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## Research Update:

### U.K.-Based Jaguar Land Rover Downgraded To 'BB-' On Weaker-Than-Expected Profitability; Ratings Kept On Watch Negative

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## Research Update:

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## Rating Action Overview

- In a weaker global auto sales environment, we anticipate that Jaguar Land Rover's (JLR's) profitability will not recover as expected and negative cash flow generation after capex and dividends will be higher than forecast.
- We are therefore lowering our long-term rating on JLR to 'BB-' from 'BB' and keeping it on CreditWatch with negative implications.
- The CreditWatch with negative implications reflects our view of JLR's exposure to the consequences of geopolitical risk, specifically regarding Brexit, which could impact JLR's competitiveness and financial position.

## Rating Action

On Dec. 4, 2018, S&P Global Ratings lowered its long term issuer credit rating on Jaguar Land Rover Automotive Plc (JLR) to 'BB-' from 'BB'. The rating remains on CreditWatch with negative implications.

At the same time, we lowered our issue ratings on JLR's senior unsecured notes to 'BB-' from 'BB'. The recovery rating on the debt is '3', reflecting our expectation of meaningful recovery (50%-70%; rounded estimate: 65%) in the event of a default. The issue rating also remains on CreditWatch with negative implications.

## Rating Action Rationale

The first seven months of JLR's fiscal year 2019 (ending on March 31, 2019) proved challenging overall for the U.K. premium car manufacturer. Retail sales, including vehicles sold by its Chinese joint venture (JV), were down 4.2%. JLR's sales continued to be weak in Europe (-10% versus the same period a year previous) as a result of market aversion to diesel. In addition, the number of units sold in China declined severely (-26% versus the same period a year previous), with JLR having to destock in the first half of fiscal 2019 in order to stop inventory buildup at its dealerships. In light of a less supportive market environment, characterized by lower sales growth and looming geopolitical risks from a potential no-deal Brexit and escalating trade tensions between Europe and the U.S., we believe JLR will have difficulty

fully offsetting its first-half performance in the remainder of fiscal 2019.

We now expect negative cash flow after capital expenditure (capex) and dividends closer to £2 billion per year over fiscals 2019 and 2020, twice our previous expectation. However, our revised scenario includes some of the mitigating measures indicated by the management to address much declined profitability and accelerated cash burn. We consider a reduction of £1 billion (cumulative) from previous capex assumptions in fiscals 2019 and 2020, and an inventory decline in the second half of fiscal 2019. This would reduce pressure on free cash flows, which were reported at negative £2.3 billion at the end of September 2018.

In our revised scenario for JLR, we are more cautious regarding the effect of the £1 billion cost reduction measures announced by top management. We spread the impact of net cost reduction measures (net of restructuring charges, which we estimate at about half of the gross amount) across fiscals 2020 and 2021. As a result of more depressed sales figures in our revised scenario than previously, weaker-than-expected pricing power, and persistently high capitalized development costs and depreciation charges, we expect negative adjusted EBIT in fiscals 2019 and 2020. This differs substantially from JLR's target guidance of a breakeven reported operating margin at the end of fiscal 2019 and a 4% operating margin in fiscal 2020.

Our base case assumes:

- Declining volumes and pricing pressure in 2019, resulting in declining revenues. For fiscals 2020 and 2021, we expect volume growth in line with our global sector forecast on sales (1%-2%), as a result of some remaining pricing pressure.
- We assume net cost reduction will impact JLR's profit and loss in fiscals 2020 and 2021, partly offset by restructuring costs and additional headwinds that we expect for the majority of original equipment manufacturers in the next two years.
- Capex excluding capitalized development costs of £2.0 billion-£2.3 billion.
- Annual capitalized development costs exceeding £1.5 billion.
- Increasing depreciation and amortization charges despite a cut in capex.
- Negligible impact on working capital changes for fiscals 2020 and 2021 after a reduction of inventory in the second part of fiscal 2019.
- Haircut to profits of companies accounted at equity, in particular those at the JV in China (Chery), resulting in lower dividends compared to the £200 million reflected in the fiscal 2018 adjusted EBITDA margin.
- No additional costs deriving from the need to mitigate operating risks in a no-deal Brexit scenario.

Based on these assumptions, we arrive at the following credit measures:

- An adjusted EBITDA margin of about 9%, down from over 10% in fiscal 2018,

recovering gradually in 2020, thanks to lower fixed and variable costs.

- Negative adjusted EBIT in both fiscals 2020 and 2021.
- Negative free cash flow after capex of cumulative £3 billion-£4 billion in fiscals 2019 and 2020.

## **Liquidity**

We consider JLR's liquidity as adequate because we project sources, namely funds from operations, available credit facilities with maturities exceeding one year, and available cash at the end of first-half fiscal 2019, cover uses including debt maturities, capex, and negative working capital, by more than 1.2x. Our assessment of adequate liquidity is supported by comfortable access to the debt market, demonstrated by the covenant free \$1 billion term loan signed by JLR in October.

Principal liquidity sources for the 12 months from Sept. 30, are

- Cash and short-term deposits of about £2.3 billion as of Sept. 30, 2018, net of liquid resources that we consider unavailable for immediate debt repayment;
- Revolving credit facility (RCF) expiring in 2020, with available undrawn committed credit lines of £1.94 billion with maturities greater than 12 months;
- Forecast reported cash flow from operations of over £2.5 billion-£3.0 billion.
- The cash position does not include a \$1 billion term loan signed by JLR during October, which we understand has been drawn down in its entirety.

Principal liquidity uses over the same period are:

- Capex of about £2.3 billion (excluding capitalized development costs);
- Scheduled bond maturities in December 2018 (\$700 million);
- Negligible working capital outflow during fiscal 2019; and
- Dividends to Tata Motors as high as 25% of profits after tax.

We consider JLR a highly strategic entity in the Tata Motors group and we believe that the company benefits from excellent banking relationships.

## **CreditWatch**

The CreditWatch placement with negative implications reflects the challenges that JLR faces as a result of Brexit, which could lead to further deterioration in JLR's and, consequently, Tata Motors' financial position. It also factors the risk of potential exposure to escalating trade tensions between Europe and the U.S. We aim to resolve the CreditWatch by adjusting our

base case once we have better visibility on the likely Brexit outcome, which could happen in the next three months. We would lower the ratings if we assess that the chances of a turnaround for JLR have diminished, with Tata Motors funds from operations-to-debt ratio slipping below 12% over a prolonged period as a consequence.

We could affirm the ratings if the Brexit outcome limits the adverse impact on JLR's turnaround, such that Tata Motors' FFO-to-debt ratio remains above 12% over the next 12-18 months.

## **Issue Ratings--Recovery Analysis**

### **Key analytical factors**

- Our issue and recovery ratings on JLR's senior unsecured notes are 'BB-' and '3', respectively. The '3' recovery rating reflects our expectation of meaningful recovery (50%-70%; rounded estimate: 65%) in the event of a default. The senior unsecured notes are: \$700 million 4.125% notes due 2018, \$500 million 4.250% notes due 2019, \$500 million 3.5% notes due 2020, £300 million 2.75% notes due 2021, £400 million 5% notes due 2022, \$500 million 5.625% notes due 2023, £400 million 3.875% notes due 2023, €650 million 2.2% notes due 2024, and \$500 million 4.5% notes due 2027.
- Our recovery expectations are underpinned by JLR's strong brand name but constrained by the large amount of unsecured debt. Although recovery prospects may exceed 70%, we cap the recovery rating at '3' due to the unsecured nature of the debt instruments.
- Our default scenario assumes deterioration in operating performance amid competitive market conditions, shifting consumer preferences, and delays in new model introduction, among other factors. We believe this would lead to a steady decline in revenue, deteriorating profitability, and higher investment requirement, which will result in cash burn and thus negative free operating cash flow.
- We value the company as a going concern given its notable market positions and its strong brand name.

### **Simulated default assumptions**

- Year of default: 2022
- Jurisdiction: U.K.

### **Simplified Waterfall**

- Emergence EBITDA: £1.2 billion
- Maintenance capex is assumed to be 3% of revenue (in line with similar large auto original equipment manufacturers)
- Cyclical adjustment of 15% (standard for the sector)
- Multiple: 5.5x

- Gross recovery value: £6.75 billion (after adjusting for priority pension claims)
- Net recovery value for waterfall after administration expenses (5%): £6.24 billion
- Prior-ranking liabilities: £0.23 billion
- Recovery value available for secured debt holders: £6.0 billion (1)(2)
- Senior secured claims: Nil
- Recovery value available for unsecured debt holders: £6.0 billion (1)(2)
- Unsecured claims: £6.73 billion(1)
- Recovery range: higher than 85% (recovery rating capped at '3' due to high unsecured debt)

(1)All debt amounts include six months of prepetition interest. (2)RCF is assumed to be 85% drawn at default.

## Related Criteria

- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria - Corporates - Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Auto And Commercial Vehicle Manufacturing Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

Downgraded

To

From

*Research Update: U.K.-Based Jaguar Land Rover Downgraded To 'BB-' On Weaker-Than-Expected Profitability;  
Ratings Kept On Watch Negative*

Jaguar Land Rover Automotive PLC

Issuer Credit Rating

BB-/Watch Neg/--

BB-/Watch Neg/--

Senior Unsecured

BB-/Watch Neg

BB-/Watch Neg

Recovery Rating

3(65%)

3(65%)

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