Article Title: ARCHIVE | Criteria | Corporates | Industrials: Releasing the Credit Impact of Captive Finance Operations From U.K. Retailers Data: (Editor's note: In line with other analytical practices of Standard & Poor's, this article has been republished to take a relatively less conservative view of captive finance operations. Specifically, customer receivables, which were previously assumed to be funded entirely through debt, are now considered to be funded with a mix of debt and equity. The overall effect of this adjustment on corporate debt protection measures is modest.) A small number of retailers in the U.K. operate captive finance business units as a means of growth and diversification. These activities can have a significant effect on an issuer's financial profile, although this is not always easy to establish because captive finance operations are usually consolidated in the credit's overall performance figures. As a result, it is necessary to split out the captive unit's results from those of its parent to gain a better measure of the retailer's creditworthiness, using the analytical evaluation examined below. The financial ratios used to evaluate U.K. retailers are largely the same key measures of financial performance applied to other corporate entities. Operating margins, return on capital, and sales and earnings growth rates are used to analyze operating performance, while EBITDA to net debt, interest coverage, and funds from operations (FFO) to net debt are used to determine debt protection levels. To establish these financial indicators, Standard & Poor's adjusts the figures reported by U.K. retailers, capitalizing the operating leases (see sidebar entitled "Calculating Operating Lease Adjustments" at the end of this article) and separating out the captive finance operations, where relevant. Captive financing in the retail sector takes the form of charge cards or customer finance. Charge-card financing is provided by a limited number of large U.K. retailers such as Marks & Spencer PLC (M&S; A/Stable/A-1), GUS PLC (A-/Stable/A-2), Signet Group PLC (BBB-/Stable/A-3), and Selfridges & Co. These players use charge cards as an effective tool for marketing their goods and services. The credit implications of these activities can be difficult to assimilate, especially when the finance subsidiaries are fully consolidated and there is no breakdown between retail and finance operations. In such circumstances, Standard & Poor's removes the receivables from the balance sheet, along with a related amount of debt and equity. In this way, the financial characteristics of the financing and retailing operations can be evaluated more precisely, according to parameters appropriate to each. The aim of this adjustment, which can have a major effect on a credit's debt protection measures, is to segregate and analyze the financing and retailing activities independently, reflecting their different asset types. The above-mentioned adjustment to financial ratios is best explained by reference to a worked example using M&S; data for financial 2001. At the outset, the minimum information required from the issuer is the amount of customer receivables generated over the period in question. With this figure usually embedded in the total accounts receivables that include trade debtors, the issuer will need to provide this data separately. Certain analytical assumptions are made when conducting an assessment on a captive finance business, namely: The analysis seeks to create the pro forma accounts of the finance company, to which finance company analytical techniques are applied. Only finance-related revenues and expenses remain at the pro forma credit company. No new debt or equity is created. No depreciation or amortization is taken into account, because fixed-asset exposure at the finance company is limited. The pro forma captive finance company is always assigned the same long-term corporate credit rating as the parent company. This is because captive finance companies and their operating companies are viewed as a single business unit due to the operational tie-in. Five-Step Guide Reveals Captive's Credit Quality In essence, the creditworthiness of the captive finance unit is gauged in five steps--an assessment of portfolio quality, construction of both the pro forma credit company's balance sheet and profit and loss statement, an evaluation of pro forma interest expenses, and the calculation of debt protection measures. Step 1: determine portfolio quality. The receivables portfolio of the pro forma company is analyzed in the same way as any finance company. Both quantitative and qualitative assessments are made. The leverage guidelines matrix (see table 1), which is based on cumulative data spanning more than two decades, provides the start point for assessing the leverage available for each asset being financed. Taking the 'A' long-term corporate credit rating of M&S;, for example, its portfolio of receivables is deemed to be of average quality. In addition, factors such as the issuer's underwriting charge-off policy, portfolio concentration, and diversity will be considered. Table 1 Debt Leverage and Fixed-Charge Coverage Guidelines RATING CATEGORY PORTFOLIO QUALITY (X) AAA AA A BBB Well-above average 3.4 5.7 7.3 8.9 Above average 2.85 5.05 6.55 8.05 Average 2.55 4.65 6.05 7.45 Below average 2.40 4.45 5.80 7.15 Well-below average 1.95 3.85 5.05 6.25 Pro forma credit company fixed-charge coverage 1.9 1.7 1.5 1.4 Source: Standard & Poor's. In the case of M&S;, total debt to equity is assumed to be 7.05 times (x) (6.05x debt + 1.00x equity), representing the average credit quality of customer receivables. Assigning the captive finance operation an 'A' long-term rating means its pro forma fixed-charge coverage is assumed as 1.5x. Table 2 Marks & Spencer PLC--Selected Financial Data --YEAR ENDED MARCH 31-- (MIL. £) 2001 2000 Total debt 1,694 1,943 Cash 414 688 Net debt 1,280 1,256 Operating leases 643 629 Lease-adjusted net debt 1,923 1,884 Customer receivables 2,259 2,141 Lease-adjusted net fixed charges 136.4 N/A N/A--Not applicable. Step 2: construct pro forma balance sheet. The first action in constructing the M&S; captive finance unit's balance sheet is to transfer £2,259 million ($3,510 million) of customer receivables from the parent and determine the appropriate amount of equity required to support the assets being transferred, that is: Customer receivables/total debt to equity (£2,259 million/7.05x) = £320.5 million. Second, work out the appropriate amount of debt for the pro forma credit company, namely: Customer receivables, less equity (£2,259 million, less £320.5 million) = £1,938.7 million. Third, as no new equity or debt is created, the parent's £320.5 million pro forma investment in its captive credit company is accounted for (see table 3). Table 3 Marks & Spencer PLC--Pro Forma Balance Sheet of Captive Finance Operations in 2001 (Mil. £) Assets 2,259.0 Debt 1,938.7 Equity 320.5 Total Assets 2,259.0 Total debt and equity 2,259.0 Step 3: construct pro forma profit and loss statement. Assuming an interest rate of 13.1% (an estimate based on company data) charged to consumers on their average outstanding balances: The captive's pro forma revenues = 13.1% x average receivables for 2001-2002 (see table 2) = 13.1% x (£2,259 million + £2,141 million)/2 = £288.2 million. These revenues are then transferred from the parent company to the pro forma credit company. Given that selling, general, and administrative (SGA) expenditure is about 3.5% of sales (or interest income): Pro forma SGA expenditure = 3.5% x average receivables = 3.5% x (£2,259 million + £2,141 million)/2 = £77 million. Therefore, £77 million of operating expenses are transferred from the parent company to the pro forma credit company. Step 4: determine pro forma interest expense. From data contained in table 2, reported lease-adjusted net fixed charges/reported average lease-adjusted net debt: = £93.5 million + £42.9 million/([£1,280 million + £643 million] + [£1,256 million + £629 million]/2) = 7.17%. Interest expense = 7.17% x pro forma average captive debt = 7.17% x ([£1,938.7 million + £1,837.7 million]/2) = £135.4 million. Consequently, £135.4 million of interest expenses are transferred from the parent company to the pro forma credit company. As a result, the pro forma income statement of the captive finance unit can now be stated (see table 4). Table 4 Marks & Spencer PLC--Pro Forma Income Statement of Captive Finance Operations (MIL. £) Revenues* 288.20 Operating expenses 77.00 EBIT 211.20 Interest expenses 135.40 EBT 75.80 Corporation tax (at 32.5%) 24.60 Net income 51.20 Fixed-charge coverage (x) 1.56 *Assumes interest revenues only, with no commission. EBIT--Earnings before interest and tax. EBT--Earnings before tax. To determine the excess fixed charge (positive or negative): i) Required earnings before interest and tax (EBIT) = interest expenses x fixed-charge coverage of 1.5x assumed for 'A'-rated captive finance unit = £135.4 million x 1.5 = £203.1 million. ii) Pro forma EBIT = £211.2 million, less £203.1 million = £8.2 million. Therefore, £8.2 million is transferred to the parent company. Step 5: calculate debt protection measures. Based on the calculations made between Step 1 and Step 4, it is now possible to establish the debt protection measures for the M&S; captive finance unit (see table 5). Table 5 Marks & Spencer PLC--Financial Statistics in 2001* (MIL. £) AS REPORTED¶ ADJUSTED§ Net debt 1,923.0 -15.8 EBITDA 845.0 641.9 Funds from operations (FFO) 646.0 600.3 Net fixed charge 136.4 1.0 EBITDA/net fixed-charge coverage (x) 6.2 631.8 FFO/net debt (%) 33.6 N.M. *All figures are lease adjusted. ¶Figures at year-end March 31. §Figures adjusted for captive finance operations. N.M.--Not meaningful. Similarly, table 6 shows the amended debt protection ratios (after adjustments for their captive finance operations) for Signet and GUS for financial 2001. Table 6 Debt Protection Measures for Marks & Spencer PLC, GUS PLC, and Signet Group PLC in 2001 DEBT PROTECTION MEASURES AS REPORTED* ADJUSTED¶ Issuer Corporate credit rating§ EBITDA/net fixed-charge coverage (x) FFO/net debt (%) EBITDA/net fixed-charge coverage (x) FFO/net debt (%) Marks & Spencer PLC A/Stable/A-1 6.2 33.6 631.8 N.M. GUS PLC A-/Stable/A-2 7.1 37.5 21.5 90.0 Signet Group PLC BBB-/Stable/A-3 5.9 26.7 6.8 29.7 *All figures are lease adjusted. ¶Figures adjusted for captive finance operations. §At July 9, 2002. N.M.--Not meaningful. It is clear from the above table that debt protection ratios for the parent companies improve when the captive finance operations are segregated, and to a significant degree in the case of M&S; and GUS, because the retail businesses have little debt (even after capitalizing operating leases). Although these two companies enjoy a very strong financial profile, their ratings are constrained to an extent by their business profiles, which reflect their participation in the highly competitive U.K. nonfood retail market. Sidebar: Calculating Operating Lease Adjustments Operating leases for all industrial companies are capitalized and the financial ratios adjusted accordingly. The most common method adopted is to calculate the present value of future minimum noncancellable operating lease commitments and add these to the reported net debt figure. Fixed rental cost, meanwhile, is restated as interest and depreciation. Under U.K. general accounting and administration practice (GAAP), however, companies do not disclose future rental commitments. Consequently, Standard & Poor's uses the factor method, where operating lease rental costs are capitalized by 5x and fixed rental costs are broken down to one-third implicit interest costs and two-thirds depreciation. The effect of this operating lease adjustment on U.K. retailers' debt measures is significant, largely because they tend to lease stores rather than own them--a marked contrast to their peers in Continental Europe, especially France-based operators. The lease adjustment calculation is best examined using reported results of J. Sainsbury PLC (A/Negative/A-1) for the year ended March 31, 2001 (see table 7). Table 7 J Sainsbury PLC--Selected Financial Data (MIL. £) Post exceptional EBITDA 958.0 Operating lease rental 302.0 Lease-adjusted post exceptional EBITDA 1,260.0 Net interest expense 76.0 Capitalized interest 24.0 Implicit interest cost* 100.7 Implicit depreciation¶ 201.3 Capitalized operating lease rental§ 1,510.0 Total fixed charge 200.7 *One-third of operating lease rental. ¶Two-thirds of operating lease rental. §Calculated at 5 times operating lease rental costs. Lease-adjusted EBITDA to net fixed-charge coverage = £1,260 million/£200.7 million = 6.3x. To calculate FFO to net debt: i) FFO = Net cash inflow from operating activities (before working capital) = £922 million, less: Working capital = negative £32 million.* Cash financing costs = £95 million. Cash taxes = £168 million. *Note: negative working capital (WC) is added back. If WC were positive, it would be deducted. ii) Therefore, the unadjusted FFO = £691 million. Lease-adjusted FFO = unadjusted FFO + implicit depreciation = (£691 million + £201.3 million) = £892.3 million. Lease-adjusted net debt = reported net debt + capitalized operating lease rental = £887 million + £1,510 million = £2,397 million. Lease-adjusted FFO/net debt (capitalized for operating leases) = £892.3 million/£2,397 million = 37.2%. The effect of the captive finance operations on Sainsbury's debt protection ratios is illustrated in table 8. Table 8 J Sainsbury PLC--Debt Protection Measures in 2001 AS REPORTED ADJUSTED* EBITDA/net fixed-charge coverage (x) 9.8 6.3 FFO/net debt (%) 77.9 37.2 *Figures adjusted for captive finance operations. Analytical E-Mail Addresses omar_saeed@standardandpoors.com hugues_delapresle@standardandpoors.com CorporateFinanceEurope@standardandpoors.com