Standard & Poor's Research

October 12, 2011

Scania (publ.) AB

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Table Of Contents

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Scania (publ.) AB

Major Rating Factors

Corporate Credit Rating
A-/Stable/A-2
South African National Scale *zaAA+/--/zaA-1*

Strengths:

- Leading market positions in Europe and South America in the manufacture of heavy trucks and buses.
- Up-to-date product range and the highest degree of component commonality in the global truck industry.
- A conservative financial policy and a modest financial risk profile, very strong profitability relative to peers', and good financial flexibility.

Weaknesses:

- Operations within industries characterized by high volatility and high capital intensity.
- Sizable operations in regions that might be susceptible to economic and political instability (such as Brazil).

Rationale

The ratings on Sweden-based truck and bus manufacturer Scania (publ.) AB reflect the group's satisfactory business profile and modest financial risk, according to Standard & Poor's Ratings Services' criteria. The ratings are supported by Scania's very strong profitability in the global truck industry. However, they also reflect the strong cyclicality of the group's operating earnings. The group's truck and bus businesses benefit from leading market positions, up-to-date product lines, and the highest degree of component commonality in the global truck industry.

We apply our parent-subsidiary criteria in our assessment of Scania's credit quality because of the relationship between Scania and its Germany-based parent, Volkswagen AG (VW; A-/Stable/A-2). VW owns 71% of the voting rights in Scania and 46% of the capital (or 72% of the voting rights and 49% of the capital, if indirect holdings managed by credit institutions are included). Consequently, Scania is fully consolidated.

VW's voting power is sufficient for it to exert a significant influence over Scania's business risk profile, strategy, and, more importantly, its financial risk profile. VW views Scania as a group brand within its portfolio. Furthermore, we regard other investors as less able to influence Scania, given the small proportion of voting rights in the hands of minority shareholders.

We assess Scania's stand-alone credit profile at 'a-'. The corporate credit ratings and outlook are capped by those on the parent, VW.

Key business and profitability developments

Scania's operating income for the first half of 2011 increased by 18% year on year, following a similar growth in revenues. The operating margin remained stable at 15.2%. This is higher than the peak-of-the-cycle margins in 2006-2008 (the industrial operations' EBIT margins were 13.6% in 2008, 13.8% in 2007, and 11.7% in 2006). The solid sales growth was supported by solid demand, especially in Northern Europe, the Middle East, and Asia. The important Brazilian market is flattening out at high levels after a booming 2010 due to subsidies for vehicle investments and strong economic growth.

The 15.2% operating margin was supported by strong volume growth and stable pricing. But negative currency effects and a somewhat negative market mix had an adverse effect where emerging markets, other than the highly profitably Brazilian market, are growing in importance. Higher raw material costs also had an increasingly negative effect on earnings. In our base-case scenario, we expect Scania's sales to increase by about 10% in 2011, showing a margin dilution of about two percentage points against the strong 16% margin in 2010, something we believe Scania should be able to reach fairly comfortably in 2011.

Key cash flow and capital-structure developments

Scania's financial performance remains significantly above levels commensurate with the ratings. At the end of June 2011, funds from operations (FFO) was very strong, just over Swedish krona (SEK) 14 billion (€1.5 billion)on a rolling 12 months basis, in line with strong full-year 2010 figures, thanks to continued strong volumes and profitability. The reported SEK3.2 billion free operating cash flow (FOCF) for the first half of 2011 was down from SEK5.9 billion reported in the extremely strong first half of 2010. This was due to higher inventory levels and investments following continued strong volume growth. The current levels of cash flow are still very strong in a historic perspective, however.

On the back of very solid cash flow generation, Scania reported a net cash position of almost SEK6 billion, resulting in very strong credit measures for the rating. According to our base-case scenario, Scania should be able to produce FFO of SEK13 billion-SEK14 billion in 2011, similar to 2010 levels. We expect Scania to continue to increase investments on a limited basis to reach its production goal of 150,000 vehicles at the peak of the next cycle. Thus, we expect reported credit measures far above those we deem commensurate with a modest financial risk profile. The indicative ratios for the modest financial profile are adjusted FFO to debt of more than 45% and adjusted debt to EBITDA of 1.5x-2.0x.

Liquidity

The short-term ratings are 'A-2' and 'zaA-1'. We consider Scania's liquidity and financial flexibility to be strong. As of June 30, 2011, the company's industrial unit reported liquidity sources consisting of:

- Cash and liquid assets of SEK6.3 billion (about €690 million), of which we consider SEK5.5 billion to be excess cash.
- Two committed revolving credit facilities of €1 billion each, one due in January 2013 and the other in May 2016. To our knowledge, the bank lines are not subject to financial covenants or rating triggers. However, the documentation for the facilities contains a material adverse-change clause.
- Two additional committed lines totaling SEK10.0 billion, due in 2016 and 2017.
- Our expectation of FFO of about SEK13 billion annually from 2011.

These sources compare with expected near-term liquidity uses totaling SEK12 billion, comprising debt maturing in 2012.

For its financial services unit, Scania pursues a policy of having dedicated financing that covers its estimated need for funding during the subsequent year.

Outlook

The stable outlook on Scania reflects that on the parent, VW. We could therefore revise the outlook on Scania if we revised the outlook on VW.

A negative rating action on VW could trigger a similar action on Scania. Furthermore, VW's strategic business decisions, such as those leading to potential closer cooperation among Germany-based MAN SE (BBB+/Positive/A-2; in which VW's voting rights slightly exceed 30%), Scania, and VW's own truck division could affect Scania's stand-alone credit profile.

Business Description

Scania, based in Södertälje, Sweden, is one of the world's leading heavy-truck and bus manufacturers. Although the group's divisions encompass buses, industrial and marine engines, and services, the truck operations dominate Scania's business. Despite strong growth in South America in recent years, Europe remains the group's major market.

Business Risk Profile: A Track Record Of Strong Profitability And Efficient Manufacturing Processes

The major supports for Scania's "satisfactory" business risk profile are:

- Leading market positions in Europe and Latin America in the manufacture of heavy trucks and buses. Scania ranks as on of the largest heavy-truck producer globally, behind Daimler AG (BBB+/Positive/A-2), Volvo (publ), AB (BBB/Stable/A-2; Nordic national scale --/--/K-2), and PACCAR Inc. (A+/Stable/A-1). It has a market-leading position in South America, notably Brazil. Scania's largest market is Western Europe, where it contributed about 41% of total heavy-truck deliveries in 2010 (45% in 2009, 51% in 2008, 52% in 2007, 57% in 2006, and 60% in 2005) and has had a relatively stable market share of about 13%-14% over the past six years. Scania is also No. 4 in the heavy bus segment, behind Daimler, Volvo, and MAN SE. The group leads the market in extending its modular concept to buses and has achieved high integration of the truck and bus segments.
- Up-to-date product range/lines. Scania offers a wide range of bus and coach products from chassis to fully built buses. However, the bus segment mainly produces bus chassis, and Scania subsequently outsources final assembly through independent bus body builders.
- Strong profitability. We don't expect the operating margin to fall to less than 4%-5% at the bottom of the cycle, reflecting Scania's focus on the owner-operator market (lower need for discounting) and the efficiency resulting from the modular concept. For the past 10 years, Scania's EBIT margin has been the highest in the global truck industry. Heavy-duty trucks dominate Scania's production and contribute to the group's superior margins because they are generally more profitable than light trucks, although they also increase the cyclicality of revenues. Industrywide profitability in bus production remains generally low, reflected in EBIT margins of 2%-4%.
- The most advanced modular production system in the truck industry, which means Scania uses the lowest number of individual parts for different vehicle specifications. This allows Scania to tailor vehicles to individual customers' needs, but still benefit from economies of scale.
- Successful turnaround of the bus operations by integrating bus chassis production into the truck operations and by restructuring the bus body building operations.
- Production flexibility. In early 2008, Scania started to assemble its P-, G-, and R-series trucks in Latin America. As a result, the company now offers the same truck range in the 100 or so markets in which it operates, providing additional production flexibility.

These supports, however, may be challenged by:

- High volatility of operations and operating profits. Sales and earnings in the heavy truck industry are volatile and follow swings in demand that are linked to the macroeconomic climate.
- Sizable operations in regions that might be susceptible to economical and political instability (notably in Brazil).
- A structurally problematic bus industry, which has low profitability. The global bus industry has been confronted with a number of challenges, including prolonged market downturns in Europe and America, price and competitive pressures, and industrywide overcapacity. However, all the industry players have taken steps to cope with these difficulties, notably by relocating labor-intensive assembly work to low-cost countries.

Financial Risk Profile: Conservative Financial Policies And Positive Free Cash Flow Through The Cycle

The main strengths of Scania's "modest" financial risk profile are:

- A conservative financial policy, in our view, shown by an organic growth strategy, conservative reserve policy, and prudent liquidity goals.
- Good financial flexibility. Scania has set sufficiently prudent liquidity goals for its industrial operations. As we understand, it intends to hold a liquidity reserve (cash and unutilized credit facilities) that exceeds its funding needs for the next two years (excluding the financial services businesses). For its financial services unit, Scania intends to have dedicated financing to cover the estimated funding demand for the subsequent 12 months.
- A historically organic growth strategy, with some minor bolt-on acquisitions mainly to complement the distribution network. We expect the group to continue its prudent, predominantly organic, growth policy in the future.
- Lower write-off rates than the industry average. This is helped by the group's absence from the North American market, which has much higher write-offs than is usual in Western Europe. Scania's average write-off ratio of in 2010, was 1.29%, lower than 1.9% in the crisis year of 2009, but still considerably higher than the 0.53% it posted in 2008.
- Mature portfolios, higher initial deposits, and better value on security because the majority of the group's financial services assets are concentrated in Western Europe.
- Conservative reserving to cover potential future losses on the existing financial services portfolio.
- Ability to generate positive FOCF through the cycle. Scania's operating cash flow stream has been steady for a number of years. Positive FOCF generation through the cycle enabled the company to report low debt in 2004-2007, and, following a very strong 2010, Scania is now in a net cash position. Also, in the trough year 2009, Scania managed to generate significantly positive FOCF, with the help of strong management of working capital.

These strengths are moderated by:

- High capital intensity.
- A high dividend payout ratio. Scania's dividend policy is based on the group's long-term performance. Payouts were between 30%-50% of net earnings over the past few years, except for 2006 when Scania paid 64%. For 2009, the payout ratio was a high 71%.

Financial Statistics/Adjustments

Scania has prepared financial statements under International Financial Reporting Standards since 2005. When assessing Scania's credit profile, we make a number of adjustments to the reported financial information (see table 1).

We make the following debt-related adjustments:

- Surplus cash: Our total adjusted debt figure for the group includes our estimate of surplus cash, which is netted from the total debt figure. Our calculation of surplus cash factors in the level of cash we consider appropriate to remain available to meet the group's business needs and includes analysis of other consolidated cash balances that might not be immediately accessible by the group. The cash amount that was not credited against debt is SEK800 million.
- Captive finance adjustments: We use our captive finance methodology as a tool to facilitate the analysis of industrial companies with captive financial service operations, such as truck makers, automakers, or capital goods companies. The debt of the captive finance company is usually assigned the same rating as that on the parent's debt because we view the captive finance company and its operating company parent as a single business enterprise. Although the ratings on the captive and the parent are equalized, we don't analyze the two on a consolidated basis. Rather, the analysis separates financing activities from manufacturing activities and analyzes each separately, reflecting the different types of assets they possess. Debt, equity, and earnings (EBIT) are allocated to the parent and captive so that both entities reflect a similar credit quality. For Scania, we determined that a financial services debt leverage factor of 7-to-1 is appropriate for the rating category, based on the quality of the captive's receivables and lease assets. This implies that captive-finance assets of SEK36.1 billion at year-end 2010 are covered by SEK31.6 billion of financial debt and SEK4.5 billion of equity. Furthermore, when calculating the cash flow figures used to calculate key ratios, we do not include cash generated by the captive finance unit (SEK612 million). For an overview of our methodology for captive finance adjustments, see "Captive Finance Operations," published on April 17, 2007, on RatingsDirect on the Global Credit Portal.

Related Criteria And Research

- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Key Credit Factors: Business and Financial Risks In The Automaker Industry, Sept. 25, 2008
- Principles Of Corporate And Government Ratings, June 26, 2007
- Captive Finance Operations, April 17, 2007

Table 1

Reconciliation Of Scania (publ.) AB Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. SEK)

	--Fiscal year ended Dec. 31, 2010--									
Scania (publ.) AB reported amounts										
	Debt	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**Cash flow from operations**	**Cash flow from operations**	**Dividends paid**	**Capital expenditures**
Reported	34,406.0	30,035.0	82,365.0	17,108.0	12,746.0	287.0	15,301.0	15,301.0	800.0	20,977.0

Table 1

Reconciliation Of Scania (publ.) AB Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. SEK) (cont.)

Standard & Poor's adjustments										
Operating leases	1,393.5	--	--	72.4	72.4	72.4	282.6	282.6	--	173.9
Postretirement benefit obligations	4,178.0	53.8	--	(45.0)	(45.0)	239.0	(153.3)	(153.3)	--	--
Surplus cash and near cash investments	(9,068.0)	--	--	--	--	--	--	--	--	--
Capitalized development costs	--	--	--	(354.0)	(185.0)	--	(354.0)	(354.0)	--	(354.0)
Captive finance activity	(31,619.9)	(4,517.1)	(4,197.0)	(1,989.0)	(418.6)	--	(612.0)	(612.0)	--	(17,702.0)
Reclassification of nonoperating income (expenses)	--	--	--	--	333.0	--	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	--	(268.0)	--	--
Minority interests	--	1.0	--	--	--	--	--	--	--	--
EBITDA - Income (expense) of unconsolidated companies	--	--	--	(16.0)	(16.0)	--	--	--	--	--
EBIT - Income (expense) of unconsolidated companies	--	--	--	--	16.0	--	--	--	--	--
Total adjustments	(35,116.4)	(4,462.3)	(4,197.0)	(2,331.6)	(243.2)	311.4	(836.7)	(1,104.7)	0.0	(17,882.1)
Standard & Poor's adjusted amounts										
	Debt¶	**Equity**	**Revenues**	**EBITDA**	**EBIT**	**Interest expense**	**Cash flow from operations**	**Funds from operations**	**Dividends paid**	**Capital expenditures**
Adjusted	0.0	25,572.7	78,168.0	14,776.4	12,502.8	598.4	14,464.3	14,196.3	800.0	3,094.9

DEK--Swedish krona.

Table 2

Scania (publ.) AB Peer Comparison

Industry Sector: Automotive - OEM'S					
	Scania (publ.) AB	**Volvo publ AB**	**MAN SE**	**Daimler AG**	**PACCAR Inc.**
Rating as of Oct. 12, 2011	A-/Stable/A-2	BBB/Stable/A-2	BBB+/Positive/A-2	BBB+/Positive/A-2	A+/Stable/A-1
(Mil. €)	**--Average of past three fiscal years--**				
Revenues	7,605.4	25,121.2	13,882.0	80,362.7	7,238.2
EBITDA	1,174.9	1,655.6	1,305.1	5,141.0	822.8

Table 2

Scania (publ.) AB Peer Comparison (cont.)					
Net income from cont. oper.	642.6	224.0	507.7	1,165.3	383.0
Funds from operations (FFO)	949.7	1,204.3	1,074.3	2,635.9	767.7
Capital expenditures	443.3	1,082.9	556.7	1,598.7	193.7
Free operating cash flow	580.2	143.3	604.7	904.9	609.0
Discretionary cash flow	364.3	(331.4)	337.0	(18.5)	342.2
Cash and short-term investments	79.8	749.5	264.0	3,783.3	1,623.5
Debt	751.5	4,829.3	1,353.8	9,630.4	109.6
Equity	2,027.1	5,783.7	5,196.6	25,006.9	2,235.9
Adjusted ratios					
EBITDA margin (%)	15.4	6.6	9.4	6.4	11.4
EBITDA interest coverage (x)	14.3	4.8	9.9	5.2	27.5
EBIT interest coverage (x)	11.2	2.0	6.9	3.6	16.8
Return on capital (%)	32.7	6.4	13.3	9.5	22.3
FFO/debt (%)	126.4	24.9	79.4	27.4	700.4
Free operating cash flow/debt (%)	77.2	3.0	44.7	9.4	555.6
Debt/EBITDA (x)	0.6	2.9	1.0	1.9	0.1
Total debt/debt plus equity (%)	27.0	45.5	20.7	27.8	4.7

Table 3

Scania (publ.) AB Financial Summary					
Industry Sector: Automotive - OEM'S					
	--Fiscal year ended Dec. 31--				
(Mil. SEK)	**2010**	**2009**	**2008**	**2007**	**2006**
Rating history	A-/Negative/A-2	A-/Negative/A-2	A-/Stable/A-2	A-/Stable/A-2	A-/Watch Neg/A-2
Revenues	78,168.0	62,074.0	88,977.0	84,486.0	70,738.0
EBITDA	14,776.4	5,164.4	15,207.0	14,518.9	11,157.1
Net income from continuing operations	9,103.0	1,129.0	8,890.0	8,554.0	5,939.0
Funds from operations (FFO)	14,196.3	2,674.8	11,165.2	12,783.7	10,024.1
Capital expenditures	3,094.9	4,067.9	6,367.4	5,146.7	4,609.6
Free operating cash flow	11,369.4	4,385.9	697.7	7,459.9	6,071.5
Discretionary cash flow	10,569.4	2,385.9	(3,302.3)	4,459.9	3,071.5
Cash and short-term investments	800.0	800.0	800.0	800.0	800.0
Debt	0.0	10,445.7	13,582.9	2,937.7	227.4
Equity	25,572.7	18,278.3	16,073.7	20,125.0	22,278.8
Adjusted ratios					
EBITDA margin (%)	18.9	8.3	17.1	17.2	15.8
EBITDA interest coverage (x)	24.7	4.7	19.0	24.4	18.2
EBIT interest coverage (x)	20.9	2.1	15.9	20.7	14.9
Return on capital (%)	44.2	7.8	45.9	49.5	35.6
FFO/debt (%)	N.M.	25.6	82.2	435.2	4,407.7
Free operating cash flow/debt (%)	N.M.	42.0	5.1	253.9	2,669.7
Debt/EBITDA (x)	0.0	2.0	0.9	0.2	0.0

Table 3

Scania (publ.) AB Financial Summary (cont.)					
Debt/debt and equity (%)	0.0	36.4	45.8	12.7	1.0

SEK--Swedish krona. N.M.--Not meaningful.

Ratings Detail (As Of October 12, 2011)		
Scania (publ.) AB		
Corporate Credit Rating		A-/Stable/A-2
South African National Scale		zaAA+/--/zaA-1
Commercial Paper		
Nordic National Scale Rating		K-1
Senior Unsecured (2 Issues)		A-
Corporate Credit Ratings History		
04-Aug-2011		A-/Stable/A-2
31-Aug-2009		A-/Negative/A-2
08-May-2009		A-/Watch Neg/A-2
25-Jul-2007		A-/Stable/A-2
31-Aug-2009	*South African National Scale*	zaAA+/--/zaA-1
23-Jul-2009		zaAA+/Watch Neg/zaA-1
03-Jun-2009		--/--/zaA-1
Business Risk Profile		Satisfactory
Financial Risk Profile		Modest
Debt Maturities		
As of Dec. 31, 2010 2011: SEK12.2 bil. 2012: SEK14.5 bil. 2013: SEK.6 bil. 2014 and thereafter: SEK6.8 bil.		
Related Entities		
Scania CV AB		

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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