Article Title: ARCHIVE | Criteria | Corporates | Industrials: Gaining a Creditable Measure of Capital Goods Companies Worldwide Data: In a cyclical and highly competitive sector such as capital goods, the underlying fundamentals of individual issuers assume significant weight when assessing creditworthiness. With demand primarily influenced by industrial production and world economic activity, market players are exposed to substantial business risk when the economy turns down as it has at present because these industry characteristics govern profitability and cash flow. Furthermore, while the industry is not necessarily capital intensive, some industry players may have significant capital commitments. As a result, when evaluating the credit quality of market participants, Standard & Poor's considers the credit's prospects through a complete business cycle and sets benchmarks for expected average credit protection measures as rating guidelines. The overall credit profile for capital goods companies worldwide is speculative-grade (that is, with long-term corporate credit ratings of 'BB+', or below). At March 31, 2002, 66% of issuers in this sector were assigned ratings in this asset class, reflecting the high proportion of middle market, North American companies issuing public debt at present. These entities hold solid niche positions, but are limited geographically because of their largely domestic operations. They also have weak financial profiles. In contrast, the capital goods sector's investment-grade credits are large multinational firms with strong business and financial profiles. Capital goods companies can be grouped into five broad product categories, namely: Heavy industrial capital equipment; Capital equipment components; Electrical equipment; Consumable or short-lived assets; and Industrial services. Five-Factor Check-Up Determines Credit Strength Although the capital goods sector is relatively broad and market players may operate across several product areas, there are five crucial aspects to consider when determining an issuer's credit rating--barriers to entry, diversification, aftermarket presence, cost position, and financial flexibility. The degree that sector companies exhibit these five qualities will play an important role in their assigned credit rating. A key distinction between investment-grade and speculative-grade credits is that the former will score highly in all five areas whereas the latter will display signs of weakness in certain aspects of assessment. Overall, investment-grade credits display strong keys to success whereas speculative-grade companies have many points of vulnerability. Barriers to entry. In a cyclical market, capital goods companies can best bolster their debt protection measures through a combination of the following: A portfolio of noncommodity products. This covers the supply of products or systems that are integral to larger "platforms" (that is, subassemblies for cars, aircraft, or power plants), which cannot be substituted easily with competitors' products when they wear out or need to be upgraded. Technological innovation. Sustained research and development efforts ensure that the product pipeline remains technologically competitive and that the issuer's product offering is differentiated sufficiently from those of other market players. New products can partially offset the intense pricing pressures faced by companies, mainly because operating efficiencies and improved product design can help to minimize unit costs and improve margins. Brand names. Brands can entrench a company in its markets, creating a strong franchise for established products. In replacement markets, branding brings further benefits, aided by conservative purchasers that tend to replace like-for-like components. Distribution channels. Commanding distributors' shelf space, often through the power of brand names, can be an important barrier to competition, especially price-based foreign competitors. Market share. High market shares enable firms to spread costs and ease the reinvestment necessary to maintain product leadership. Leading market shares also strengthen the issuer's position with its distributors. Product, customer, and geographical diversification. Geographical, product, and market diversification help offset the high volatility in cash flow generation that tends to weaken creditworthiness and increases resilience to economic recession. In addition, there are specific benefits to be gained from diversification in terms of: Product lines. A broad product portfolio decreases business risk and can mitigate cyclical pressures. New products, offering increased value to customers, enable the price base to be reset and also ease pricing pressures. Customer base. Customer diversity can ease price pressures and protect against a sudden loss of demand. Geographical reach and scale. Regional markets may be in different stages of the business cycle, with a downturn in one market offset by stability in others. Also important is the company's ability to tailor strategies to the needs of local markets and to manage foreign exchange risks. Aftermarket presence. Cash flow volatility can also be stabilized through the existence of a strong aftermarket, covering three main aspects: Recurrent revenues. Product consumables that require replacement are less sensitive to general economic conditions and may be counter cyclical, especially when customers curtail purchases of new equipment and extend the lives of older systems. Service content. A developed service content, particularly in respect of maintenance and repair functions, provides protection against industry demand volatility. Moreover, regulatory requirements for approved service providers can also constitute an important entry barrier. Captive installed base. This is of particular importance in establishing a core level of demand and eliminating competitive pressures. Cost position. The business cycle can play havoc with pricing, with margins coming under severe pressure in periods of weak demand when the desire to fill available capacity and cover fixed costs. Consequently, rating analysis looks carefully at the following three factors: Operating efficiency. Pricing pressures are a challenge for capital goods companies as they strive to reduce their operational leverage. As a result, margin pressures must be offset by initiatives to reduce costs. Variable costs versus fixed costs. Achieving cost structure variability by limiting fixed capital investments (often by outsourcing production of noncritical components) helps companies to maintain healthy credit protection measures in highly cyclical industries. Strong management systems. Cost-efficient manufacturers have above-average cost control, budgeting, and risk functions. In a downturn, the ability to cut costs rapidly to meet weakened demand is important in limiting margin erosion. Financial flexibility. A strong financial position is important in highly cyclical industries such as capital goods. Accordingly, the analytical rating team will need to establish the issuer's position with regard to: Management of working capital. In cyclical downturns, reduced financing requirements for working capital and capital expenditures mitigate any deterioration of debt leverage and cash flow protection measures. Capital goods companies can improve financial flexibility in times of stress by turning receivables into cash and reducing inventories. Liquidity access. Market sentiment can often restrict a capital goods company's access to the debt markets, reducing the entity's ability to recapitalize its balance sheet and relieve financial stress. As a consequence, companies are expected to maintain an adequate level of committed facilities for their business needs and should not be excessively reliant on short-term funding, which can be difficult to access in times of economic uncertainty. Financial policy. In strongly rated companies, financial leverage should be below average over the cycle and a conservative balance sheet is highly desirable.