Industry Outlook

Moody's Global
Corporate Finance

January 2008

European Auto Original Equipment Manufacturers

Europe

Table of Contents:

Analyst Contacts:

Frankfurt 49.69.70730.700

Falk Frey
Senior Vice President

Eric de Bodard
Team Managing Director

Summary

2006 and 2007 have been challenging years for the European automotive industry and Moody's expects these challenges to persist in 2008, as European car manufacturers continue to face difficulties improving market share and enhancing profitability.

The following factors will be important when assessing the credit quality of European Original Equipment Manufacturers (OEMs) in the next year:

- Enduring overcapacity in key markets
- Stagnating demand in Western European markets
- Growth opportunities in developing countries
- A potential shift in consumer demand caused by stricter safety and environmental regulations and high raw material prices could alter product mix
- Continuing depreciation of the US dollar would burden profitability and the competitive position of certain European OEMs

Moody's Investors Service

Overview

Flat Market Outlook for 2008

For 2008, Moody's expects new passenger car registrations to be broadly at the same level as in 2007 (+1.0%), but with significant differences in individual markets, which have been impacted by various locally specific factors. The French market will be boosted (+6.0%) by the implementation of an incentive scheme starting in 2008 and new German passenger car registrations in Germany should recover by 3.5% from depressed levels in 2007. However, Moody's expects Italy's car market to be down by 3.5% due to the strong market performance in 2007 (Jan-Nov +6.6%) which had been boosted by governmental incentives to replace old cars. In Spain, consumption is expected to be hit by house price weakness and expected credit defaults of private households. Moody's therefore expects a decline in passenger car registrations in 2008 by around -6%, whereas registrations in the UK may rise only slightly (+1.0%) in view of slowing GDP growth and softening housing markets.

Growth Opportunities in Developing Countries Offer Some Relief

While Western European markets stagnate, developing countries, especially the BRIC countries, will continue to drive growth for new passenger car registrations throughout 2008 and probably beyond. However, associated investment and political risks should not be neglected. Indeed, Moody's cautions that past cyclicality in demand in emerging markets has been much higher than in mature markets, with profits quickly turning into severe losses at times.

Positive Rating Actions Could be Triggered by Company Specifics

Potential positive rating actions for European car manufacturers are expected to be mainly due to company-specific circumstances rather than market developments. In the case of Daimler (A3/P-2/Positive) in particular, a potential rating change would largely be driven by the company's future financial policy. Fiat's ratings (Ba1/NP/Positive) could potentially be upgraded to investment grade within the next 6-12 months if (1) the company is able to maintain the positive momentum seen in 2007 against the background of a more challenging environment, and (2) if Moody's can gain confidence that its financial profile can be sustained at the expected 2007 performance levels.

Strong Liquidity will weaken as a result of sizable buy-back programs

Currently strong liquidity profiles of European OEMs could come under pressure if the current share repurchase programs continue beyond 2008 or shareholder activists force the company's to pour out more cash to shareholders either in sizable dividend payments or additional share repurchases.

Key Trends

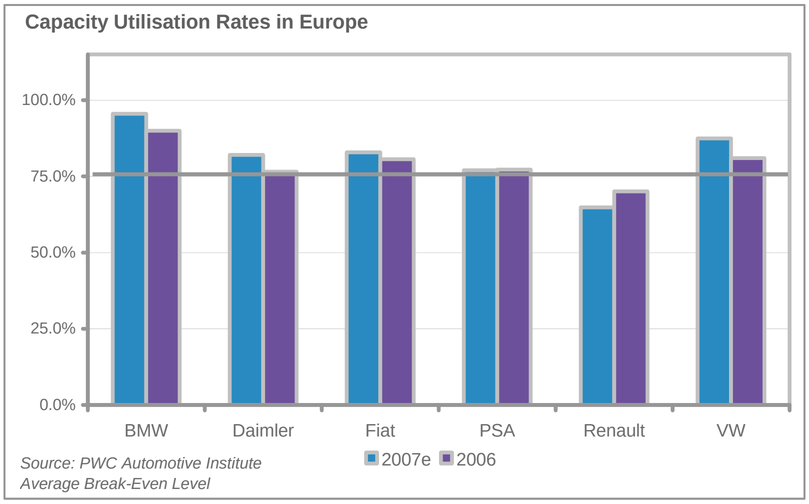
1. Overcapacity in Key Markets

The automotive industry is characterised by inherent cyclicality in demand and a highly rigid cost structure, resulting in high operating leverage. Therefore, capacity utilisation enhancement and incremental volume increases are key drivers for profits and sufficient cash flow generation to finance the continuous flow of product renewals, additional models and growth opportunities in new markets. Especially in the Triad (North America, Western Europe and Japan), a sustained level of excess production capacity has been observed for years despite the stagnation of end-consumer demand in these markets.

In addition, Moody's views cautiously the rapid increase in production capacity in Eastern European countries - mainly Czech Republic, Slovenia and Romania - by both European OEMs and Asian manufacturers. Although demand for new cars in Eastern European countries is currently strong, most of the installed capacity - especially pertaining to Asian manufacturers - has been built to benefit from the lower labour costs in Eastern Europe and to secure a competitive advantage over existing Western European plants. Western Europe is the key market being targeted. The same rationale is behind Peugeot's move to Slovakia. In Moody's view, the balance of capacity reductions in Western Europe, new capacity built up in Eastern Europe and additional demand from those countries remains equal at best and therefore it does not help to solve the problem of overcapacity in Western Europe, which is running at 20-25%.

European Auto Original Equipment Manufacturers

Figure 1



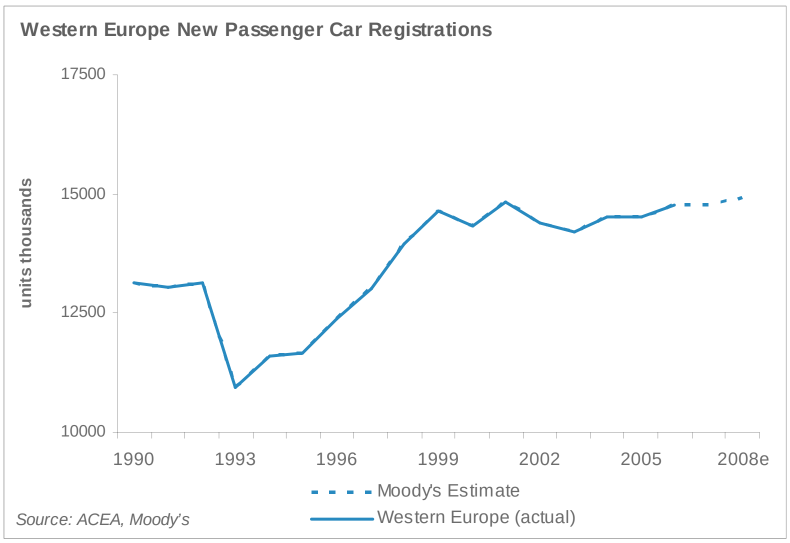
2. Stagnating Demand in Major Western European Markets

On a global scale, worldwide demand for cars and trucks is expected to grow at around 3% per annum over the next five years, mainly driven by buoyant demand from emerging countries outside the Triad, namely Brazil, Russia, India and China - often known as the BRIC countries. ***For Western European markets, however, Moody's expects new passenger car registrations to remain almost flat in 2008***. European OEMs face challenges including ongoing stagnant demand for new vehicles, imports from competitors outside Europe – e.g. from Toyota, Hyundai and its affiliate Kia, continuing excess capacity, and rising costs from stricter safety and environmental regulations in their domestic markets.

Moody's believes that Western European markets are still the most important source for earnings and cash generation for European OEMs; therefore, it remains a precondition for these companies' financial health to gain market shares and generate revenue growth in a stagnant overall environment. The importance of the Western European markets, especially the home market of each European manufacturer, results from a dense distribution network, low distribution and logistic costs, favourable pricing compared to other markets and no exposure to foreign exchange rates - except to the British pound.

For 2008, Moody's expects the number of new passenger car registrations to marginally increase from 2007 (+1.0%) to around 14.9 million vehicles but with significant differences in the direction of individual markets as a result of specific factors.

Figure 2



European Auto Original Equipment Manufacturers

France

The French market for new car registrations exhibits less volatility than other Western European markets. Although Moody's economists expect French GDP to only increase modestly again in 2008, Moody's expects a sharp rise in demand for new passenger cars of 6.0%, driven by the implementation of a regulatory incentive scheme. French OEMs Peugeot and Renault, which hold around 57% of the market (Peugeot Citroen 31.3%, Renault 26.3%),[1] should benefit most as both have recently renewed or are currently renewing the majority of their product range. Furthermore, as they are both focused on small and medium-sized cars, the two should also benefit from the trend to low CO_2 emission standards and thus smaller vehicles.

Germany

While the German market for new passenger cars has struggled in 2007, Moody's expects a recovery to normal levels in 2008, with 3.5% growth and a volume of approximately 3.2 million registrations. Going forward, the long-term level of new passenger car registrations should be in the range of 3.0 to 3.3 million a year. The sharp decline in 2007 has been prompted by the impact of a three percentage-point VAT increase that resulted in a significant pull-forward of registrations into Q4 2006 and double-digit growth of 12.5% in that quarter. Clearly, Volkswagen Group (with around 30% market share) as well as BMW Group and Mercedes-Benz Cars should benefit from this positive market demand in their home territory, mitigating tougher market conditions in North America.

Italy

Strong growth in 2007 has been generated by government tax breaks to encourage potential customers to buy less polluting cars. With the fiscal incentive scheme implemented in 2007 to be continued through 2008 Moody's expects only a 3.5% decline from high 2007's registration levels. Demand will also be undermined by the slower GDP growth expected for 2008 by Moody's economists. Market conditions for Fiat Group as the clear market leader (31% market share) will become more challenging and offsetting lower domestic volumes in other European markets will be tough - especially given that French competitors have a strong pipeline of new products.

Spain

2007 was not a good year for Spanish new passenger car registrations, with a forecast decline of 2.0%. However, Spanish sales might receive a year-end boost as potential car buyers order before an incentive scheme comes to an end. Consumption in 2008 is expected to be hit by house price weakness and credit defaults of households. Moody's thus expects a decline in passenger car registrations of around 6.0%.

UK

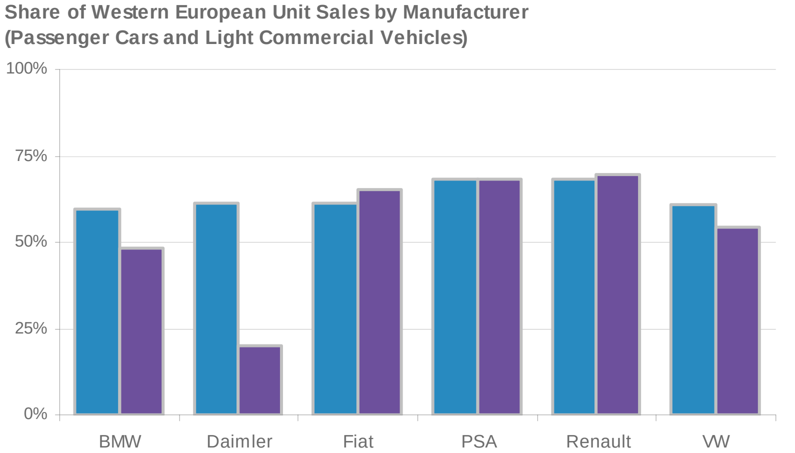
In 2007, car registrations will have risen by around 2.8%, the largest increase for two years and a solid performance given that economists predicted weaker spending and softening house prices at the beginning of the year. However, the impact on consumption of lower GDP growth, higher interest rates and a softening housing market is likely to become noticeable in 2008; Moody's therefore forecasts a lower growth rate in new passenger car registrations of around 1.0%.

Figure 2 highlights the importance of the Western European market development for each of the European car manufacturers by sales.

[1] Cars and light commercial vehicles, Source: ACEA.

European Auto Original Equipment Manufacturers

Figure 3

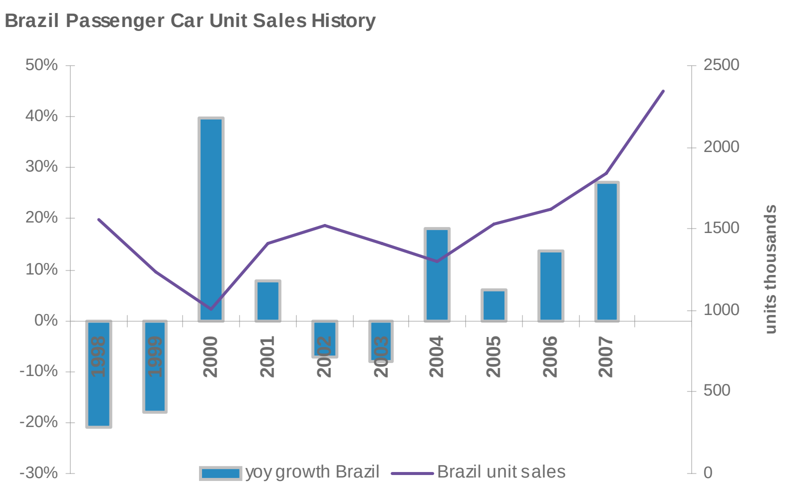


Source: Company Data
Note: Daimler YTD 2007 excluding Chrysler, YTD 2007 as of September 30 2007 (for Renault as of June 30 2007)

3. Growth Opportunities in Developing Countries

While Western European markets stagnate, developing countries - especially the BRIC countries - will continue to drive growth for new passenger car registrations throughout 2008 and probably beyond. Demand in these countries and in emerging markets in general is driven by their rapid economic growth, rising income per capita and continued population growth. However, rapid economic expansion leads to extremely volatile sales growth and profit margins are well below those in Western European markets. In order to increase market share, European OEMs need to invest in local production and distribution centres. Associated investment and political risks should also not be neglected even if deemed manageable by Moody's. Strategic alliances with local companies will be key for maximising profits and minimising risk factors. Moody's cautions, however, that cyclicality in demand in emerging markets in the past has been much higher than in mature markets. In Brazil, for example, new car registrations decreased by more than 35% within two years (from more than 1.6 million units in 1997 to slightly above 1.0 million units in 1999) before a strong but volatile recovery – registrations will have reached around 2.4 million in 2007 (+27%).

Figure 4



Source: Automotive News

In addition, Moody's cautions that a general deterioration in the worldwide economic dynamic would also lead to plummeting demand for cars and trucks in these countries.

4. Mix Change Caused by Environmental Regulations as well as Rising Raw Material Prices Brings Risk of Margin Squeeze

The strong rise in oil prices together with other raw materials has made vehicles more expensive to build and to own. In addition, stricter emission regulations and potentially emission-based taxes and insurance costs could in Moody's view lead to a sustainable shift in the mix of new vehicle demand, away from large vehicles and SUVs towards smaller and more fuel-efficient vehicles. In different ways, this development is already taking place in North America where demand for large SUVs and pick-ups is weakening and needs to be highly incentivised or Japan where demand for mini cars (up to 600ccm) has been the only segment growing in recent years in an overall declining market.

Since the environmental debate has gained in importance, governments have been trying to put pressure on the automotive industry to reduce CO_2 emissions per vehicle and to produce fuel-efficient cars. CO_2-related incentives, introduced in countries like France, Italy, and Spain, should stimulate consumer demand in this direction. Consequently, the industry needs to develop more fuel-efficient and hybrid vehicles, which will likely lead to increasing R&D expenditure in 2008 and beyond. The European association of car manufacturers (ACEA) estimates the additional costs to implement CO_2-reduction limits of 130g/km for the average fleet to be around €3,650 per vehicle. Moody's estimates the costs of complying with the 2012 CO_2 emission targets to be more in the area of €300–1,000 per car due to economies of scale and cost sharing through co-operations and alliances between OEMs and suppliers in various areas of R&D. However, as a result of intense price competition, these costs might not be passed on to consumers resulting in further pressure on already-low profit margins of the European OEMs.

Figure 5

CO2 Emissions and Targets by Car Manufacturer

	Average mass kg/unit	Average CO2 g/km (2006)	Unit sold Europe (2006)	2012 CO2 target	Reduction until 2012 (%)
BMW	1,453	182	740,000	137	-25%
Daimler	1,472	184	861,000	138	-25%
Fiat	1,112	144	1,050,000	122	-15%
Ford	1,219	162	1,490,000	132	-19%
GM	1,257	157	1,425,000	129	-18%
Nissan	1,202	164	274,000	126	-23%
Porsche	1,596	282	39,000	144	-49%
PSA	1,201	142	1,882,000	126	-11%
Renault	1,234	147	1,232,000	127	-14%
Toyota	1,214	152	773,000	127	-16%
Volkswagen	1,366	165	2,745,000	134	-19%
Total sector (weighted)	1,289	159	13,744,000		

Source: European Commission

Among individual European rated manufacturers, the burden on German OEMs Daimler and BMW – which have important SUV businesses, large and powerful passenger cars but a relatively low overall volume of unit sales to spread the additional research, development and manufacturing costs – would be the highest. The volume manufacturers Volkswagen, Renault, Peugeot and Fiat should be less burdened on a per unit basis and may benefit from their small car offerings; however, their profit margins are lower than for Mercedes-Benz and BMW cars. Figure 4 depicts the 2012 target for the average fleet consumption of CO2 set by the EU commission based on the average weight of the OEM's fleet in order not to pay a penalty fee. Should the OEMs not meet the set targets by 2012 they have to pay a penalty fee of €20 per car for each gram missed per car. The penalty rises over time to €35 per car in 2013 and €60 per car in 2014 up to €95 per car by 2015.

European Auto Original Equipment Manufacturers

These theoretical penalties can be substantial as the following example illustrates. A car maker selling 1.5 million cars in Europe per year with the average CO2 emission per car 10 g/km above its required target in 2012 has to pay €300million (1.5m x 10g x 20€), increasing to more than €1.4billion (1.5m x 10g x 95€) by 2015 if emissions would still be 10 g/km per car above target. Moody's has not incorporated any penalty fees in the current ratings of any European car maker. However, we consider the risk of penalty payments burdening profit margins could be higher for luxury car makers BMW and Daimler as they need to reduce emissions by a higher percentage point than small car producers PSA or Fiat although the ability to pass on costs to consumer might be higher in the luxury segment than for small cars.

The persistently high level of raw material prices adds additional pressure on the cost side. Further strong demand for raw materials is expected to keep prices high in the near future.

5. The Weakness of the US Dollar is a Challenge for the German Manufacturers

The continued weakening of the US dollar against the Euro is weighing on the profits of OEMs including Daimler, BMW and VW, which generate part of their revenues in the US but do not bear respective costs in the currency. Although financial hedging to various degrees can smooth the depreciation effects in the profit and loss statements, such a process becomes more and more expensive. Moreover, longer term, a sustained weak US dollar versus the euro would seriously hurt the profitability and cash generation of those manufacturers - as well as their competitive position. Consequently, affected OEMs need to consider how to address more thoroughly the possibility of natural hedging, considering the transfer of production facilities to the US in order to match the cost structure with the expected revenues Moody's recognises the considerable challenges in changing complex production- and supply chain networks in order to achieve a better balance in foreign currency exposure over the long term. BMW and Volkswagen have already announced that they are seeking opportunities to increase natural hedging.

6. Strong Liquidity Profiles will Weaken due to Sizable Share Repurchase Programs

Liquidity profiles of the European Auto manufacturers are generally strong based on high on-balance-sheet cash positions and ample headrooms under high quality credit arrangements that even in a stress scenario (of no access to debt capital markets to refinance short term debt maturities) would provide sufficient liquidity for the next 12 months period to serve arising cash needs.

However, Moody's cautiously monitors the various announcements of sizeable share buy backs. Daimler has already bought back own shares in the amount of €3.5 billion and intends to buy back further shares for an amount of up to €4.0 billion until end of August 2008. The company stated that it might consider continuing with repurchases thereafter. As of September 30, 2007 Fiat also has repurchased €0.4 billion own shares as part of an allowance for a maximum amount of €1.4 billion until October 2008. In addition BMW and Volkswagen have the authorisation to buy back own shares but have not yet stated their intention to actively pursue such possibility. In Moody's view share repurchase activity that matches free cash flow generation might be neutral to ratings as it does not increase debt levels of a company. Current ratings of Daimler already include the expected cash outflow for the committed share repurchase volumes. For Fiat's ratings to return to investment grade, Moody's would expect free cash flow to be applied at least partly to further debt reduction and a cautious approach to stock buy backs.

European Auto Original Equipment Manufacturers

7. Rating Trends for European OEMs – Who will Benefit from the Market Outlook?

This section highlights the aforementioned key rating drivers and their implications for each of the European manufacturers' ratings in 2008:

BMW (A1/P-1/Stable)

While Moody's expects the strong momentum in global unit sales to slow in 2008, we are still expecting BMW Group sales to grow on a global scale as well as in Europe, partly helped by the anticipated German market recovery. Full-year availability of the X5, new variants of the 3- and 1-series (coupe and convertible versions) and an additional MINI version (Clubman) should offset volumes for the ageing 5- and 7-series. Key risks to BMW's ratings would be posed by an inability to successfully implement its strategic review programme, which targets a turnaround of its declining profit margins. Adverse currency effects from the weakening US dollar and Japanese yen, as well as rising costs for reducing CO2 emissions, may not be offset by the company's strong top-line growth and high capacity utilisation rates. Moody's believes that BMW has the potential to improve its cost efficiency and margins and continue to generate free cash flows in the event of successful implementation of its strategic realignment. EBIT margins sustainably above 7.5% in the automotive business as well as the ability to demonstrate sustained profitable product and geographic diversification could lead to upward rating pressure in the longer term.

Daimler (A3/P-2/Positive)

Following our upgrade of Daimler to A3 as a result of a successful limitation of the residual exposure to Chrysler, Daimler's ratings have the potential to further improve as indicated by the positive outlook. Key to further improvements would be the final determination of the company's financial policy for the longer term. Daimler's operating performance is expected to strengthen, benefiting from the availability of the new C-class, the launch of the GLK SUV as well as from continued strong demand for trucks in Europe and a potential recovery in North American demand from the second half of 2008. The weaker US dollar has less of an impact on Daimler's accounts than on BMW's as the truck business is naturally hedged and the Mercedes-Benz Cars division should benefit from the cost savings and efficiency improvements achieved with the "CORE" programme. Moody's expect further savings with the launch of the new E-class expected for 2009.

Fiat (Ba1/NP/Positive)

Fiat's biggest challenge will be to demonstrate the sustainability of its current profitability, cash flows and financial flexibility against a background of a less benign environment. A potential decline in the Italian car market in 2008, resulting from the expiration of the incentive scheme as well as a less favourable Brazilian demand could prove challenging. An upgrade to investment grade within the next six months is possible should Moody's gain confidence in Fiat's ability to resist these challenges with an operating performance no worse than in 2007.

Renault (Baa1/P-2/Stable)

Renault's rating and stable outlook have benefited from the strong performance and profits of its Alliance partner Nissan; the dividend received as well as the geographic diversification resulting from Nissan's strong presence in North America and Japan. More recently, Nissan's operating performance has come under pressure and Renault's core automotive performance – although in line with company targets – has been well below what would be expected for the high Baa rating category for some time. Thus, failure to make substantial progress in Renault's automotive business' performance supported by favourable demand in the French home market would put pressure on the current ratings.

European Auto Original Equipment Manufacturers

Peugeot (Baa1/P-2/Negative)

Peugeot (PSA) faces significant challenges. Key threats to the current ratings are (i) the need to regain European market shares through a younger and broader product range; (ii) improving capacity utilisation rates in its European plants, key to improving profitability; and (iii) executing a turnaround at its supplier subsidiary Faurecia. Nonetheless, Moody's notes that the expected strong demand for passenger cars in PSA's home market should provide a good basis for an improved operating performance to the extent necessary to stabilise the ratings (e.g. 2008 EBIT margin > 3.5%, Free Cash Flow > €1.0 billion)[2].

Volkswagen (A3/P-2/Stable)

Globally, we would expect Volkswagen (VW) to grow unit sales volumes, mainly driven by market demand from China, Eastern Europe and South America. In Western Europe, the positive effects of a recovery in the German car market, additional niche model variants under the VW brand (Passat Coupé, Scirocco) as well as the new VW Touran and Audi A4 will mainly be offset by ageing key volume models such as Golf and Passat and newer models launched in these segments by competitors (including Renault Laguna, Ford Mondeo, Mazda 6, Kia c'eed and Hyundai i30). Additionally, we expect the dollar-euro exchange rate to have a negative effect on VW's profitability in 2008 compared to 2007.

The stable rating outlook is based on our expectation of further improvements in the company's profitability in line with its target of achieving a group profit before taxes of at least €5.1 billion in 2007 - which should lead to significant free cash flow generation in the automotive business. Any upward rating pressure – which could, for example, stem from VW's plans in the European truck market having no material impact on the current strong financial flexibility – would at this stage only impact Volkswagen's standalone rating (Baseline Credit Assessment). Absent the event risk of a truck deal, the Baseline Credit Assessment would be upgraded to the same level as the A3 issuer rating (which benefits from government support), driven by VW's strong free cash flow generation (€6.2bn in 2006, €2.0bn in 2005) and Moody's expectations of further strong FCF in 2007 and a continuation in the positive margin trend in the next few years. At present, none of the other rating factors for government-related issuers – support and dependence levels as well as the unpublished rating of Lower Saxony – are set to change the ratings. Moody's also expects the company to preserve its conservative policies and profitability in respect of its financial services operations.

2 Moody's adjusted ratios.

European Auto Original Equipment Manufacturers

Appendix

Peer Comparison

Figure 6

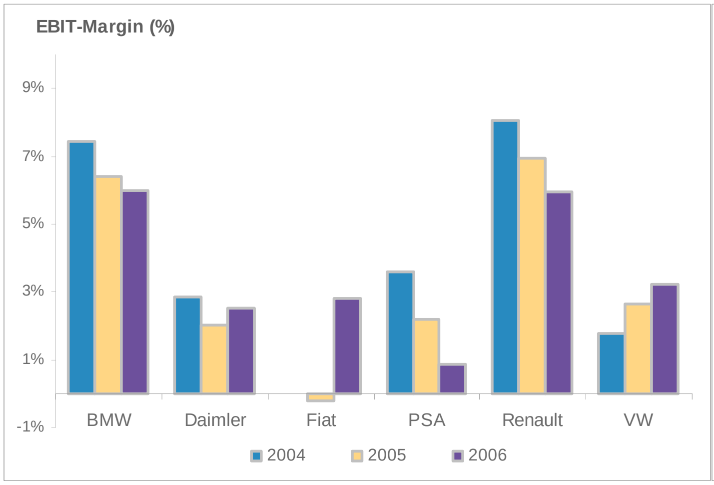


Figure 7

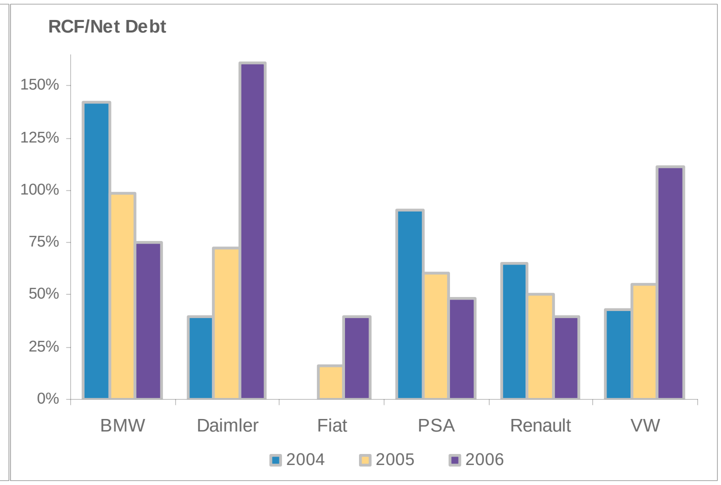


Figure 8

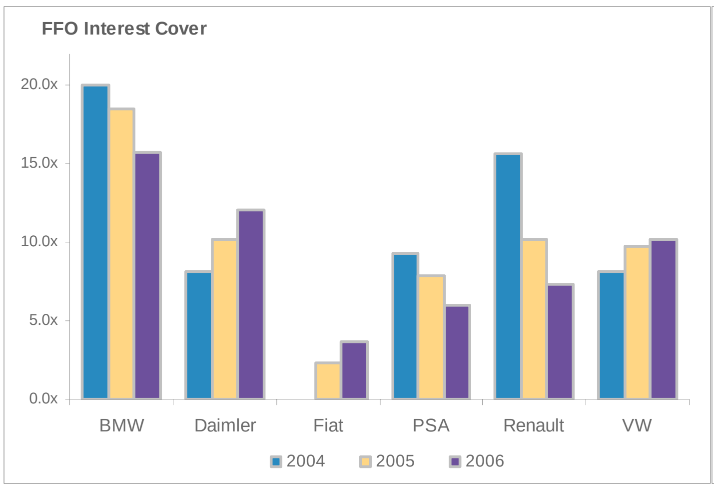


Figure 9

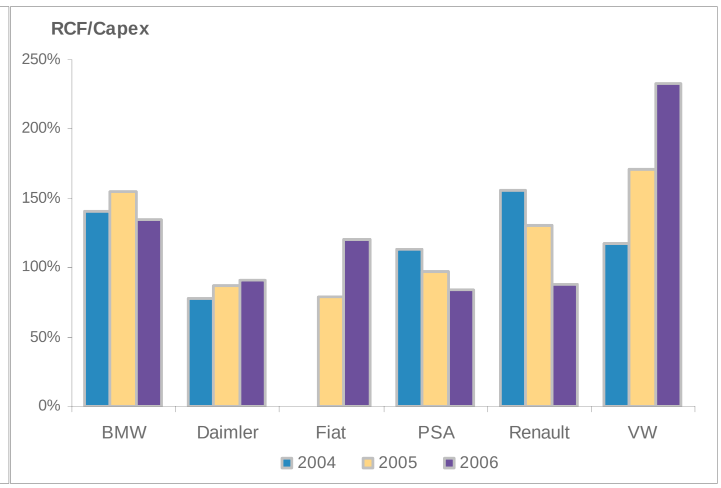
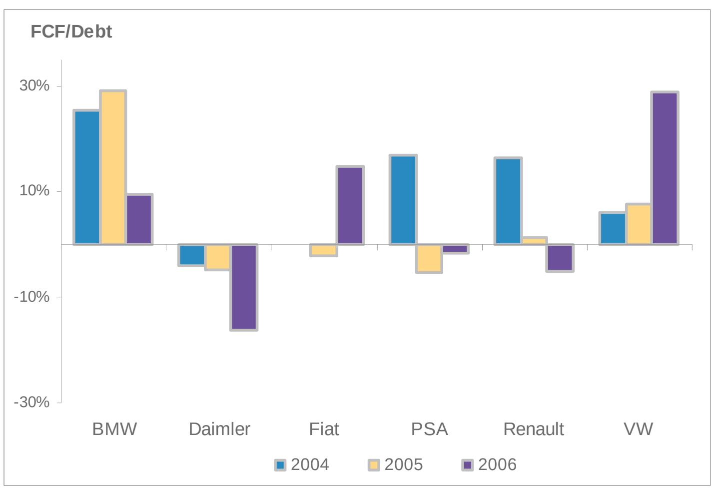


Figure 10



Source: Company Data, Moody's Financial Metrics

European Auto Original Equipment Manufacturers

Western Europe new passenger car registrations by markets

Figure 11

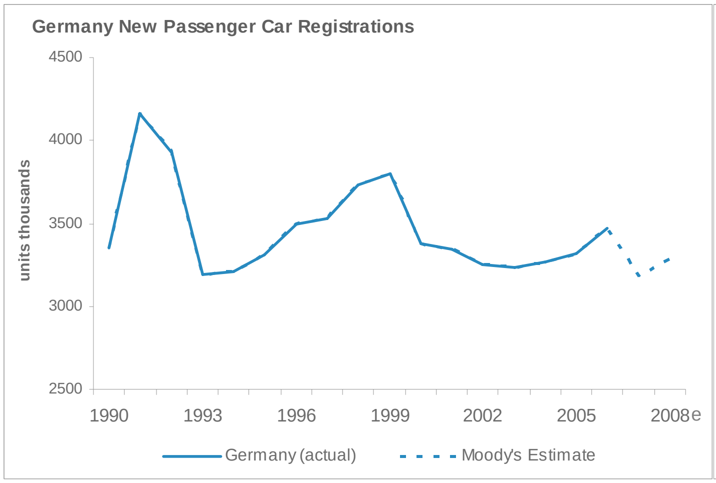


Figure 12

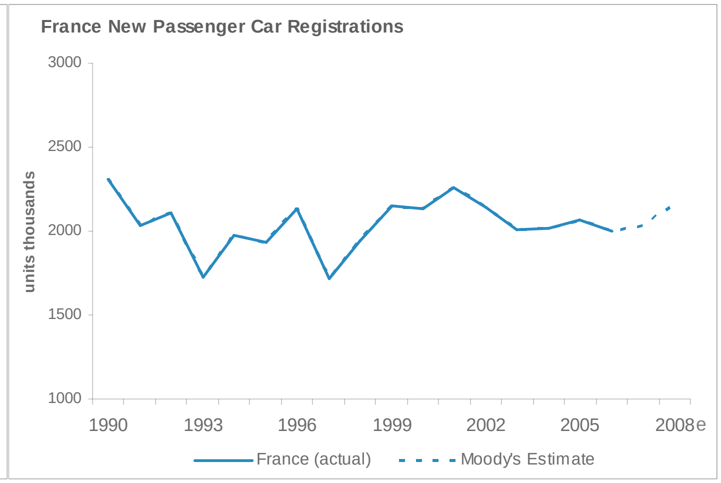


Figure 13

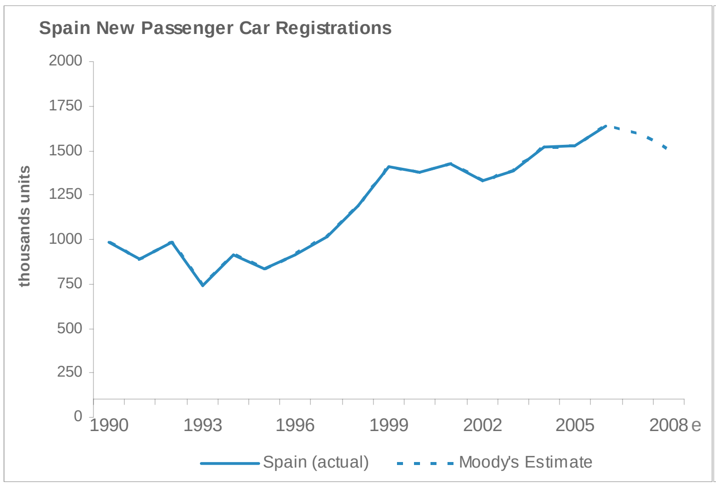


Figure 14

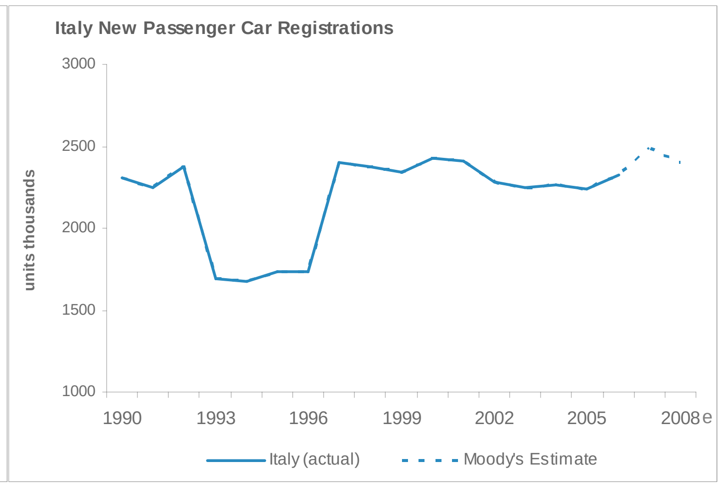
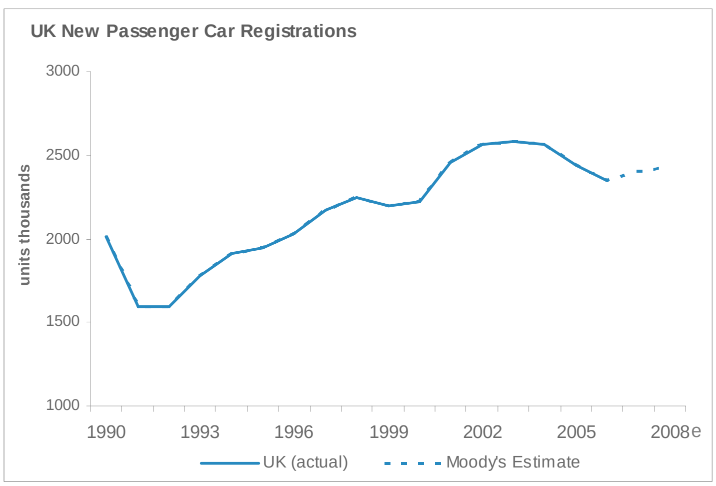


Figure 15



Source: ACEA, Moody's

Moody's Related Research

Industry Outlook:

- European Automotive Manufacturers, June 2007 (103627)

Special Comment

- Europe's Automotive Manufacturers, September 2007 (104309)

Rating Methodologies:

- Global Automobile Manufacturer Industry, December 2007 (106747)
- Global Auto Supplier Industry, June 2005 (93002)

Analyses:

- Bayerische Motoren Werke (BMW) AG, July 2007 (103937)
- Daimler AG, November 2007 (105763)
- Fiat SpA, September 2007 (104700)
- Peugeot SA, January 2007 (101582)
- Renault SA, January 2007 (101863)
- Volkswagen AG, November 2007 (105684)
- AB Volvo, April 2007 (102488)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

European Auto Original Equipment Manufacturers

Report Number: 106912

Author	Editor	Production Specialist
Falk Frey	Nick Ashwell	Nita Desai

Moody's Investors Service