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Corporates

EMEA
Special Report

EMEA Corporate Capital Expenditure

Cut-backs Support Free Cash Flow Recovery

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Related Research

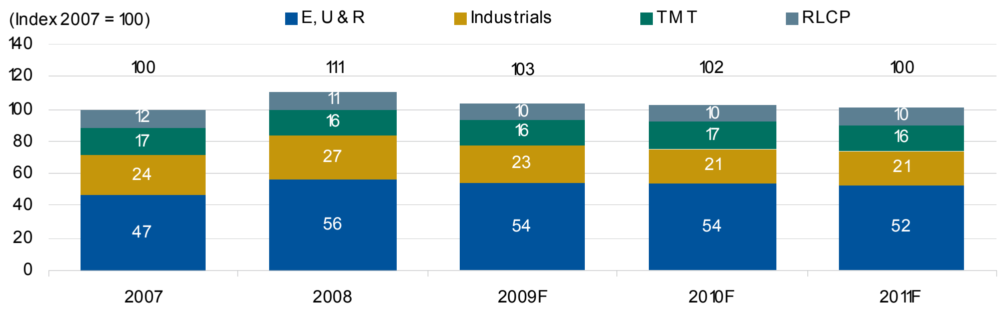
- *Global Economic Outlook (October 2009)*
- *Stabilising Corporate Ratings in Europe and Asia-Pacific (October 2009)*
- *EMEA Industrial Capital Expenditure Cut-backs (February 2009)*
- *Corporate Forecasts: Macro-Level Assumptions (April 2009)*

Summary

Capital expenditure (capex) reduction has been a key tool in cash conservation efforts for EMEA corporates during what for many sectors has been a challenging year. The amount of flexibility that corporates have to reduce capex is substantial and can be implemented with relative speed.

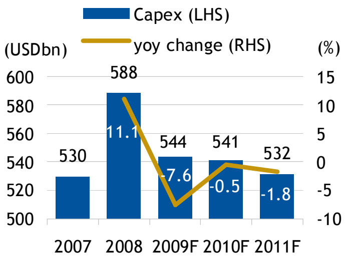
- Based on its internal forecasts for a sample of 230 EMEA corporates, Fitch expects EMEA capital expenditure to fall by 8% in 2009, with sharp cutbacks in the industrial sector (down 17%) and retail, leisure and consumer products (down 15%), partly offset by continued investment by power utilities (up 9%). Capex is forecast to remain subdued in 2010 and 2011.
- These forecasts are an improvement on expectations in February 2009, and reflect the growing consensus that while demand conditions are likely to remain weak for some time, an anaemic recovery is beginning. Companies are now more optimistic about the outlook for commodity prices and general demand than they were at the start of 2009, even though cyclical sectors are continuing to adopt a cautious approach. The key drivers for this positive development are the major fiscal stimulus packages around the world, the reversal of the inventory cycle and improved financial conditions.
- Free cash flow (FCF) shrank by a massive USD123bn in 2008 to a negative USD28bn but Fitch expects a significant improvement in 2009 as cash conservation measures put in place at the end of 2008 are executed. Further improvements are expected for 2010.
- Of the USD123bn negative FCF swing, the cyclical industrial sectors accounted for USD73bn (59%) and the heavily investing energy sector for USD32bn (26%).
- The energy, utilities and regulation (EU&R) sectors are expected to remain in negative FCF mode on an aggregate basis from 2007 until 2011, reflecting heavy investment through the cycle.
- Continued investment has been helped by the boom in EMEA corporate bond issuance in 2009. This has been partly driven by the EU&R sectors, which accounted for 36% of total issuance of EUR404.7bn as at 30 September 2009, up from 15-30% in recent years.

Capex Trend - By Sector



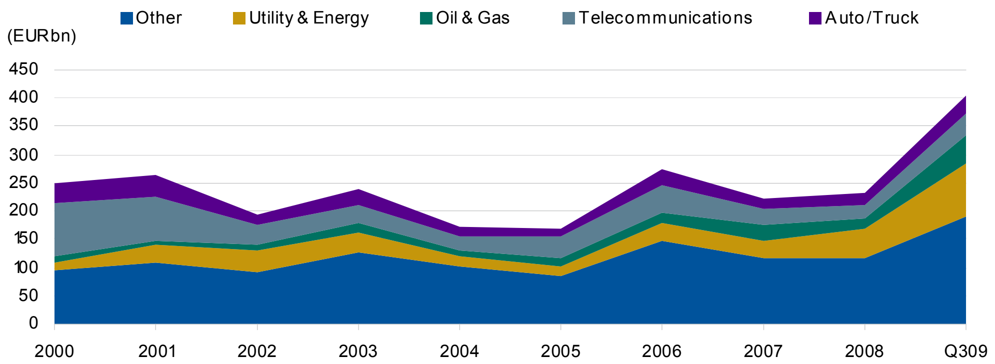
Source: Fitch

Capex



Source: Fitch

EMEA Corporate Bond Issuance



Source: Dealogic

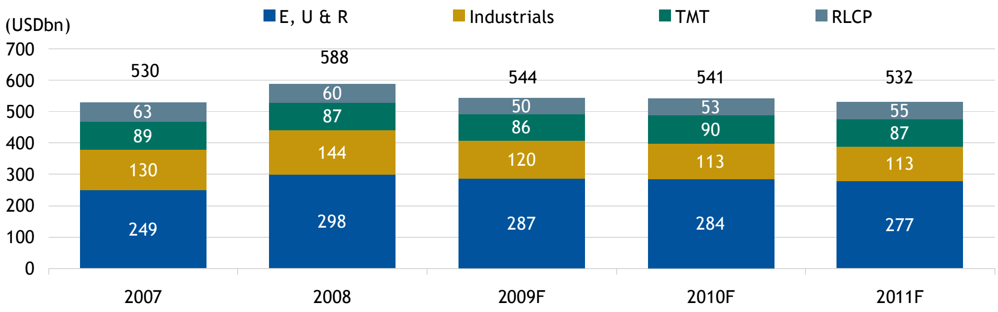
Capital expenditure (capex) = corporate investment in property, plant and equipment (excluding business acquisitions)

Overview

Capex

Overall, the extent of capex cuts now expected for 2009 is more modest than estimated at the start of 2009. Fitch's first review of how capex plans were reacting to the current recession (see the agency's "*EMEA Industrial Capital Expenditure Cut-backs*" report, dated 6 February 2009 and available at www.fitchratings.com) suggested that, in response to top-line pressures and a funding shortage, capital expenditure could be cut across the corporate space by as much as 30% for companies in the industrial sectors, and by 10%-30% in other sectors.

Capex Trend - By Sector



Source: Fitch

These predictions were made in February 2009, when EMEA economies were in their most rapid stage of contraction. A key feature of this period was almost complete uncertainty about the future shape of the recession. Capital markets were shut to all but the highest rated corporates and banks were reining in lending to protect balance sheets. While the drop in output has been severe, EMEA economies are now stabilising and are likely to resume a growth trajectory, albeit slowly (see Fitch's "*Global Economic Outlook*" report, dated 1 October 2009, available at www.fitchratings.com). Combined with a rebound in investor demand for corporate bonds this represents a significant easing of pressure to cut capex.

Fitch's predictions, based on detailed forecasts for 230 rated entities across all corporate sectors, show an 8% fall in capex overall in 2009. Industrial companies are still driving this downward trend, with a 17% cut in spending over the period. The EU&R sector's outcome, a fall of 4% overall, includes a 7% fall in oil and gas at one end of the spectrum and a rise of 9% in the utilities sector at the other. Capex in the oil and gas sector, and also in metals mining, has been much more buoyant than

Sample by Sector - EMEA

Sector	Issuers
Industrials	88
Energy, utilities and regulation	60
TMT	43
Retail, leisure, consumer	39
Total	**230**

Source: Fitch

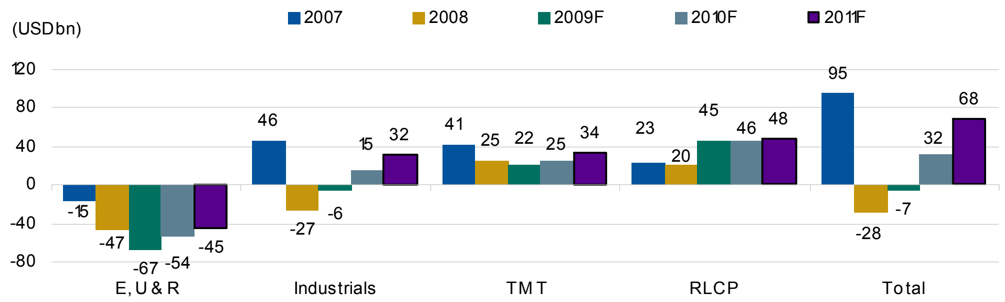
anticipated at the start of 2009. This reflects a more confident outlook as commodity prices have stabilised, and increased faith in longer term demand dynamics.

Emerging markets entities have scaled back capex spending more than developed market peers, with cuts averaging 17% versus 5% for the latter. This reflects the continuing difficult liquidity position of many emerging market issuers, for example those in the CIS (see Fitch's "*Corporate Liquidity Study — EMEA and Asia-Pacific*" report, dated 15 September 2009 and available at www.fitchratings.com).

Free Cash Flow

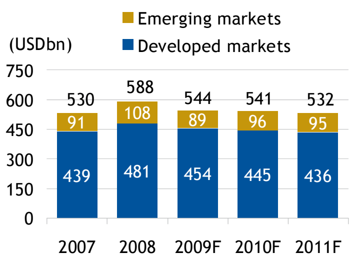
The collapse in FCF generation in 2008 was stark, with weaker demand conditions especially in the latter part of the year wiping an aggregate USD123bn off FCF for our sample to give a total outflow of USD28bn.

FCF Trend - By Sector



Source: Fitch

Capex - Developed vs. Emerging



Source: Fitch

Fitch is expecting an improvement in FCF in 2009, with issuers reacting aggressively to weakened demand and reduced availability of funds. Capex, operating cost and dividend cuts, combined with working capital management, is expected to limit FCF outflow to only USD7bn in 2009, before it returns to positive USD32bn in 2010.

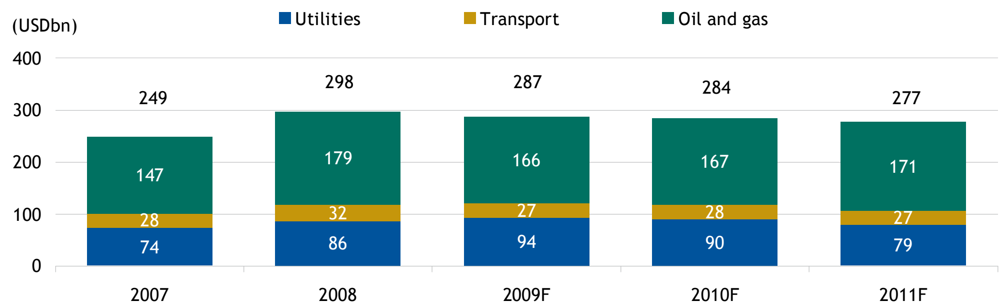
EU&R companies are investing strongly through the low point of the cycle and Fitch expects FCF to bottom out at negative EUR67bn in 2009. FCF among industrials shows the most distinct downturn, from positive USD46bn in 2007 to negative USD27bn in 2008; it is expected to recover gradually from 2009. Technology, media and telecoms (TMT) and retail, leisure and consumer products (RLCP) companies have maintained and are forecast to continue to maintain positive FCF throughout the period — although this does vary considerably by sub-sector.

Free Cash Flow (FCF) = cash flow after capex and dividends, but before acquisitions and share buybacks/share issuance

Sector Analysis

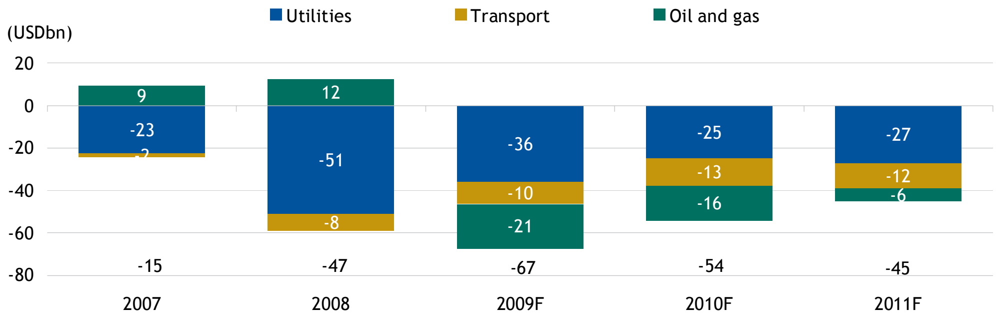
Energy, Utilities and Regulation

Energy, Utilities and Regulation - Capex by Sector



Source: Fitch analysis

Energy, Utilities and Regulation - FCF by Sector



Source: Fitch analysis

Energy, Utilities and Regulation - Capex and FCF

(USDm)	2007	2008	2009F	2010F	2011F
Capex					
Utilities	73,604	86,108	93,816	89,668	79,493
Transport	28,049	32,019	26,914	27,587	27,058
Oil and gas	147,484	179,414	166,241	167,152	170,860
Total	**249,137**	**297,541**	**286,971**	**284,407**	**277,411**
FCF					
Utilities	-22,517	-51,253	-36,074	-24,977	-27,212
Transport	-1,968	-7,842	-10,463	-12,878	-11,950
Oil and gas	9,376	12,304	-20,801	-16,271	-6,153
Total	**-15,109**	**-46,792**	**-67,339**	**-54,125**	**-45,316**

Source: Fitch

The EU&R sector's expected capex spend will be relatively constant over the forecast period, having risen in recent years due to European asset replacement by utilities and increased development costs in the oil and gas sector. This is despite falls in demand for both electricity and gas in many countries — a phenomenon largely without precedent in western Europe — and sharp falls in oil prices in early 2009. The asset-intensive nature of the sectors results in a need for consistent investment throughout the cycle, with medium- to long-term views being taken as demand prospects over the longer term are considered to be good and correlate to GDP and population growth.

Stable business profiles with good access to capital markets, and typically high ratings compared with the general corporate universe, provide the means to continue to fund significant capex programmes when cyclical downturns depress pricing and result in negative FCF. Fitch forecasts that negative FCF will have multiplied by a factor of 4.5x between 2007 and 2009 – driven by all three sub-sectors.

Oil and Gas

Fitch believes oil and gas capital expenditure peaked in 2008 and will fall by 7% in 2009, to be followed by modest increases in 2010 and 2011. The USD13bn fall in capex in this sector in 2009 is not sufficient to offset the impact of falling oil prices on profitability (50% plus reduction for many entities), and FCF which is expected to swing from a positive USD12bn for the sample group in 2008 to a negative USD20bn in 2009.

The capex of the oil majors, which make up 41% of the sample, are all forecast to decline; the current forecast is a 8% reduction in 2009. Overall capex spend by these groups has proved more resilient than Fitch and others had expected at the start of the downturn, as companies continue to take a positive view of short-term price recovery and longer-term demand prospects. Development and extraction of discovered resources takes time, and therefore short-term delays and/or suspension of capex in times of depressed prices can have a constraining effect on an entity's growth when recovery occurs. Oil majors have remained committed to projects currently underway, but have taken a more cautious approach to making final investment decisions on projects, such as oil sands, that require consistently higher oil prices to be profitable. Increased spend therefore continues to take place despite an expectation of negative FCF, which has swung from a positive EUR7bn in 2008 to a forecast negative USD9bn in 2009.

Such investment, however, tends to be a luxury afforded to large western European entities which have planned for the cycle and managed their gearing appropriately — drawing more debt in the down cycle yet remaining within their target gearing ratios. Emerging market (EM) groups, primarily in the CIS and Turkey, have seen capex fall by 14% between 2008 and 2009; and if Gazprom is stripped out from the EM component (as it is more in line with the global average) this leaves the remainder down 20%, reflecting the harsher liquidity issues faced by lower-profile EM issuers in this asset-intensive sector.

Utilities

For the utility sector, here represented primarily by integrated and regulated power utilities, capex is forecast to peak in 2009, increasing by 9% from 2008, before declining by 4% in 2010. There are very wide variations between companies, with the capex spend from 2008 to 2009 ranging between a positive 65% to a negative 35%. This illustrates the nature of capex spend in this sector, where earnings are relatively predictable and there are a large number of long-term projects being executed under a variety of strategic and regulatory rationales. The FCF of entities that are subject to asset-based remuneration is generally not affected by volume and pricing volatility, and ongoing investment should therefore not result in material ratio weakening.

Negative FCF has become the norm for utilities in recent years, reflecting expansion capex by regulated players and acquisition debt burdens by integrated groups. 2008 is expected to represent the trough for FCF for this sample group, with a 31% improvement in 2009 and a return to 2007 levels by 2010. Much of this fall represents the time lagging effect of fuel input prices to end-user charges for integrated utilities, as well as individual company hedging policies and M&A activity. Structural market changes are having an additional impact on earnings in countries such as Spain and Germany, thereby exacerbating the impact of falling prices and demand.

Transport

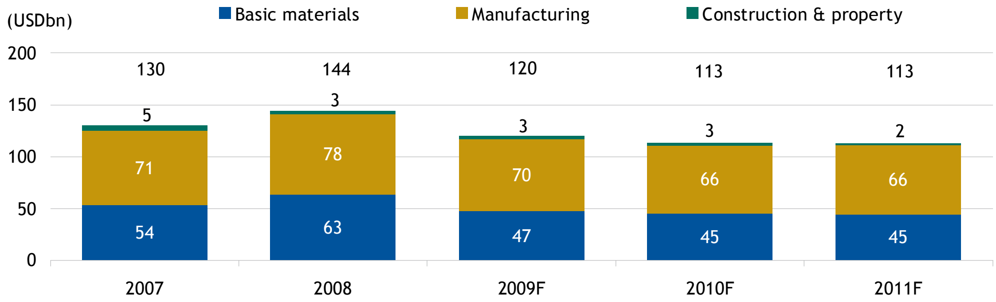
The transport sector — in Fitch's sample represented by a limited number of airlines, toll roads, railways and shipping — has been severely affected by the current economic downturn, with air passenger numbers down by 7.5% (YTD August) across Europe and a reduction in global cargo traffic of more than 20%. There have been volume reductions at toll roads throughout Europe, varying from just under 1% in France to nearly 10% in Spain in H109, with the most significant reductions resulting from the fall in heavy goods vehicle traffic.

Overall FCF for the sample group — a negative USD2bn in 2007 — is forecast to continue worsening until 2010 when it will bottom out at negative USD12.9bn. These falls are to a certain extent mitigated by cuts in capex of 19% in 2009, as entities struggle to adjust their fixed cost bases.

The overall picture is affected by significant falls for individual entities which have either reached the end of big capex programmes during the period, or have planned reductions in line with demand variations. Airline capex is forecast to experience more modest falls, of only 5% on in 2009. This is because airline companies have to continue to invest in modern aircraft to improve fuel efficiency.

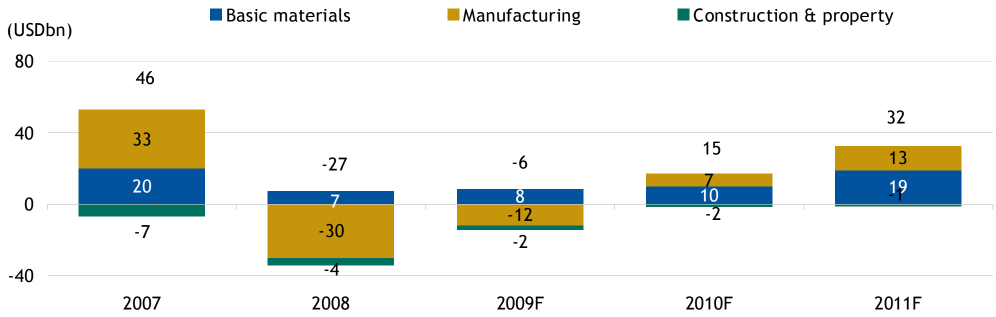
Industrials

Industrials - Capex by Sector



Source: Fitch analysis

Industrials - FCF by Sector



Source: Fitch analysis

Industrials - Capex and FCF

(USDm)	2007	2008	2009F	2010F	2011F
Capex					
Basic materials	53,601	63,331	47,370	45,392	44,560
Manufacturing	71,150	78,287	69,844	65,548	66,473
Construction and property	4,788	2,684	2,817	2,522	1,735
Total	**129,540**	**144,301**	**120,031**	**113,462**	**112,768**
Free cash flow					
Basic materials	19,939	7,356	8,417	9,834	19,095
Manufacturing	32,834	-30,227	-12,081	7,123	13,429
Construction and property	-6,882	-4,120	-2,258	-1,528	-941
Total	**45,891**	**-26,991**	**-5,922**	**15,429**	**31,583**

Source: Fitch

The more limited cuts in industrials' capex than earlier expected mainly reflect more buoyant commodity prices during the latter part of 2009. However, Fitch still expects continued cuts in investment into 2010 and 2011. Overall, the industrial sectors are not expected to revert to 2008 or even 2007 levels of capex during the forecast period.

The cyclical industrials sector is the only one other than EU+R to dip into negative FCF, in this case during 2008 and 2009 only. The recovery is expected to be reasonably strong, with the restrained approach to capex playing a key part. FCF should be firmly back in positive territory in 2010 for all sectors except construction and property.

Manufacturing

Manufacturing industries are on the whole less capital-intensive and less cyclical than the commodity-driven basic materials and construction and property sectors. However, manufacturing companies plan a 11% capex cut in 2009 and continued reductions also in 2010. This will help restore FCF, which swung from USD32bn in 2007 to a negative USD30bn in 2008. This was mainly driven by the automotive-related segments – the massive cash burn of the five main OEMs resulted in their FCF swinging from USD10bn to a negative USD41bn in that time. This sector is cutting capex by 19% this year, with more modest reductions in 2010. Other manufacturing sectors are more resilient. Aerospace and defence, partly protected from demand cyclicality through long term government and commercial contracts, will cut capex slightly in 2008 but then plan good expansion in future. The capital goods segment is increasing capex by 7% in 2009 but is expected to reduce this by 14% 2010 and further in 2011.

Basic Materials

The commodity-based industries have experienced a roller coaster ride in the last twelve months, following the boom-like conditions preceding the sharp demand cuts in Q408. With commodity prices recovering (e.g. copper prices recently having recouped their losses from halving since September 2008) capex plans have been adjusted upwards since the early part of the year. Metals mining companies, which were then expected to reduce capex by over 60% are now likely to limit such cuts to less than 40%. Investment is likely to remain subdued in the next two years.

Elsewhere in the basic materials universe, chemicals will cut capex by around one fifth with flat plans for the near future. Building materials issuers will modestly raise their 2009 investment levels but plan some contraction in 2010. Pulp & paper, which is beset by structural challenges plan to cut capex by nearly a third which is more severe than expected at the beginning of this year.

FCF remains positive throughout the 2007-2011 period for the basic materials companies in the sample. While the chemicals segment dips into the red during 2008-2010, this is more than compensated by the resilience of the metals mining issuers. The latter will experience FCF halving in 2009 but recovery by 2011 is likely to exceed both 2007 and 2008 FCF levels.

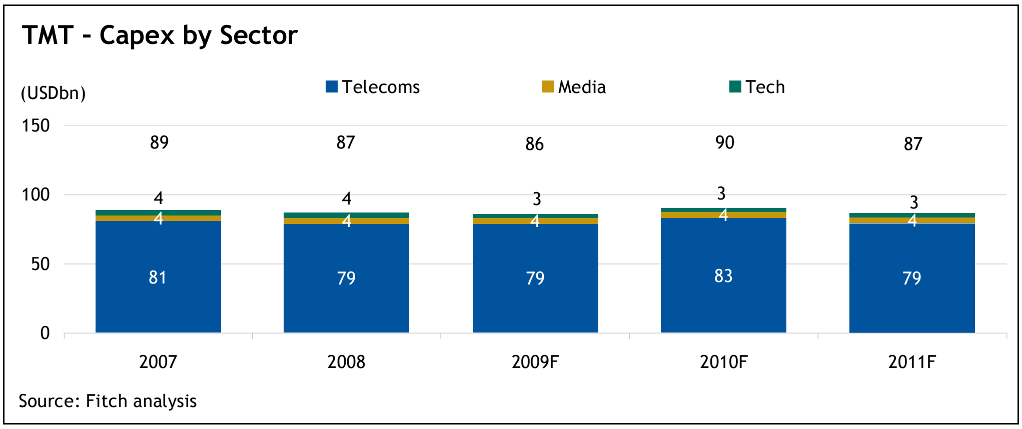
Construction and Property

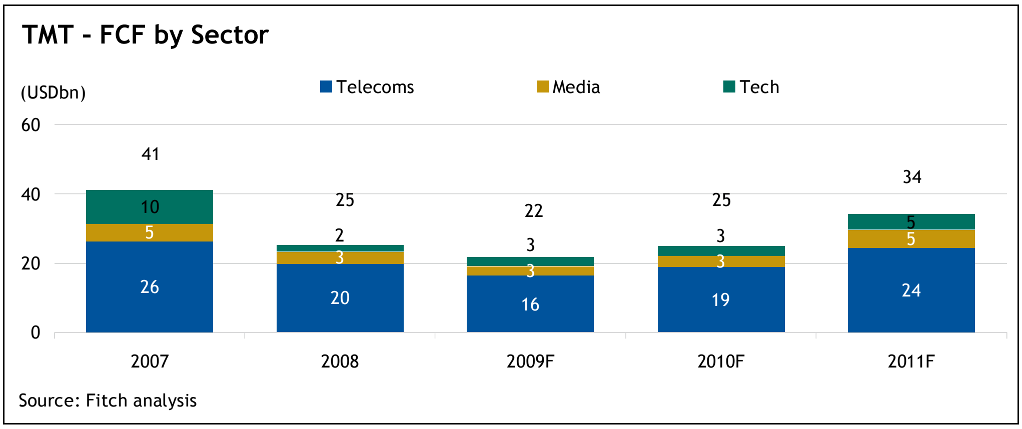
Contrary to Fitch's expectations at the start of 2009, capex by the construction and property sector is now likely to rise (by +5%) but is likely to fall in future. This change partly reflects a change in the rated universe, with a number of struggling Russian companies no longer part of the sample.

Negative FCF remains a feature from 2007 until 2011 although the amount declines steadily, aided by restrained investment spending.

TMT

TMT capex spend is dominated by large, western European telecoms companies (telcos), with media and technology companies demonstrating lower spend. The overall picture, as a result, is one of relative stability, with a 1% fall in capex predicted in 2009, following a 2% fall the previous year.





TMT - Capex and FCF

(USDm)	2007	2008	2009F	2010F	2011F
Capex					
Telecoms	80,747	78,969	78,852	82,988	79,080
Media	4,064	4,122	4,464	4,354	4,493
Tech	3,711	3,756	2,790	2,852	3,036
Total	**88,522**	**86,847**	**86,106**	**90,194**	**86,609**
FCF					
Telecoms	26,339	19,870	16,479	18,964	24,364
Media	5,043	3,442	2,541	3,086	5,191
Tech	9,732	1,891	2,712	2,904	4,556
Total	**41,114**	**25,203**	**21,732**	**24,954**	**34,111**

Source: Fitch

Telecoms

Although western European telcos fared slightly worse than expected from the economic downturn, the requirement for them to continue to invest in network infrastructure to drive new products and increase penetration — and as a key component of cost rationalisation — has kept capex spending essentially flat in 2009 on 2008, with a 5% increase anticipated in 2010. Fitch considers investment through a downturn as broadly credit supportive, as failure to do so in competitive markets could leave a company at a disadvantage.

Obviously this general view can be tempered by individual circumstances. The CIS telcos (representing only about 5% of the sample), for example, faced serious liquidity challenges going into the current downturn due to their reliance on short-term financing. The overall 43% fall in capex among CIS telcos was a key plank of the survival strategy of many issuers. Combined with far lower competition in many of these markets and similar cuts by rivals, the competitive impact of these investment cuts is unlikely to be to the long-term detriment of these issuers, assuming they are reversed in due course.

FCF reductions have been significant in telecoms as a whole, reflecting the high operational gearing in the sector, with cost bases largely fixed. After falling by a quarter between 2007 and 2008, FCF is forecast to be largely flat for 2009 (excluding a large special dividend expected to be paid by Wind Telecomunicazioni Spa) and 2010. This reflects how most companies have conserved cash, including through dividend reductions (e.g. BT Group plc), in response to continued falling revenues in 2009.

Media

With some groups in ad-funded media segments suffering badly in the recession and also from structural competitive challenges, Fitch expects FCF to halve on average between 2007 and 2009. However, improvements in 2010, largely the result of cost cuts and cash conservation, are expected to lead to a return to the 2007 FCF levels by 2011.

That Capex remained flat between 2007 and 2008, and is forecast to increase by 8% between 2008 and 2009, appears counterintuitive. This reflects the distorting influence of Vivendi (from which we exclude SFR, which we include in telco), where capex is expected to increase in 2009, largely as a result of acquisitions made in 2008. Stripping out Vivendi from the sample leaves a more reasonable 10% fall in capex between 2008 and 2009.

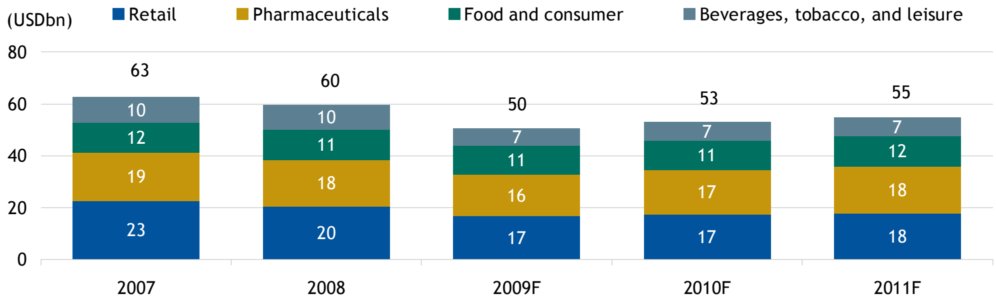
Technology

The technology sector is highly cyclical and volatile. As end-product demand started to wane in 2008, FCF fell by 81% compared with the 2007 boom. For example, Nokia Corporation's FCF plummeted from USD7.6bn in 2007 to approximately USD200m in 2008, reflecting a combination of losses at Nokia Siemens Networks and pressure on handset sales. Capex spend, by contrast, did not reduce until 2009. As the recession has deepened, Fitch expects cost cuts, including a capex cut of 25% by the sector sample, and other cash conservation measures to more than offset the worst of the further volume declines. Fitch is forecasting moderate improvements in both FCF and capex in 2010, driven by gradual improvements in end-market conditions.

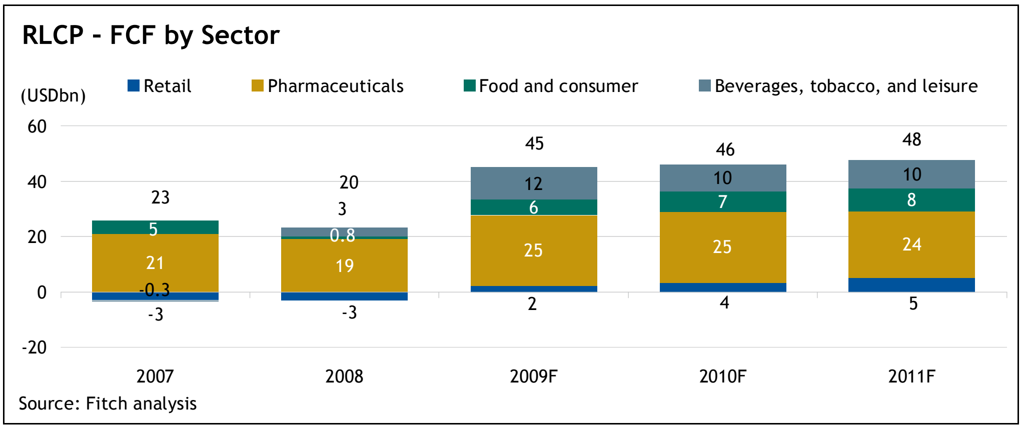
Retail, Leisure and Consumer Products

A 15% drop in capex is forecast for the RLCP sector between 2008 and 2009, following more modest falls between 2007 and 2008, before gradually recovering in 2010 and 2011.

RLCP - Capex by Sector



Source: Fitch analysis



RLCP - Capex and FCF

(USDm)	2007	2008	2009F	2010F	2011F
Capex					
Retail	22,630	20,444	16,588	17,294	17,736
Pharmaceuticals	18,574	18,063	16,308	17,231	18,021
Food and consumer	11,578	11,472	10,967	11,298	11,785
Beverages, tobacco and leisure	9,734	9,614	6,635	7,217	7,218
Total	**62,516**	**59,593**	**50,498**	**53,040**	**54,760**
FCF					
Retail	-2,916	-3,080	2,461	3,543	5,103
Pharmaceuticals	21,057	19,328	25,278	25,464	24,201
Food and consumer	4,937	838	5,669	7,376	8,271
Beverages, tobacco and leisure	-318	3,272	11,574	9,598	10,099
Total	**22,760**	**20,358**	**44,982**	**45,981**	**47,674**

Source: Fitch

What is more surprising is the dramatic improvement in FCF, which is forecast to more than double between 2008 and 2009, and to remain at these levels until 2011. Only USD9bn of this USD25bn improvement is due to capex cuts. The remainder is due to a combination of dividend cuts, more general cash conservation measures and the full year impact of acquisitions (implying that the like-for-like cut in capex is higher than Fitch's numbers suggest).

Retail

Retail sector capex is expected to fall by 19% in 2009 before a slow recovery. FCF is expected to improve from negative USD3.1bn for the sample as a whole in 2008 to a forecast USD2.5bn in 2009, mainly represented by capex cuts of EUR3.8bn.

Pharmaceuticals

In contrast to retail companies, the pharmaceuticals sector started from a solidly positive FCF base in 2007, which after an 8% fall in 2008 is expected to increase by 30% in 2009. Capex reductions of 10% in 2009 account for less than a third of this improvement.

The largest single mover in this segment is Bayer. Fitch expects to see the company's FCF boosted by a positive swing in working capital in 2009, and also capex cuts. Adjusting for this credit gives a picture of modest capex cuts and smaller improvements in FCF.

Food and Consumer

Capex in the food and consumer sector is forecast to remain relatively stable, falling by 5% between 2007 and 2009 before recovering to pre-downturn levels by 2011. However, FCF plummeted by 84% in 2008, before a forecast increase to above 2007 levels in 2009. This pattern is relatively widespread across the sector, reflecting the effect of completed and ongoing restructuring and positive working capital expectations at some issuers.

Beverages, Tobacco and Leisure

The beverages, tobacco and leisure segment will cut capex by 31% in 2009 — the sharpest reduction in the RLCP sector. As elsewhere, a modest recovery is predicted for 2010. FCF improved considerably from a marginally negative figure in 2007 to positive territory in 2008; it is forecast to triple in 2009. This is mainly a result of recent corporate activity in the sector, with Imperial Tobacco, Pernod and Carlsberg all expected to post increases in FCF, largely as a result of acquisitions. Interestingly, for these acquirers, Fitch is predicting absolute falls in capex. This suggests that like-for like falls may be higher than the agency is predicting overall.