Article Title: ARCHIVE | Criteria | Corporates | Industrials: Is Size Reflected in European Credit Ratings? Data: (Editor's note: This article draws on material originally published on RatingsDirect on March 28, 2000, under the title "Australasian Corporate Ratings: Does Size Matter?". It has been updated to reflect European experience and to answer repeated inquiries about the relevance of size on an issuer's credit ratings.) Investors, and company management teams, often assume that absolute size--measured in revenue, assets, cash flow, number of employees, or market capitalization--is used as a discrete rating factor when assessing credit risk. This is not the case. There is no minimum size criterion for any given rating level, as size alone does not constrain a company's rating. Smaller entities are only considered to be at a greater risk when their size exacerbates any weaknesses relative to competitors or where it implies a degree of vulnerability to business or financial adversity. The industry (or industries) in which a company operates, together with the company's competitive position within that industry, are key factors in assessing business risk. This in turn determines the level of financial risk appropriate for a rating category. The analytical focus centers on the company's relative operating strengths and weaknesses in both its industry and markets, and whether or not its financial profile mitigates or aggravates these risks. Areas of key analytical concern, including a company's size, are determined by the industry success factors, along with any aspects of vulnerability affecting the industry or issuer. Certain issues such as a high dependence on only one major production facility or market, or a limited number of customers--characteristics common to small and midsize enterprises (SMEs)--could also affect credit quality, even when this dependence underpins the company's high degree of success. The qualitative characteristics used by Standard & Poor's to define an SME are: Strong links between the entity, the owner, and the owner's family. An organizational structure that features owner management, or the owner or the owner's family members, on the supervisory board. An organizational structure with historically close relationships between management and employees. Existing funding availabilities that are based predominantly on bank facilities and loans. Limited or no access to the equity or capital markets. Limited financial flexibility due to restrictions in the company's capacity to raise new equity. Most owners have only limited capital resources to support capital increases, or may be unwilling to provide support. The entity's brands and products are well-known in one or more relatively small markets or niche industries. Although international comparisons are prevalent in the automotive, pharmaceuticals, and chemical industries where large multinational corporations operate, as well as in internationally traded commodities such as oil and gas, they are less relevant in regional or national markets such as retailing or property investment. That said, the trend toward global industry consolidation, coupled with the introduction of the euro, means that size comparisons with international peers are becoming increasingly pertinent to issuers of all sizes across Europe. It is relative size and performance, however, rather than absolute size, that are crucial to an issuer's ratings--particularly in terms of market position, diversity, and financial flexibility. Sustainable Market Shares Strengthen Competitive Position Companies with large and sustainable shares generally are in a stronger competitive position than their rivals. Take Germany-based braking and electrical systems manufacturer Robert Bosch GmbH (AA-/Stable/A-1+), for instance. It has had leading positions in most of its business segments, being among the top three players within the vehicle components, home appliances, and electrical hand tools industries. After the takeover of Mannesmann Rexroth AG in 2000 (not rated), the company also gained a leading share in the industrial and mobile hydraulics industry. Similarly, Sweden-based AB Electrolux (BBB+/Positive/A-2) profits from the group's position as a leading appliance manufacturer and its geographical diversification. Electrolux has a number of strong brand names and is the clear market leader for household appliances in Europe and the third-largest in the U.S. Company size can be a negative rating factor if there is a significant divergence between the market leader and smaller players. Switzerland-based Mettler-Toledo International Inc. (BBB-/Stable/--) was able to profit from its market-leading position in weighing instruments and applications, achieving investment-grade status in March 2000 following an improvement in its business risk and a strong financial performance. (Revenues in 2000 were almost $1.1 billion.) Mettler-Toledo's competitor and industry number two, U.S.-based Weigh-Tronix LLC (B-/Stable/--), however, has seen its ratings fall from 'B+' in 2001 after disappointing trading results and concerns over the company's financial flexibility. Revenues for the year ended March 31, 2001, were $295 million. Leading positions are not always synonymous with either competitive advantage or industry dominance. If an industry has a number of large, but comparably sized participants, none may gain a particular advantage or disadvantage. Such is the case in the German cement industry, where major players Heidelberger Zement AG (BBB+/Negative/A-2) and Dyckerhoff AG (BBB/Stable/A-2) hold strong positions in the domestic market. Despite low levels of building and infrastructure activity, the combination of stable price levels and competitive cost structures have resulted in good operating margins and returns in the past few years. Conversely, large companies in highly fragmented industries such as transportation, logistics, and security services can find it difficult to exert influence over pricing because all players are exposed to intense competition. Sweden-based Securitas AB (BBB+/Stable/--), for example, holds the number-one spot in security services in both Europe and North America, yet has less than 10% of the market worldwide. The retailing and consumer products sectors offer numerous examples where size is a credit strength, including supermarkets, confectionery, and brewing. That said, it is only one of the key success factors considered alongside brand recognition, product and geographical diversity, economies of scale, and effective distribution networks. Germany-based Metro AG (BBB+/Stable/A-2) ranks among the world's largest retailers with sales of almost €47 billion ($41.2 billion). Its ratings are underpinned by the leading positions of the group's cash-and-carry business, both in the domestic market and elsewhere in Europe. They also reflect Metro's strong positions in consumer electronics retailing, its overall scale, and its adequate financial profile. On a somewhat smaller scale, Kamps AG (BB+/Stable/--), also Germany-based, generated €1.5 billion in sales in 2000. It operates in the retail bakery segment and the prepackaged bakery products segments. Kamps' ratings reflect leading positions in its domestic market, a growing European presence, the stability of the bakery goods market, and the group's moderate financial profile. These factors are offset to some extent, however, by the risks arising from Kamps' very rapid growth. Economies of Scale Versus Defendable Niche Positions Good operating efficiency is an important factor in all issuers' business profiles, but becomes crucial in larger organizations looking for economies of scale. In the automotive industry, for example, the use of a common vehicle platform (set of components) across several models can lead to significant savings in development and production costs. One of the most successful practitioners of this strategy in Europe is Germany-based Volkswagen AG (VW; A+/Stable/A-1), which has improved profit margins as a result of its ongoing efforts in this direction. France-based Peugeot S.A. (A-/Negative/A-2), meanwhile, plans to produce most of its Peugeot- and Citroën-branded vehicles on three main platforms and also share certain components across these platforms over the medium term, under its "cross-platform" strategy. These initiatives should lead to lower unit costs (especially product development and tooling), and will help increase the frequency of product launches. As implementation of this strategy progresses, Peugeot expects to maintain one of the sector's youngest and most diverse product ranges. Other issuers for which economies of scale are important include: Sweden-based bearing manufacturer SKF AB (BBB+/Stable/--), which operates in a global industry known for its tough conditions such as overcapacity, strong customer bargaining power, commoditization, cyclical demand, and high fixed costs. SKF has endeavored to improve and strengthen its industry position through rationalization and refocusing the group's businesses. Comprehensive efficiency programs have led to lower break-even levels, which limit the adverse effects of cyclical downturns. France-based TotalFinaElf S.A. (AA/Stable/A-1+), which profits from its standing as the world's fourth-largest private international oil and gas company. Thanks to the competitive cost structure used across most of its operations, the company is able to gain economies of scale, as does BP PLC (AA+/Stable/A-1+). Nevertheless, SMEs can survive and perform satisfactorily in industries dominated by companies with large market shares, providing the small companies can build defendable market positions in niche segments of the industry. Sports-car designer and manufacturer Porsche AG (not rated) of Germany, for instance, has successfully defended and expanded its strong position in luxury sports cars against competitors such as Italy-based Lamborghini (part of VW) and Ferrari (Fiat SpA; --/--/A-3). Similarly, Sweden-based steel manufacturer SSAB Svenskt Stal AB (BBB+/Stable/A-2) has developed a strong international niche position in speciality steels. As a result, it is able to compete against large-scale volume steelmakers such as France-based Usinor (long-term rating BBB/Watch Pos, short-term rating 'A-2'). Diversification Cushions Issuers Against Adversity Diversification, both operational and geographical, is considered a positive credit protection measure. A diverse product range, and customer and supplier base, as well as geographically well-spread production facilities, generally cushion a company against adversity. Consequently, the entity is able to withstand product obsolescence, customers and suppliers facing trading or financial difficulties, increased competitive pressures, and operational downtime or restrictions. Geographical diversity can also afford some protection against adverse changes in regional markets and economies. A well-diversified company will have no single business unit that is dominant. Moreover, the level of diversity should be sufficient to underpin stable cash flows through the industry cycle. The potential benefits of diversification, however, need to be balanced against: The performance and prospects of each business; The extent to which the company's cash flow benefits from its operating diversity through the industry cycle; and The company's ability to manage its diverse operations. Germany-based Siemens AG (AA/Negative/A-1+) is a global conglomerate, with activities spread across six core business segments--energy, industry, information and communications, transportation, health care, and lighting. Its ratings reflect the group's financial strength and diversification, balancing its exposure to cyclical industries and economic conditions. Similarly, ratings on Switzerland-based ABB Asea Brown Boveri Ltd. (AA-/Positive/A-1+) reflect its leading market positions in power transmission and distribution systems, automation, oil, gas, and petrochemicals equipment, and building technologies, as well as its conservative financial profile. U.K.-based engineering group Smiths Group PLC (A-/Stable/A-2) serves industries such as aerospace, medical, housing, defense, and telecommunications. Its geographical spread is also impressive. Consequently, the group's diversity can lend some cushioning against a recession in any single country or region. The position of other European credits may not be as strong, owing to a mix of constraining factors that cover exposure to competitive and cyclical markets, modest business spans, the fortunes of the domestic market, and a narrow product range. Exposure to competitive and cyclical markets. Automotive and aerospace supplier GKN PLC (BBB+/Stable/--), also U.K.-based, benefits from strong niche positions, especially in constant velocity joints, powdered metal parts, and helicopters. It is, however, modest in size compared with the world's leading automotive suppliers, aerospace manufacturers, and aerospace component suppliers. Italy-based Inter Auto Parts Italia SpA (IAP; B/Stable/--) shares similar constraints. The group's ratings reflect its exposure to the mature, competitive, and highly fragmented Italian automotive spare-parts distribution market, as well as an aggressive financial profile following the 1998 LBO. Negative rating factors are IAP's moderate size, relative--although diminishing--concentration in the Italian market, lack of significant business diversification, and intensive working capital (working capital is equivalent to one-half of total sales). Moreover, IAP remains exposed to contract cancellations from large suppliers, as well as possible changes in Italian distribution channels. A modest business span. For Leica Geosystems Holdings AG (BB/Stable/--), the Switzerland-based manufacturer of high-precision surveying and optical measurement instruments, a modest range of business operations is a key rating factor and the company is particularly at risk in this respect. To address the shortcoming, the company has announced the acquisition of U.S.-based ERDAS and LH Systems (both not rated). The fortunes of the domestic market. Despite being Europe's leading supplier of sanitary plumbing systems and one of few Pan-European players in the sanitary products industry, Germany-based Geberit AG (BBB-/Positive/--) faces continuing uncertainty over the domestic construction market, the group's relatively small size, and its limited geographical diversity. Sirona Dental Systems SARL (B+/Stable/--), a German dental equipment manufacturer and distributor, is also highly dependent on domestic sales, although it has signaled increased demand in international markets. A narrow product range. Geographical diversification is not a problem for Grohe Holding GmbH (BB-/Stable/--), the holding company of Germany-based sanitary-fittings manufacturer Friedrich Grohe & Co. Through international expansion, Grohe now generates 70% of sales outside Germany and has developed a leading position in many European countries and a niche position in the U.S. high-range faucets segment. Ratings are constrained, however, by the manufacturer's narrow product program. Well-Defined Market Focus Delivers Stable Earnings Base The break-up of conglomerates or diversified companies normally has negative implications for credit quality: as operations become more focused, cash flow becomes potentially more volatile because there are fewer industries and markets to generate earnings. That said, a company might also narrow its focus by exiting less profitable businesses, regions, or cyclical segments, and increasing its reliance on stable, higher margin businesses where it has stronger market positions. Siemens' exposure to the cyclical semiconductor industry, for example, has gradually been reduced. Its 51% stake in component manufacturer Infineon Technologies AG and its 12.5% plus one share stake in EPCOS AG (BBB+/Stable/--) are its only remaining, nonstrategic investments in this field. Until January 2001, the residual chemicals interests of France-based life sciences group Aventis S.A. (A/Positive/A-1) diluted an overall business profile dominated by pharmaceuticals interests. The announced divestiture of a 50% stake in Wacker-Chemie GmbH (not rated) and the finalized divestiture of a 67% interest in Messer Griesheim GmbH (BB/Stable/--), however, have improved the group's business profile as well as its financial profile. In such cases, reduced diversity could have a neutral or modestly positive impact on credit quality. Financial Flexibility is a Fundamental Necessity Profitability, cash flow adequacy, capital structure, and the ability to position a company for future earnings growth are fundamental to financial performance. Critical factors are the company's policies and practices governing attitude to financial risk, the strength and sustainability of the company's performance, and prudential credit protection measures. Most of these aspects, of course, fall under the control of management. As a result, the ratings assessment process closely examines the management team's role in determining operational success, as well as its tolerance of risk. The former is covered in the competitive position analysis and forms an important part of the business profile, while the latter is a crucial element of financial policy and therefore one of the key rating factors used to determine the financial profile score. Standard & Poor's evaluation of financial flexibility focuses on the company's prospective cash needs and sources of funding (both operational and nonoperational), particularly its capacity to generate free cash flow to meet its debt maturities, and the company's options under stress should business or financial conditions deteriorate. Other issues considered are: Large contingent liabilities; Serious legal problems; Lack of insurance coverage; Extensive bank collateralization and restrictive loan covenants that place a firm at the mercy of its bankers; Contingency plans; Accumulated cash holdings (and cash equivalents); Access to the capital markets; Affiliations with other entities; and The ability to divest assets. Poor financial flexibility is usually an important negative rating factor for SMEs because of their limited capacity to withstand unexpected setbacks, and their limited access to external cash debt or equity to cover near-term vulnerabilities or temporary cash shortfalls. Adverse developments that would be a setback for firms with greater resources could result in severe problems for an SME's performance, possibly leading to its demise if access to funds is restricted (see sidebar). SideBarField001 As bank disintermediation spreads across Europe, companies are increasingly looking to access the public debt markets. In the U.K., bond issuance has become an important source of financing for investment-grade and speculative-grade issuers alike. Other large European economies such as Germany and Italy, however, lag some way behind in tapping the bond markets for funding. With the exception of smaller issues, public debt markets in Germany were until recently accessed only by companies with well-known names such as engineering group Voith AG and the fashion group Escada AG (both not rated) or investment-grade credits such as distributor Adolf Wüerth GmbH & Co. KG (A/Stable/A-1). Things are set to change, however, as more European corporations strive to gain greater independence from the banks. In May 2001, for instance, engineering group Rheinmetall AG (BBB/Stable/ A-2) and industrial gasses manufacturer Messer Griesheim Holding AG (Messer Griesheim; BB/Stable/--) issued bonds to the value of €350 million and €550 million, respectively. Messer Griesheim's original bond amounted to only €400 million and was increased due to strong demand. Bonds are not the only capital funding option, however. Syndicated loans are also available, structured differently from conventional bank loans and featuring covenants and risk-dependent interest margins. These loan ratings are based on the entity's corporate credit rating. Messer Griesheim GmbH, the main operating subsidiary of Messer Griesheim, has used this route for its senior secured bank facilities, being assigned a 'BB' rating. Once the loan collateralization is agreed, there may be a possibility of notching up the loan rating (that is, raise the rating of the loan higher than the corporate credit rating). The likelihood of notching will depend on the existing jurisdiction and bankruptcy laws of the country concerned, as well as on the amount and quality of the pledged assets. Syndicated loans are not yet widely used and Standard & Poor's expects SMEs to continue to realize their funding mainly by bank facilities and common bank loans. Gaining the Right Perspective on Credit Quality of SMEs There is a controversial notion that SMEs with growth prospects represent a better credit risk than larger, older, and perhaps declining companies. Although intuitively appealing, this view ignores some important considerations, namely: Larger firms generally have substantially more staying power and often benefit from the extended support of key stakeholders in times of stress (see above). This can serve as a platform from which the company can launch new products and services and thereby thrive. In contrast, the promise of small firms can fade very quickly, and their relatively small equity bases provide little protection from financial distress, especially against the high debt burden some companies deliberately assume. Fast growth often is pursued at the expense of profitability, and often is subject to poor execution, even if the idea is well conceived. SMEs risk being too ambitious, or continuing with high-risk financial policies as they aggressively pursue growth, limiting any improvements in credit quality. As Standard & Poor's Global Default Studies show (see "European Ratings Performance: Strong Growth and Low Defaults-for Now", published on RatingsDirect on April 19, 2001), there is little evidence to suggest that high-growth companies initially assigned speculative-grade ratings have the potential to upgrade. Many more have defaulted in the past decade than have achieved investment-grade ratings.