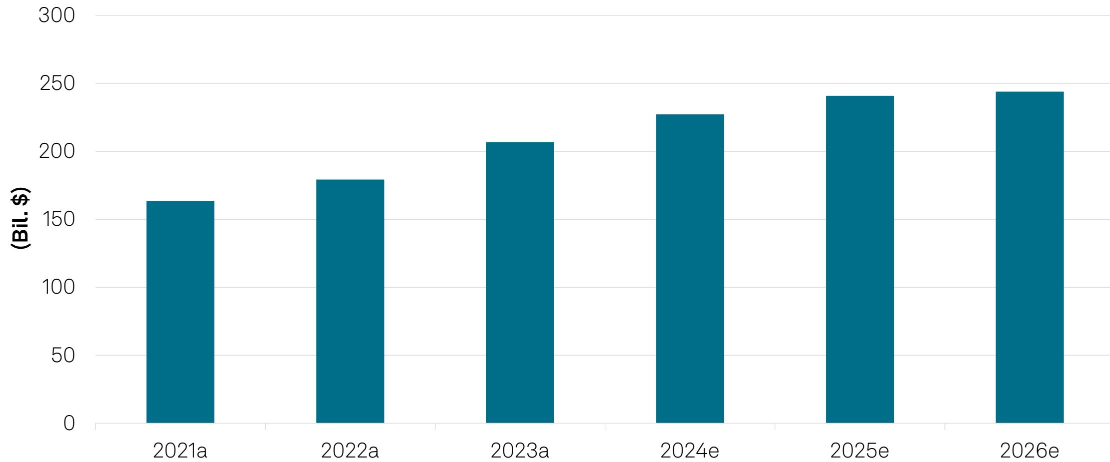
3. Climate change increases risks.

The growing frequency of devastating physical events, including hurricanes, storms, and wildfires, is elevating the industry's credit risks.

Capital spending continues to break records. We expect capital spending for North America's electric, gas, and water utilities will grow by a compound annual growth rate (CAGR) of about 10%. Accordingly, we expect 2025 capital spending to reflect about $240 billion (see chart 9). To date, the industry's capital spending has been primarily focused on safety, reliability, and energy transition.

Chart 9

North America regulated utilities' rising capital expenditures

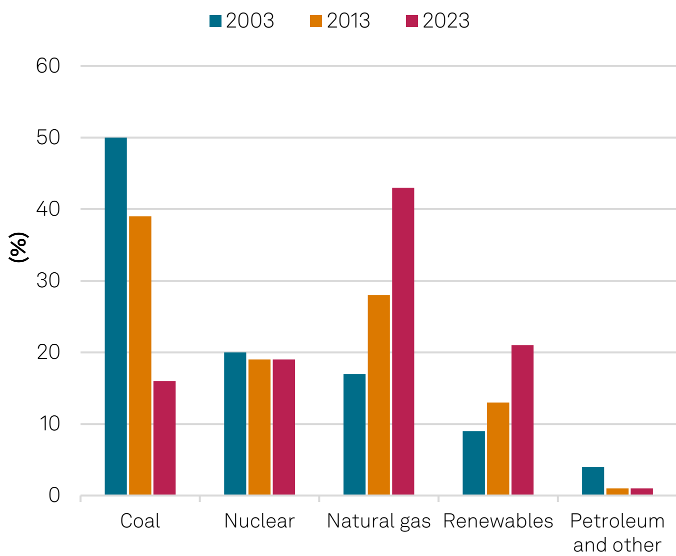


a—Actual. e—Estimate. Capital expenditures represent North American investor-owned electric gas, and water utilities.
Source: S&P Global Ratings.

Energy transition remains key. Over the past decade the industry has invested billions on reducing its reliance on coal-fired generation by about 50% (see chart 10), and today, coal represents only about 15% of total electric generation. Most of the coal was replaced with natural gas, which has about half the carbon emissions. We expect the industry will replace most of its remaining coal-fired generation by about 2030 with renewables and batteries, further reducing its carbon and greenhouse gas (GHG) emissions. The industry has reduced its GHG emissions by nearly 30% over the past decade (see chart 11), and we expect it will reduce them by another 30% by 2035.

Chart 10

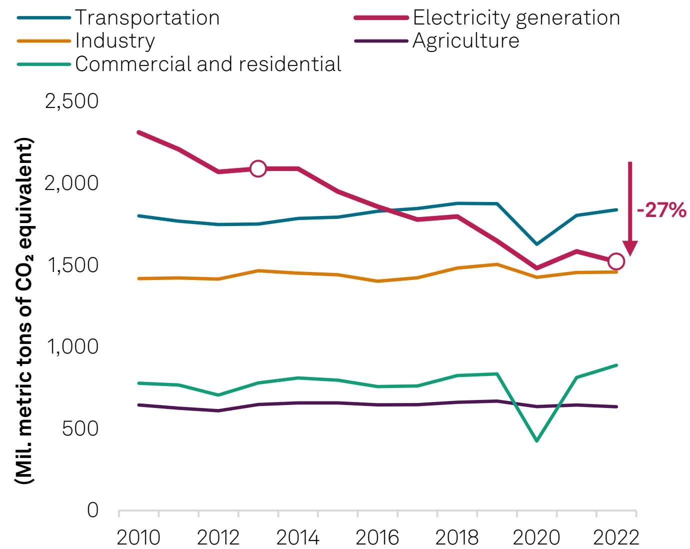
U.S. generation transformation



Source: U.S. Energy Information Administration.

Chart 11

GHG emissions by economic sector (2010-2022)

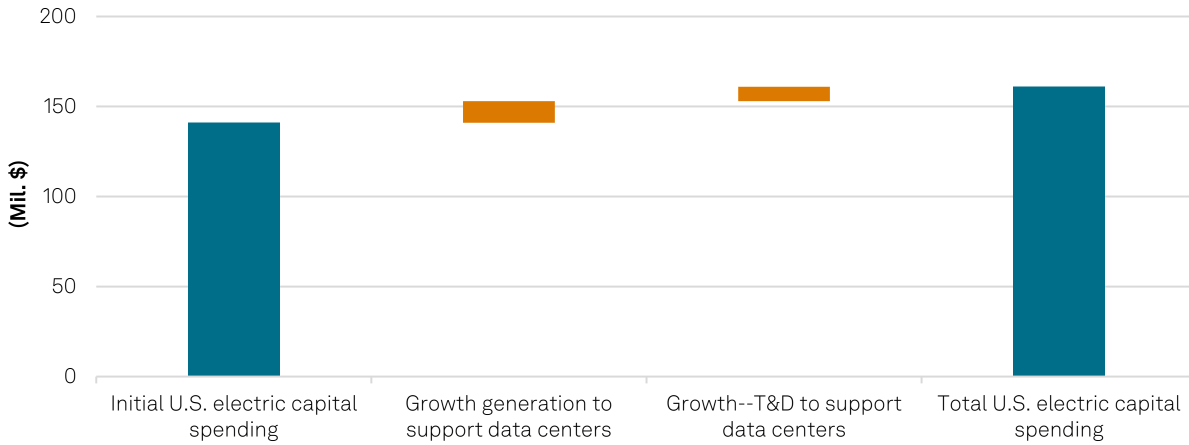


Source: U.S. Environmental Protection Agency.

Data center growth is relatively new, and our current base-case assumptions do not fully incorporate the incremental spending necessary for it. The higher spending for data centers is more likely to begin in 2026. Accordingly, 2026 capex could potentially increase by about another 15% above our current base case (see chart 12).

Chart 12

Data center growth will increase U.S. electric utility annual capital spending by about 15%

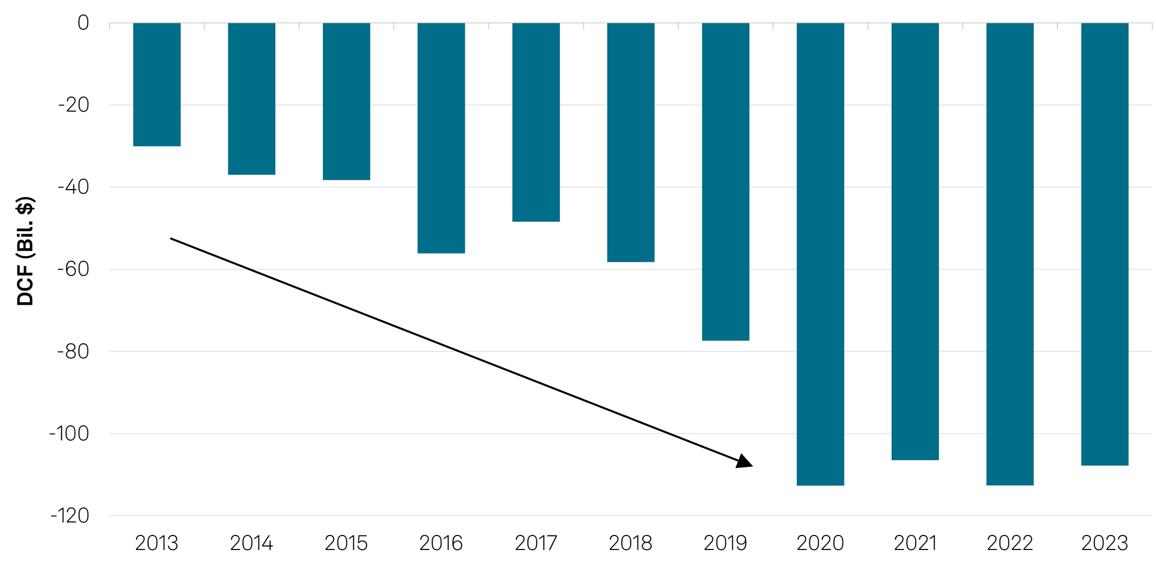


T&D—Transmission and distribution. Source: S&P Global Ratings.

Cash flow deficits will rise as a result, increasing the pressure on the industry's credit quality. Over the past decade the industry's cash flow deficits have grown from about $50 billion to consistently over $100 billion (see chart 13), and we expect this trend will continue.

Chart 13

North America regulated utilities' cash flow deficits

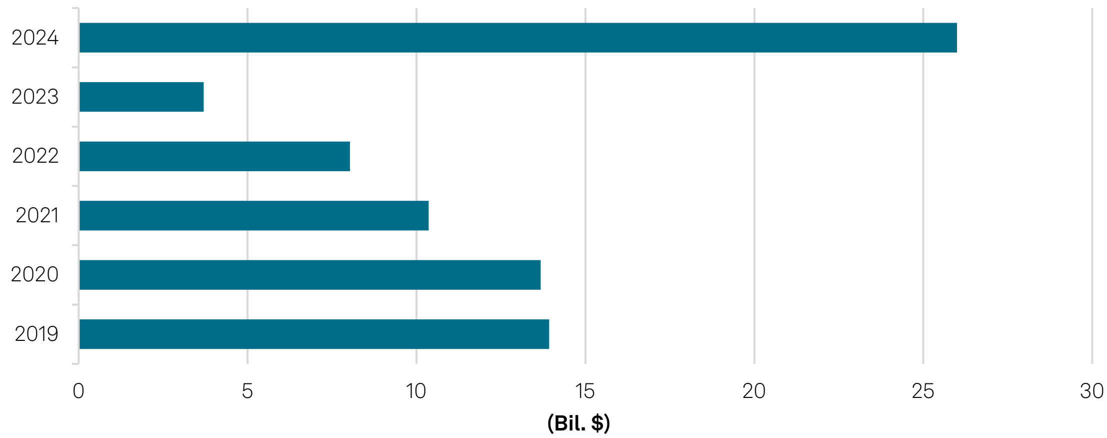


DCF—Discretionary cash flow. Sources: S&P Global Capital IQ, S&P Global Ratings.

Hybrid security issuance reached an all-time high of about $26 billion in 2024, far exceeding the previous record of about $14 billion in 2019 (see chart 14). We expect the industry will maintain this level of issuance in 2025 given its increased capital spending. This robust issuance supported the industry's 2024 financial measures because we typically assess hybrid securities as more credit supportive than debt, with most of these securities having intermediate (50%) or high (100%) equity content.

Chart 14

North America regulated utilities' annual hybrid securities issuance

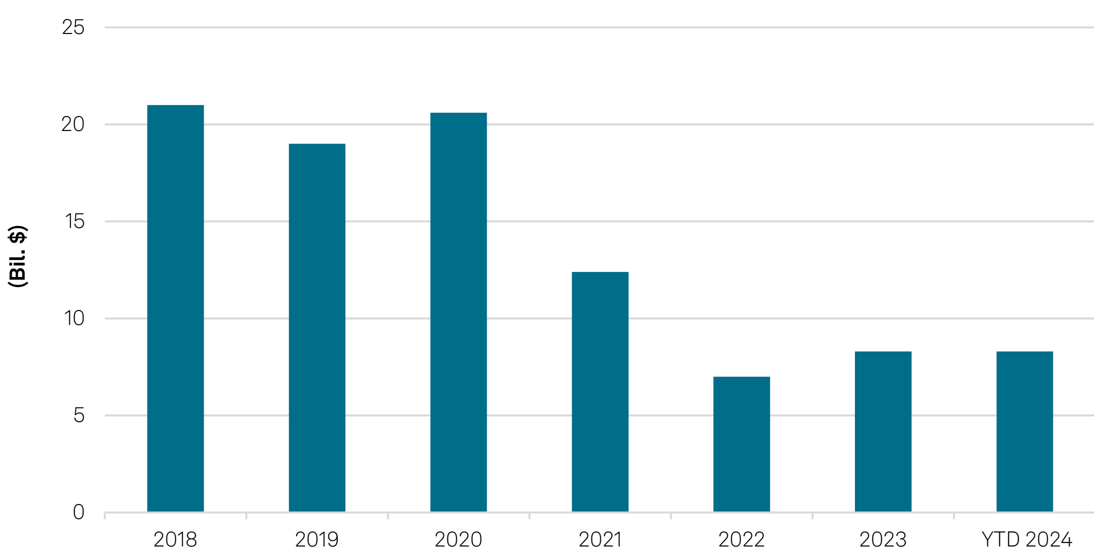


Sources: S&P Global Ratings, S&P Global Market Intelligence.

Common equity issuance has been weak and consistently below our expectations since 2021, pressuring the industry's financial measures. It raised only about $8 billion in 2024, and we estimate that the full year will reflect only about $10 billion. This is well below the industry's average run rate of about $20 billion annually between 2018-2020 (see chart 15). We expect 2025 common equity issuance will again be relatively weak and more reflective of 2024 levels. Without significantly more common equity issuance, we expect the industry's financial measures will continue to weaken, albeit gradually, supporting our negative outlook.

Chart 15

North America regulated utilities' common equity issuance



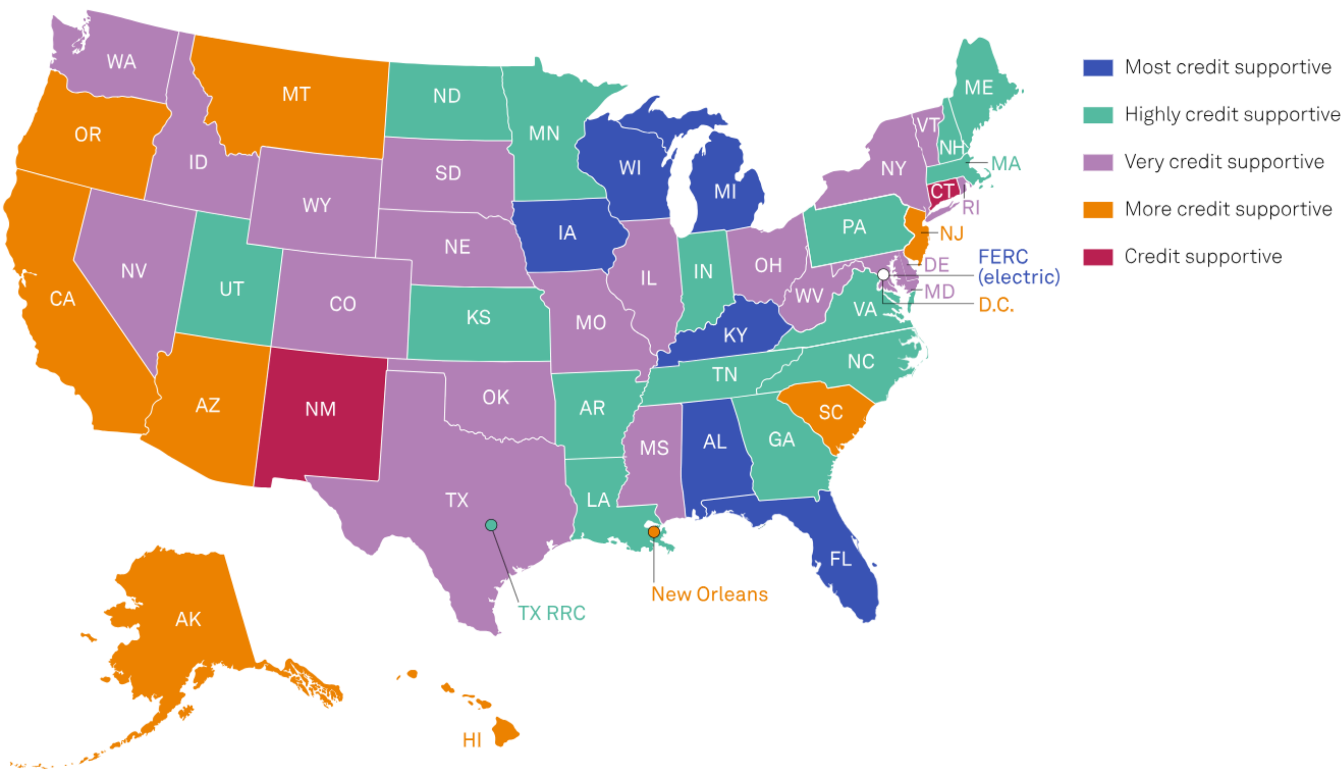
YTD—Year-to-date as of Dec. 15, 2024. Sources: S&P Global Ratings, S&P Global Market Intelligence.

Effective management of regulatory risk will continue. We assess all North America's regulatory jurisdictions as credit supportive or better, reflecting the industry's generally stable and predictable cash flows (see chart 16). Over the past decade much of the industry has implemented regulatory mechanisms such as decoupling, interim rates, capital trackers, formula rate plans, forward test years, muti-year rate case filings, and regulatory riders to significantly improve cash flow stability while minimizing regulatory lag (that is, the timing difference between when a utility incurs costs and when it's recovered from ratepayers).

Chart 16

Regulatory assessment by state

As of November 2024



Source: S&P Global Ratings.

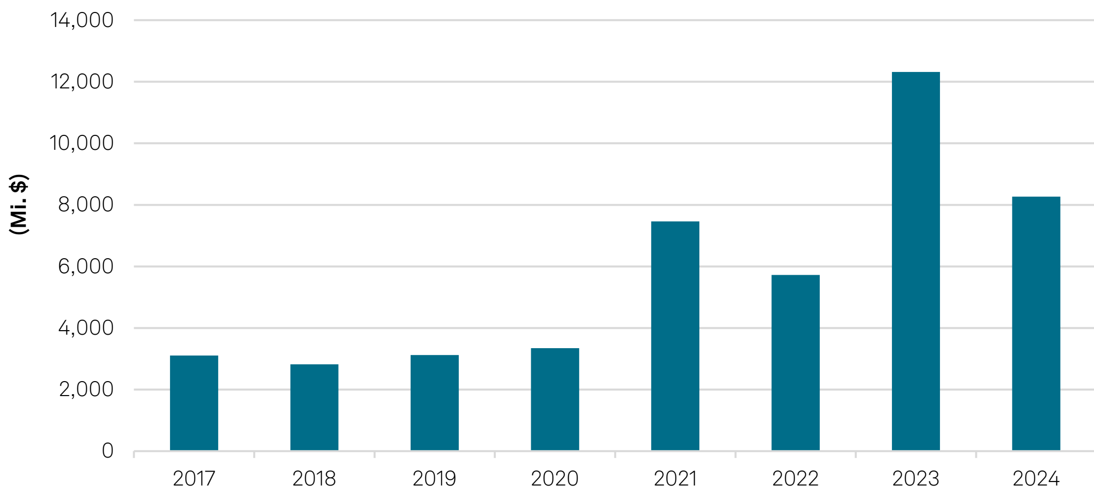
In general, we expect utilities will operate in a regulatory jurisdiction that is supportive of their credit quality by allowing for the full recovery of all their operating and capital costs in a timely manner. We also expect the regulatory jurisdiction will provide a consistent and predictable regulatory framework that results in cash flow stability. Our view of the industry's regulatory constructs supports the industry's mostly investment-grade ratings despite the industry continuing to operate with material cash flow deficits.

Recently, we revised downward our assessment of Connecticut's regulatory construct to credit supportive from more credit supportive. We now expect the state's regulated utilities will be increasingly subject to below-average authorized ROEs, regulatory lag, and an inconsistent ability to earn their lower authorized ROEs. These developments will increase the utilities' cash flow volatility, decrease the stability of their financial performances, and weaken their ability to consistently manage regulatory risk. Other regulatory jurisdictions that we continue to carefully monitor include Arizona, Colorado, District of Columbia, Illinois, Maryland, Michigan, New Mexico, Texas, and West Virginia.

Regulatory rate case order increases have substantially risen over the past four years, reflecting the industry's robust capital spending. Rate case increases for 2021-2024 have increased by more than 2.5x compared to 2017-2020 (see chart 17), and there are more than 100 U.S. rate cases pending, for which utilities are requesting over $16 billion more in revenue. This is in line with our base case that this year's rate case orders will again be robust and most likely in the top three years for rate case order increases.

Chart 17

U.S. rate case orders

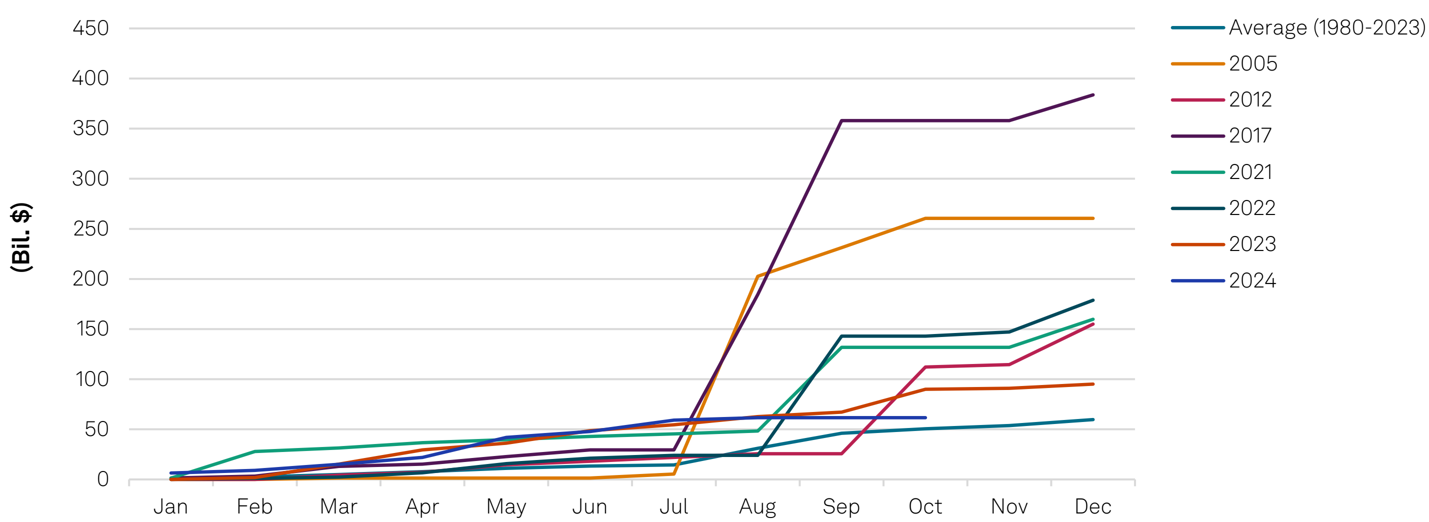


Source: S&P Global Commodity Insights.

Utilities' exposure to physical risks are increasing. According to the National Oceanic and Atmospheric Administration (NOAA), on an inflation-adjusted basis, 2021 and 2022 represent two of the most destructive years for extreme weather events since 1980 (see chart 18). We assume these trends will persist, magnifying physical risks for the utility industry.

Chart 18

U.S. billion-dollar weather disaster year-to-date event cost (CPI-adjusted)



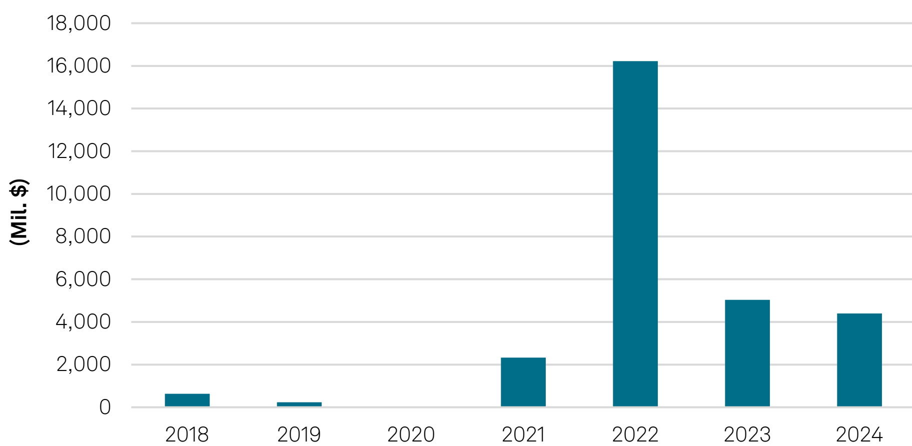
Source: National Ocean and Atmospheric Administration.

Drier, hotter weather has increased the acreage designated as high-fire-risk across the U.S. This is already taking a toll on credit ratings. For example, in 2024 we downgraded parent Xcel Energy Inc. and subsidiary Southwestern Public Service Co. (SPS) because of the scale and severity of the wildfires in the Texas panhandle, which highlights their increasing wildfire exposure. Overall, because of climate change, we expect the industry's wildfire risk will increase.

Securitization increased, which we assess as supportive of credit quality (see chart 19). Securitization allows for the issuance of debt secured by a non-bypassable charge to the customer's bill, allowing the utility to fully recover storm-related costs at a lower interest rate for customers. Because the debt is secured by the high likelihood of customers paying their bills, the associated interest costs are typically lower. We often deconsolidate such debt, resulting in stronger credit measures.

Chart 19

S&P Global Ratings-rated utility-related securitization issuance (2018-2024)



Source: S&P Global Ratings.

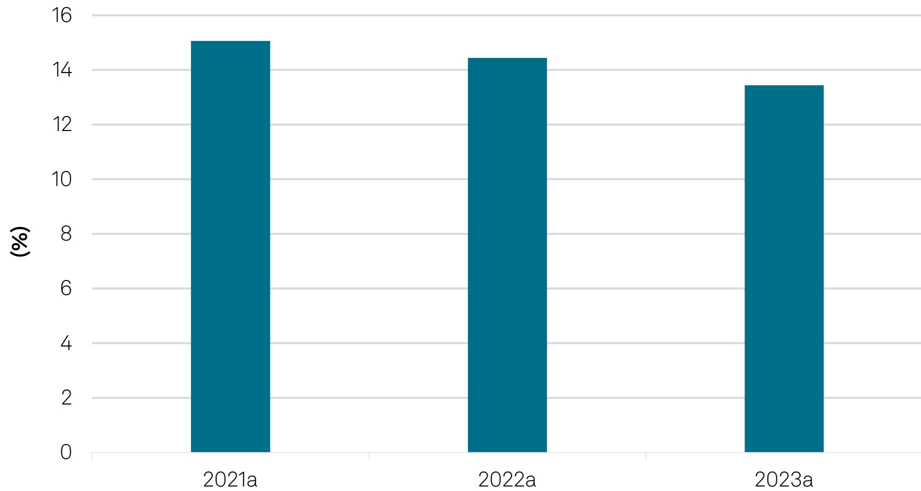
We expect securitization will remain an effective tool that the industry will continue to use. Our base case includes increasing severe natural disasters and weather events as well as continued efforts to decarbonize the energy sector, which sometimes requires securitization to fully recover under-depreciated retiring fossil-fuel generating plants.

Credit metrics and financial policy

We expect rising capital spending and increasing cash flow deficits that are not sufficiently funded in a credit-supportive manner will continue to pressure the industry's financial performance. Its average funds from operations (FFO) to debt was about 15% in 2021 and has gradually fallen to about 13.5%, primarily reflecting rising leverage (see chart 20). Given our expectations for continued increasing capital spending over the next decade, we expect financial performance and credit quality will continue to be pressured.

Chart 20

North American regulated utilities' average FFO to debt



a—Actual. Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Wildfire mitigation efforts.

Wildfire risk mitigation, while clearly a credit positive, may not fully address the threats associated with extreme weather events.

2. Data centers and sales growth.

Data center electricity demand will likely boost revenues at North American investor-owned regulated utilities and provide modest support for the industry's credit quality.

3. Managing the customer bill.

The average electric customer bill is about 2% of U.S. median household income, which represents good value for customers relative to other typical household bills. Preserving this value is critical for the industry to maintain credit quality.

Wildfire risk has expanded. Recent events in the Northeast U.S. lead us to believe wildfire risk has spread and now potentially affects nearly every utility across North America. (About 15 years ago, it was primarily limited to just Southern California.)

Wildfire risk is highly negative for credit quality. The scale of potential liabilities, unpredictable nature of exposures, and frequency of events have materially increased wildfire risk for many utility stakeholders. From a credit standpoint, litigation risk is more problematic than risk of damage to infrastructure because it is difficult to predict or quantify and is so far without sufficient mitigation or containment. Also, wildfire-related litigation payments are typically not recoverable in rates or through other regulatory mechanisms, making them more problematic than physical risk.

Additional wildfire risks to credit quality include:

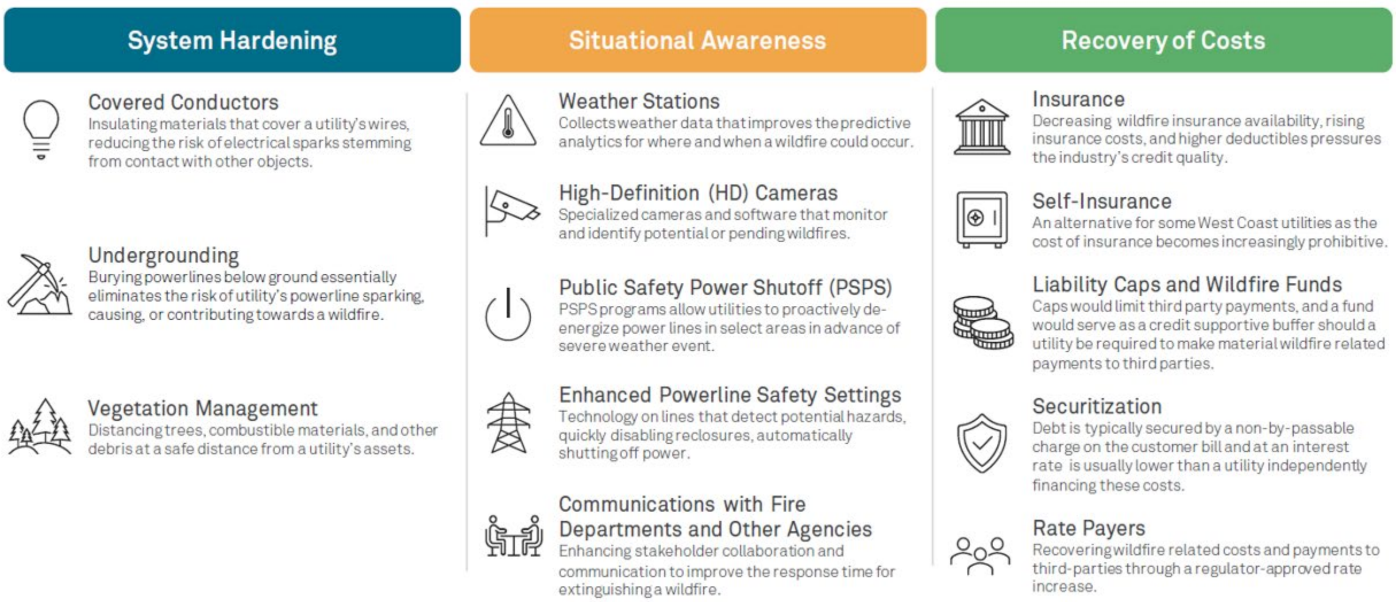
- Insurance is becoming more expensive and less available.
- It only requires a relatively small percentage of damaged or destroyed structures from a wildfire to have a material negative effect on a utility's credit quality.

- The utility industry's relatively high leveraged balance sheets and modest authorized ROEs are not a backstop for wildfire risk.
- Utilities that are impacted by a catastrophic wildfire and material third-party claims typically cannot implement other strategic initiatives.

Mitigation strategies. We expect the industry will develop plans that reduce damages, minimize litigation risk, and expand capabilities for cost recovery from wildfires. We believe the industry will be able to implement much of these strategies over the nearer term because most are not predicated on the development of new technologies or products. That said, because the industry operates in many different service territories and topographies, we expect each utility's mitigation plan will be customized to its unique exposure. Chart 21 represents an array of wildfire mitigation strategies that either have or are being implemented by many utilities across North America.

Chart 21

North American regulated utilities' wildfire mitigation efforts



Source: S&P Global Ratings.

Data centers will likely deliver a return to electricity sales growth. We expect electricity sales will increase at a CAGR of about 1.1%. This reflects our view that systematic and careful planning across the investor-owned utility sector will likely limit its realistic capability to grow at a substantially faster pace. In general, the expansion of utility infrastructure assets is a long-term planning process that requires permitting, siting, and regulatory approvals.

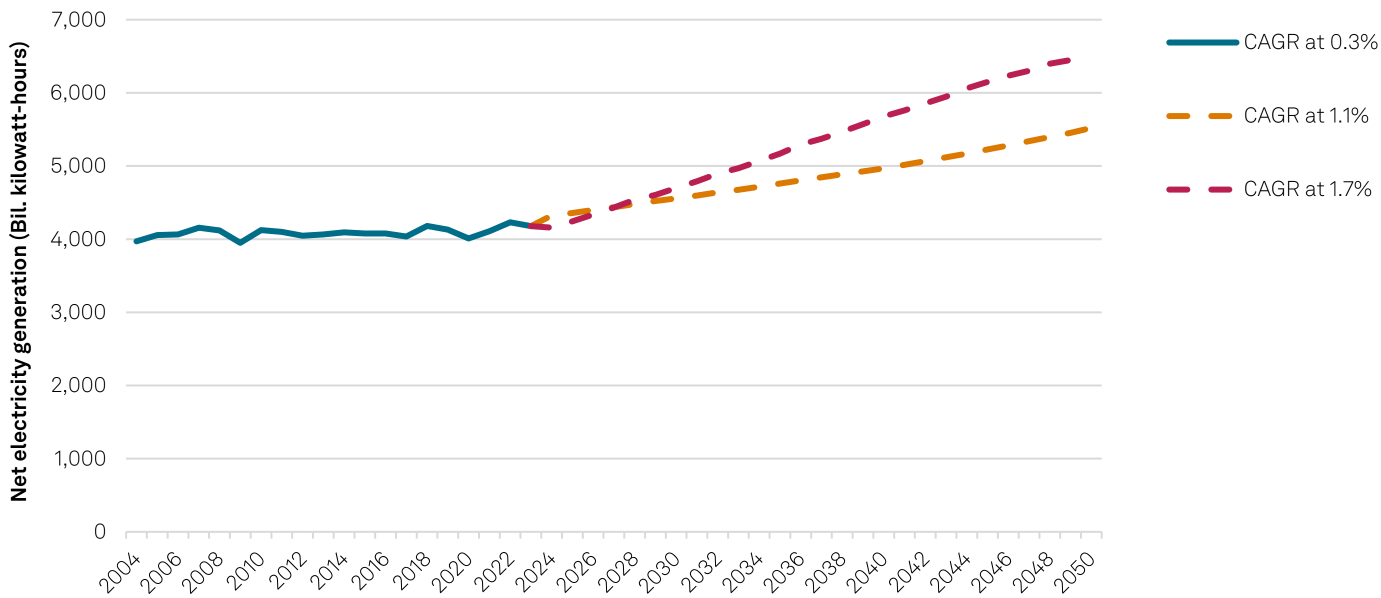
However, even a 1% CAGR for electricity sales will likely prove transformative for the utility industry, which has experienced flat sales growth over the past two decades. In particular, the growing number of data centers will allow the industry to spread its fixed costs over a wider base. We anticipate this will provide some cushion for the industry to effectively manage regulatory risk and maintain credit quality without necessarily requiring that every rate case order is highly supportive of credit quality.

We also expect electric utilities' sales CAGR will be maintained over the longer term (see chart 22), which will support the industry's long-term credit quality. We expect growth in data center numbers will support most of the industry's growth through 2030. In the following decade, increased onshoring of manufacturing and wider spread adoption of electric vehicles will also support growth.

Chart 22

Growth will be transformative for utilities used to stagnation

Electricity demand: U.S. regulated electric utilities



Data as of June 2024. CAGR—Compound annual growth rate. Sources: U.S. Energy Information Administration (historical and 1.1% CAGR) and S&P Global Commodity Insights (1.7% CAGR).

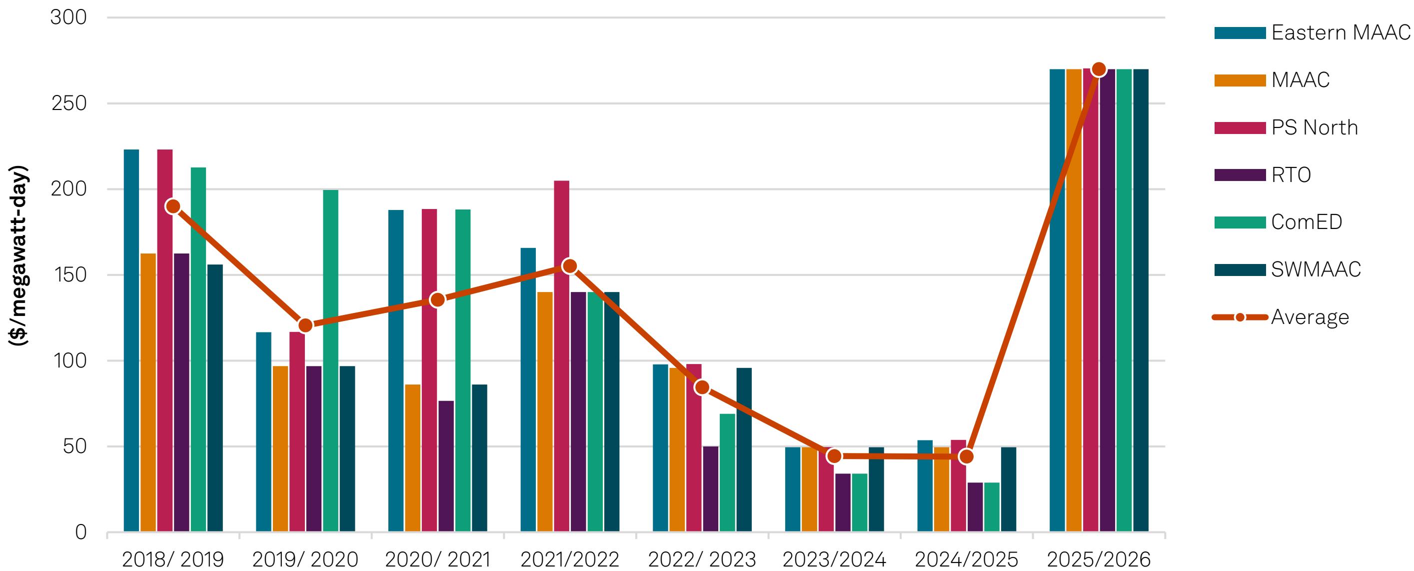
Data center credit risks. The industry must structure rates and contracts to ensure that the new data center customers are paying their share of electricity costs. Meeting the demands of relatively few, but very large, data center customers will require significant capital spending and infrastructure investments. If utilities assign a significant portion of data center-related infrastructure costs to existing residential customers, customer bills would increase. This, in turn, pressures regulators to limit rate case increases, which can negatively affect the industry's ability to effectively manage regulatory risk.

Therefore, we expect the increased capital spending needed to accommodate data center growth will be primarily recovered from data center customers over decades. Such a plan comes with risks. For example, a technological breakthrough that reduces or eliminates the need for data centers could shift the recovery of these long-term infrastructure investments onto residential customers.

Capacity prices. Pennsylvania-New Jersey-Maryland (PJM) Interconnection capacity prices materially increased during its latest capacity auction (see chart 23). These higher prices are directly passed onto customers, significantly increasing the electric utility bill. If these higher prices persist, it will likely result in higher customer complaints, pressuring regulators to limit increases to other areas of the customer bill that could potentially pressure a utility's ability to effectively manage regulatory risk.

Chart 23

PJM capacity auction results



Source: PJM website.

U.S. Environmental Protection Agency (EPA). In 2024 the EPA released final rules aimed at reducing pollution from fossil fuel-fired power plants, which included carbon pollution standards and effluent limitation guidelines and standards for coal-fired power plants. These rules would have increased costs for utilities, specifically regarding the requirement to install carbon capture and sequestration or storage technology on coal-fired power plants intending to operate beyond 2039.

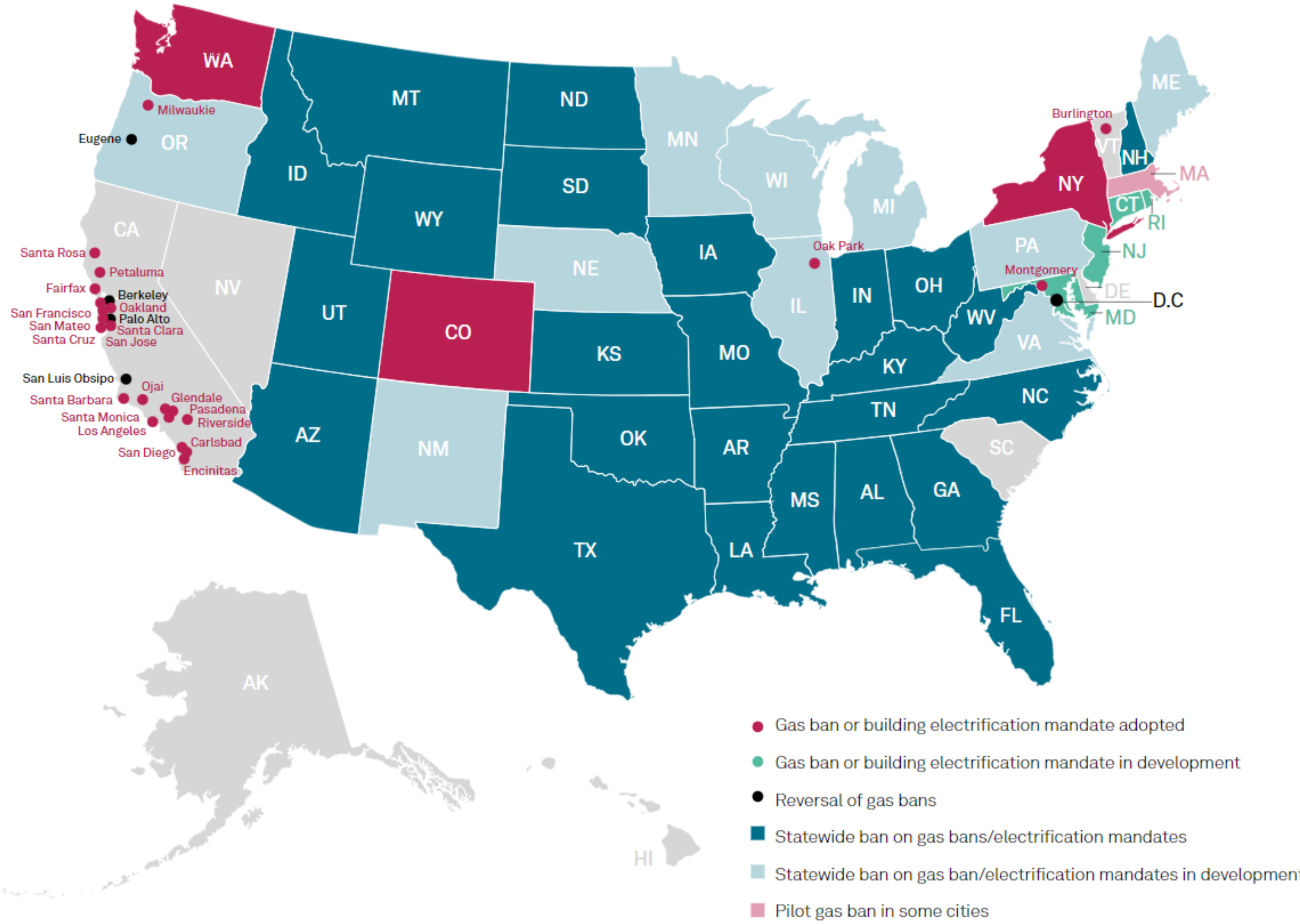
However, we note that the incoming U.S. presidential administration and Republican majority in congress could modify or eliminate these rules. We will monitor executive, legislative, or legal actions that could impact the industry's credit quality.

Full electrification. We expect the longer-term credit quality for some natural gas local distribution companies (LDC) will become increasingly challenging, especially for utilities that operate in warmer climates or whose cities or states have banned new gas connections, severely limiting the growth of natural gas LDCs (see chart 24). We expect this trend will also gradually persist through the passage of local city and town building codes that limit carbon and other emissions.

Offsetting some of this risk is that a majority of states have imposed a ban on the ban of new gas connections. Furthermore, gas LDCs are attempting to reduce their environmental risks by decreasing their carbon footprint through investing in renewable natural gas, blending hydrogen, and initiating various hydrogen infrastructure projects.

Chart 24

Gas bans and electrification mandates



Data as of April 26, 2024. *Municipalities shown on map are a subset of municipalities in the U.S. that have gas ban policies or electric reach codes in place. §Colorado and Burlington mandates target emissions requirements set out in respective laws or regulations. Source: S&P Global Commodity Insights.

Cybersecurity. While cybersecurity breaches against infrastructure assets have been relatively low, we believe the threat of cyberattacks remains high. The 2024 cybersecurity breach against American Water Works Co. Inc. underscores the risks. But the sector has heavily invested to limit this risk. We believe the sector's ongoing vigilance in this area is critical to maintaining credit quality.

Related Research

- Wildfire-Exposed U.S. Investor-Owned Utilities Face Increasing Credit Risks Without Comprehensive Solutions, Nov. 6, 2024
- Data Centers: Rapid Growth Creates Opportunities And Issues, Oct. 30, 2024
- Evolving Risks In North American Corporate Ratings: Climate Change, Oct. 29, 2024
- Data Centers: Welcome Electricity Growth Will Fall Short Of U.S. Data Center Demand, Oct. 22, 2024
- Energy Transition: U.S. Investor-Owned Regulated Electric Utilities Face Hurdles With The EPA's Finalized Rules For Fossil-Fueled Power Plants, Oct. 17, 2024
- North American Utility Regulatory Jurisdictions Update: Some Notable Developments, Sept. 24, 2024

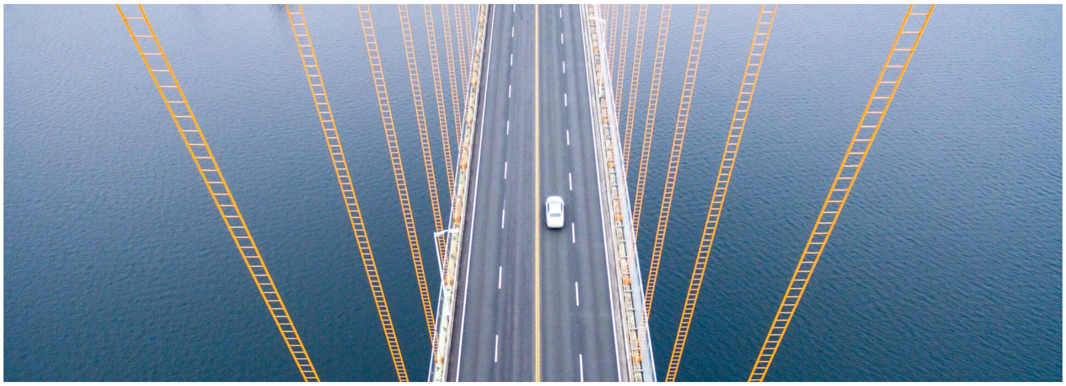
S&P Global Ratings

Transportation Infrastructure

Revenue growth moderates amid geopolitical uncertainties

January 14, 2025

This report does not constitute a rating action.



What's changed?

Our global portfolio's creditworthiness is stable or slightly improving, following strong operations in the past two years and improved balance sheet profiles across transportation asset classes. Transit is recovering but still faces weaker ridership in certain regions.

Mobility trends are normalizing. Global portfolio traffic will return to more GDP-linked rates of growth of about 3% against user fee increases and eroding disposable income.

What are the key assumptions for 2025?

Revenue growth moderates to 5%-6%, as U.S. and China slow, the eurozone and Pacific regions and Asia continues to recover and grow, and emerging markets find their footing.

Issuers shift toward capital investments and merger and acquisition (M&A) activity increases, as outlooks bode well and interest rates decrease.

What are the key risks around the baseline?

Geopolitical tensions and growing protectionism. U.S. and global political changes and associated policy uncertainty could introduce more volatility in certain jurisdictions. Widening tariffs with trade partners and intensifying tensions could hit global trade, consumption and travel patterns, and supply chains.

A sharper-than-forecast global economic slowdown weakening travel demand. Economic performance is paler than we currently forecast, along with higher interest cost burdens.

A slower-than-expected decline in interest rates. Persistent U.S. economic growth and potential tariff-induced inflation are headwinds to further cuts.

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Cross-Sector Outlook

S&P Global Ratings' view on the global transportation infrastructure sector for 2025 is largely stable. Many asset classes operators have now completed their credit recovery and are shifting their focus toward ramping up capital investment programs and shareholder returns. We expect airport operators to advance both replacement and capacity-enhancing projects and toll operators to expand road networks either organically or through M&A activity.

We expect volume growth across most asset classes and mobility patterns to normalize to about 3% growth, correlated to slower economic performance in many countries. This is after most assets having recovered to pre-COVID-19 levels in the past year. Some regions, like Asia, could register higher growth.

We anticipate the transportation infrastructure sector's operating margin will remain stable. That said, geopolitical rifts and trade protectionism policies (i.e., tariffs) will underpin volatility and uncertainty for certain issuers in certain countries; for example, port operators and the logistics value chain could be impacted including air cargo, commercial trucking, rail, etc., although the degree and duration of the impact as well as any potential credit implications are difficult to precisely measure at this time.

Central banks have started lowering their interest rates, and we expect more monetary-policy easing to come, albeit at a variable pace among the multiple jurisdictions. More importantly, the descent of interest rates will be slower than the rise. This will pressure financing costs for deferred and new growth investments and refinancing risk; however, many transportation infrastructure issuers have pushed out their maturities. In addition, trade policies could fuel inflation in many countries, which, along with potentially weaker economic environment and unemployment, will test mobility demand, especially as two years of elevated inflation has significantly increased prices for mobility across the globe.

Finally, larger and more frequent natural disasters threaten to disrupt infrastructure assets in exposed locations (including higher costs for maintenance and indirect costs of insurance). At the same time, the global drive toward a "net-zero" economy heightens transition risks and will require significant investments, particularly for issuers that are highly exposed.

Industry Outlook: Airports

Ratings trends and outlook

Over 85% of our rated global portfolio (including U.S. and Canada public finance) has a stable outlook. Robust travel demand (despite high fares in some regions) has underpinned the financial metrics recovery and, in some cases, stirred a nascent positive rating trend. Going forward, we expect stable air mobility trends. We believe decelerating interest rates will help airport operators advance both replacement and capacity-enhancing projects along with sustainability investments. At the same time, the resurgence of dividend distributions could decelerate rating upside potential for some issuers if not managed prudently.

We assigned an investment-grade rating to JFK Millennium Partners LLC's $1.95 billion project financing issuance to refinance costs relating to the design and construction of the John F. Kennedy International Airport Terminal 6 Redevelopment Project on the sites of the former Terminal 6 and current Terminal 7 in New York.

On Dec. 19, 2024, we assigned an 'A-' preliminary issuer credit rating to Milan's airport operator SEA S.p.A. We view SEA's earnings profile as strong, supported by its solid market position as the largest airport system in Northern Italy (35.3 million passengers in 2023) and high operational diversity and flexibility that will maintain its good traffic growth over the next two to three years. This is anchored by a protective dual-till regulatory framework and a long-term concession expiring in 2043, which we believe will support stability and predictability in cashflows.

In India, we observed positive ratings trends—we upgraded GMR Hyderabad International Airport Ltd. (BB/Stable) on higher approved tariffs and robust traffic, while Delhi International Airport Ltd. (BB-/Positive) was upgraded in July 2023 to 'B+' from 'B' on the back of stronger traffic recovery and profitability, and subsequently again in May 2024 to the current 'BB-' rating due to expected higher tariffs underpinning material improvements in cash flow.

Main assumptions about 2025 and beyond

1. Passenger traffic growth will moderate after a strong post-pandemic rebound.

We expect air passenger traffic growth to moderate to the single-digit-percent across most of our rated airports globally, reflecting stable air mobility patterns.

2. Capital investments will lift over the next year or two to support growth.

With easing inflation (albeit still high in certain jurisdictions) and interest rates beginning to decrease, many airport issuers will resume their focus on deferred maintenance and growth investments. Some rated airports operating close to full capacity are beginning to discuss expansion investments. In the U.S. capital investment has increased significantly across airports of all hub sizes.

3. Climate transition and physical risks factors will gain prominence.

Climate transition and physical risks, depending on the location, could translate into greater capital and investment costs and impact passenger volumes, particularly for issuers that are highly exposed.

Asia-Pacific

Asia-Pacific passenger volume growth will moderate from 2025, after a strong rebound over 2023 and 2024. Across the Asia-Pacific market, seat capacity will strike a better balance as airfares continue to normalize. Still, airline capacity remains a constraint in some markets, which may affect growth.

Greater China's international passenger demand will continue to recover, back to prepandemic levels over the next 12-18 months. In mainland China, we expect capital expenditure (capex) momentum to moderate, and new investment will be increasingly based on demand.

Hong Kong airport capex will likely stay elevated over 2025, and focus will stay on the capacity expansion and passenger experience upgrade-related projects. We expect debt to climb further and delay credit metric recovery. Despite our estimation of passenger volume steadily returning to prepandemic levels by mid-2026, airline capacity and labor shortage remain key constraints.

South Korea traffic volume in 2025 will exceed that of prepandemic levels, after a full recovery in 2024. The newly added fourth runway and the expansion of Terminal 2 could further boost Incheon International Airport's revenue on the back of increased handling capacity. We forecast all revenue streams for the airport—including revenues from duty-free shops—will grow in the next two years.

Total passenger traffic for Indian airports will increase 8%-15% annually over fiscals 2025 and 2026 (ends March 31). Both domestic and international passenger traffic surpassed prepandemic levels by at least 110% since early fiscal 2024. Strong demand for both leisure and business travel, higher airline capacity, and more daily flights on commissioning of recent terminal expansions will support traffic growth. Margin improvement will also be supported by higher nonaeronautical revenue following the completion of terminal expansions, particularly in the retail and duty-free segments.

We expect 3%-5% growth in passenger volume for Australian and New Zealand airports in 2025. Some airports have exceeded pre-pandemic traffic levels, while others will achieve this by the end of 2025. Aero-related capex will remain elevated over 2025 to 2027 for capacity addition and is backed by agreed pricing with the airlines.

Europe, the Middle East, and Africa (EMEA)

Moderate traffic growth in the lower-single-digit percent area for European airports. We expect European airports' credit quality to remain sound on the back of the industry's strong business fundamentals and recurring cash flows. Higher indebtedness still poses a challenge for most airports while management teams develop future strategies on investments and shareholder distributions. There is ratings upside potential for European airports whose credit metrics are improving thanks to robust traffic, favorable tariff regulations, manageable capex plans, and, ultimately, accommodating their debt structures to the post-pandemic environment.

Europe is leading the initiatives around limits on CO2 emissions that could result in restrictions on capacity deployment and lower passenger growth, especially in those regional airports relying on short-haul flights that can be replaced by rail journeys as mobility transition gains traction.

The ongoing dynamics of European airports are currently stable, with airports returning into business as usual. Under our base case, we expect the performance of each airport in 2025 to be mainly driven by the competitive position of each airport, rather than by sector trends like over the last five years. As part of this return to business as usual, we will monitor closely how the gradual restart of the shareholder dividends impacts and supports our forecast credit metrics.

North America: U.S. and Canada

North American airports have fully recovered from pandemic-related passenger declines, aided by a shift in consumer preferences for experiences (instead of goods). There are some large hub exceptions where regional business travel has not fully returned, often offset by growth in international traffic.

The annual 2025 passenger growth rate in the U.S. is likely to slow to 2%-3% as airlines pull back on domestic overcapacity due to stagnating demand as well as the weakness of ultra-low-cost carriers (e.g., the recent bankruptcy filing of Spirit Airlines), well-documented new aircraft delivery delays (i.e., the Boeing 737 Max), and engine reliability issues (i.e., the Pratt & Whitney PW1100G geared turbofan hamper operations.) There still remains a high propensity to travel, though down from the post-pandemic rebound.

Strong demand will drive passenger growth of about 8.5% in 2025 for rated Canadian Airport Authorities (CAAs), although aircraft availability constraints continue to weigh on the network. As expected, passenger volumes for rated CAAs continued to moderately grow in 2024 at about 6% year over year in total, and volumes have nearly recovered back to prepandemic levels.

Latin America

Traffic will continue to grow for airports at 2x-3x the region's GDP growth rate. Our forecast also considers strong demand from the U.S., especially for tourism; gradually stabilizing economies in Mexico and the Caribbean; and most regional airports to continue expanding above prepandemic levels. These increased volumes have triggered expansion needs as airports reach operation saturation. We see airports in the region focused on expanding and modernizing existing facilities—primarily by expanding terminals and runways in major cities. However, some countries may not be able to adequately address future air transport demand given the lack of space adjacent to airports.

Several countries have started major airport expansion projects, which we expect will boost the operators' capacity and create new opportunities for airport-related businesses. For instance, Brazil is investing heavily in its main airport, Sao Paulo-Guarulhos International Airport, while Mexico inaugurated the Aeropuerto Internacional Felipe Angeles in Mexico City in 2022 and a new airport in Tulum. On the opposite side, Mexico City Airport annual capacity has been capped at about 42 million passengers, forcing the migration to adjacent airports.

As leisure travel demand is growing, driven by a rising traffic mainly from North America since the pandemic, several Caribbean islands (Turks & Caicos, US Virgin Islands) are now considering private partnerships to renew and expand their airport capacity, as was the case for Jamaica's Kingston Airport, Aeropuertos Dominicanos in the Dominican Republic, and San Juan Airport in Puerto Rico. That said, many of these airports face physical climate challenges that weigh on our downside risk analysis.

Credit metrics and financial policy

Asia-Pacific

In Asia-Pacific, capex and distribution policies will drive the credit metric trends. Capex will expand in many countries in the next couple of years, and some airports have resumed paying dividend distributions. Those having completed their key expansion projects could see improving credit metrics driven by traffic and deleveraging efforts.

For Hong Kong, continuous increase in debt and funding costs will offset most of the cash flow improvement, leading to a slow credit metrics recovery. The size and schedule of its expansion capex are key credit drivers for Airport Authority Hong Kong. Its financial metrics could also face pressure if the air traffic volume and cash flow recovery detract to below our expectation.

For South Korea, operating performance and financial metrics at Seoul's Incheon International Airport are likely to further improve in 2025 and 2026. This is largely due to a fast recovery in passenger traffic and the completion of the Phase 4 expansion. We expect capex to substantially decline in 2025 from the peak in 2024 when the expansion was completed.

For Indian airports, we need greater clarity on dividend policies considering stronger cash flows, which is underpinned by robust recovery in traffic and profitability, and expected higher tariffs that incorporates investment in expansion capex. We believe relatively attractive onshore rates and multiple financing options will support expansion plans. Onshore financing remains key to debt financing, and rated airports tapped the domestic debenture market to refinance some of their U.S. dollar bonds in 2024, given that the cost of onshore debt has not increased as much as for offshore debt. Private markets could provide an alternate source of funding amid tougher market and financing conditions.

Credit metrics will remain steady for Australian and New Zealand airports. They will need to strike a balance between debt usage and equity to fund capex to preserve their credit profile. Rated airports are committed to their credit profile and will exercise flexibility on their capex, particularly discretionary nonaeronautical capex.

EMEA

Our ratings on European airports will mainly depend on each airport's financial discipline to cope with peak capex and shareholders' deferred compensation when the sector debt leverage has increased by 20% in the past years. Our rated airports began to recover on investments from 2023, and we expect a strong pipeline to remain under our projections in 2025 and 2026. In terms of dividends, our issuers displayed a prudent financial policy that supported our ratings, and that delayed the recovery on dividends toward 2025. Under our projections, by 2026 our portfolio will return to a level of dividends that will be comparable and slightly above than that of 2019, and we project 2025 levels will be approximately one third of our forecast for 2026.

North America: U.S. and Canada

In the U.S., high passenger volumes and inflation-related concession revenues growth fuel top-line growth for airports and rising operating expenses and debt service increases did not uniformly hamper 2023 financial performance (as highlighted in our annual median report) with similar ranges likely in 2024. For 2025, we expect debt levels will continue to grow as capital investment ramps up to update facilities and add capacity. Credit ratings for consolidated rental car special facilities at airports have fully recovered, and we anticipate the generally strong financial performance will continue.

In Canada, continued strong growth in passenger volumes will bolster CAAs' revenues in the coming year, with support from annual increases to aeronautical fees. In some cases, increases to Airport Improvement Fees to fund large capital programs will mitigate debt issuance.

Latin America

Latin America airports' financial metrics could come under pressure due to investments in infrastructure and environmental sustainability amid pressure over high interest rates. In addition, the latter also puts pressure on refinancing costs, hence we expect they will weaken coverage ratios.

In many cases, our ratings on Latin American airports are linked to those on respective sovereigns, making sovereign rating actions a crucial factor in rating changes on the airports. This is either because airports are government owned or because of the regulated nature of the airport's tariffs. This was the case of the recent downgrade of Aeropuerto Internacional de Tocumen S.A., which we downgraded to 'BBB-' from 'BBB' following the same action on the sovereign on Nov. 27, 2024.

Key risks or opportunities around the baseline

1. Traffic growth could be lower than we forecast due to affordability concerns.

Stickier inflation could pressure consumer spending on air travel.

2. Geopolitical tensions could weigh on travel demand.

Geopolitical tensions could reduce leisure traffic and redirect routes to or from Asia-Pacific, but for the overall portfolio the impact is limited at this stage.

3. Aggressive shareholder returns and growing capital investment needs could increase debt levels.

Higher shareholder returns may elevate debt levels, especially when these are not commensurate with traffic growth.

Traffic growth could be lower than we forecast due to affordability concerns. The prospect of stickier-than-expected inflation, as well as a slower-than-projected drop in borrowing costs could pressure consumer spending on air travel, particularly if ticket prices remain elevated.

Geopolitical tensions could weigh on travel demand. Geopolitical tensions in Europe (i.e., Russia-Ukraine) and the Middle East could reduce leisure traffic on some touristic destinations and redirect routes to or from Asia-Pacific, but for the overall portfolio the impact is limited at this stage.

Aggressive shareholder returns and growing capital investment needs could raise debt levels. Higher-than-expected shareholder returns, and growing costs of capital investment and deferred maintenance may result in elevated debt levels and pressure financial metrics, especially when these are not commensurate with traffic growth.

Ratings Trends: Airports

Chart 1

Ratings distribution

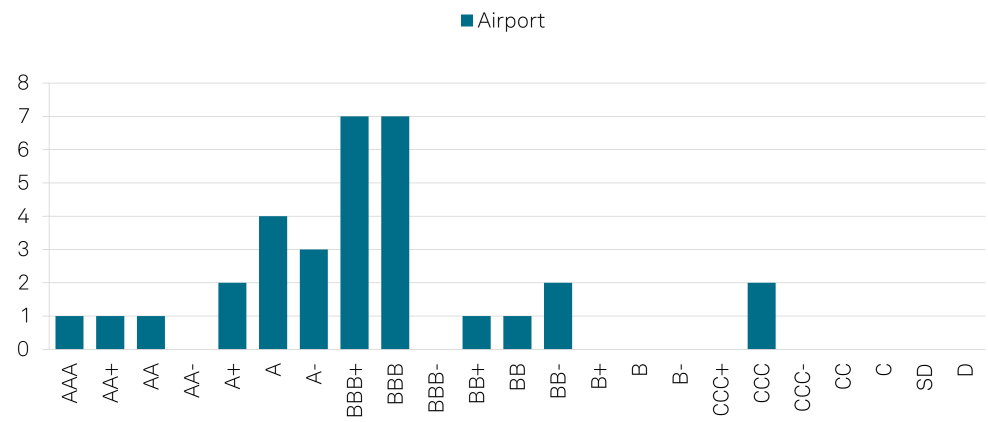


Chart 2

Ratings outlooks

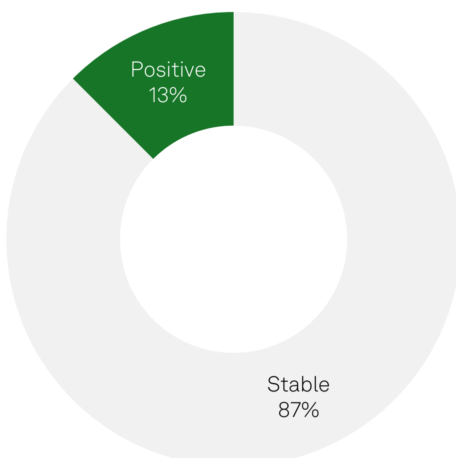
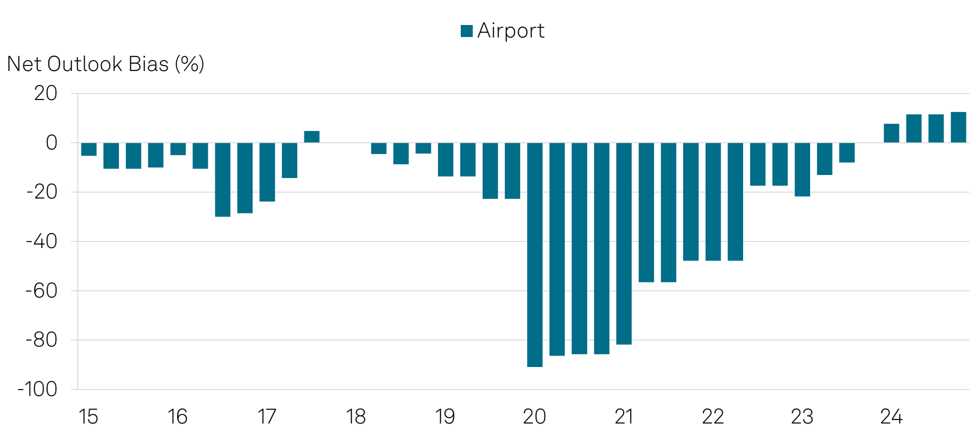


Chart 3

Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Credit Metrics: Airports

Chart 4
Debt / EBITDA (median, adjusted)

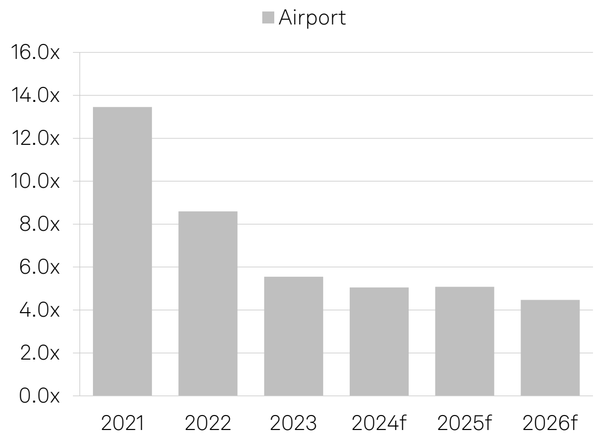


Chart 5
FFO / Debt (median, adjusted)

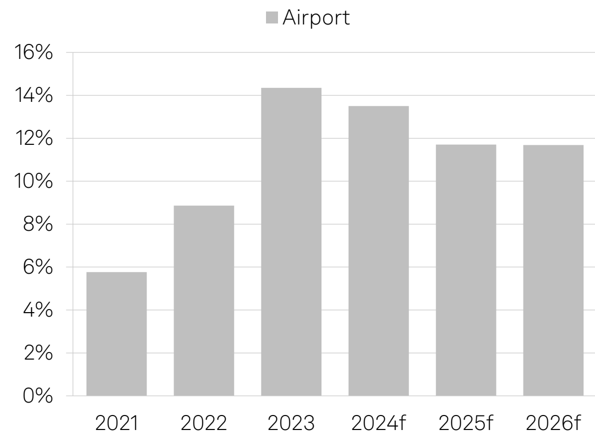


Chart 6
Cash flow and primary uses

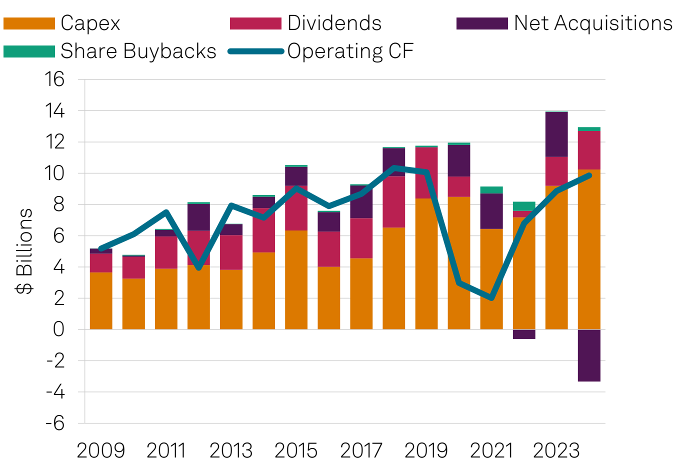
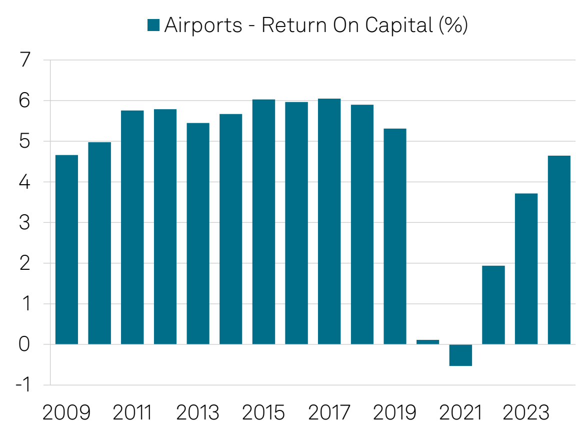


Chart 7
Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2024) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: Ports

Ratings trends and outlook

About 60% of our rated portfolio currently has a stable outlook, and 25% has a positive outlook. In EMEA, the few negative outlooks are driven by external factors rather than the asset's stand-alone performance. Given ports' relevance to their local and regional economies, most of our rated ports have strong links to the credit quality of their respective sovereign, either because of material ownership or because the rating on the country caps the issuer credit rating.

Geopolitical tensions and protectionist trade policies will test the resilience of port issuers across the globe and may curb capital investments. That said, our rated ports in general have a larger buffer in their credit metrics to withstand potential downturn volume risk and volatility.

We assigned an investment-grade rating on the first North America cruise port P3 San Juan Cruise Port LLC's $187 million notes, which will fund the construction and operation of the San Juan Cruise Terminal project. The project is exposed to full passenger volume risk.

We revised our outlook on Adani Ports and Special Economic Zone Ltd. (BBB-/Negative) to negative in November 2024, reflecting the potential impairment on its funding access and increase in funding costs. This follows a U.S. indictment of three board representatives of an unrated Adani group entity that could affect investor confidence in other Adani group entities (because the founder is on the board of multiple entities within the group). In our view, this could further raise questions regarding the management and governance of various Adani group entities.

The negative outlook was a reversal of our earlier positive outlook in June 2024. The positive outlook then reflected our view that Adani Ports' strong competitive position and diversification will support healthy cash flows.

Main assumptions about 2025 and beyond

1. Geopolitical tensions weigh on our volume and capital investment forecast.

Regional conflicts and trade protectionism policies curb and add volatility to our volume growth forecast. Similarly, we expect subdued capital investments until there is clarity on global trade conditions.

2. Strong competitive advantages support top lines.

Long-term contracts, diversity in cargo and customers, and pricing flexibility soften the blow.

3. Operational challenges remain manageable.

Highly efficient ports should be able to navigate through delays and congestion.

Asia-Pacific

Uncertain trade and foreign policies from the incoming U.S. administration. More tariffs against Chinese exports are likely. We factor in a rise in the effective U.S. tariff rate on Chinese imports to 25% from 14% from the second quarter of 2025, and retaliation by China in kind. Countries with a large trade surplus with the U.S. (Vietnam, Thailand, Malaysia, and India) could be vulnerable to universal tariffs.

Mainland China's throughput growth will decelerate against weakening exports. Policies by the U.S. new administration will shade the momentum as about 15% of China's exports are shipped to the U.S. Some factories may also rush shipments early 2025 in expectation of additional tariffs from later 2025. This could frontload demand to a certain extent, as evidenced by fast export growth in the past couple of months. With a weaker throughput outlook, we believe a port-handling tariff hike is less likely to materialize in 2025 given the looming downside risks of throughput.

Throughput growth in Hong Kong may stay soft, with intensified competition from other ports in the Greater Bay Area. Hong Kong's throughput narrowing will not likely recover substantially in the near term.

Rising cargo and resilient container volumes in India support port revenues. Good operating efficiency and medium-term contracts for containers support healthy margins.

Australian and New Zealand ports' trade volumes will grow modestly. Continuing cost-of-living pressures will result in lower import volumes, while containerized and bulk exports are resilient, aided by agricultural commodities. High-margin motor vehicle imports will ease a bit after strong growth in the past two years. Earning growth will also be supported by still-high inflation, linked pricing, and secure property rentals.

EMEA

The ports in EMEA we rate have shown a robust performance and resiliency to shocks over time given their strategic location or critical role to the local, and sometimes national, economies. This supports our expectation that as volumes and trading routes readjust, volumes will grow back at the same rate of the GDP of the port area of influence, and in some cases slightly higher as capacity extension or acquisitions are completed. We expect yields to be flat with limited upside potential as economic and geopolitical turmoil ease.

North America: U.S. and Canada

U.S. ports will face the highest level of uncertainty due to proposed tariff increases and anticipated retaliatory measures impacting both imports and exports. We forecast volume measures in both tonnage and containers will demonstrate growth in 2024 over 2023, aided by the threat of tariffs and, in the U.S., a potential strike by the International Longshoremen's Association on Jan. 15, 2025. While an East Coast strike was averted in October 2024, there appears to be no agreement in sight between labor and the shipping lines regarding automation, including the use of rail-mounted gantry cranes sought by carriers.

For San Juan Cruise Port, we expect passenger volumes will fully recover to 2019 levels by 2026.

In Canada, we expect modestly stronger growth in volumes in 2025, relative to 2024, on the back of stabilization in operations and steady economic activity. The largest Canadian port authorities experienced labor unrest that stopped operations in November 2024. The Federal Labour Minister issued an order to end the disputes following a 10- and seven-day lockout at the Ports of Vancouver and Montreal, respectively, citing the economic impact that could materialize from a prolonged disruption.

Latin America

Potential pressures on global trade will limit port operators' ability to adjust rates like in other regions. We expect flat volumes among Brazilian ports in 2024 as higher exports of agricultural products and protein will be mitigated by lower import volumes. There are new ports that were constructed in Peru dedicated to mining exports to China.

The Panama Canal remains exposed to hydrological cycles, while it doesn't execute and complete investments to address its water scarcity issues. About 3% of the world trade flows through the Panama Canal, which could be constrained by severe drought cycles that happens every two to three years in the country. In the 2023 El Niño cycle, the Autoridad del Canal de Panama was forced to limit operations to 22 daily transits for the first time (versus 35 historically). Because we expect this type of event to be more frequent and severe in the near future, we will monitor the execution of its mitigating investment plan, which will likely increase vessel traffic by approximately 11-15 daily Panamax-equivalent transits and provide an additional resource of water. On the rating side, a potential negative impact is offset by a cushion to its 'aa' stand-alone credit profile to its 'BBB+' issuer credit rating due to sovereign cap (capped at two notches above the sovereign).

Credit metrics and financial policy

Asia-Pacific

Our rated issuers will withstand volume risks despite uncertainty on trade throughput. We expect our rated Chinese issuers' financial metrics to mildly trend down given their continued capital spending needs for new capacities. Particularly, some are operators of the largest ports in mainland China that have been running at nearly full capacity, such as Shanghai Port and Yantian Port, with planned capacity expansion. That said, our mainland China and Hong Kong issuers have ample credit buffers against volume risks given their strong operating cash flow and paced capital spending.

Australian and New Zealand rated ports have strong balance sheets. These are likely to be absorbed by higher shareholder distributions and/ or opportunistic capex, such as property development, berth extensions, and trade diversification. Policy commitments to their ratings means shareholder distributions will be restrained should the need arise.

EMEA

In EMEA, EBITDA margins will remain comfortably above the industry average, with some exceptions given their distinct business propositions. Financial leverage also varies significantly on the capital intensity of each port's business models. Growth driven by acquisition plans and aggressive expansion plans weighs more severally on leverage ratios amid uncertainty and high dividend payouts. That said, both capex and dividends have been flexible when facing downside risks.

North America: U.S. and Canada

In the U.S., strong volumes in 2024 are likely to carry through the first quarter of 2025, after which the implications of any tariffs may be observed. As activity slowed in late 2022 and into fiscal 2023, ports experienced a 2% median decline in tonnage and 5% growth in operating revenue, while operating expenses increased 14%. As a result, fiscal 2023 median coverage declined but remained strong at 2.8x, with debt capacity and liquidity remaining relatively stable. Despite inherently exposed to volatility, many U.S. not-for-profit ports we rate have very strong market positions due to their critical role in supporting various industries, local and regional economies, and the overall health of the U.S. economy. While there could be some short-term disruptions—there is the possibility of a U.S. east coast port strike in January 2025—we believe port operators have the long-term credit strengths to absorb near-term volatility.

In Canada, two companies are undertaking significant capital programs that each involve building a new terminal (Vancouver Fraser Port Authority and Montreal Port Authority). We expect the financing plan for both to include an increase in their approved debt limit to accommodate the funding needs of these projects. As a result, we expect the authorities' coverage and debt metrics will weaken during the construction period before improving once the terminals are open.

Key risks or opportunities around the baseline

1. Trade tensions and geopolitical factors.

Trade tensions may accelerate the relocation of supply chains to several alternative countries in Southeast Asia and elsewhere. Similarly, geopolitical factors could affect supply chain or shipping routes.

2. Modernization.

Infrastructure remains a key focus of investment and a main differentiating factor for the ports we rate. Significant investments will be required for ports to facilitate vessels' transition to clean energy.

3. Continued disruptions.

Additional investments may be required to manage its challenges to ports' reliability.

Trade tensions and geopolitical factors present key challenges. Trade tensions remain a key downside risk for throughput growth for Chinese port operators over the next several years. This may also accelerate the relocation of supply chains to several alternative countries in Southeast Asia and elsewhere, or via reshoring and near-shoring. Similarly, geopolitical factors could affect supply chain or shipping routes.

Modernization drives efficiency and attractiveness. Infrastructure to accommodate large vessels and handle them more efficiently, together with automation and digitalization, remain a key focus of investment and a main differentiating factor for the ports we rate. Additionally, significant investments will be required for ports to facilitate vessels' transition to clean energy and drive electrification and energy efficiency.

Continued disruptions can be costly to ports' standing. In the face of congestion and inefficiencies that increase operational costs, additional investments may be required to manage its challenges to ports' reliability.

Ratings Trends: Ports

Chart 8

Ratings distribution

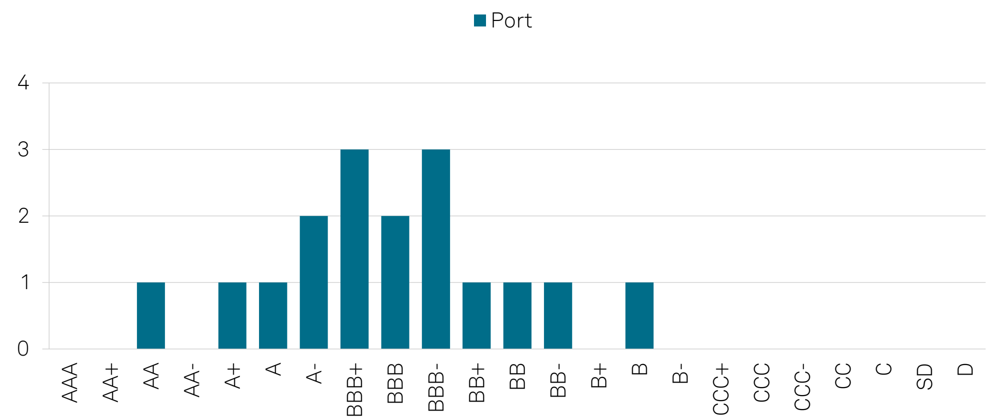


Chart 9

Ratings outlooks

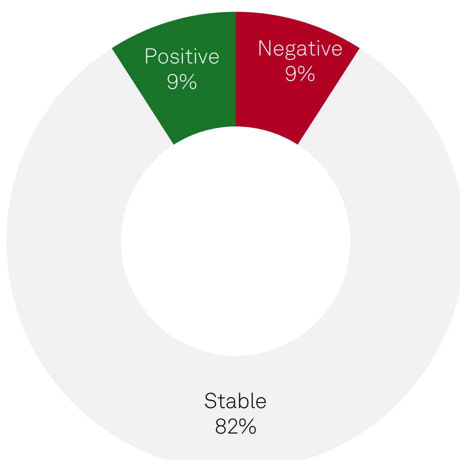
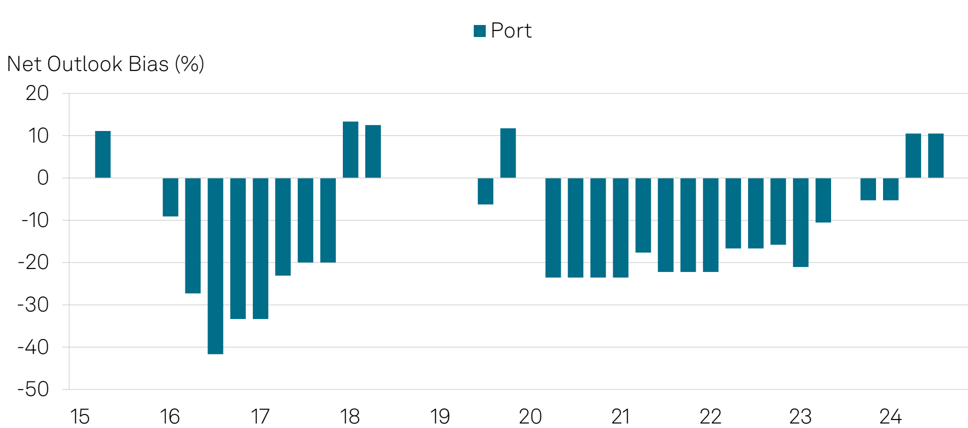


Chart 10

Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Credit Metrics: Ports

Chart 11

Debt / EBITDA (median, adjusted)

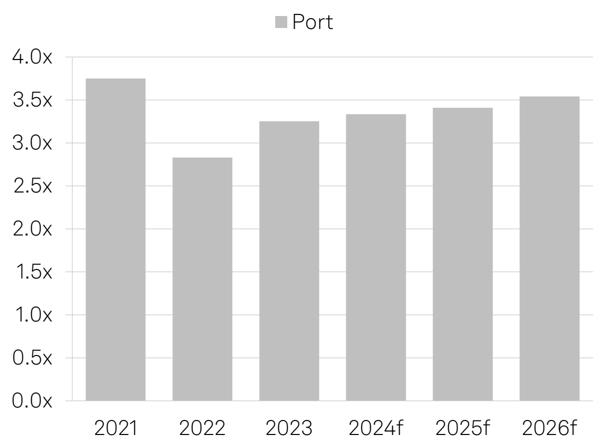


Chart 12

FFO / Debt (median, adjusted)

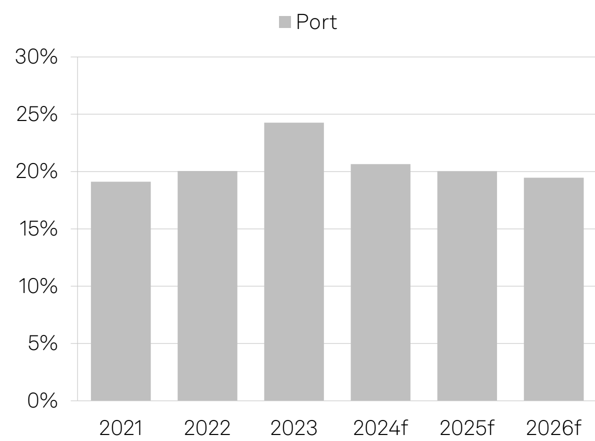


Chart 13

Cash flow and primary uses

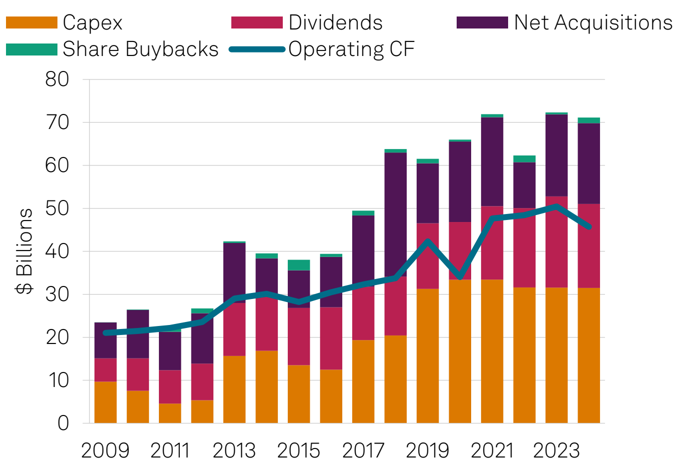
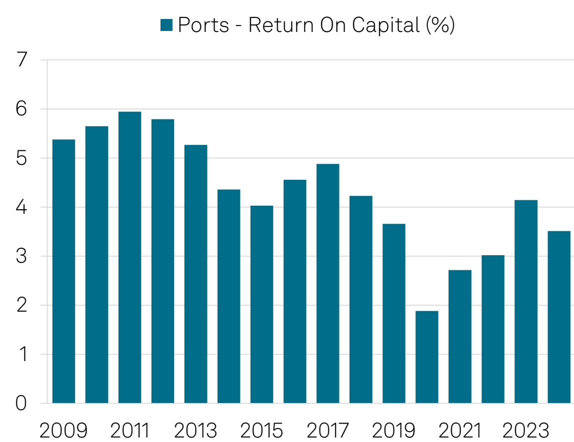


Chart 14

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.

Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2024) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: Roads

Ratings trends and outlook

Not surprisingly, 100% of road operators (corporate global and not-for-profit north American issuers) have stable outlooks because this asset class has seen strong performances and financial resiliency, supported by strong revenue growth in past two years on inflation linked to toll increases. With inflation easing, we expect revenue growth for most toll operators to normalize. We have one negative outlook on a North American project financing asset, Toll Road Investors Partnership II. We also lowered the rating on this toll road following the rejection of its entire toll rate increase request, resulting in significant uncertainty around potential future toll increases and mounting pressure on the project's liquidity, as traffic remains well below prepandemic levels.

We expect capital spending and investment activity to increase in this sector and for toll operators to expand road networks either organically or through M&A activity, add express/managed lanes, and finance the ongoing shift toward all-electronic or open-road tolling (albeit at significantly high construction costs or valuation in the sector).

In Canada, the Federal Bridge Corp. Ltd. owns, manages, and operates the Canadian interests of four international bridges and associated structures between the Province of Ontario and the United States. While the current outlook is stable, as a provider of efficient transportation of goods between Canada and the US., it is significantly exposed to uncertainty due to potential tariff increases.

Main assumptions about 2025 and beyond

1. Revenue growth normalizes.

We expect earnings growth to moderate in most markets, driven by modest traffic growth and normalized toll increases. That said, toll fatigue could emerge as a risk in some countries.

2. M&A activity accelerates.

There will be high levels of activity either through steps to acquire new concessions, extend existing concessions, or M&A.

3. Leverage rises.

We expect leverage to increase either due to new debt-funded investments or shareholder-friendly practices.

Asia-Pacific

We expect traffic growth to moderate to below 5% in Asia-Pacific. We expect mainland China toll road traffic volume to grow at below 3% in 2025, slower than 2024 levels, due to base effects and China's economic slowdown. Potential hits to Chinese export from U.S. tariff hikes and lower investments in face of uncertainties may drag freight transportation. Sluggish consumption confidence and household income may hit small-sized vehicles' traffic. Moreover, toll revenue growth will likely be lower than traffic growth due to the government's overall goals to lower logistics expenses. At the same time, toll road investment will stay elevated because part of concessions are expiring in the next few years.

We expect South Korea revenue to increase in 2025, compared with 2022-2024, backed by strong traffic volume growth. After the completion of phase 1 of Seoul-Sejong Expressway, we project traffic volume will grow more than 5% in 2025. We forecast capex will moderate in 2025 because many investments have been already executed.

We forecast Australian toll road traffic will grow 2-4%. Some roads could face negative or tepid growth due to construction activities or cost pressure on consumers. Still, inflation-linked or fixed toll increases will assist earnings growth. Limited domestic opportunities could cause the Transurban group, the only rated toll road operator, to look offshore for growth.

EMEA

Traffic growth in European roads of 1%-2% in 2025, in line with expected GDP growth, with revenues supported further by inflation passthroughs. Therefore, we expect revenue and EBITDA growth of 2-3% in 2025. At the same time, we forecast higher capex in our portfolio and slightly lower dividends in 2025 compared with 2024. The European rated toll road portfolio is solidly positioned and expected to remain stable.

Finally, our European portfolio is heavily exposed to the dynamics of French toll roads, which are approaching the last 10 years of their concessions, so we expect them to gradually deleverage ahead of their maturities. This would improve credit metrics but wouldn't necessarily reflect a rise in overall creditworthiness. We expect European infrastructure companies, particularly those focused on brownfield operations, to continue monitoring acquisitions and auctions abroad given the limited pipeline in Europe through the concessional model.

North America: U.S. and Canada

For North American P3 toll roads, revenue growth will moderate in 2025, following significant toll increases (in some cases, 10%-15%) in 2023 and 2024. We expect toll rates increases to revert to historic levels except for 407 International, which raised its tolls and fees by more than 20% (based on our calculation) for 2025. As we anticipated, despite the high toll increases in the past two years, most toll roads continued to see modest traffic growth in 2024. We expect this trend in commuter traffic to continue in 2025.

However, the new U.S. administration's platform includes shrinking federal government employment, which could affect commuter volumes if executed, especially for rated toll roads in Virginia. For freight traffic, there remains some uncertainty over its growth with the new administration’s tariff plan; that being said, most P3 toll roads are not materially exposed to freight traffic except ITR Concession, which generates almost 75% of its revenues from freight traffic.

For U.S. not-for-profit issuers, our expectations for traffic and transaction growth of 1%-2% are slightly lower but aligned with GDP as stable fuel prices and benign economic conditions support stable to slow growth. All eyes will be on the implementation of congestion pricing in New York City beginning in January 2025. How the transportation network changes (e.g., regional bridge and tunnel volumes, transit ridership, and overall congestion in Manhattan and in the region) as well as the congestion charge revenue performs will be of great interest to a large group of stakeholders.

Latin America

Vehicle volumes on roadways will grow at 1.0x-1.5x elasticity to GDP, considering a slowdown on trade volumes globally. This follows historical higher growth of 3x-4x elasticity to GDP growth in 2024, driven by heavy-vehicle traffic, particularly in Brazil and Mexico, where robust exports supported the economic performance. We expect capex to rise among Brazilian entities that expanded their portfolios by participating in new concession auctions. Indeed, we observed record new issuances to fund transportation assets in the Brazilian local market, totaling R$28billion (up to November 2024), about 80% higher than in the previous year, and we expect it to repeat in 2025. We also expect maintenance investments earlier than we previously projected due to the degradation of pavement caused by greater heavy-vehicle volumes.

In Mexico, we believe the imposition of higher import taxes in the U.S. coming from the new administration may result in lower growth trajectory, in comparison to past volume increases. Still, we don't expect a decline because Mexico is part of the supply chain of many industries in the U.S. and would be hard to replace. Finally, we expect metrics to remain generally stable in the next one to two years as growing revenue offsets capex in some markets.

Credit metrics and financial policy

Asia-Pacific

Leverage remains high or increases for most Asia-Pacific issuers. Mainland China's toll road operators' financial leverage will likely rise given their large investment need to undertake expansion projects to renew part of their concession rights. At the same time, operators from several major economically advanced provinces are mandated to sustain spending in transportation infrastructure in the country.

In South Korea, financial leverage will remain weak in 2025, because debt will likely stay elevated due to maintenance needs and phase 2 of construction of the Seoul-Sejong Expressway.

Australia-based Transurban group's balance sheet remains strong. The group is committed to its rating and will fund any new opportunities appropriately. While the group retains an active interest in the U.S. market, it will balance any offshore growth against any potential domestic opportunities.

EMEA

The financial policies of some of the European road operators will play a key role as the majority of their concessions mature over the coming fifteen years. The issuer closest to maturity in our rated portfolio is Holding d'infrastructures de transport S.A.S., which faces the maturity of its main concession in December 2031.

The new tax on long-distance transport infrastructure for French toll roads impaired the EBITDA of our European portfolio in 2024 (see 'New French Transport Infrastructure Tax Could Delay Operators' Long-Term Deleveraging', published on Jan. 22, 2024). We include this tax under our calculation of EBITDA, rather than on taxes. The French toll roads could also be exposed to a one-off negative impact should the Corporate Income Tax increase for fiscals 2024 and 2025. Such an increase is included in the draft of the French 2025 Finance Law that is currently under discussion in the French Parliament and could affect the cash flows of the impacted companies in 2025 and 2026.

North America: U.S. and Canada

Project financing toll roads typically maintain their credit quality by releveraging on the back of credit metric improvements (based on inflation-linked toll increases and unfettered demand response). Despite the high interest rates, toll road sponsors continued to take debt-funded distributions, driven by substantial toll revenue growth. Additionally, revenue growth supported refinancing at higher interest rates.

With increased costs of building infrastructure projects and high interest rates, the Transportation Infrastructure Finance and Innovation Act (TIFIA) loan will continue to play a critical role in financing upcoming managed lanes for P3s.

For U.S. not-for-profit toll roads, issuers with tolling policies linked to the CPI or other inflation-linked measures might report higher revenue growth in 2025, although some could defer allowable rate increases for fear of public opposition to maintain toll affordability, or because of previously implemented toll increases in recent years. In 2023, toll road financial metrics remained resilient despite higher expenses and increased debt loads, with higher traffic demand and toll increases producing a 5% median growth in operating revenue, and we expect similar ranges in 2024 and 2025.

As toll-related revenues increase from enforcement, fines, late fees, and penalties, there is often corresponding pressure from policymakers in some states to place limits or caps on these enforcement amounts, which could lead to higher toll rates to make up the difference. Lost revenue from open road tolling (i.e., removal of booths and reliance on electronic toll collection) remains an issue for many operators, though it is still manageable from credit perspective.

Latin America

In Latin America, financing conditions are likely to be tighter to fund its investments, given forecast higher interest rates in the region, while costlier interest expenses continue consuming a considerable portion of the companies' cash flows. High inflation and a weaker economic performance could hamper Chilean toll road operators, as inflation-adjusted toll rates start to weigh on commuter traffic. Finally, we are monitoring the development of the early termination of the Rutas de Lima toll road concession in Peru, announced in early 2023.

Key risks or opportunities around the baseline

1. Regulation risk in mainland China.

The regulation revision outcome remains pending. The revision will likely reform concession periods and payback mechanisms of new projects.

2. Highly leveraged M&A or shareholder friendly policies.

Valuation for this asset class has been growing significantly. The ratings of toll road operators could be hindered if they fund this M&A activity with material leverage.

3. Affordability concerns in some countries.

Toll rates have grown significantly. A rise in unemployment and weaker economic performance could hurt travel demand in some countries.

Regulation risk will matter in mainland China. The regulation revision outcome remains pending. The development of the country's "Regulations on the Administration of Toll Road" policy has been stalling, while the bulk expiry of toll road concession is approaching. The revision will likely reform concession periods and payback mechanisms of new projects, under a backdrop of heavy debt burden and diminishing returns in the sector.

Highly leveraged M&A or shareholder friendly policies could weigh on the ratings. Given the resiliency of toll road assets, valuation for this asset class has been growing significantly. The ratings of toll road operators could be hindered if they fund this M&A activity with material leverage.

There are affordability concerns in some countries. With 7%-15% toll increases in the last two years, toll rates have grown significantly. As consumer strength weakens, a rise in unemployment and weaker economic performance could hurt travel demand and commuting patterns in some countries.

Ratings Trends: Roads

Chart 15
Ratings distribution

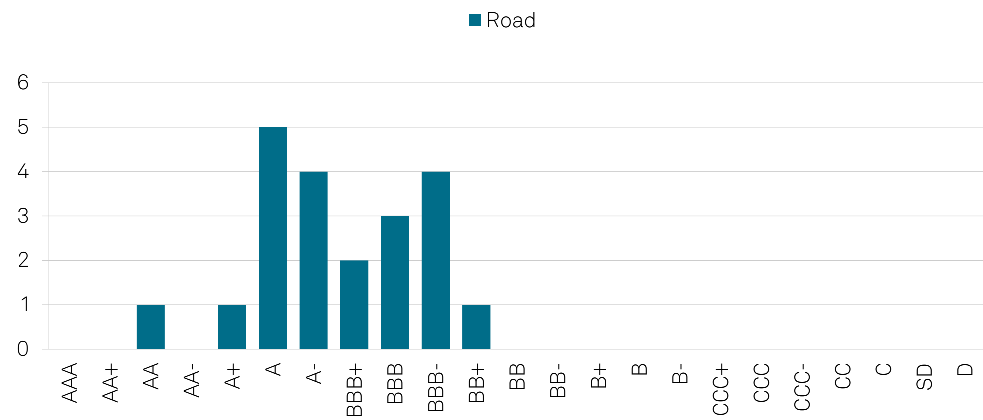


Chart 16
Ratings outlooks

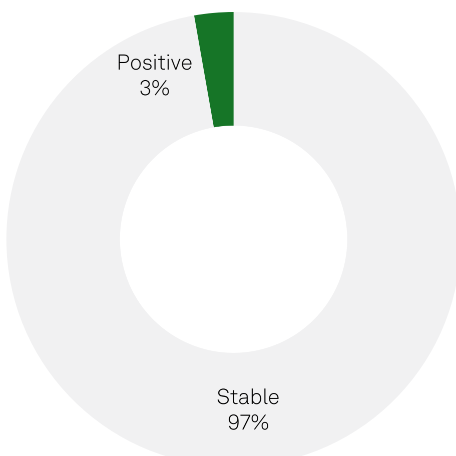
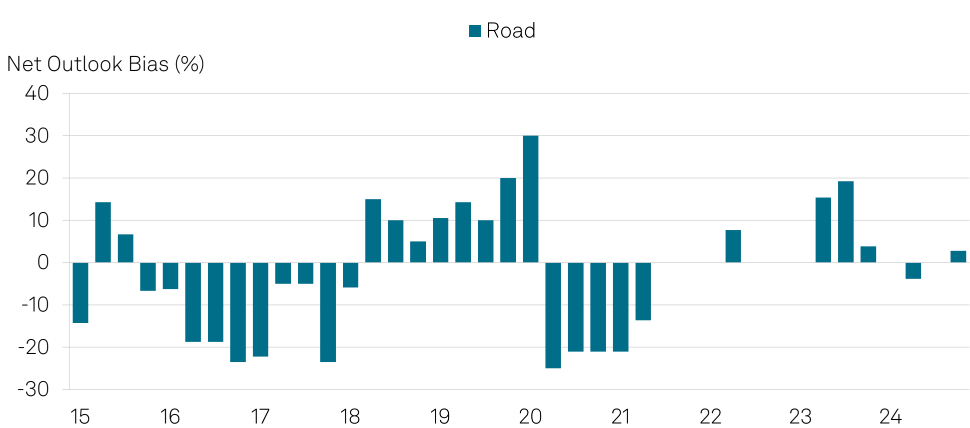


Chart 17
Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Credit Metrics: Roads

Chart 18

Debt / EBITDA (median, adjusted)

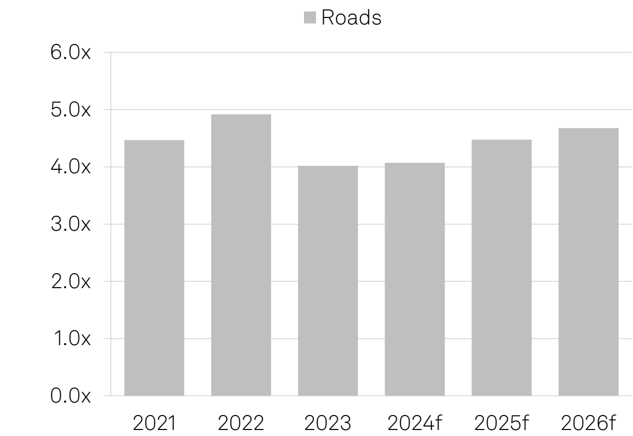


Chart 19

FFO / Debt (median, adjusted)

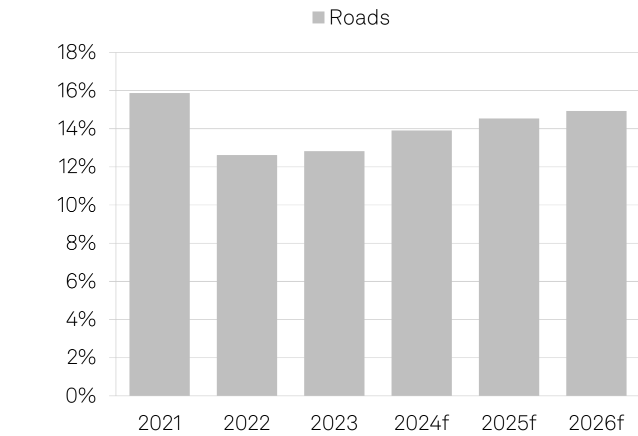


Chart 20

Cash flow and primary uses

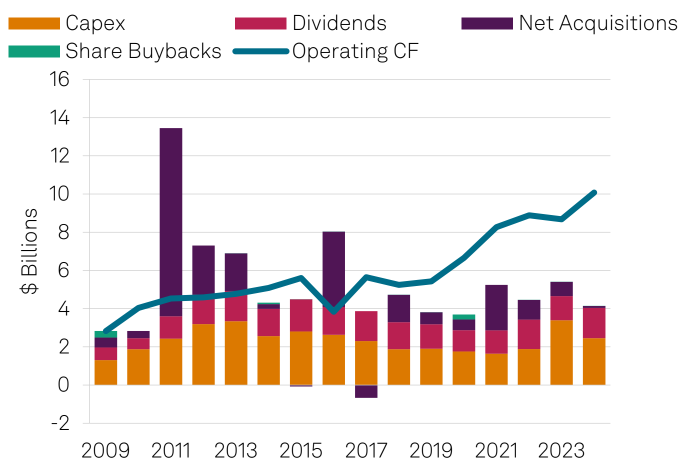
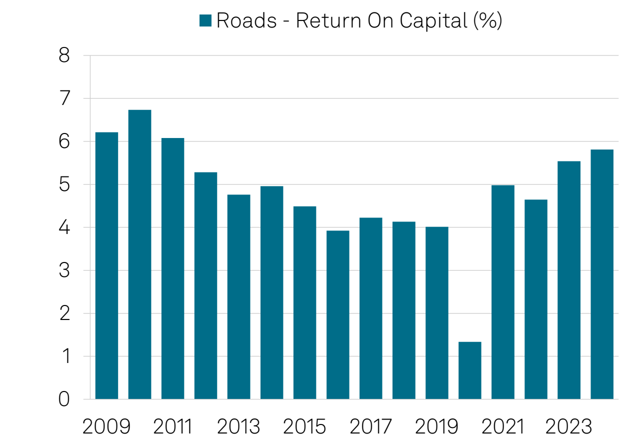


Chart 21

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2024) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook: Railways And Mass Transit

Ratings trends and outlook

We revised our sector view to stable from negative for U.S. public mass transit operators in September 2024. This was due to stabilizing credit fundamentals from dedicated tax revenue growth often outpacing fare revenue decreases, recovering-but-still-weaker ridership, and operators' ability to adjust service levels and expenses to restore fiscal structural operating fund balance. In other regions, railways and mass transit issuers have now recovered or will recover to prepandemic levels. We expect slow but stable operating performance at these issuers, which is reflected in our stable outlooks for over 80% of rated railway and mass transit operator ratings. We also still have negative outlooks on two railway operators in Europe, mirroring their respective sovereign ratings.

We assigned ratings on the first private railway project in North America in over 100 years, a 235-mile, high-speed rail (HSR) system that runs from Miami to Orlando with full ridership risk. We assigned a 'BBB-' to Brightline Trains Florida LLC's $2.2 billion notes and a 'B' rating on its holding company Brightline East LLC's $1.3 billion notes.

Main assumptions about 2025 and beyond

1. Steady and slow ridership growth.

Transit operators have lagged prepandemic recovery, and we expect slow growth for most transit operators in most countries.

2. Limited shareholder returns.

We expect dividend distributions to remain limited in 2025 and 2026, which will maintain credit metrics amid the strong pipeline of investments.

3. Waning federal support.

In some regions, operators face local funding challenges going forward against a backdrop of waning government support.

Asia-Pacific

We forecast stable performance for rail operators next year after largely recovering to prepandemic levels. In mainland China, operating conditions for metro businesses in the major cities will remain stable, underpinned by resilient operations under government support. Chinese metro remains highly leveraged because fare box is unable to cover operating costs. The government policy is to keep fares low while providing subsidies to sustain metro operations and injecting capital to build new lines as a public service.

Hong Kong metro operations has largely recovered, and we expect them to remain stable over 2025. However, station commercial and property rentals will remain under pressure due to weak retail sentiment. Prevailing cross-border consumption in Mainland China by locals continues to erode retail spending in Hong Kong.

In Japan, passenger revenues will be 95%-100% of fiscal 2018 levels in fiscal 2024 (ending March 31, 2025). We expect the recovery from the pandemic to have largely run its course and that growth of passenger revenues will continue at a moderate pace as rising income from tourists covers sluggish income from commuters and other business users due to the entrenchment of telecommuting and online meetings. Average consolidated EBITDA margins of the rated issuers will return to prepandemic levels and stabilize in the next one to two years thanks to steady passenger demand, price hikes, cost cuts, and a rise in nonrailway operations earnings.

Rail ridership levels in Singapore will fully recover to prepandemic levels by fiscal 2026 (ending March 31, 2026), given the prevalence of the hybrid work environment. Steady traffic supports 7%-9% revenue growth over fiscal years 2025-2026. Government grants remain critical due to insufficient fare hikes or cost recovery as the affordability of public transport is an important socioeconomic policy tool in Singapore.

EMEA

We expect stable operating performance from our rated European railway companies, which are mostly publicly owned. European governments now have a stronger focus on reinforcing the role and usage of railway and public transport, under a wider strategy to decarbonize transportation and lower dependency on imports of fossil fuels. This materialized as policies to incentivize the usage of railway and public transport, but also a strong pipeline of investments going forward to improve the catchment areas and the quality of the service. This is mostly focused on passenger transportation, but also includes the more challenging task of increasing freight transportation through railways. This challenge has led some players to refocus on their homeland countries by disinvesting from noncore activities, such as Deutsche Bahn and NS Groep.

In parallel to this, the eurozone progresses slowly but steadily on the open to competitive dynamics of commercial railway services, mostly HSR. The entrance of competition on HSR in Italy led to an increase on the passengers transported and a decline in tariffs, and we Spain is now developing similarly. We are unclear yet on whether the entrance of competition will extend also to public service operations (PSO), which includes mass transit. PSO activities are usually operated under models with lower profitability, and the entrance of private players could be riskier, especially if they also have to provide the rolling stock. The U.K. is currently beginning a process in the other direction, with PSO activities expected to gradually return within the control of the U.K. government.

North America: U.S. and Canada

We expect the Brightline project to continue ramping up ridership and fare in line with our downside expectation. Thus far, revenues have outperformed our downside expectation (during the ramp-up phase, we focus on performance relative to our downside scenario) but underperformed our base-case expectations. The project's long-distance ridership, which generates close to 80% of its ticket revenues, has outperformed our base-case expectation. However, this growth in ridership has come at the cost of lower-than-expected fares. Going forward, managing short-term ridership and overall fare are key challenges for the project. In addition, with new cars being put in service in mid-October and management's peak travel time optimization efforts, we expect revenue performance to bridge the gap relative to our base case.

For U.S. not-for-profit issuers, slow transit ridership growth will continue from a lower baseline**,** and in some regions, operators face local funding challenges going forward against a backdrop of waning federal support via discretionary funding programs expected under the new administration and Congress.

Conversely, in Canada, the operating environment and demand profile continue to be strong given the essentiality of the service and support revenue generation at the British Columbia Ferry Services Inc (BCFS).

Credit metrics and financial policy

Asia-Pacific

Asia-Pacific issuers face capital spending challenges. Metro capex in mainland China is likely to diverge among regions, with investment continuing in developed regions, particularly in tier-one cities with population influx. Expansion in smaller cities is slowing as governments tighten control over investment-led debt growth.

Hong Kong's MTR Corp. Ltd.'s credit metrics will weaken, driven by debt-funded capital spending overshadowing operational revenue increase. Cash inflow from property development could take longer to materialize than before, straining available resources used to cross subsidize the continuous capital spending.

Similarly, in Japan, debt funded investments could strain credit strength. Our rated Japanese issuers will have negative FOCF due to their heavy investment burdens. This ensures their ratios of funds from operations to debt remain stuck.

Europe

Lower credit metrics in our rated portfolio of European issuers in 2024-2026, compared with 2022 and 2023. Despite our forecast for higher revenues in 2025 and 2026, this will limitedly translate into higher EBITDA amid weaker operating margins – consequence of passing through inflation into their remuneration in 2022 and 2023. In addition, we anticipate a strong pipeline of investments in 2025 and 2026, which is partially supported by our assumption of lower-for-longer dividends.

North America: U.S. and Canada

Sizeable liquidity will allow the Brightline project to meet ramp-up period challenges. Brightline is currently under the ramp-up period that we expect to extend until 2028. During the ramp up, there are sizable liquidity reserves available to support the project while it is on a path to revenue stabilization. During this phase, we are rating to our downside assumptions—given revenue does not initially cover expenses, we are evaluating the cash burn on the reserves. Currently, revenues are performing above our downside expectation (albeit weaker than our base-case expectation); as a result, cash burn is slower than we expect, which is a credit positive.

For U.S. not-for-profit issuers, tax and political support have been key in stabilizing credit fundamentals for mass transit operators—either due to revenue growth or from interim and longer-term financial commitments from state lawmakers and regional stakeholders. However, the outlook is negative on three transit agencies, including Bay Area Rapid Transit (A+/Negative), San Francisco Municipal Transportation Agency (A+/Negative), and Washington Metropolitan Area Transit Authority (WMATA; AA-/Negative). Notably, these are all large, urban transit providers with a historical reliance on fare revenue that project sizable outyear operating fund deficits once remaining stimulus aid is depleted.

In Canada, the rating on BCFS was lowered to 'AA-', despite the strength in the demand profile, from 'AA' to reflect projected weakening in the debt service coverage and debt burden as the company undertakes its large asset-intensive capital program in the next five years.

Key risks or opportunities around the baseline

1. Weakening leverage profile of some Asia-Pacific issuers.

An increase in debt could strain credit strength. Nonrailway business expansion could heighten revenue volatility amid slow medium-term growth in the railway business.

2. Competition.

The entrance of competition on commercial lines is likely to continue progressing. National incumbents' investments to foster efficiencies and quality of service will be key to help them maintain their profitability.

Weakening leverage profile of some Asia-Pacific issuers. A larger-than-expected increase in debt due to accelerated growth investment in areas such as real estate development and the maglev bullet train project could strain credit strength. Nonrailway business expansion could heighten revenue volatility amid slow medium-term growth in the railway business.

Incumbents need to prepare for competition. The entrance of competition on commercial lines is likely to continue progressing, leading to lower tariffs as we have seen with the new HSR competitors in Italy and Spain. National incumbents' investments to foster efficiencies and quality of service will be key to help them maintain their profitability.

Ratings Trends: Railways And Mass Transit

Chart 22

Ratings distribution

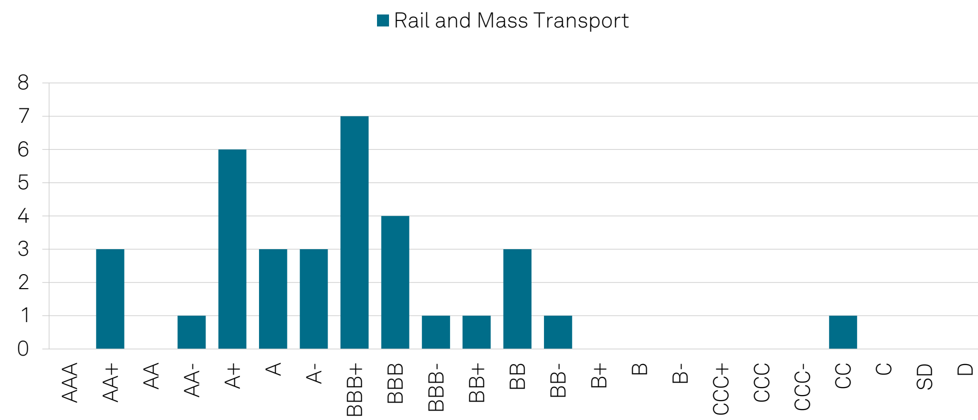


Chart 23

Ratings outlooks

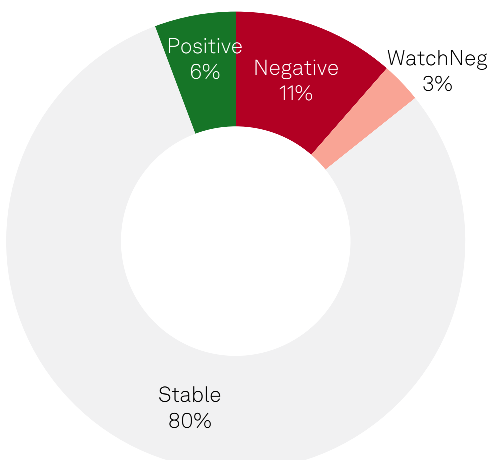
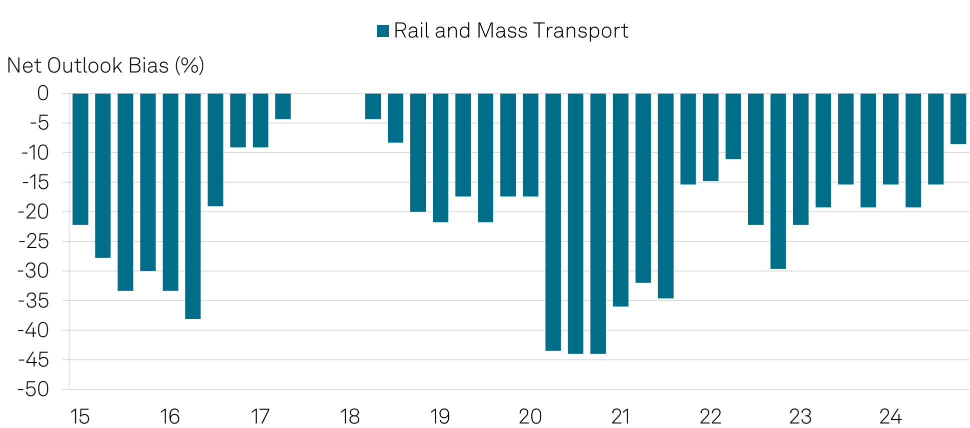


Chart 24

Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Credit Metrics: Railways And Mass Transit

Chart 25

Debt / EBITDA (median, adjusted)

Chart 26

FFO / Debt (median, adjusted)

Chart 27

Cash flow and primary uses

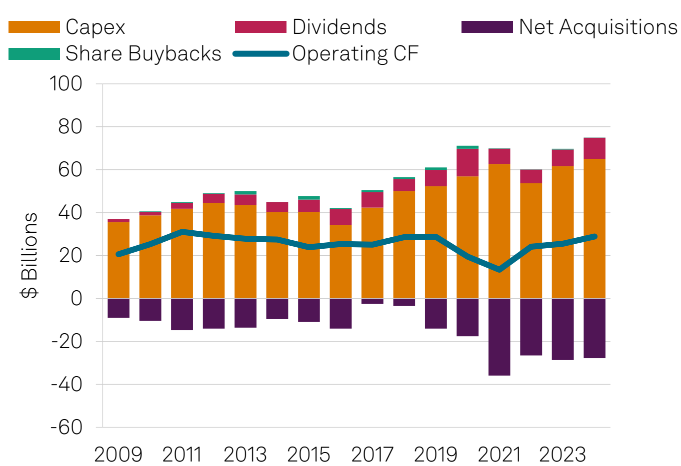
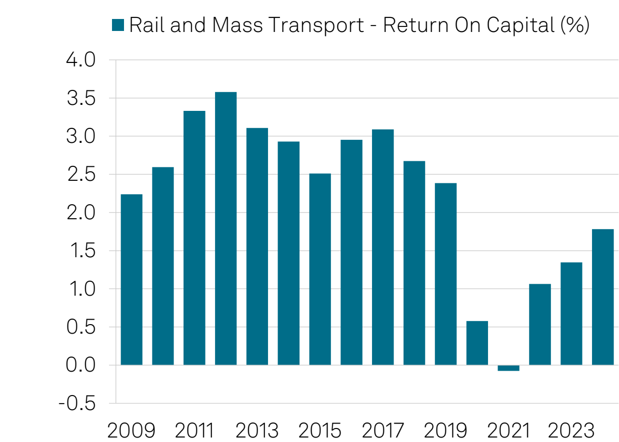


Chart 28

Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.

Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2024) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

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