Article Title: ARCHIVE | Criteria | Corporates | General: Assumptions: Analytical Adjustments For Captive Finance Operations Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the article titled "Methodology: The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers," published on Dec. 14, 2015. This article partially superseded the article titled "2008 Corporate Criteria: Ratios And Adjustments," published April 15, 2008.) Making adjustments to amounts reported in companies' financial statements is an integral part of Standard & Poor's Ratings Services' analysis. These analytical adjustments improve the analytical relevance and consistency of the financial ratios that we use in our credit analysis. This article provides an update on our adjustments for captive finance operations, last published April 15, 2008, in "Corporate Ratings Criteria 2008" (see section "Encyclopedia Of Analytical Adjustments," subsection "Captive Finance Operations"). The only change is the inclusion of a table that sets leverage guidance for the captive finance company's assets, driven according to the quality of its asset portfolio (see below, "Leverage guidance for captive finance companies' assets"). We expect no changes to issuer credit ratings purely as a result of the introduction of this guidance. Captive Finance Operations A captive finance operation (captive) functions primarily as an extension of a company's marketing activities. The captive facilitates the sale of goods or services by providing financing (in the form of loans or leases) to the company's dealers and/or end customers. The captive can be structured as a legally separate subsidiary, or as a distinct operating division or business line of the company. Captive finance units organized as separate subsidiaries are rated the same as their parents in the overwhelming majority of cases, meaning we view their default risk as indistinguishable from that of the parent. Whatever the legal/organizational structure, the two businesses are not analyzed on a consolidated basis. Rather, we segregate financing activities from corporate/industrial activities and analyze each separately, reflecting the differences in business dynamics and economic characteristics, and the appropriateness of different financial measures. Our approach is to create a pro forma captive unit to enable finance company analytical techniques to be applied to the captive finance activity, and correspondingly appropriate analytical techniques to the pure industrial company. Finance assets (e.g., loans receivable and leases)--along with appropriate amounts of financial debt and equity--are allocated to the pro forma finance company; all other assets and liabilities are included in the parent/industrial balance sheet. Similarly, only finance-related revenues and expenses are included in the pro forma finance company income statement. The debt and equity of the parents and the captives are apportioned so that both entities will reflect, in most cases, identical credit quality. In our analytical methodology for captive finance operations, we attribute debt and equity to the pro forma finance company based on our assessment of the quality of the finance assets, taking account of factors such as underwriting standards, charge-off policy, quality of the collateral, and portfolio concentration or diversity. The adjusted financial measures are highly sensitive to assumptions we make about the leverage appropriate to the finance assets in question. We continue to refine our leverage guidelines for major finance asset types. Leverage guidance for captive finance companies' assets Correlation Of A Captive's Financial Strength With Its Portfolio Quality CAPTIVE'S FINANCIAL STRENGTH (TOTAL DEBT/EQUITY, X) AAA AA A BBB BB B PORTFOLIO QUALITY Excellent 6 7 8.5 10 11 12 Strong - 6 7 8.5 10 11 Satisfactory - - 6 7 9 10 For example, if we assess a captive's portfolio quality as "Strong" or commensurate with an 'A' business profile, we would typically judge a captive's ratio of finance company debt to finance company equity (as defined below, see "Calculations") of about 8.5x as being in line with a 'BBB' category corporate credit rating for the parent company. This 8.5x level corresponds to a ratio of total finance assets/finance company equity of about 9.5x. For the same portfolio quality, a ratio of about 7x (or 8x for finance company debt/finance company equity) would be consistent if the parent was rated in the 'A' category. The table, which provides guidance and not rules, does not reflect the many nuances within the categories described or other risks that influence the captive's financial profile, like liquidity, legal or country-related risks, and its specific asset mix. For portfolios of speculative-grade quality--poorer than "Satisfactory"--guidance is best provided on an ad hoc basis. Adjustment Procedures Note: In almost all instances, financial statements fully consolidate majority-owned captive finance operations: Here, consolidated financial statements are assumed as the starting point. Where separate financial statements are also available for the finance unit, information from these can be used to refine the adjustment. Data requirements: On-balance-sheet finance receivables and leases, net; Finance receivables and leases sold or securitized--carried off-balance-sheet; Finance company revenues (if actual finance revenues are unavailable, we use 15% of total finance receivables); Finance company administrative expenses (if actual finance company expenses are unavailable, we use 3% of total finance receivables); Debt-to-equity ratio: determined to reflect our view of the "leveragability" of the captive's assets (on- and off-balance-sheet finance receivables and leases); Interest rate (the average rate experienced by the company); and Required fixed charge coverage--an interest coverage appropriate for the rating. (1.25x is often used.) Calculations: Total finance assets: on-balance-sheet finance receivables and leases plus finance receivables and leases sold or securitized (carried off-balance-sheet). Finance company EBIT: finance company revenues minus noninterest expenses. Finance company debt: total finance assets times the debt-to-equity ratio/(1 plus the debt-to-equity ratio). This can never be more than reported consolidated debt; if so, the debt-to-equity ratio should be adjusted. (Separately, consolidated debt also is adjusted to reflect the debt equivalent of securitized assets and hybrid securities.) Finance company equity: total finance assets minus finance company debt. Finance company interest: most recent two-year finance company debt times interest rate. Finance company required EBIT: finance company interest times required fixed-charge coverage. Transfer payment: finance company EBIT minus finance company required EBIT (which can be positive or negative). Subtract finance company revenues from total revenues to derive adjusted industrial company revenues. Subtract finance company operating expenses, including depreciation, from total operating expenses to derive adjusted industrial company operating expenses. Industrial EBIT: adjusted revenues minus adjusted expenses plus transfer payment. Reduce reported interest by finance company interest, if reported captive finance company's interest is included in consolidated operating expenses; otherwise, no adjustment is required. Reduce reported debt (adjusted for securitized assets) by finance company debt. Reduce reported equity by finance company equity (after increasing total reported equity by the minority interests in the captive finance company's equity, if the captive is not fully owned, and its reported equity excludes minority interests). Remove the finance company's cash flows, including capital expenditures, from reported cash flows. These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by the issuer-specific or issue-specific facts, as well as Standard & Poor's assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions change from time to time as a result of market and economic conditions, issue-specific or issuer-specific factors, or new empirical evidence that would affect our credit judgment.