Article Title: ARCHIVE | Criteria | Corporates | Industrials: Liquidity Shapes Europe's High-Yield Consumer-Oriented Credits Data: Based on examples of high-yield European retail, consumer goods, media, and leisure companies, which currently represent more than 25% of all Western European corporates rated in the 'BB' and 'B' categories, Standard & Poor's has assembled its views on the key aspects it focuses on when analyzing speculative-grade credits. Credit ratings in the lower range of the 'BB' or 'B' categories, especially those of companies that have been acquired through leveraged buy-outs (LBOs), tend to be primarily driven by their weak financial profile. Standard & Poor's weighs immediate financial risks more heavily than potential business profile benefits, which can only accrue if a business remains viable over the longer term. These overriding financial risks can stem from issuers' limited access to alternative sources of funding, dependence on steadily increasing internally generated cash flows to meet their financial commitments, onerous debt amortization schedules, and tight financial covenants. Business Risk Remains the Starting Point for Evaluating Credit Quality Standard & Poor's business risk analysis of speculative-grade credits--as with that of investment-grade issuers (that is, those with long-term ratings of 'BBB-' or above)--focuses on industry risk, competitive position, and operating efficiency. However, the ability of an attractive business profile to positively influence a company's rating becomes more limited according to the level of financial stress. As a result, the weighting of business risk in the overall rating declines at the lower end of the rating scale. Therefore, although well-established companies such as U.K.-based biscuits manufacturer United Biscuits Finance PLC (BB-/Negative/B), which is the largest U.K. biscuit manufacturer by far, U.K.-based do-it-yourself (DIY) retailer Focus Retail Group Ltd. (BB-/Stable/--), which ranks number two in the U.K., or Yell Group PLC, the U.K.'s largest independent publisher of classified telephone directories, have investment-grade business risks, their ratings are capped by their leveraged financial profiles (see Tables 1 and 2). Conversely, business risk factors weigh more heavily for issuers rated 'BB' and above. Deterioration in the business profile was the primary cause of rating revisions in a couple of recent cases at the higher end of the 'BB' category. The rating downgrade to 'BB/Stable' from 'BB+/Negative' of U.K.-based cash-and-carry operator and food retailer The Big Food Group PLC (BB/Stable/--) on Feb. 5, 2003, for instance, reflected its weakened business profile primarily due to continuing underperformance of its Iceland food retail business. Standard & Poor's continues to view Big Food's financial profile and liquidity as adequate for the current ratings. Similarly, the revision to stable from positive of the outlook on France-based cognac and spirits manufacturer Rémy Cointreau S.A. (BB/Stable/--) on Sept. 24, 2001, was primarily driven by lower prospects for cognac, especially in the key U.S. market, rather than by a weakening of the group's financial profile (see Table 2). Table 1 European Media and Leisure High-Yield Credits COMPANY BRITISH SKY BROADCASTING GROUP PLC MODERN TIMES GROUP AB GALA GROUP HOLDINGS PLC HEAD N.V. TRAVELEX PLC YELL GROUP PLC Sector TV & radio TV & radio Gaming & leisure Gaming & leisure Gaming & leisure Printing & publishing Period ending June 30, 2002 Twelve months to Sept. 30, 2002 Sept. 30, 2002 Twelve months to Sept. 30, 2002 Nine months to September 2002 Twelve months to Sept. 2002 Corporate credit rating BB+/Positive BB+/Stable BB-/Watch Neg BB-/Stable BB-/Stable BB-/Stable LBO No No Yes No Yes Yes Sales (mil. €) 4,442 610 433 380 354 1,594 EBITDA (mil. €) 472 55 116 33 33.9 456 EBITDA net fixed charge coverage (x) 1.7 (target: 4-5x within 12 months) Just below 4.0x lease-adjusted gross interest coverage (target 4-5x) 2.7 2.8 2.4 2.5x EBITDA/interest coverage in six months to Sept. 2002 EBIT net fixed charge coverage (x) 0.5 N.A. 1.7 N.A. N.A. N.A. EBITDAR/interest plus rents (x) 1.5 More than 2.0 2.4 2.3 2.3 N.A. Lease adjusted FFO/net debt (%) 7.8 (target: 20% within 12 months) N.A. 16.0 14.8 0.5 N.A. Lease-adjusted net debt/EBITDAR (x) 5.6 N.A. 4.0 4.1 1.0 N.A. Lease-adjusted net debt/EBITDA (x) 6.4 4.0 Lease-adjusted total debt/EBITDA (target: 3x within 18 months) 4.5 4.1 1.8 Just over 5x total debt/EBITDA in six months to Sept. 2002 (target: below 6x in 2003, reducing to about 5x in 2004) COMPANY ANTENNA TV S.A. FINDEXA II AS SBS BROADCASTING S.A. TDL INFOMEDIA GROUP PLC THE POLESTAR CORP. PLC Sector TV & radio Printing & publishing TV & radio Printing & publishing Printing & publishing Period ending Twelve months to Sept. 2002 Twelve months to Sept. 2002 Twelve months to Sept. 2002 Dec. 31, 2001 Sept. 30, 2002 Corporate credit rating BB-/Negative B+/ Stable B+/Stable B+/Stable B/Stable LBO No Yes No Yes, same structure for new owner Yes Sales (mil. €) 161 287 487 149 775 EBITDA (mil. €) 11.7 69 36 45 N.A. EBITDA net fixed charge coverage (x) 0.5 N.A. 1.0 (target: 1.5x) 2.8x EBITDA/ cash-paid interest coverage (target: to remain above 2.5x) (Target: More than 2x lease-adjusted interest coverage on cash paying debt EBIT net fixed charge coverage (x) N.A. N.A. N.A. 0.6 N.A. EBITDAR/interest plus rents (x) 0.5 (Target: FFO/total debt is expected to exceed 10% in 2003) 1.7 1.4 N.A. Lease-adjusted FFO/net debt (%) (8.0) (Target: FFO/total debt expected to exceed 10% in 2003) 14.7 6.6 N.A. Lease-adjusted net debt/EBITDAR (x) 12.9 N.A. 4.7 (total debt/EBITDA) 5.0 (target: to remain below 5.5x) (Target: cash paying debt/EBITDA of less than 5x in 2002) Lease-adjusted net debt/EBITDA (x) 15.8 (target: 5x by 2003) Target: total debt/EBITDA coverage of 5x expected in 2003 8.7 (total debt/EBITDA) (target: 5x) 5.4 N.A. N.A.—Not available. Table 2 European Consumer Goods/Retail High-Yield Credits COMPANY PROVIMI S.A. BIG FOOD GROUP PLC RÉMY COINTREAU S.A. FAGE DAIRY INDUSTRY S.A. FOCUS RETAIL GROUP LTD. GATE GOURMET LLC Sector Animal feed Cash and carry/supermarkets and convenience stores Spirits Dairy products DIY retail Airline catering Period ending June 30, 2002 March 31, 2002 March 31, 2002 Dec. 31, 2001 Oct. 31, 2001 Dec. 31, 2001 Corporate credit rating BB+/Stable BB/Stable BB/Stable BB/ Negative BB-/Stable BB-/ Stable LBO Yes* No No No Yes Yes Sales (mil. €) 1,459 8,353 1,018 294 2,339 3,243 EBITDA (mil. €) 120 274 236 34 282 223 EBITDA net fixed charge coverage (x) 4.0 3.0 3.7 2.9 1.2 (target: 3x in 2002) EBIT net fixed charge coverage (x) 3.1 2.1 3.3 2.1 N.A. 0.4 EBITDAR/interest plus rents (x) 4.0 1.8e (target: to maintain 1.6x) 3.7 2.9 1.4 post transaction (target: 1.6x by 2004) 1.1 Lease adjusted FFO/net debt (%) 19.5 20.1 16.7 19.5 (target: 25%) N.A. 9.0 (target: 20% in 2002) Lease-adjusted net debt/EBITDAR (x) 3.8 3.5 3.1 3.5 5.1 post transaction (target: 3.9x by 2004) 9.5 (target: 3x in 2002) Lease-adjusted net debt/EBITDA (x) 3.8 4.5 3.1 3.5 7.5 post transaction 14 COMPANY UNITED BISCUITS BUHRMANN N.V. BRAKE BROS PLC TM GROUP LTD. PREMIER FOODS PLC Sector Biscuits and snacks Office products distribution Food service distribution Convenience storese Food and non-alcoholic drinks Period ending Dec. 31, 2001 Dec. 31, 2001 Dec. 31, 2001 Twelve months to Aug. 24, 2002 Dec. 31, 2001 Corporate credit rating BB-/Negative B+/Watch Neg B+/Stable B+/Stable B+/Negative LBO Yes Yes Yes Yes Yes Sales (mil. €) 1,983 10,408 2,222 1,085 1,333 EBITDA (mil. €) 198 547 114 46 109 EBITDA net fixed charge coverage (x) 1.7 2.5 N.A. 1.8 1.5 EBIT net fixed charge coverage (x) 0.5 1.7 N.A. N.A. 1.2 EBITDAR/interest plus rents (x) 1.6 2.1 1.8 expected year-end 2002 (target: 2.0x by 2004) 1.3 1.5 Lease adjusted FFO/net debt (%) 9.7 14.7 N.A. N.A. 7.7 Lease-adjusted net debt/EBITDAR (x) 5.5 4.0 4.7 expected year-end 2002 (target: 4.1x by 2004) N.A. 5.4 Lease-adjusted net debt/EBITDA (x) 6.0 4.5 N.A. N.A. 5.8 *Considered an LBO as it has substantial leverage, private equity houses as major shareholders (subject to regulatory approval), and LBO-like financing arrangements. e--Estimate for fiscal year-end 2003. N.A.—Not available. Financial Analysis Revolves Around Speculative-Grade Issuers' Constrained Liquidity and Dependence on Internally Generated Cash Flows Specific adjustments to key indicators for LBOs. When analyzing LBO debt measures, Standard & Poor's generally makes the following adjustments. Shareholder and vendor loans and preferred shares or other quasi-equity instruments generally are not included in debt as long as they do not pay cash interest or dividends and provide an equity-like cushion to bank and bondholders through deep subordination. These instruments are considered as debt as soon as they start paying cash interest, cash dividends, or if the quasi-equity becomes repayable on similar terms as other debt, however. Similarly, the interest charge generally only includes cash interest payments and excludes noncash interest and dividends provided that these accrue until debt is repaid. Cash exceptional charges and the expected related savings and synergies are generally included when evaluating key profitability and cash flow indicators (EBITDA and EBIT, and funds from operations [FFO], respectively). This reflects Standard & Poor's focus on actual cash generation in the analysis of LBOs. Exceptional charges generally relate to the integration of recently acquired companies or to any planned restructuring. The impact of exceptionals can be significant: Focus Retail's EBITDA interest coverage (before Standard & Poor's analytical adjustments) in the first half of financial 2002, for example, was 2.7x before exceptionals and 2.2x after. These exceptionals relate to the integration of the group's 2000 acquisitions, U.K. DIY retail chains Great Mills and Wickes. Projected synergies are also critically reviewed and assessed. The retail, consumer goods, leisure, and media sectors lend themselves well to LBOs. This reflects that the retail and consumer goods industries, given their maturity and stability, tend to generate predictable cash flows, enabling them to service relatively high leverage. Similarly, several media and leisure industry issuers have businesses within specific but defensible market niches. Given their generally high degree of maturity, these businesses can, however, rarely sustain spectacular sales growth. As a result, projections based on above-market sales growth are treated with skepticism. Cost synergies are analyzed on a case-by-case basis, taking into account that a significant share of any improvement in production costs tends to be passed on to the consumer in mature and competitive industries. Ability to cover interest payments. The main ratios used to assess an issuer's ability to meet interest payments through internally generated earnings are: EBITDA (generally assessed after exceptional items)/cash interest; EBIT (again, generally assessed after exceptional items)/cash interest; EBITDAR (Earnings before interest, tax, depreciation, amortization, and rents)/cash interest plus rents, for companies which have substantial operating lease obligations. Typically, a 'BB-' long-term rating can only be achieved with a ratio of EBITDA interest coverage well in excess of 2x, while issuers with EBITDA interest coverage of less than 2x are generally rated in the 'B' category. This compares with median EBITDA interest coverage of 3.1x for the 'BB' category and of 1.7x for the 'B' category. Therefore, although U.K.-based Premier Foods PLC (B+/Negative/--) is a major U.K. branded and private label food manufacturer, its ratings are constrained by its very aggressive financial profile, with expected EBITDA interest coverage for financial 2002 of 1.7x pro forma for the acquisition in May 2002 of U.K. branded food assets from Nestlé S.A. (AAA/Negative/A-1+). When operating leases are a material cash expense to the business, Standard & Poor's also calculates interest coverage using EBITDAR/interest payable plus rents. This measure is especially appropriate for the retail, leisure, and lodging sectors, which require numerous outlets. It is, however, not discriminating and makes cross-sector comparisons difficult, especially of sectors with limited or no operating lease obligations. Ability to meet principal repayment. The ability of speculative-grade issuers to meet debt repayments through internally generated cash flow is a critical rating factor. Although investment-grade issuers normally have ready access to external cash funding to cover temporary shortfalls, speculative-grade credits--especially LBOs--usually lack this flexibility and are often prevented by their financial documentation from utilizing alternative sources of credit or even sale of assets for repaying debt. To evaluate an issuer's ability to meet its senior debt repayments, expected prefinancing cash flow is compared with the credit's senior debt repayment schedule. Prefinancing cash flow is computed as shown in Chart 1. 1 In addition, Standard & Poor's differentiates between scheduled mandatory senior debt repayments and those under cash sweeps. Cash sweeps are bank loan mechanisms that aim to partly apply "excess cash flow" to senior debt repayments. Excess cash flow generally corresponds to prefinancing cash flow after mandatory senior debt repayments. Consequently, an issuer's financial flexibility will be enhanced by having fewer mandatory repayments and a cash sweep, as the latter only applies if the company performs according to plan and actually generates "excess cash flow." Issuers in the 'BB' category, including Yell or LBOs such as Focus Retail, are considered to have the appropriate flexibility to meet their mandatory senior debt repayments. This reflects their ability to generate prefinancing cash flow--based on their profitability, tight working capital management, generally limited capital expenditures, and very modest (if any) dividends and acquisitions--as well as their manageable debt repayment schedule. On the other hand, the negative outlook on United Biscuits Finance reflects that the company needs to increase its prefinancing cash flow from its current level of about £40 million ($63 million) to meet gradually more demanding mandatory debt repayments over the next few years. Conversely, companies rated in the 'B' category are often dependent on significant improvements in their sales and profitability to meet senior debt repayments. U.K.-based food service distributor Brake Bros PLC (B+/Stable/--), for instance, enjoys satisfactory liquidity in the short term because of relatively modest mandatory debt repayments to 2005. Nevertheless, the company is dependent on significant improvements in earnings and cash flow to meet the higher mandatory debt repayments starting in 2006. Ability to effectively deleverage. The ability of issuers to effectively deleverage and rapidly improve their debt protection measures is also a primary rating factor, and one that can enable ratings to be forward looking, even when debt ratios are weak. Despite dismal debt measures in the wake of a substantial €95 million ($96 million) net loss in the year ended March 1998, Rémy Cointreau was initially assigned a 'BB-' long-term rating and stable outlook on July 6, 1998, reflecting Standard & Poor's confidence in management's ability to substantially reduce debt through divestments and improved earnings and cash flow generation. The company's FFO coverage by net debt has subsequently improved to 16.8% in financial

2002 from negative 8% in financial 1998. Similarly, despite the increase in its leverage following changes in its ownership, Focus Retail's 'BB-/Stable' long-term corporate credit rating was affirmed on Nov. 29, 2002, due to its strong free cash flow generation and track record. The group reduced its senior bank debt to £265 million at the end of the first half of financial 2002, from £315 million in financial 2001. Companies that only deleverage gradually are generally rated in the 'B' category. Owing to a very aggressive financial profile coupled with a mature business, Premier Foods' debt measures are only expected to improve very slowly. Brake Bros' substantial leverage, with expected debt to EBITDAR of 4.7x at financial year-end 2002, is also expected to improve only gradually. Leverage is primarily measured through FFO/debt (adjusted for leases where relevant) and debt/EBITDA (or lease-adjusted debt/EBITDAR where relevant). Compliance with senior debt financial covenants. Most speculative-grade issuers, particularly LBOs, have financial covenants on their senior bank debt, which often gradually tighten over time. These covenants ensure that cash generated by operations, as well as those from any potential asset sales, is primarily applied to debt servicing. Standard & Poor's monitors issuers' financial flexibility under such covenants and will likely take negative rating actions if these covenants are at risk of being breached. This reflects that a breach of senior debt covenants, leading to an event of default, could enable secured lenders to gain control over the major assets of a company. These circumstances are usually very negative for junior debtholders. In European LBOs, unsecured bondholders are generally contractually and structurally subordinated to senior lenders. A number of rated speculative-grade credits benefit from revolving credit lines to finance working capital and provide liquidity. These revolvers are, however, generally part of the senior debt package and share the same financial covenants. Consequently, any failure to comply with financial covenants would result in this liquidity crutch being withdrawn at a time when the company needs it most. Some rating actions are primarily driven by covenants issues: Netherlands-based office products supplier Buhrmann N.V. (B+/Watch Neg/--), for instance, was downgraded to 'B+' and remained on CreditWatch with negative implications on Dec. 4, 2002, reflecting that despite the renegotiation of senior bank debt covenants, its headroom in this respect remains very limited due to a declining operating performance and poor visibility for 2003. The group had already renegotiated its financial covenants in December 2001, just before it was about to breach them. In a few very specific instances, covenants restricting payments to shareholders, capital expenditure, or acquisitions can support credit quality. Netherlands-based animal feed manufacturer Provimi's (BB+/Stable) banking arrangements, secured in August 2002 when the company was acquired by private equity houses CVC Capital Partners and PAI Management, for example, require a substantial part of excess cash flow to be applied to debt repayment. In addition, the arrangements strictly limit Provimi's ability to upstream cash to its shareholders. This is consistent with the acquisition vehicle having very little or no cash pay debt service obligations. As a result, Standard & Poor's was able to affirm Provimi's ratings on the announcement of the acquisition. Conclusion Ultimately, neither the business profile nor any given set of financial ratios is likely to be sufficient in itself to support a rating if liquidity is constrained by financial covenants or looming debt amortization. Analyst E-Mail Addresses
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