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Research Update:

Germany-Based Automaker Volkswagen Placed On CreditWatch Negative On €6.5 Billion Charge For Global Recall

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Overview

- Volkswagen AG (VW) has announced it will take a €6.5 billion provision in its third-quarter results, in relation to a recall of 11 million vehicles worldwide, which show discrepancies between diesel test results and actual road use.
- This follows an earlier announcement by the U.S. Environmental Protection Agency that VW violated U.S. environmental laws in relation to 482,000 vehicles.
- We therefore anticipate that VW will incur substantial penalties and remediation costs to resolve this matter.
- We are placing our 'A/A-1' long- and short-term ratings on VW on CreditWatch with negative implications. The CreditWatch placement reflects the risk that we could lower our long-term ratings by one or more notches, depending on our assessment of the impact of the recall on the group's credit metrics and underlying business prospects.

Rating Action

On Sept. 24, 2015, Standard & Poor's Ratings Services placed its 'A/A-1' long- and short-term corporate credit ratings on Germany-based auto manufacturer Volkswagen AG (VW) on CreditWatch with negative implications. We also placed our long- and short-term ratings on VW's debt instruments on CreditWatch with negative implications.

In addition, we placed our 'A/A-1' long- and short-term ratings on Volkswagen's "core" subsidiaries, captive finance entity Volkswagen Financial Services AG (VW FS), its subsidiary Volkswagen Bank GmbH, and finance subsidiary Volkswagen Group Services S.A. We also placed on CreditWatch with negative implications our 'A' long-term issuer credit and financial strength ratings on captive insurer Volkswagen Insurance Co. Ltd.

Rationale

The CreditWatch placement follows VW's announcement that it will take a €6.5 billion charge to third-quarter results to cover the costs of a global recall of 11 million vehicles which show discrepancies between diesel test results and actual road use. This follows an announcement by the U.S. Environmental Protection Agency (EPA) that VW had violated U.S. environmental laws in relation to 482,000 diesel cars sold in the U.S. during 2009-2015.

VW appears to have installed software designed to manipulate the level of emissions and, at least in the U.S., circumvent emissions regulations.

We expect VW to incur substantial remediation costs to correct the engines of the cars affected and potentially face material fines from regulators. Criminal charges in the U.S. may also follow. We expect the group's leverage metrics to be constrained by this charge, and for cash flow to reduce as these expenses are incurred. Although VW's adjusted credit metrics currently have a degree of headroom to accommodate such remediation costs, we see the risk that fines from regulators and other authorities, could lead to costs exceeding the €6.5 billion charge the company currently has in place. We will also assess the impact on VW's liquidity, which stood at €27.7 billion of cash and marketable securities on June 30, 2015.

There is a risk that this recall may significantly affect VW's reputation, thus weakening the group's operational performance, due to lower volumes or additional costs. The resignation of the CEO indicates that there could be a weaker management, governance, and risk framework than we had expected. We note positively that the company is taking further steps and is cooperating with the relevant authorities.

This incident could also indicate a wider industry problem, if other manufacturers have followed similar practices, and it may lead to tougher industrywide regulations and requirements for diesel engines.

As of June 30, 2015, our figure for adjusted debt was €32.3 billion. The ratios of funds from operations to adjusted debt and debt to EBITDA for the 12 months ended June 30, 2015 were about 59% and 1.4x, respectively.

CreditWatch

We will resolve the CreditWatch within 90 days, once we have assessed the potential impact on the group's leverage metrics, future profitability, cash flow, business prospects and governance.

We may lower the ratings by one notch, if we expect leverage metrics to weaken below adjusted funds from operations to debt of 45% and adjusted debt to EBITDA of 2.0x. We may lower the ratings by more than one notch, if we conclude that VW's business prospects have also weakened.

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Auto And Commercial Vehicle Manufacturing Industry, Nov. 19, 2013

- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments, April 1, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 4, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- Captive Finance Operations, April 17, 2007

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Volkswagen AG		
Corporate Credit Rating	A/Watch Neg/A-1	A/Stable/A-1
Senior Unsecured	A/Watch Neg	A
Volkswagen Group Services S.A.		
Corporate Credit Rating	A/Watch Neg/A-1	A/Stable/A-1
Commercial Paper	A-1/Watch Neg	A-1
Volkswagen Bank GmbH		
Counterparty Credit Rating	A/Watch Neg/A-1	A/Stable/A-1
Senior Unsecured	A/Watch Neg	A
Commercial Paper	A-1/Watch Neg	A-1
Volkswagen Financial Services AG		
Counterparty Credit Rating	A/Watch Neg/A-1	A/Stable/A-1
Senior Unsecured	A/Watch Neg	A
Volkswagen Insurance Co. Ltd.		
Corporate Credit Rating		
Local Currency	A/Watch Neg/--	A/Stable/--
Financial Strength Rating		
Local Currency	A/Watch Neg/--	A/Stable/--
VW Credit Canada Inc.		
VW Credit Inc.		
Volkswagen International Luxemburg S.A.		
Senior Unsecured [1]	A/Watch Neg	A
Volkswagen Financial Services Australia Pty Ltd.		
Volkswagen Financial Services Japan Ltd.		
Volkswagen Financial Services N.V.		
Volkswagen Group of America Finance LLC		

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Volkswagen Leasing GmbH		
Senior Unsecured [2]	A/Watch Neg	A
Volkswagen International Finance N.V.		
Senior Unsecured [2]	A/Watch Neg	A
Senior Unsecured [2]	cnAAA/Watch Neg	cnAAA
Junior Subordinated	BBB+/Watch Neg	BBB+
Preferred Stock	BBB+/Watch Neg	BBB+

Ratings Affirmed

Volkswagen Finans Sverige AB		
Counterparty Credit Rating		
Nordic Regional Scale	--/--/K-1	

[1] Guaranteed by Volkswagen AG.

[2] Guaranteed by Volkswagen Financial Services.

N.B.--List does not include all ratings affected.

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