EMEA Corporates – August 2022 Updated Base Cases

Deteriorating Macro-Economic Environment and Mounting Geopolitical Risk Put Credit Profiles at Risk

Increasing Recession Risk: Fitch Ratings expects intensifying inflation combined with reduced global GDP growth prospects and tighter monetary policy to put EMEA Corporates' credit profiles under increasing pressure in 2023-2024. This could be exacerbated by additional effects of the conflict in Ukraine, in particular potential further gas supply interruption.

Demand Erosion: We believe that weakening demand should have a limited effect on most corporate sectors' revenue in the near term as existing pent-up demand still creates some cushion against the inflationary environment and deteriorating consumer and corporate confidence. But we have become more pessimistic for 2023-2024 as we expect the general economic slowdown will weigh on several sectors when the post-Covid recovery momentum slows.

Cost Inflation to Hit Margins: Several sectors have been able to absorb some degree of wage and raw materials inflation in the past year but accelerating cost increases will be difficult to further pass through entirely. We also anticipate consumer downtrading to cheaper products and greater competition to burden profitability.

Russian Gas Cut-off: We expect supply chain issues to persist and be aggravated by a potential abrupt interruption of Russian gas supply, which would create a major macro-economic shock in Europe. The scenario shown assumes reduced and intermittent Russian gas supply, but not a full cut-off. A change in our base case to the latter could trigger further revision of our base cases because of sustained high gas and electricity prices, a weaker growth environment in Europe and a crystallisation of interest rates rises.

Sector Vulnerability: Short-term prospects for housebuilders, building products and industrial sectors such as capital goods and automotive are still protected by robust order books, while the lifting of travel restrictions and strong pent-up demand will support transport, lodging and gaming. However, we believe that these sectors would not be totally immune to rising commodity costs and demand erosion and have revised down our expectations for 2023 operating margins.

We have kept broadly unchanged our margin assumptions for other sectors in 2022 but prominent risks for 2023-2024 include inability to pass on all of cost inflation and potential downtrading for retailers, food & beverage, chemicals, building products and telecom operators. Sectors including oil & gas and fertilisers should benefit from high commodity and fertiliser prices while decelerating economic growth will only moderately affect energy consumption.

Main Risk Factors by Sector[a]

		Demand erosion	Wage inflation	Raw materials/ commodity inflation	Inability to pass through cost increases	Supply-chain disruption	Gas rationing in Europe
Airlines	2022	Green	Orange	Red	Orange	Orange	Green
	2023-24	Orange	Orange	Red	Red	Orange	Green
Automotive	2022	Green	Orange	Orange	Orange	Red	Orange
	2023-24	Orange	Orange	Orange	Orange	Orange	Orange
Building Materials & Products	2022	Orange	Orange	Orange	Red	Red	Orange
	2023-24	Orange	Orange	Orange	Red	Orange	Green
Chemicals & Fertilisers	2022	Orange	Orange	Orange	Orange	Orange	Red
	2023-24	Red	Green	Orange	Red	Green	Red
Diversified Industrials	2022	Green	Orange	Orange	Green	Orange	Orange
	2023-24	Orange	Orange	Orange	Orange	Orange	Orange
Food, Beverages & Consumer	2022	Green	Green	Orange	Green	Orange	Green
	2023-24	Orange	Green	Orange	Orange	Green	Orange
Gaming	2022	Green	Green	Green	Green	Green	Green
	2023-24	Orange	Green	Green	Green	Green	Green
Healthcare	2022	Green	Red	Orange	Orange	Orange	Green
	2023-24	Green	Red	Orange	Green	Green	Green
Housebuilders	2022	Green	Green	Orange	Green	Orange	Green
	2023-24	Orange	Orange	Orange	Orange	Orange	Green
Integrated utilities	2022	Orange	Green	Orange	Red	Orange	Red
	2023-24	Orange	Green	Orange	Orange	Green	Red
Lodging	2022	Green	Orange	Green	Green	Green	Green
	2023-24	Orange	Orange	Green	Orange	Green	Green
Metals	2022	Orange	Orange	Orange	Orange	Green	Orange
	2023-24	Orange	Orange	Orange	Orange	Green	Orange
Mining	2022	Green	Orange	Orange	Green	Green	Green
	2023-24	Green	Orange	Orange	Green	Green	Green
Oil & Gas	2022	Green	Green	Orange	Orange	Green	Orange
	2023-24	Orange	Green	Orange	Orange	Green	Orange
Retail	2022	Orange	Orange	Orange	Red	Orange	Green
	2023-24	Orange	Orange	Orange	Red	Orange	Green
Technology	2022	Green	Orange	Green	Green	Orange	Green
	2023-24	Orange	Orange	Green	Green	Orange	Orange
Telecom	2022	Green	Orange	Green	Orange	Green	Orange
	2023-24	Green	Orange	Orange	Green	Orange	Green

[a] Green – neutral to positive credit impact; orange – mildly negative, red – negative
Source: Fitch Ratings

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This report is a collection of sector base case summaries prepared in July and August 2022.

EMEA Airlines Updated Base Case August 2022

Near-Term Robust Demand Recovery Masks Mid-Term Risk

Lower GDP Growth to Punish Airlines from 2023

Air transportation is strongly correlated with GDP growth and our lower expectation for the latter puts the industry outlook under pressure. This is temporarily more than offset by the robust returning demand following the lifting of travel restrictions, pent-up demand and limited supply due to operational issues. Air transport's indispensability is demonstrated by the pace of recovery and resilience throughout the pandemic. Western European air passenger traffic is around 90% of 2019 levels, while eastern Europe is hovering around 80%. We expect the general economic slowdown will weigh on the sector from 2023, when the post-Covid recovery momentum slows.

Airlines' labour and fuel costs are the biggest components in their cost structure and we expect higher increases in labour and fuel costs above inflation and also than our *Global Economic Outlook* (GEO) assumptions. Labour costs will increase above inflation due to the effect of temporary salary cuts. We also take a more conservative approach for unhedged positions than our GEO and assume the oil price stays at around USD85/barrel through 2025 (the GEO's long-term oil price assumption is at around USD65/barrel). EMEA airlines are traditionally better hedged for fuel, although still below pre-pandemic levels, than those in other regions, reducing volatility and giving them a competitive advantage on intercontinental routes.

Limited Deleveraging Capacity

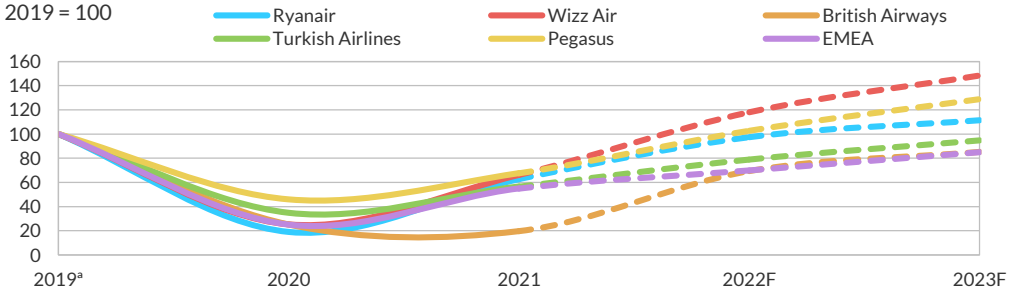
The airlines' deleveraging capacity is limited. It rests not only on supply and demand dynamics over the coming years, but also on how flexibly they can adjust their investment programme to market demand dynamics. Many airlines have already deferred their aircraft deliveries during the pandemic and we expect their capex to be above the pre-pandemic level in the next two years.

Fitch believes airlines have become leaner, more resilient and better able to manage typical recessionary pressure. Nonetheless, we expect lower GDP growth to put additional pressure on already thin margin bases, weakened post-Covid balance sheets and increasing risk of downgrades, although multi-notch rating downgrades are unlikely in our view.

What to Watch

- **Fuel and Labour costs:** They account for up to half of operating costs. Medium-term oil prices and negotiations with unions will be key to containing cost overruns.
- **New Travel Norms and Covid-Related Restrictions:** We expect some structural loss of demand from corporate air travel. How companies will overcome this remains to be seen. Lifting of the remaining restrictions (eg in Asia) may boost traffic in/out of EMEA. However, they could be re-imposed.

RPK Forecast on EMEA Airlines



[a] Financial year ending March 2020 for Ryanair and Wizz Air
Source: Fitch Ratings

Key Metrics – Revision to Previous Case

	2022	2023-2024
Revenue	⇗	⇔
EBITDA	⇔	⇘
EBITDA margin	⇘	⇘
FCF	⇔	⇘
Leverage	⇔	⇗

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		
Supply chain disruption		
Gas rationing in Europe		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

EMEA Automotive Updated Base Case August 2022

Underlying Metrics Remain Strong Despite Deteriorating Environment

Limited Effect of Revised GDP Growth

Fitch Ratings believes that negative effects on automotive demand from weaker macro-economic factors should be offset in the medium term by pent-up demand built up over the past two years by severe production interruptions due to Covid-19-related and semiconductor shortages. We have not lowered our base case assumptions for European manufacturers' and suppliers' revenue. Fitch expects manufacturers to restrain output despite lower global GDP growth expectations and weakening consumer and corporate confidence. New vehicle sales are typically well correlated with major macro-economic indicators. We now assume new vehicle sales will fall by about 7% in Europe in contrast to the slight increase of 2021. Our assumptions still remain 40% below 2019 volumes.

Increased raw materials and labour costs will remain a constraint on profitability but we anticipate operating margins will stay solid as manufacturers continue to benefit from a favourable product mix. Limited supply enables them to focus on higher-end products. It is unclear how the supply chain will absorb the rise in commodity prices, in the event that manufacturers cannot pass on the cost to their customers.

We have broadly maintained our assumptions for capex across the sector as automotive companies have some ability to manage their investment. Likewise, we do not anticipate major M&A or shareholder distribution to change in our updated base cases. This should protect cash generation and the low leverage across the sector.

Supply Chain Disruptions to Persist

We believe that supply chain disruptions related to the microchip shortage and the war in Ukraine will persist, but without jeopardising sector revenue. The potential acceleration of the shift to electric vehicles, particularly in Europe, could require a modest increase in investment. Higher interest rates may have a moderate effect on captive finance entities' refinancing conditions.

What to Watch

- Continued component shortages force increases in inventories and working capital needs.
- A prolonged decline in consumer demand ensuring stronger than expected volume drops.
- Increasing electric vehicle sales, and longer-term impact on profitability of OEMs.

Key Assumptions

	March GEO[1] base case 2022	June GEO[1] base case 2022	March GEO[1] base case 2023	June GEO[1] base case 2023
US GDP growth (annual average, %)	3.5	2.9	1.6	1.5
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
Consumer confidence index	2.00	3.00	3.00	3.50
ECB policy rate (MRO, December, %)	0.00	1.00	0.25	1.50
Crude oil (Brent USD/PB, annual average)	100	105	80	85
Global new vehicle sales (m)	83	80	87	84
European new vehicle sales (m)	9.5	9.1	9.9m	9.6

[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision to Previous Case

	2022	2023-2024
Revenue	⇔	⇩
EBITDA	⇗	⇔
EBITDA margin	⇔	⇔
FCF	⇔	⇔
Leverage	⇔	⇔

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials or commodity inflation		
Inability to pass through cost increase		
Supply chain disruption		
Gas rationing in Europe		
Increased interest rates		
Acceleration of Electrification Shift		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

EMEA Building Products Updated Base Case July 2022

Underlying Metrics Dependent on Consumer Confidence

Strong Demand and Pricing Counters Inflationary Pressures

Under our new base case we expect price increases to drive higher revenues for building products companies in 2022 but we have not revised upward our revenue growth expectations for 2023-2024. EMEA building products demand recovered strongly after the pandemic, with good growth in 2021 benefitting from strong residential activity (new build and renovation) with an element of catch-up from pandemic delays, and stimulus packages driving infrastructure and renovation activities. Strong demand continues to hold but we expect this to reduce as consumer confidence declines in 2H22 and 2023.

The demand profile has largely allowed building products companies to establish strong and consistent price increases to initially deal with the supply chain and logistics challenges and thereafter the steadily increasing raw material and energy cost inflation. However, we have become more pessimistic about the ability to pass on further cost increases with declining consumer confidence. The sector's typically niched participants remain exposed to short-term supply chain disruptions (medium term alternate sourcing), while the sector has moderate reliance on gas.

We expect divergence in spend potential with repair/maintenance activities to remain strong as pressures build on new investments. The extent of declining consumer confidence is likely to determine the extent of negative impacts on both discretionary spend investments and new builds.

Our new base case shows lower EBITDA margins (although neutral absolute EBITDA generation) for 2022 as slowing demand limits pricing potential. It also includes modest downward revisions of margins and organic EBITDA in 2023-2024, chiefly due to reduced consumer confidence and the potential increase in costs. This impact is likely to be divergent depending on the end-market and market position, with larger market leaders already showing comparatively greater ability to push through price increases than smaller companies.

Environmental Initiatives to Support Demand

EU and UK building products market growth is also likely to benefit from infrastructure stimulus demand programmes and environmental improvement initiatives. While both will support market demand, the latter will notably benefit participants providing products to improve environmental standards or energy efficiency, and these are likely to outperform more traditional products.

What to Watch

- Ability to push through price increases in the face of declining consumer confidence
- Potential divergence between repair and maintenance, and new-build/discretionary spend
- Euro participants benefit from governmental support for energy efficiency investment

Key Assumptions

	March GEO[1] base case 2022	June GEO base case 2022	March GEO base case 2023	June GEO base case 2023
US GDP growth (annual average, %)	3.5	2.9	1.6	1.5
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
US inflation (December, yoy, %)	4.5	6.5	2.6	2.8
EZ inflation (December, yoy, %)	3.4	5.3	1.1	1.4
US Consumer spending (%)	3.7	3.6	2.3	1.9
EZ Consumer spending (%)	4.4	2.6	2.8	2.0
US policy rate (December, %)	2.00	3.00	3.00	3.50
ECB policy rate (MRO, December, %)	0.00	1.00	0.25	1.50
Crude oil (Brent USD/PB, annual average)	100	105	80	85

[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision to Previous Case

	2022	2023-2024
Revenue	⇗	⇔
EBITDA	⇔	⇘
EBITDA margin	⇘	⇘
FCF	⇔	⇔
Leverage	⇔	⇔

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		
Supply chain disruption		
Gas rationing in Europe		
Increased interest rates		
Acceleration of Environmental Standards		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

EMEA Chemicals & Fertilisers Updated Base Case July 2022

High Margins Challenged, Gas Rationing Looming

High Energy and Feedstock Cost Amid Slowing Growth

The downward revision of economic growth will weigh on demand growth assumed for chemicals as the latter tend to grow in line with GDP. Coupled with high inflation, it will also challenge the ability of chemical companies in EMEA to pass through high raw material costs to their customers, despite their success in doing so in recent months. A reduction of chemical profits in Europe on weakening demand will accentuate in 2023 with lower GDP growth and increasing international competition as supply chains normalize.

The competitiveness and profitability of European chemical producers are severely affected by a much higher gas cost than in other regions, and the loss of discounted Russian naphtha since the war started. The pace of earnings correction will depend on the scale of imports from lower-cost regions, such as the US or the Middle East, which have access to competitively priced natural gas, used more predominantly as feedstock than in Europe.

Most EMEA chemical companies have regained significant financial flexibility due to strong results in 2021 and early 2022. Therefore, they have comfortable headroom on average to weather a deterioration of the economic environment. This is reflected by the vast majority of credits having a Stable Outlook in our portfolio. A conservative allocation of bumper earnings is key to preserving their capital structures through the cycle.

Stronger earnings expectations for fertiliser companies in EMEA reflect higher expectations of fertiliser prices, driven by high crop prices, reduced supply and high gas cost. However, Europe-based production of nitrogen fertilisers will continue to be at risk of curtailments or shutdowns due to the volatility in gas prices.

Gas Rationing is a Major Risk

Germany, Europe's largest chemicals producer, is heavily reliant on Russian natural gas and is likely to ration supply to industrial companies in the next winter, leading to production cuts in the event of Russian gas cut-off or material reduction of supply. This pressure is particularly acute for products using gas as a feedstock, such as ammonia or acetylene, and would affect several chemical producers with significant asset concentration in Europe. The framework that will prevail in such a situation is unknown at this stage and could affect entire value chains.

What to Watch

- Gas rationing in Europe could affect the production of European assets, especially in Germany
- Weakening demand and increased imports would result in a pressure on earnings in Europe
- Competitiveness of European producers is impaired by higher feedstock and energy costs

Key Assumptions

	March GEO[1]/Price Assumptions Base Case 2022	June GEO/Price Assumptions Base Case 2022	March GEO/Price Assumptions Base Case 2023	June GEO/Price Assumptions Base Case 2023
Global GDP growth (annual average, %)	3.5	2.9	2.7	2.6
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
EZ inflation (December, yoy, %)	3.4	5.3	1.1	1.4
Crude oil (Brent USD/bbl, annual average)[a]	100	105	80	85
TTF natural gas (USD/mcf)[a]	20	25	10	15
Henry Hub (USD/mcf)[a]	3.5	4.0	2.5	2.5
DAP – FOB US Gulf Export (USD/tonne)	650	850	450	500
Potash – FOB Vancouver (USD/tonne)	450	580	350	460

[a] We complement our analysis using market-based forward-price indications given that oil derivatives and gas are used as inputs for chemical companies rather than source of revenues.
[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision to Previous Case

Chemicals	2022	2023-2024
Revenue	⇗	⇗
EBITDA	⇘	⇘
EBITDA margin	⇘	⇘
FCF	⇔	⇔
Leverage	⇗	⇗

Fertilisers		
Revenue	⇗	⇗
EBITDA	⇗	⇗
EBITDA margin	⇗	⇗
FCF	⇔	⇔
Leverage	⇔	⇔

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		
Supply chain disruption		
Gas rationing in Europe		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

EMEA Diversified Industrials and Capital Goods Updated Base Case August 2022

Underlying Metrics to Stay Strong Despite Inflationary Pressure

Pent-Up Demand Offsets Effect from Lower GDP Growth

Fitch Ratings has broadly maintained its expectations for revenue or EBITDA growth among the EMEA-based diversified industrial sector, which remains around the mid-single digits in 2022 and only slightly lower in 2023-2024. This is because the downward revision to global GDP growth expectations is unlikely to have a material effect on the demand dynamics across the sector. While end-markets are very diversified and often show different cycles, we continue to believe that the large-scale business customer spending which delayed during the pandemic will need to be realised in the short term. This is supported by the large order books at many companies.

Cost Inflation to Pressure Margins

Our rating case expectations are for higher EBITDA margins in 2022 relative to 2021, reflecting the strong customer demand and recovery from the pandemic. However, we have revised them downwards by an average of around 1pp - 1.5pp from our prior expectations as wages, energy and input costs (raw materials) will increase more steeply than revenue and burden margins.

There is likely to be some softening in the effect of inflation through cost pass through mechanisms or renegotiation of existing contracts but these will likely have a delayed effect and only cover a portion of the higher costs. Relatively strong pricing power and underlying demand has meant that in an increasing number of cases, diversified industrial companies have been able to reopen existing contracts with their customers to adjust price terms and reflect the steep inflation. We expect to see more of this in 2H22 and 2023 as the alternative to such compromises will increasingly mean a cancellation of existing contracts.

Supply Chain Disruptions to Persist

The supply chain disruptions related primarily to semi-conductors, which have been affecting the sector since 2021 and amplified this year by the volatility surrounding materials sourced from Russia and Ukraine. We expect these issues to remain a concern in H2 2022 and 2023, although most companies will continue to manage their capacity with only minor negative effects. Our prior expectation of accelerated dividends and share buyback has been scaled back, and we now expect a more disciplined approach to shareholder returns in the short term.

What to Watch

- Interest rate increases may reduce the financial flexibility of some 'B' category issuers, especially those needing to refinance upcoming maturities over the next 12 months
- Automation presents a significant long-term opportunity but will require higher capex

Key Assumptions

	March GEO[1] Base Case 2022	June GEO Base Case 2022	March GEO Base Case 2023	June GEO Base Case 2023
US GDP growth (annual average, %)	3.5	2.9	1.6	1.5
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
US inflation (December, yoy, %)	7.0	6.5	4.5	2.8
EZ inflation (December, yoy, %)	5.0	5.3	3.4	1.4
Consumer confidence index	2.00	3.00	3.00	3.50
US interest rate (Dec, %)	0.25	3.00	2.00	3.50
ECB policy rate (MRO, Dec., %)	0.00	1.00	0.25	1.50
Crude oil (Brent USD/PB, annual average)	100	105	80	85
USD/EUR	0.88	0.95	0.90	0.95

[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision to Previous Case

	2022	2023-2024
Revenue	⇗	⇔
EBITDA	⇗	⇔
EBITDA margin	⇘	⇔
FCF	⇗	⇔
Leverage	⇗	⇔
Capex	⇗	⇔

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		
Supply chain disruption		
Gas rationing in Europe		
Increased interest rates		
Acceleration to Automation		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Rating

EMEA Food, Beverages, Tobacco and Consumer Updated Base Case August 2022

Economic Slowdown Scenario Reduces Profit Expectations

Limited Impact on Credit Quality Despite Delayed Deleveraging

We have broadly maintained our expectations for moderately strong demand dynamics in 2022 as we anticipate continued recovery of out-of-home consumption in 1Q22-3Q22, followed by a general caution in consumer spending in 4Q22. The latter is the result of increases in spending for items including mortgage servicing, heating, food and grocery, whose costs have been increasing and will be reflected from 4Q22 in slower revenue and profit growth for companies, compared to the expectations of a continued post-pandemic demand recovery that we had formulated in our Outlook for the fast-moving consumer goods (FMCG) sector at the end of 2021.

Consumers in developed markets should be more resilient in supporting their spending habits, having the ability to draw on savings accumulated during the pandemic, while consumers in emerging markets are already showing signs of a deterioration in spending power.

We believe these dynamics will be exemplified by downtrading, with purchases orientated towards cheaper products and higher competition from private-label alternatives and by a more limited input cost pass-through capability in 4Q22 and 2023, in contrast with our previous expectation that companies would have been able in 2023 to complete the pass-through of input costs that they may have initially decided to phase out gradually from 2022. We have revised downward our assumptions for EBITDA in 2023-2024, but still expect companies to defend their profit levels.

Our updated rating case includes more limited deleveraging capacity for companies in 2023 due to potentially stable profits and cash flow generation. The higher interest charges will affect cover ratios but most companies have long-dated debt or well-spread-out maturities with limited need to refinance at higher margins. Therefore, as most ratings are not premised on major deleveraging in 2023 and cash flow should mostly remain positive, these changes in assumptions reduce financial flexibility but do not materially affect credit quality.

Raw Materials Security Stresses Working Capital

Higher costs and, particularly in 2022, a run to securing good availability of inputs, is leading to higher levels of inventory and working capital, absorbing cash flow. Smaller companies, if not quick enough to secure raw materials or read the volatility of commodity markets, may end up with insufficient supply, or over-paying for inputs. There is increased use of factoring lines, which is a cheaper form of funding than revolving credit facilities, but we add this to our debt calculations.

What to Watch

- Pricing power and ability to pass on higher costs; lower-priced propositions protect profit
- Companies' willingness and speed of readjusting shareholder remuneration downwards

Key Assumptions

	March GEO[1] Base Case 2022	June GEO Base Case 2022	March GEO Base Case 2023	June GEO Base Case 2023
US GDP growth (annual average, %)	3.5	2.9	1.6	1.5
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
US inflation (December, yoy, %)	4.5	6.5	2.6	2.8
EZ inflation (December, yoy, %)	3.4	5.3	1.1	1.4
US policy rate (December, %)	2.00	3.00	3.00	3.50
ECB policy rate (MRO, December, %)	0.00	1.00	0.25	1.50
Crude oil (Brent USD/PB, annual average)	100	105	80	85
US Consumer Spending (% growth)	3.7	3.6	2.3	1.9
EZ Consumer Spending (% growth)	3.5	2.6	4.4	2.0
US Unemployment Rate (%)	3.8	3.6	3.9	3.7
EZ Unemployment Rate (%)	7.1	6.8	6.9	6.7

[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision to Previous Case

	2022	2023-2024
Revenue	⇔	⇔
EBITDA	⇔	↘
EBITDA margin	⇔	↘
FCF	⇔	↘
Leverage	⇔	↗

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		
Supply chain disruption		
Gas rationing in Europe		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

EMEA Gaming Updated Base Case July 2022

More Impact from Regulation than from Economic Slowdown

Historically, despite clearly being a discretionary expense for consumers, gaming demonstrated resilience to economic downturns and falling consumer incomes. Fitch Ratings assumes only modest pressure on the sector's revenues and profitability from lowered economic growth and costs inflation over 2022-2024.

During the pandemic, gaming operators have increasingly focused on online operations, where energy consumption and personnel costs are materially lower as a share of revenue than they are for retail operations, especially those focused on destination-based tourism, such as in Las Vegas or Macau. Even for companies with sizeable retail operations like Flutter and Entain, the total share of employee costs is less than a fifth of total operating costs (COGS + SG&A), compared with shares of 30% and above for casino operators.

High cost flexibility for marketing expenses and the ability to pass through cost inflation to customers should help EMEA gaming operators protect their margins from most of the wage and energy inflation. Our forecasts assume lower operating profitability in 2023 for majority of rated EMEA gaming operators, but mostly that is related to UK exposure and effects from regulation.

Some markets with less stable regulation regimes can face increases in tax rates, but geographically diversified operators will be able to reduce the impact of such event-type risks on cash flows.

Revenue Per Customer More Affected by Regulation

We expect more material effect on revenue per customer from the review of UK Gambling Act, whitepaper for which is to be published in 3Q22. Measures may include online stake limits (potentially affecting revenue per customer), advertising restrictions (revenue dynamics and cost of customer acquisition) and affordability checks (revenue per customer).

In recent years, affordability checks have been increasingly introduced by gaming operators such as Flutter, Entain and 888. Coupled with many responsible gaming initiatives imposed by regulators, this could lead to increasing sensitivity of consumer gaming demand to overall spending. We therefore now assume slightly lower revenue growth in the medium term (medium single digit vs high single digit previously), with net gaming revenue growth rate behind the growth rate of the account base. At the same time, online gaming (iGaming) and online sports betting markets worldwide retain their long-term growth potential.

What to Watch

- Lower revenue growth with NGRs behind the growth rate of customer base.
- Increased tax burden in jurisdictions with less predictable regulation regimes.
- UK Gambling Act Review remains important for credit profiles: whitepaper to introduce a range of affordability checks, as well as more advertising restrictions and online stake limits.

Key Assumptions

	March GEO[1] Base Case 2022	June GEO Base Case 2022	March GEO Base Case 2023	June GEO Base Case 2023
Eurozone GDP growth (annual average, %)	3.0	2.6	2.3	2.1
Eurozone inflation (December, %)	3.4	5.3	1.1	1.4
ECB policy rate (MRO, December, %)	0.00	1.00	0.25	1.50
Eurozone consumer spending (%)	4.4	2.6	2.8	2

[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision to Previous Case

	2022	2023-2024
Revenue	↘	↘
Selling & marketing expenses	↗	↘
EBITDA	↘	↘
EBITDA margin	↘	↘
FCF	↘	↘
Leverage	↗	↗
M&A spending	↗	↘

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		
Supply-chain disruption		
Gas rationing in Europe		
Responsible gaming regulations		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

EMEA Healthcare Updated Base Case August 2022

Limited Impact on Rating Cases from Deteriorating Environment

Resilient Healthcare Demand, Focus on Medical Cost Inflation

Fitch has not materially changed its rating cases in the healthcare and pharmaceutical sector following the publication of its *Global Economic Outlook* in June 2022. Our previous base cases already reflected the deteriorating economic environment, with a key focus in the sector on medical costs. Fitch expects robust demand for healthcare services as the post-pandemic backlog of delayed non-essential interventions and routine check-ups remains high across Europe, with occupancy and capacity utilisation expected to gradually improve into 2023.

We have broadly maintained our expectations for profitability in the healthcare sectors. We expect operating profit to remain constrained by medical cost inflation (defined as cost per patient treatment), negative operating leverage from only gradually recovering capacity utilisation and more stringent care and nursing regulations. We also expect rising costs to weigh on our updated profitability assumptions, particularly wages (which can be higher than 40% of sales for hospitals) and energy. We expect near-term pressure on profitability, particularly in the labour-intensive healthcare service sectors such as acute care, as rising medical costs cannot be immediately passed on through the mostly regulated revenue line, but rather spread over the following two years.

Generics Profitability, Consumer Health Demand

We believe that the generics segment would be more vulnerable to a deteriorating economic environment than innovative pharma, as this sector has generally lower pricing power and more integrated supply networks, which are at greater risk of dislocation (a trend mirrored for medical devices, a sector that may also be challenged by input prices and raw material availability). We view economies of scale and flexible manufacturing structures as critical in the current economic environment.

Consumer health and elective treatments might suffer from weaker demand in a macro environment characterised by consumer spending constraints, which will also limit the generally better pricing power in this segment.

What to Watch

- Healthcare service occupancy rates and medical cost trends, including labour costs
- Possible new spike in Covid-19 cases requiring emergency healthcare responses (which Fitch treats as event risk)
- Diminished free cash flow generation resulting in heightened refinancing risks, cost of funding, and weakened liquidity, especially for leveraged credits

Key Assumptions

	March GEO[1] Base Case 2022	June GEO Base Case 2022	March GEO Base Case 2023	June GEO Base Case 2023
US GDP growth (annual average, %)	3.5	2.9	1.6	1.5
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
US inflation (December, yoy, %)	4.5	6.5	2.6	2.8
EZ inflation (December, yoy, %)	3.4	5.3	1.1	1.4
US policy rate (December, %)	2.00	3.00	3.00	3.50
ECB policy rate (MRO, Dec., %)	0.00	1.00	0.25	1.50

[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision to Previous Case

	2022	2023-2024
Revenue	⬌	⬌
EBITDA	⬌	↘
EBITDA margin	⬌	↘
FCF	⬌	↘
Leverage	⬌	⬌

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		
Supply chain disruption		
Gas rationing in Europe		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

EMEA Housebuilders Updated Base Case August 2022

Good Sales and Margins Visibility for 2022 through to 2023

Raw Material Cost Inflation Passed Through House Price Appreciation

Demand for new modern houses across different regions remains favourable. The UK housing market remains underpinned by a persistent shortage of new builds. In vast areas of Spain the demand for new homes has outpaced its supply in recent years. The orderbooks of many Fitch-rated issuers are therefore at an all-time high. This, paired with fixed-cost agreements with suppliers, provides solid visibility on housebuilders' sales and margins for the next 12 months.

New build volumes may start to decline in 2023 and 2024, given consumer confidence indicators, and housebuilders may adjust average selling price accordingly, but underlying demand remains.

As energy-intensive raw materials, such as steel, concrete and glass, appreciated the most over the past six months, housebuilders may agree to indemnify their suppliers for soaring costs on future developments. However, these raw materials are just a portion of the total construction costs, which also include the cost of labour (substantially stable), land (which many housebuilders sourced in favourable times) and other "soft" costs (marketing and sales).

In the current environment, Fitch estimates that 1%-2% house price appreciation (HPA) should offset a 4%-6% increase in raw materials costs. Fitch's rated housebuilders had mid-single-digit HPA in 1H22, preserving their margins. Disruptions in the supply chain have delayed some projects but this is limited to some specific developments.

Rising interest rates make mortgages more expensive, ultimately affecting the final home price for buyers. Historically, interest rates have been low for some time and small increases will affect some buyers. Even if buyers are comfortable with rising rates, they still have to consider the security of their employment and their future income.

Rated Entities' Cost of Debt Locked In

Fitch's rated housebuilders have generally no imminent need to refinance their debt, with many issuing their inaugural bond in 2021 at a fixed rate and with maturities between five and 10 years. Developer loans used to fund specific schemes and repaid upon completion may become more expensive but these are limited in their amount and have a very short life.

What to Watch

- Fixed-price contracts possibly challenged by contractors; housebuilders' ability to preserve margins through HPA
- Affordable mortgages and their availability

Key Assumptions

	March GEO[1] base case 2022	June GEO base case 2022	March GEO base case 2023	June GEO base case 2023
UK GDP growth (annual average, %)	3.8	3.8	2.0	1.1
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
UK inflation (December, yoy, %)	5.7	9.2	1.9	2.6
EZ inflation (December, yoy, %)	3.4	5.3	1.1	1.4
UK policy rate (December, %)	1.25	2.00	1.75	2.50
ECB policy rate (MRO, December, %)	0.00	1.00	0.25	1.50

[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision to Previous Case

	2022	2023-2024
Revenue	⇗	⇔
EBITDA	⇗	⇔
EBITDA margin	⇔	⇔
FCF	⇔	⇔
Leverage	⇘	⇔

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand Erosion		
Wage Inflation		
Raw Materials/Commodity Inflation		
Inability to Pass Through Cost Increases		
Supply Chain Disruption		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

EMEA Integrated Utilities Updated Base Case July 2022

Energy Disruption Is Affecting EMEA Integrated Utilities

High Energy Prices and Russian Gas Supply Risk

Lower European GDP growth prospects do not have a material direct impact on our projections at sector level as the latter are driven by various factors, including margins on generation, profitability under long-term contracts, renewables remuneration schemes and returns on network assets.

We maintain our moderate price and margin assumptions for our rating case projections of the generation business despite a steep increase in energy prices. Clean gencos (eg hydro, nuclear, wind and solar) would benefit materially from the current market prices, to the extent their margins are not long-term incentivised/hedged through power purchase agreements. This advantage is limited by increasing political risk, which could imply the clawback of extra profits deriving from extremely high market prices. Higher energy prices, and also their higher volatility, have increased utilities' working capital needs partly due to increased margin call requirements. Most of our rated utilities have good access to capital markets and available credit lines to support their liquidity needs.

One of the main risks for EU utilities relates to Russian gas supplies, which have been substantially reduced in recent months. An escalation of geopolitical tensions leading to a complete cut of Russian supplies to the EU would have material financial consequences for some European utilities, but we do not expect a disruptive impact on the whole Fitch-rated portfolio. In a scenario of complete cut of Russian supplies, some EU countries would be more severely hit than others and Fitch would expect the EU to take a coordinated approach to gas imports and rationing. We expect some market rules and contractual obligations to be suspended, with national regulators and governments stepping in for demand- and supply-side oversight and intervention, in coordination with the EU.

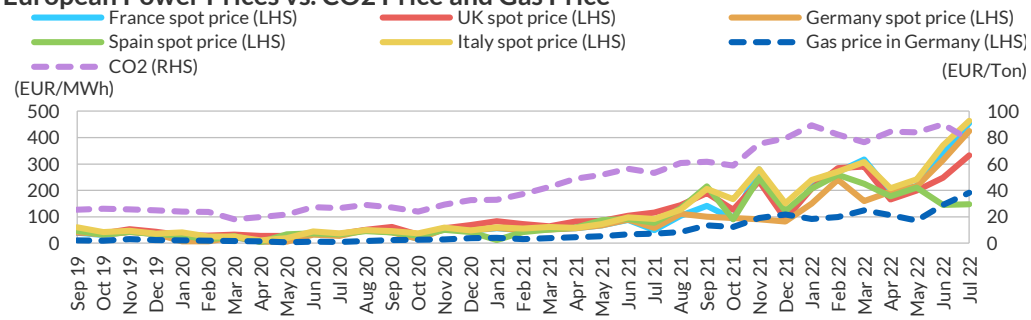
European Utilities Resilient to Windfall Tax, Political Risk Remains

Fitch believes the introduction of windfall taxes on issuers' profits (or other forms of market intervention including price caps) in several countries resulting from high energy prices will not by itself lead to negative rating actions on rated utilities. This is because we factor in moderate price assumptions in our rating cases for generating companies over the entire rating horizon. This means our ratings are not dependent on extra profits due to higher prices, and our price assumptions would remain unchanged even if the windfall taxes remained in place for more than one year. Moreover, many utilities in well-developed energy markets are largely hedged or long-term contracted at or near price levels that the governments still consider 'fair', making the majority of their generation exempt from the new taxes, at least for 2022.

What to Watch

- **Russian Gas Supplies to the EU**: A complete cut of Russian supplies to the EU would lead to market disruption and have material financial consequences for some European utilities.
- **Financial Structures**: Increasingly ambitious capex plans have a clear strategic rationale but reduce rating headroom.

European Power Prices vs. CO2 Price and Gas Price



Source: Fitch Ratings, Bloomberg

Reaction of Governments to Rising Energy Prices

	UK	Italy	Germany	France	Spain	Poland	Romania	Greece
Windfall profits tax	✓	✓			✓		✓	✓
Retail price caps (suppliers)				✓	✓[a]	✓	✓	✓
Wholesale price caps (generators)		✓		✓	✓			✓
Reduced energy or fuel taxes		✓	✓	✓	✓	✓		✓
Transfers to vulnerable customer groups	✓	✓	✓	✓	✓	✓	✓	✓

[a] Temporary cap for the regulated tariff of natural gas
Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		
Supply chain disruption		
Gas rationing in Europe		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

EMEA Lodging Updated Base Case July 2022

Better Forecasts for 2022, but Worse in 2023

GDP Growth Slowdown Scenario

We have raised our rating case assumptions for revenue per available room (RevPAR) for 2022. All hotel groups' key performance indicators are pointing to a strong summer. Booking levels are high and, since April-May 2022, average room rates have been above pre-pandemic levels and our forecasts. Strong pent-up demand and high household savings are pushing room rates up, together with cost inflation pass-through.

The leisure segment will continue to attract demand, in contrast to the impaired recovery of business travel and events, which will take longer to normalise, especially in this cost-saving environment. However, the new 'bleisure' concept derived from hybrid working models is gaining traction and will partly offset the lack of pure corporate trips.

We forecast that the current average room rates will not be sustainable over 2023 as economic growth slows. We have lowered our forecasts for RevPAR by around 10%, reflecting increases in the cost of living. This rise in prices will force consumers to modify discretionary expenditure by trading down to less expensive hotels, while hoteliers lower room rates to maintain occupancy rates above break-even levels.

We now expect 2022 RevPAR to be 20% below 2019 levels (against our previous estimate of 33% below), although we forecast 2023 RevPAR to be 15% below 2019 (previously 7% below), showing a delay in recovery.

We are reducing our EBITDAR margin assumptions for 2023 to account for higher staff costs in response to the shortage across Europe. Margin pressure will depend on hotel profiles (e.g. asset heavy versus asset light, budget versus luxury).

Covid-Related Restrictions Could Come Back

The sector remains vulnerable to reinstatement of restraints related to Covid-19, such as travel restrictions, quarantines and compulsory tests. The risk remains acute as another wave of the pandemic emerges across Europe, as hotel companies continue to operate far below their pre-Covid performance.

What to Watch

- The sector remains vulnerable to economic or public health-related disruption as it has not yet recovered from reduction in demand, with low to no rating headroom for hotel companies.
- Increased salaries due to staff shortages will have a major effect on margins, especially for asset-heavy models (as this expense accounts for more than a third of revenue).
- A new delay in the RevPAR recovery would affect deleveraging and lead to Outlook revisions and possibly downgrades for the weakest profiles.

Key Assumptions

	March GEO[1] Base Case 2022	June GEO Base Case 2022	March GEO Base Case 2023	June GEO Base Case 2023
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
EZ inflation (December, yoy, %)	3.4	5.3	1.1	1.4
ECB policy rate (MRO, December, %)	0.00	1.00	0.25	1.50
RevPAR (Revenue per available room, EUR)	55	67	76	69
EZ consumer spending	4.4	2.6	2.8	2.0

[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision to Previous Case

	2022	2023-2024
Revenue	⬀	⬂
EBITDA	⬀	⬂
EBITDA margin	⬀	⬂
FCF	⬀	⬂
Leverage	⬂	⬀

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials or commodity inflation		
Inability to pass through cost increase		
Supply chain disruption		
Gas rationing in Europe		
Resumption of Covid-related restrictions		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

Metals & Mining Updated Base Case July 2022

Continued Price Moderation for 2H22 Captured in Price Deck

Supply Demand Fundamentals Remain Robust

Global GDP growth forecasts are coming down, due to high energy costs, supply chain disruptions, lockdowns in China and waning consumer confidence. However, pent-up demand from the coronavirus pandemic remains for cars and consumer products, which will materialise over time as and when existing constraints are resolved. Governments are establishing policies to incentivise the roll-out of decarbonisation to meet their pledges under the Paris Agreement, which requires vast amounts of metals across the commodity spectrum.

Strong Cash Flow Generation in Mining

Prices for mining products remain supportive. On balance there has been more upside than downside volatility so far in 2022. Copper and aluminium sold off in June, but those are actively traded commodities that tend to reflect wider market sentiment. Overall, Fitch Ratings' commodity price assumptions already factor in material price moderation for 2H22 through to 2024.

Inflation has picked up across energy costs, consumables and labour. We have assumed an increase in cash costs of 5%-10% for 2022 in our forecasts across EMEA companies, but anticipate energy cost reductions once oil and gas markets adjust over the longer term. Labour cost rises will be sticky, but for now currency depreciation against the US dollar in major mining jurisdictions mostly offsets labour cost inflation in US dollar terms. The same may apply to locally procured consumables. Cash flow generation in 2022 will be healthy and clearly above mid-cycle in 2023 for most miners.

Steel Margins to Normalise Quicker

The operating environment has become more challenging, particularly in Europe, where the energy gap for industrial sectors is significant. In China we expect stimulus to feed through later in the year for infrastructure and fixed-asset investment, which should provide support to domestic demand, mostly compensating for weaker private consumption including in the property sector. The US, Brazil and India remain reasonably resilient.

Favourable market dynamics outside China are now normalising faster than expected, but earnings will remain robust in 2022, as realised sales and order books will carry steel companies through 1H22. Incrementally, more export volumes will compete for demand in less protected markets such as Europe. Our earnings and cash flow projections for EMEA steel companies for 2023-2024 have not materially changed as we had already factored in material moderation of EBITDA/tonne towards mid-cycle levels, except for Ukrainian companies, which are severely affected by the war.

What to Watch

- The longer lockdowns in China extend into 2H22, the more likely that inventory build-up for steel and aluminium will lead to a more pronounced price correction and margin squeeze.
- The competitiveness of many European steel mills and smelters is impaired by high energy costs.

Key Assumptions

	March GEO[1]/ Price Assumptions Base Case 2022	June GEO/ Price Assumptions Base Case 2022	March GEO/ Price Assumptions Base Case 2023	June GEO/ Price Assumptions Base Case 2023
China GDP growth (annual average, %)	4.8	3.7	5.1	5.3
World GDP growth (annual average, %)	3.5	2.9	2.8	2.7
Copper (LME spot, USD/tonne)	9,500	9,500	8,500	8,500
Iron (62%, CFR China, USD/tonne)	110	120	85	85
Hard coking coal (FOB Australia, USD/tonne)	300	400	160	200
Aluminium (LME spot, USD/tonne)	2,950	2,950	2,600	2,600
Zinc (LME spot, USD/tonne)	3,500	3,600	2,900	3,000
Thermal coal (FOB Newcastle 6,000kcal/kg, USD/tonne)	220	270	104	120
Nickel (LME spot, USD/tonne)	20,000	25,000	17,000	20,000

[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision to Previous Case

Mining	2022	2023-2024
EBITDA	⇗	⇔
EBITDA margin	⇔	⇔
FCF	⇔	⇔
Leverage	⇔	⇔
Steel		
EBITDA	⇘	⇔
EBITDA-margin	⇘	⇔
FCF	⇘	⇔
Leverage	⇗	⇔

Source: Fitch Ratings

Main Risk Factors[a]

Mining	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		

Steel/Aluminium		
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		
Gas rationing in Europe		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

EMEA Networks Updated Base Case July 2022

High Inflation Positive, Negligible Volume Risk

Regulated networks' exposure to rising inflation positively affects financial profiles despite the possibility of hedging mismatch risk. The networks' exposure to inflation depends on the degree of inflation linkage embedded in the regulation. Most regulatory frameworks link regulatory capital value (RCV) and allowed opex to inflation, with an important benefit for allowed revenues. For example, UK water networks earn revenue based on a real return on an RCV that grows with inflation over time while paying a nominal coupon on their debt structure, creating a mismatch risk.

Some networks (mainly in the UK) seek to hedge against inflation mismatch through the use of index-linked swaps, but this could be counterproductive, if the hedge drives very large derivative liabilities. Generally, the bulk of EMEA networks' financial debt is not linked to inflation, so the benefits related to inflation-driven higher margins will only be marginally offset by higher cost of debt related to the increasing rates for variable-rate existing debt and new issuances.

The chart shows the size of inflation-linked swap portfolios by company in UK water, measured as notional value to RCV, as well as the level of derivative liability that each company presents, measured as mark-to market (MTM) value to RCV. Yorkshire Water (YWS) is the most exposed, with MTM liability of about 40% to RCV, and to reflect this risk we downgraded YWS's class B notes in February 2021. MTM liabilities rank super-senior to secured debt.

Insulated from Volume Risk: Regulated networks' allowed revenues are not based on volumes, but tariffs applied to customers depend on estimated volumes. If outturn volumes are lower or higher than estimates and revenues are over or under recovered, these are trued-up in subsequent years.

Limited Political Risk: Fitch believes the networks would be largely unaffected by political risk aimed at reducing the cost of energy bills for households. Network-related costs usually constitute less than 20% of a typical bill (standard variable tariff price cap set by UK regulator Ofgem) and government intervention would provide limited benefits for households, while materially increasing uncertainty (and potentially funding costs) for networks.

Material Risk for Some Gas Transit Networks: We downgraded Net4Gas s.r.o. to 'BB+'/Rating Watch Negative (from 'BBB'/Stable before the Ukraine war) and eustream, a.s. to 'BBB'/Rating Watch Negative (from 'A-'/Stable), with a Standalone Credit Profile of 'bbb-'. The rating actions reflect our view of substantially higher risk to these issuers' long-term ship-or-pay contracts with Gazprom.

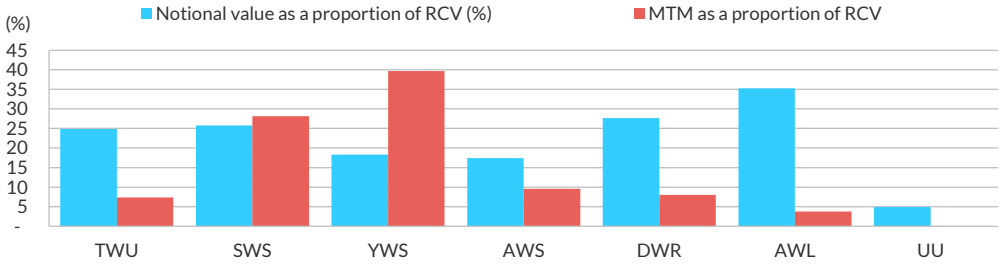
The progressive escalation of sanctions between the EU and Russia could prevent the receipt of scheduled payments from Gazprom in case of further measures. While these companies could accommodate alternative gas flows, and therefore receive other capacity bookings, visibility on this is limited.

Key Assumptions – Chart on Inflation

	March GEO[1] Base Case 2022	June GEO Base Case 2022	March GEO Base Case 2023	June GEO Base Case 2023
UK GDP growth (annual average, %)	3.8	3.8	2.0	1.1
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
UK inflation (December, yoy, %)	5.7	9.2	1.9	2.6
EZ inflation (December, yoy, %)	3.4	5.3	1.1	1.4
ECB policy rate (MRO, Dec., %)	0.00	1.00	0.25	1.50

[1] Global Economic Outlook. Source: Fitch Ratings

Size of Inflation-Linked Swap Portfolios Versus RCV for UK Water at FYE21



Thames Water (TWU), Souther Water (SEW), Yorkshire Water (YWS), Anglian Water (AWS), Dwr Cymru (DWR), Affinity Water (AWL), United Utilites (UU)
Source: Fitch Ratings, companies' annual performance reports

Main Risk Factors[a]

	2022	2023-2024
Volume		
Political		
Regulatory		
Supply chain disruption		
Capex/opex inflation		
Gas rationing in Europe		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

Oil & Gas Updated Base Case July 2022

Crude, Natural Gas Prices Will Remain High for Now

Exceptionally Strong Cash Flows

We revised upwards our base-case crude and natural gas prices (O&G) assumptions in June 2022. Decelerating economic growth will only moderately affect energy consumption, while reduced supplies from Russia will lead to temporary undersupply in oil and in particular European natural gas and global LNG markets. As a result, energy commodity prices are likely to remain high at least in the short term and for European gas even longer. New price records are possible, particularly if Russia's natural gas exports to Europe are halted and a physical deficit of natural gas prompts Europe to introduce gas rationing in any form.

The current energy crisis benefits O&G producers globally. Industry inflation will be creeping up, and windfall taxes, similar to those announced in the UK, Hungary and Italy, could be considered elsewhere. But the positive impact of high commodity prices on O&G producers' cash flows is likely to be more pronounced. Even based on our previous assumptions most upstream producers should generate exceptionally strong pre-dividend FCFs, which are being used to increase shareholder distributions and intensify capex and M&A, but also to cut debt. Our updated price deck should translate into even higher operating cash flows and FCF, and lower leverage for most O&G issuers.

Most refineries and integrated producers are also benefiting from the current environment as crack spreads remain very high and more than offset increased energy and hydrogen costs, which is likely also to lead to higher profits/FCF for the segment.

Gas Rationing Scenario in Europe

However, several integrated producers in our portfolio could be affected to varying degrees if natural gas rationing is introduced in Europe. Some of the companies' assets may be forced to operate at reduced capacity. We have revised the Outlook on MOL Hungarian Oil & Gas Company plc's 'BBB-' rating, the most exposed company, to Negative from Stable, to reflect this risk.

Windfall Taxes

Windfall taxes should not have a dramatic impact on O&G companies' cash flows – considering where commodity prices are – but cast doubt on the sector's regulatory environment. Over time such practices could lead to reduced investment activity in affected jurisdictions.

What to Watch

- Reduced supplies from Russia could widen deficits in the global energy markets
- OPEC+ and US shale response, and LNG availability will be key mitigants
- Several refineries in Europe could be affected by gas rationing
- Wider use of windfall taxes

Key Assumptions

	March GEO[1]/Price Assumptions Base Case 2022	June GEO/Price Assumptions Base Case 2022	March GEO/Price Assumptions Base Case 2023	June GEO/Price Assumptions Base Case 2023
Brent crude (USD/bbl)	100	105	80	85
WTI crude	95	100	76	81
TTF natural gas (USD/mcf)	20	25	10	15
Henry hub natural gas (USD/mcf)	4.25	6.25	3.25	4
Global GDP growth (%)	3.5	2.9	2.7	2.6

For other assumptions please see Fitch's Global Economic Outlook – June 2022
[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision to Previous Case

	2022	2023-2024
Revenue	⇗	⇗
EBITDA	⇗	⇗
Unit margins	⇗	⇗
FCF	⇗	⇗
Leverage	⇘	⇘

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		
Supply chain disruption		
Gas rationing in Europe[b]		
Windfall taxes		

[a] Green – for neutral to positive impact; orange – mildly negative, red – negative
[b] For downstream-focused companies.
Source: Fitch Ratings

EMEA Real Estate Updated Base Case August 2022

Some Leases have CPI Uplifts, but Rents Have to be Affordable

High Inflation Positive For Rents

Continental European property leases often have forms of annual CPI indexation (some with caps) so, where applicable, 1H21 rent increases that captured high inflation figures were paid by tenants as contracted. Fitch believes a successive second year (in 2023) of contractual high rent increases may be less palatable for tenants, particularly for retail and residential sectors.

In the UK, where inflation indexation in leases is not normal, Fitch continues to use a pedestrian low-single-digit annual rent increase for lease expiries (or yoy declines in retail passing rents). Fitch's rating case continues to include more pedestrian (2%-3%) levels of overall rent increases despite higher levels in other European and central and eastern European (CEE) portfolios.

Residential-for-rent property companies may charge tenants utility costs (electricity, heating) but this is viewed as a pass-through cost rather than a profit centre, so any under-recoveries in 2022 will be recouped in future years. Logistics still has innate growth. Prime city offices remain in demand, whereas retail is slowly recovering in footfall and property values, with delayed or subdued rental growth.

Many property companies have greater than 70%, many at 90%-100%, of their long-dated debt at fixed interest rates. Therefore immediate policy rate rises will not deplete existing ample interest cover ratios, and locked-in existing euro-denominated average cost of debt (1.5% to 2.0%) or around 3% for sterling will take time to increase as debt is scheduled for refinancing at higher rates.

Fitch's rated real estate companies do not depend on selling assets to refinance near-term debt maturities, although that option exists.

Interest Rates Affect Property Valuations and Loan-to-Values

Interest rates are a key input into property yields – among other factors such as inflation-protected rents, location, asset quality, supply and demand dynamics – along with investor appetite for the different asset classes. It is therefore inevitable that when the low-interest-rate environment – which created high valuations – ends, valuations will decrease. Loan-to-value ratios are likely to increase, but Fitch's analysis has concentrated on net debt/rental-derived EBITDA cash flow leverage, matching the longevity of rental income with long-term nominal debt and its long-term interest rate fixing.

What to Watch

- Despite contractual CPI rent increases, rents need to remain affordable for tenants.
- Given on-going secular sector changes, also consumers' and retailers' continued weakness, the retail asset class is likely to see subdued rental growth.

Key Assumptions

	March GEO[1] Base Case 2022	June GEO Base Case 2022	March GEO Base Case 2023	June GEO Base Case 2023
UK GDP growth (annual average, %)	3.8	3.8	2.0	1.1
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
UK inflation (December, yoy, %)	5.7	9.2	1.9	2.6
EZ inflation (December, yoy, %)	3.4	5.3	1.1	1.4
UK policy rate (December, %)	1.25	2.00	1.75	2.50
ECB policy rate (MRO, December, %)	0.00	1.00	0.25	1.50

[1] Global Economic Outlook. Source: Fitch Ratings =

Key Metrics – Revision to Previous Case

	2022	2023-2024
Revenue (rent-derived)	⇗	⇔
EBITDA	⇗	⇔
Interest expense	⇗	⇗
Interest coverage ratio	⇘	⇘
Net debt/EBITDA leverage	⇔	⇔

Source: Fitch Ratings

Real Estate Asset Classes - Prospects

Prime Office	Continued demand for well-located, quality, flexible, ESG-conducive space
Secondary Office	Most vulnerable to economic downturn and increased remote working
Retail	Retailers slowly recovering, rents affordable (or in the UK resetting at lower levels), including footfall at 90% of pre-pandemic levels
Logistics	Continued growth in logistics (e-commerce) and industrial (on-shoring)
Residential-for-Rent	Supply and demand, and regulated European rentals below market rents, are conducive for continued income stability and high occupancy
Community Service	Many of these leases CPI linked, often on long-dated leases

Source: Fitch Ratings

EMEA Retail Updated Base Case July 2022

Profitability Affected by Economic Slowdown: Retailers May Not Be Able to Pass on All of Cost Inflation

We have generally not revised downwards our base case assumptions for revenues, because we expect lower sales volumes to be broadly offset by higher prices. Demand in food retail is resilient, although in periods of economic slowdown preferences shift to cheaper products, including retailers' own labels. For non-food retail, demand could be reduced by consumers delaying purchases of non-essentials, especially big-ticket items like furniture.

We have lowered our expectations for profit margins. Food retailers typically operate on low margins and their inability or unwillingness to pass on the soaring costs of food, to protect market share, and inability to fully mitigate energy and wages inflation, will put pressure on their profits. We have cut our assumptions of EBITDA margin by 50bp for 2022, and an additional 20bp-30bp in 2023.

For non-food retailers, we have also lowered our base case assumptions for profitability. Profit margins are structurally lower than for goods manufacturers, given low added value. Higher costs can easily, and for some retail categories (like clothing) materially, affect profitability. In addition, rent is a major cost for brick-and-mortar retailers, although rent inflation varies by location, with some legacy UK rent agreements linked to the retail price index.

If energy prices and other operating costs, such as wages or transport, reduce from current highs, we expect retailers should be able to pass through normal COGS inflation, in particular if real wages become more neutral, or return to positive levels. However, this is not our central scenario currently, hence we still expect a negative earnings trend in 2023-2024.

Supply Chain Disruption to Wane Gradually

Some retailers face disruptions in the supply chain, particularly in non-food categories, leading to unavailability and longer delivery times, increasing working capital needs and cash-flow volatility, which could last beyond 2022. Retailers with large committed revolving credit facilities, positive free cash flows or cash cushions should be more able to absorb this volatility.

What to Watch

- Retailers will have to navigate between protecting their margins through passing on cost inflation, while keeping market share by absorbing some, which will pressurise their margins.
- Lower profitability could delay deleveraging and put pressure on retailers with low rating headroom, leading to outlook changes.

Key Assumptions

	March GEO[1] base case 2022	June GEO base case 2022	March GEO base case 2023	June GEO base case 2023
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
UK GDP growth (annual average, %)	3.8	3.8	2.0	1.1
Germany GDP growth (annual average, %)	2.5	1.6	2.1	2.3
France GDP growth (annual average, %)	3.0	2.4	2.2	2.1
EZ inflation (December, yoy, %)	3.4	5.3	1.1	1.4
UK inflation (December, yoy %)	5.7	9.2	1.9	2.6
Germany inflation (December, yoy %)	4.0	5.6	1.4	1.6
France inflation (December, yoy %)	3.0	4.2	1.3	1.5
ECB policy rate (MRO, December, %)	0.0	1.0	0.25	1.5
UK policy interest rate	1.25	2.0	1.75	2.5
EZ consumer spending	4.4	2.6	2.8	2.0
UK consumer spending	6.3	4.6	2.7	1.4
Germany consumer spending	3.6	3.6	2.8	2.5
France consumer spending	4.4	2.5	2.0	2.4

[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision to Previous Case

	2022	2023-2024
Revenue	⬌	⬌
EBITDA	⬊	⬊/⬌
EBITDA margin	⬊	⬊
FCF	⬊	⬊/⬌
Leverage	⬈	⬈/⬌

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials or commodity inflation		
Inability to pass through cost increases		
Supply chain disruption		
Gas rationing in Europe		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

Western European Technology Updated Base Case August 2022

Long-Term Positive Trend Offset by Economic Uncertainty

Positive Underlying Industry Trends, Government Funding

Underlying technology industry trends remain positive. The software and cloud services subsector continue to benefit from workflow modernisation and Fitch Ratings expects revenue growth in this segment. Government funding, like the European Union digital transition plan, could underpin growth in IT services and support some capital investment. We assume that component supply chain constraints will begin to ease in 2H22. Semiconductor foundry overcapacity should not be a major concern before 2023, as investment in capacity (even with the Chips Acts on both sides of the Atlantic) will take time to complete. Semiconductor capacity additions coupled with weaker end demand could result in overcapacity in 2023-2024.

Impact of Economic Uncertainty Varies by Segment

Growth in the software subsector and parts of IT services should continue to grow even with a weak macroeconomic backdrop, although the pace of growth could be constrained by softer end-market spending as certain projects may be postponed or cancelled.

The technology hardware subsector is more likely to be influenced by the economic cycle. The impact could range from a more prolonged downturn if end-customer demand is negatively affected by recession, or limited to a shorter period of underperformance as inventory levels adjust. Hardware producers (whether semiconductors or telecoms equipment) are more exposed to rising raw material and energy costs than companies that are more involved with software and IT services. Inflationary pressures could pressure margins if higher costs cannot be passed on to customers.

Companies should still have some ways to preserve free cash flow. They still have the ability to adjust their capex plans if end-customer demand falls away. Higher interest rates and limited visibility on profitability may make M&A activity less appealing.

What to Watch

- Signs of supply chain constraints beginning to ease in 2H22 as certain consumer and industrial applications experience weaker demand. There have been supply shortages for technology hardware products to mid-2022 due to the strong post-pandemic recovery, but supply and demand should become more balanced.
- Weaker end-customer demand for semiconductors, coupled with capacity additions, which could result in overcapacity in 2023–2024, with some downward pressure on prices.
- The sustainability of revenue growth for the software and cloud services subsector, which should continue to benefit from workflow modernisation as well as from European Union digital transition funding.

Key Assumptions

	March GEO[1] base case 2022	June GEO base case 2022	March GEO base case 2023	June GEO base case 2023
US GDP growth (annual average, %)	3.5	2.9	1.6	1.5
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
US inflation (December, yoy, %)	4.5	6.5	2.6	2.8
EZ inflation (December, yoy, %)	3.4	5.3	1.1	1.4
US policy rate (December, %)	2.00	3.00	3.00	3.50
ECB policy rate (MRO, December, %)	0.00	1.00	0.25	1.50

[1]Global Economic Outlook. Source: Fitch Rating

Key Metrics – Revision

	2022	2023-2024
Revenue	⇔	⇔
EBITDA	⇔	↘
EBITDA margin	⇔	↘
FCF	⇔	⇔
Leverage	⇔	⇔

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		
Supply chain disruption		
Gas rationing in Europe		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

Western European Telecoms Updated Base Case July 2022

Delayed Impact From the Deteriorating Environment

Sustained Lower GDP Growth to Weigh on Credit Revenues

Fully integrated western European telecoms operators are not immune from a macro-economic downturn but the impact on their revenue and EBITDA is likely to be gradual and delayed. In contrast, mobile tower operators will show strong resilience as a result of largely immune business models. Fitch Ratings does not expect to make significant revisions to our 2022 revenue and EBITDA projections but forecasts thereafter are likely to weaken as a result of potentially reducing customer spend and inflationary cost increases that squeeze profit margins.

The essential nature of telecoms connectivity services, the contracted revenues, a high mix of fixed costs and a sizeable degree of energy cost hedging provide operators with some immunity towards macro-economic pressures in the short-term. However, a longer period of weakened economic growth will lead to lower revenue growth as business customers delay spend and consumers begin to trade down to lower priced bundles. We expect the level of revenue contraction to be in line with GDP, though potentially with a short delay.

Lower revenue growth in conjunction with higher costs due primarily to contract renewals at potentially higher prices, inflationary pressures on wages and contracted infrastructure costs such as mobile towers and leases will burden EBITDA margins by 1pp to 3pp of revenue.

Different Dynamics by Market

The extent to which margin pressure can be absorbed will differ by operator and competitive dynamics. In markets such as the UK, operators will be able to raise prices, potentially ahead of inflation. In markets such as Italy where one operator is building scale, the scope for price increases could be diminished amid a bid to maintain market share. Existing cost reduction programmes and the decreasing impact of legacy product declines may also help temper the effects of inflation, though at the expense of margin expansion.

Western European telecoms operators have a number of levers they can pull to minimise the impact on free cashflow. These levers include reducing or delaying capex spend for IT projects and network roll outs, accelerating cost reduction programmes, temporarily curbing advertising budgets, and raising prices. The exact mix will vary by operator and market.

What to Watch

- The impact of higher interest rates on infrastructure transaction multiples. A higher cost of debt could reduce divestment proceeds and the attractiveness to sell assets.
- A potential greater emphasis on achieving in-market consolidation as a means of improving free cash flow and investment returns.

Key Assumptions

	March GEO[1] base case 2022	June GEO base case 2022	March GEO base case 2023	June GEO base case 2023
US GDP growth (annual average, %)	3.5	2.9	1.6	1.5
EZ GDP growth (annual average, %)	3.0	2.6	2.3	2.1
US inflation (December, yoy, %)	4.5	6.5	2.6	2.8
EZ inflation (December, yoy, %)	3.4	5.3	1.1	1.4
US policy rate (December, %)	2.00	3.00	3.00	3.50
ECB policy rate (MRO, December, %)	0.00	1.00	0.25	1.50

[1] Global Economic Outlook. Source: Fitch Ratings

Key Metrics – Revision

	2022	2023-2024
Revenue	⬌	↘
EBITDA	⬌	↘
EBITDA margin	⬌	↘
FCF	⬌	⬌
Leverage	⬌	⬌

Source: Fitch Ratings

Main Risk Factors[a]

	2022	2023-2024
Demand erosion		
Wage inflation		
Raw materials/commodity inflation		
Inability to pass through cost increase		
Supply chain disruption		
Gas rationing in Europe		

[a] Green – neutral to positive impact; orange – mildly negative, red – negative. Source: Fitch Ratings

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