Article Title: ARCHIVE | Criteria | Corporates | General: Net Debt Adjustments Reflect Asset Quality, Strategic Intent Data: (EDITOR'S NOTE: —This criteria article is no longer current. It has been superseded by the article titled, "2008 Corporate Criteria: Ratios And Adjustments," published April 15, 2008.) The credit profile of industrial companies that have accumulated cash and financial investments is, of course, enhanced by the available liquidity. But Standard & Poor's Ratings Services' analytical methodology regularly goes a step further, by adjusting both financial and operating ratios to reflect a company's surplus cash and liquid financial assets (that is, unless the surplus is deemed to be only temporary). Making Ratios More Indicative Of Credit Risk Industrial credit ratios are intended to capture the degree to which a company has leveraged its risk assets, and highly liquid financial assets involve virtually no risk. Moreover, ratios are designed to indicate a company's ability to service debt obligations from operating cash flow, and surplus cash and/or highly liquid assets are, in a sense, available to repay or service debt, apart from ongoing cash flow generation. Accordingly, we often net surplus cash against debt and debt-like obligations, so that "net debt" is what figures in ratio calculations. In some situations, we also use a "net interest expense" when calculating the denominator of coverage ratios, by subtracting interest income derived from the surplus cash. However, we restrict this treatment to cases where the surplus cash and debt are structurally linked. (Absent such linkage, we generally exclude interest income from the numerator, while using gross interest in the denominator.) Maintenance of surplus cash also distorts operational benchmarks and measures that are important for peer comparisons in all cases. Given the relatively low returns on low-risk financial assets, maintaining such assets depresses asset-related margins (even without taking into account interest expense that is required if the company is financing the cash with debt that otherwise would not be needed). The key analytical considerations regarding net debt adjustments are the quality of the financial assets themselves, and the company's purpose and strategies for maintaining them--although doing so involves commensurately higher levels of debt. Some possible strategies--and the implications for the permanence of the surplus--are discussed below. Near-term liquidity vs. real surplus Virtually all companies require some cash to facilitate their operations. Retailers, casinos, restaurants, and supermarkets, for example, need cash to make change. More broadly, companies require a certain level of cash for very-near-term liquidity. We neither give any special credit nor make any adjustments for cash that merely is adequate to support ongoing operations, although the amount sometimes can be quite substantial--especially for companies operating numerous and far-flung facilities, and those with transactions in diverse currencies. We expect companies to be ready to engage in dialogues with us to gauge these near-term operating liquidity needs, and our sector comparisons and reviews target peer consistency on this matter. (Aside from potential netting for surpluses, maintaining adequate liquidity always is an important rating consideration. A company with a deficient level of cash for working capital would be penalized in its rating assignment.) However, many companies possess still greater cash and/or liquid, low-risk, financial resources. Determining which of several different possible purposes and strategies that could pertain is important to our analytical treatment. In many situations we use net calculations; in many others, we do not, usually determined by the strategies of the company in question. The strategies below are arrayed in descending order, i.e., starting with the most supportive of a net approach, and ending with a number of strategies that do not lead to a net approach. Strategies that support net-debt treatment Defeasance (both legal and economic). Because the company places very high-quality assets in a trust to cover the interest and principal of a specific debt issue, this is the most obvious application of the net debt adjustment. (Please see "Defeasance Of Corporate Bonds May Be Gaining Popularity," published July 25, 2006, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis. Tax arbitrage. Some companies can manufacture in various tax havens, retain related profits in those low-tax locales, and avoid "tollgate" taxes by holding financial investments there, while financing and incurring tax-deductible interest expense in higher-tax rate jurisdictions. Such structural basis for maintaining cash is another solid reason for applying the net debt adjustments. (However, for analytical purposes, any tollgate taxes payable upon repatriation are subtracted from the cash.) The large, cash-rich pharmaceutical companies offer a good example of this tax arbitrage strategy. And, given the magnitude of this aspect of these companies' finances, profitability measures could be quite distorted without also adjusting return on asset ratios to a net basis. (Please see "Credit FAQ: Tax Relief On

Foreign Cash And Its Special Benefit To U.S. Drug And Medical Device Firms," published Sept. 14, 2004, and "Ratings Implications Of Earnings Repatriations Under The American Jobs Creation Act," published June 26, 2006, on RatingsDirect.) Funding future obligations. Some companies' may earmark financial assets on their balance sheet to provide for anticipated litigation outcomes or for their retiree benefit obligations. In particular, some large German manufacturers assert that their financial policy is to hold cash against retiree obligations. Indeed, while these assets may not be legally segregated, we view them as offsetting the liability. Application of the net-debt approach in such cases presumes, of course, that the debt-like liability itself is included in our adjusted debt. (U.S., U.K., and Dutch companies, among others, are forced by law to fund their pension obligations in a trust. Our pension adjustment adds back only any unfunded portion, which is equivalent to netting these financial assets against the debt-like pension liability.) Meet seasonal requirements. A company may choose to pre-fund its intra-year borrowing needs, by borrowing (or not repaying outstanding debt balances), holding the proceeds in cash or near-cash investments, drawing down the cash as the year progresses, and then replenishing it at period end. The company should not be penalized relative to a company that instead relies on borrowing only as the need actually materializes, thus avoiding the debt showing up on its financial statements. (In both cases, there may be equal prudence, because the latter company typically would be able to rely on a revolving credit agreement.) To avoid such a distortion and promote comparability, we would use a net debt approach. However, it would be tricky to estimate the impact on interest expense involved for this pattern--one reason we are reluctant to focus on net interest expense. Maintain access to financial markets. As with the above strategy, some companies believe it is in their best interests to keep a fairly stable presence in the financial markets, especially in commercial paper markets. They maintain their market presence on regular basis, rather than going in and out of the markets as their own cash flow pattern dictates. Strategies that do not support net-debt treatment Cyclical safety net. Some companies tend to accumulate cash during the good times, and hold onto it for self-preservation during the expected lean years. For companies that have large ongoing capital requirements, this can be critical. The large U.S. auto companies offer a dramatic example. Similarly, high-tech companies tend to operate with a large cash cushion, given the vicissitudes of the technology product life cycles. Such cash is not really an offset to debt, and net debt is not used as the basis for analysis in these instances. (Nonetheless, it is hard to forecast how much cash is appropriately dedicated to spending in future downturns. So our analysts might calculate supplementary ratios based on netting, just to gain perspective and for peer comparison purposes.) Reserve for investment opportunities. Cash earmarked for investment in operations--expansion or capital projects--or acquisitions does not qualify for netting against debt. The cash position is temporary, although some companies may take their time until the opportunity they seek arrives. Of course, having such cash to invest is a great positive that must not be overlooked; it figures in other aspects of the analysis: The potential additional cash flow that can be anticipated from enlarged operations is considered in financial projections, and the current availability of cash enhances liquidity. Awaiting return to shareholders. In the current financial environment, this situation may be the most common, at least in the U.S. Many companies that have been successful at generating surplus cash are motivated to repurchase stock or pay out special dividends. While shareholder enrichment programs may stretch out over several quarters or even a few years, the cash position of such companies is ephemeral, and should not be netted against debt. There are many instances where the purpose may be mixed or the strategy unclear. Local business practice can then form the basis for deciding whether the cash position is likely to be long-lasting. Accordingly, companies with surplus cash that operate in the European context are regularly afforded net debt treatment, given the acceptance--even tradition--of European companies operating permanently with surplus cash. (Whatever portion is deemed to be needed for operations is excluded from the adjustment.) In contrast, North American companies operate in an environment that looks askance at cash accumulation. Shareholders expect these funds to be invested, or returned to them for reinvestment. We therefore presume that, in most cases, their surplus cash will be distributed to shareholders sooner or later. Accordingly, few companies in North America are analyzed on a net-debt basis. Some companies participate in global industries, and may be influenced, to some extent, by the behavior of cross-border peers. This can provide additional insight into what to expect in those instances. Asset liquidity and accessibility are considered A company's excess cash may be invested in assets of varying quality or liquidity. We tend to be fairly conservative about which assets can be used to fully offset debt. However, a diversified portfolio of risk assets--such as equities, for example--can constitute a reasonably high quality investment, and is certainly very liquid. To the extent that asset values may be subject to decline, we would haircut the investment prior to the netting adjustment. There are situations where we would not adjust for excess cash on the balance sheet because the company has only limited access to the funds. Such exceptions include: Funds held at partially owned subsidiaries. Joint-venture partners or minority shareholders may insist on maintaining significant liquidity at the subsidiary level, or may otherwise limit the repatriation of cash to the group's central treasury operations. Operating subsidiaries that are tightly regulated. These business units may be prevented from up-streaming cash toward their parents, or may have to maintain substantial cash balances for regulatory reasons. In particular, consider captive insurance subsidiaries. While cash appears unencumbered, it usually has to be invested in line with the subsidiary's insurance status and regulations. (On the other hand, the insurance liabilities are analyzed in the context of the insurance operations, and not usually deconsolidated for analytical purposes.) Pension funding vehicles. Even pension surpluses are generally regarded as inaccessible for all practical purposes.