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Jaguar Land Rover Automotive PLC Downgraded To 'BB'; Outlook Stable

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The U.K.'s underperforming auto market, an unexpectedly strong market aversion to diesel in Europe, and high investments continue to weigh on Jaguar Land Rover Automotive PLC's (JLR's) margins, which have decreased by more than half since 2015.

JLR's lower resilience than peers to an increasingly complex environment and higher exposure to event risks (like Brexit and emerging trade wars) threaten to delay its targeted recovery of profitability.

We are lowering our long-term ratings on JLR to 'BB' from 'BB+'.

The stable outlook continues to mirror that on JLR's sole shareholder Tata Motors, which reflects improving adjusted funds from operations (FFO) to debt.

MILAN (S&P Global Ratings) July 26, 2018--S&P Global Ratings today lowered its long-term issuer credit rating on U.K.-based premium auto manufacturer Jaguar Land Rover Automotive PLC (JLR) to 'BB' from 'BB+'. The outlook is stable.

At the same time, we lowered our issue ratings on JLR's senior unsecured notes to 'BB' from 'BB+'. The '3' recovery rating is unchanged.

A combination of headwinds hit U.K.-based premium auto manufacturer JLR in the fiscal year ended March 31, 2018. Despite the sound performance of global auto markets during 2017 and in 2018 to date, volumes at JLR, including units sold at its Chinese joint venture (JV), were up only 1.7% (614,000 versus 604,000) compared with our initial projections of 10%-20% growth. The group's underperformance resulted from a 13% drop in sales in the U.K. market, which declined 15.7% in March 2018 versus previous years, according to LMC Automotive. This came alongside decreasing sales in other European markets, where JLR suffered from the accelerated decline of diesel sales, which decreased 5%. All this happened at a time of heavy investments in JLR's production facility in Slovakia and in electrification of its product offering; research and development (R&D), and capital expenditure (capex) represent 15% of sales. JLR's profits took a hit as adjusted EBITDA margins (which include dividends paid out by JLR's Chinese JV) fell below 6% from 7% in fiscal year 2017 and 9% in fiscal year 2016. We conclude that the company's lack of scale and diversification, which the group has been trying to address, only provides modest resilience to JLR's profitability from market-specific risks. We are thus revising our assessment of JLR's business risk profile to fair from satisfactory.

Volumes (including the Chinese JV) in the first quarter of fiscal year 2019 (ended June 30, 2018) are up 5.9%, mainly as a result of the recovery of the U.K. market from historical lows in the same period of the previous fiscal year. Still, the group's sales elsewhere in Europe are down 7%, which we believe is partly because of the difficultly of adapting to the shift in consumer preferences away from diesel to hybrids. Although the company maintains a strong commitment to extend electrification options to the entire product line-up from 2020, we believe that, beyond the I-PACE first battery SUV, having only a limited set of models with mild and plug-in hybrid features could weigh on volumes in a market that has been more dynamic in terms of consumer demand than expected.

Although we do not yet factor this into our base case, we believe event risk is higher for JLR than for its peers. We believe that an escalation in the trade war between the U.S. and Europe enveloping tariffs on cars imported into the U.S. is a high risk. This would have a negative impact on JLR, since its lack of production facilities in North America (which accounts for a little less than 20% of group sales), coupled with the highly competitive conditions in the U.S. market in terms of new products and competitive pricing, would make it challenging for the group to pass on tariffs to consumers.

While the outcome of the Brexit negotiations remains highly uncertain, we believe this is a unique risk for JLR compared with its main peers', owing to the group's reliance on the U.K. market for approximately one-fifth of its sales. To mitigate the risks attached to Brexit, we anticipate some additional near-term costs for JLR in adjusting the supply chain and inventory levels. In the event of a disruption related to Brexit, the financial impact would be material--up to £1.2 billion in extra annual costs for the group--according to a statement by JLR's CEO.

The materialization of either of these events would jeopardize the planned recovery of profitability at JLR in the medium term (public target: long-term reported EBIT margin of 7%-9% compared with 3.8% in fiscal year 2018).

In our base-case scenario, we expect a gradual recovery of EBITDA margins, owing substantially to the fallout of some supply chain issues that affected the group's performance in fiscal year 2018, costs linked to the new production plant in Slovakia, and the gradual move to modular longitudinal vehicle architecture. Nonetheless, we project our adjusted EBITDA margin would recover to 2016 levels (9.0%) only in 2020. Because of persistently high capex needs, we expect negative free operating cash flows (FOCF) until 2020, which could be detrimental to the rating in the absence of relatively comfortable headroom in the credit metrics.

The stable outlook on JLR reflects the consolidated outlook on India-based Tata Motors, which reflects our expectation that the company's modest volume growth, and improving profitability at JLR from a shift in production to low-cost Slovakia facilities and controlled capital spending, would lift its ratio of FFO to debt to 30%-40% over the next 12-18 months. A continued turnaround in Tata Motors' commercial vehicles (CV) business should also support the recovery.

We may lower the rating on JLR if we lower the rating on Tata Motors, which could occur if the ratio of FFO to debt fails to recover to more than 25% over the next 12 months. This could happen if the company's operating performance remains weak while its capital spending stays elevated. Reported EBITDA margins of less than 11.0% would indicate weak operating performance. Brexit-related trade restrictions, U.S. import tariffs, reduced volumes, or profit margin at JLR due to competition or changing consumer preferences, and a wavering Indian CV business could result in such a scenario.

We are unlikely to upgrade JLR and Tata Motors over the next 12 to 24 months, unless the consolidated ratio of FFO to debt were to well exceed 45% on a sustainable basis, and the company is close to breakeven on FOCF. JLR's improved performance, without a commensurate increase in capital spending; reduced Brexit and U.S.-tariff risks; and a sustained recovery in Tata Motors' India operations could indicate such a scenario.

RELATED CRITERIA

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