FitchRatings

Fitch Downgrades Jaguar Land Rover to 'BB-'; Outlook Negative

Fitch Ratings - London - 16 July 2019:

Fitch Ratings has downgraded the Long-Term Issuer Default Rating (IDR) and senior unsecured rating of Jaguar Land Rover (JLR) to 'BB-' from 'BB'. At the same time Fitch has placed the IDR on Negative Outlook, removing it from Rating Watch Negative where it was placed on 4 February 2019.

The downgrade reflects the weakening of JLR's business profile as risks rise in its markets, particularly in technology requirements as well as its investment in new models and platforms. The prospect of a disorderly Brexit and the spectre of US tariffs on car imports from Europe are additional risks. Fitch expects JLR's negative free cash flow (FCF) will continue until financial year to end-March 2021 (FY21) reflecting its intensive investment programme in electric powertrain, model replacement and new chassis architecture.

The Negative Outlook reflects the risk that Brexit and tariff risks are realised and have a significant further negative effect on JLR's financial structure and profitability. The ratings could also be lowered if JLR's investment in future fleet mix and new technologies does not offset declines in the global auto market, reducing JLR's ability to increase its revenues.

Key Rating Drivers

High Operational Leverage: JLR's business risk profile is negatively affected by its small scale relative to investment grade auto manufacturers as well as its high operating leverage. JLR's margins and cash flow were sharply affected by declining sales in China and Europe. Countering the sales slowdown over the last twelve months has been cost reductions in UK manufacturing and the move to lower cost manufacturing in Slovakia to support new model lines. Fitch expects volumes to remain relatively flat for FY20 as it forecasts negative sales growth in Europe and flat sales in China.

Profitability Remains Weak: Fitch expects JLR's EBIT margin to recover to between 1%-2% in FY20 and FY21, from negative 1.8% (excluding write-downs) in FY19 bolstered by the strong mid-cycle refresh performance of the Range Rover and Range Rover Sport models, following the introduction of the plug-in hybrid drivetrain. We expect the cost savings generated by Project Charge, which include staff cuts and other material cost savings, to lead to a mild recovery in profitability. We expect the EBIT margin to increase to 4% in FY22 as the effect of higher margin model launches is felt.

Capex Drives Negative FCF: Despite a cut in investment spending in FY19, JLR's capex levels remain high relative to its peers. This is related to investment in new models, a new modular chassis and electrification, including investment in a new battery facility. Fitch expects JLR to generate significantly negative FCF for FY20 and FY21, before turning marginally positive following the completion and launch of these key chassis and electrification programmes.

Aggressive Investment Plan: We expect investment spending to remain high at between GBP3.5 billion-4 billion from FY20-22. Fitch expects investment in new models, such as the Defender and Range Rover replacements, to bolster revenue and profitability in FY21 and FY22. JLR's investments in electric drivetrain and battery plants should protect the company from capacity constraints in electric vehicle production, and ensure the supply chain remains under JLR's control for future production.

Increased Leverage: Fitch expects funds from operations (FFO) adjusted net leverage to increase to just below 1.5x in FY21 from 0.9x in FY19 and 0.1x in FY18. The increase in net leverage has been driven by declining funds from operations and the issuance of debt to finance the company's negative FCF and investment.

Hard Brexit Potentially Disruptive: The risks of a disorderly Brexit remain high. Related disruptions to supply chain flows could result in production delays with a short-term impact on cash flow. The clearance of imported parts to support just-in-time assembly, and the risk that the supply chain could significantly lengthen could add unwelcome uncertainty to deliveries.

However, Fitch expects any tariff effects in trading with the EU to be largely absorbed in the short-term by likely pound sterling depreciation as 80% of its products are sold in non-sterling markets. JLR has planned to reduce the risk of a hard Brexit, for example by increasing the buffer of production stock. Fitch expects these steps will limit interruptions in output.

Limited Scale and Product Diversity: JLR's scale and range of products are smaller than premium-segment peers, which raises the risk of volatility in earnings and cash flow. Fitch expects JLR's strategy of increasing the number of its models using new modular architecture to both reduce the risk of new model launches and to increase capacity utilisation. However, Fitch forecasts modest growth in JLR's overall volumes, based on model renewal and new nameplate launches such as the Defender and Range Rover replacement. Fitch expects JLR to be extremely focused on margin per unit going forward, with stronger stock control to improve cash generation.

Fuel Efficiency Requirements Challenging: Tightening emission controls remain a challenge for JLR as its product portfolio is currently weighted towards larger, less fuel-efficient SUVs. Diesel accounted for about 71% of JLR's sales in Europe in FY19; this could be reduced by JLR's plans to offer the option of electrification on all of its vehicles from 2020. JLR's early introduction of the PHEV technology has improved sales of its high-end SUVs compared to its rivals. The construction of a battery assembly facility at Hams Hall will reduce the costs of its electric cars.

Derivation Summary

JLR competes in the premium segment with Daimler AG's Mercedes (A-/Stable), BMW AG and Volkswagen AG (BBB+/Stable), notably VW's Audi brand. JLR is much smaller than the larger German peers, has a more limited product portfolio and has a largely UK manufacturing base. This limits economies of scale and leads to concentration risk. The company has been expanding its model range and has increased the diversification of its manufacturing following the opening of a new factory in Slovakia. Nevertheless, the concentration of manufacturing in the UK means that JLR is the most exposed of our portfolio of automotive manufacturers to a disorderly Brexit.

JLR's profitability and cash flow generation during this period of investment are significantly lower than other rated peers such as Fiat Chrysler Automobiles N.V. (BBB-/Stable) and Peugeot S.A. (BBB-/Stable). JLR's profitability and FCF declined further in FY19 to negative 1.8% and negative 6.3% respectively. JLR's capital structure is also the weakest amongst its peers, with FFO adjusted net leverage increasing to 0.9x in FY19 and forecast to increase to just below 1.5x in FY21.

No country-ceiling, parent/subsidiary or operating environment aspects has an impact on the rating.

Key Assumptions

- EBIT margin to recover to between 1%-2% in FY20 and FY21, increasing to 4% in FY22

- Capex of between GBP3.5 billion-4 billion per annum from FY20 to FY22

- No dividend payment in FY20

RATING SENSITIVITIES

Developments that May, Individually or Collectively, Lead to Positive Rating Action

- Operating margin sustainably above 2%

- Significantly positive FCF margin

- FFO-adjusted net leverage below 0.5x

Developments that May, Individually or Collectively, Lead to Negative Rating Action

- FCF margin does not recover to positive by FY22

- Failure to mitigate the worst effects of a disorderly Brexit or significant changes to current tariff regimes, resulting in a materially weaker financial profile than forecast

- Operating margin sustainably below 1%

- FFO-adjusted net leverage above 1.5x

Liquidity and Debt Structure

Liquidity Contingent on Refinancing: At FY19, JLR reported cash and cash equivalents of GBP2.75 billion, short-term liquidity deposits of GBP1 billion and committed undrawn facilities of GBP1.9 billion maturing in 2022. Liquidity is more than sufficient to cover short-term maturities which consist of a USD500 million bond maturing in November 2019 and a USD500 million bond maturing in March 2020. However, the company's consistently negative FCF means that additional debt will need to be raised in 2019 in order to maintain a cash balance at the target of 12-15% of revenue. JLR has recently announced a USD700 million receivables financing facility and a GBP500 million UK export finance guarantee which we expect to support an additional loan facility. Fitch restricts GBP500 million of cash to account for intra-year working capital volatility.

Summary of Financial Adjustments

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Jaguar Land Rover Automotive plc	LT IDR BB- Downgrade		BB

	BB- Downgrade		

Additional information is available on www.fitchratings.com

Applicable Criteria

Parent and Subsidiary Rating Linkage (pub. 16 Jul 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)

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Dodd-Frank Rating Information Disclosure Form
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