



Methodology  
*Rating Merchandisers*

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*Insight beyond the rating.*

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All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, Web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.

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# Rating Merchandisers

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Note: DBRS provides third-party, independent evaluations in four major areas: the corporate sector, financial institutions, public finance and structured finance. The corporate sector consists of a wide variety of industries.



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## I. Overview

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DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. They are opinions based on forward-looking measurements that assess a company's ability and willingness to make timely payments on outstanding obligations (whether principal, interest or dividend) with respect to the terms of an obligation. Ratings are not buy, hold or sell recommendations and they do not address the market price of a security.

DBRS rating methodologies include consideration of general business and financial risk factors applicable to most industries in the corporate sector as well as industry specific issues and more subjective factors, nuances and intangible considerations. Our approach is not based solely on statistical analysis but includes a combination of both quantitative and qualitative considerations. The considerations outlined in DBRS methodologies are not intended to be exhaustive. In certain cases, a major strength can compensate for a weakness that would be more critical for a peer company. Conversely, there are cases where one weakness is so critical that it overrides the fact that the company may be strong in most other areas.

DBRS rating methodology is underpinned by a stable rating philosophy, which means that in order to minimize the rating changes due primarily to global economic changes, DBRS generally factors the impact of a cyclical economic environment into its rating. Consequently, DBRS takes a longer-term "through the cycle" view of a company and, as such, rating changes are not based solely on normal economic cycles. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future. An equally important aspect of DBRS analysis is its broad industry coverage, which it undertakes in order to understand the major differences and subtle nuances within a particular industry and to form an appropriate rating of a company relative to its competitors.

As a framework, DBRS rating methodologies consist of three components that together form the basis of the rating: an assessment of the company's general business risk profile based on cross-industry and macro business considerations; an assessment of the company's financial risk profile primarily based on quantitative ratio analysis; and consideration of industry-specific factors and measures particularly unique to the company. To some extent, the business risk and financial risk profiles are inter-related. The degree of financial risk considered acceptable for a company depends to a large measure on the business risks it faces.

Critical in the determination of a rating is the application of the analyst's experience and expertise in forming an initial rating opinion and recommendation for the rating committee and the role of the DBRS rating committee as the final decision maker. DBRS rating committees, which comprise experienced and knowledgeable DBRS personnel, strive to provide objective and independent rating decisions which are based upon all relevant information and factors, incorporate both global and local considerations, apply DBRS-approved methodologies and reflect the opinion of DBRS.

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## II. General Business Risk Profile

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A fundamental component of DBRS analysis is the consideration of macro business factors that apply to most, if not all, industries within the corporate sector. The general business risk profile is largely a qualitative assessment of the environment a company is affected by and operates in. An assessment of the general business risk profile serves as a backdrop for the analysis of the company's financial risk profile as well as other qualitative and quantitative factors that are particularly unique to the company. Differing business risk profiles impact the assessment of a company's financial risk profile, and thus, it is important to understand the extraneous influences and business factors a company is or could be affected by despite its financial strength.

### KEY CONSIDERATIONS IN EVALUATING A COMPANY'S BUSINESS RISK PROFILE

The following considerations, while not intended to be an exhaustive list, indicate the key areas DBRS considers in evaluating a company's business risk profile:

#### *Economic Environment*

The importance of the industry within the overall economy, in terms of either how it impacts or is impacted by the economy, shapes a company's viability. Also of importance is how the industry is influenced by current economic factors such as inflation or deflation, supply and demand, interest rates, currency swings and demographics.

#### *Legislative and Regulatory Environment*

Whether an industry is regulated or not is key, as the degree of regulation and legislative oversight can severely restrict or assist a company depending on its stage of growth, industry influence and regulatory relations. A regulated industry imposes a certain rigour and governance. It is also important to understand the frequency of change or stability in industry rules and whether regulations may require companies to make costly modifications to their infrastructure.

#### *Competitive Environment*

The nature of the market structure (e.g., monopoly versus oligopoly) determines the extent of competitiveness and the barriers to entry a company may face. Many industries are undergoing significant structural changes such as consolidation or deconsolidation, excess capacity, or competitive threats from new capacity in "low-cost" countries such as China, Brazil and Russia in both domestic and international markets. Even small changes in the competitive environment can have a profound impact on a company.

#### *Country Risk*

Governments often intervene in their economies and occasionally make substantial changes in policy regarding competition, ownership, wage and price controls, restrictions on foreign currency, capital and imports/exports, among other things. Such policy changes can significantly affect a company, and therefore, considerations include the company's main location or country of operation, the extent of government intervention and support, and the degree of economic and political stability. The assessment of country risk is not limited to direct government actions to interfere with the private sector, but also encompasses the full range of financial and economic events that can spill across a country, causing widespread defaults in otherwise healthy corporate credits. As such, country risk can have considerable implications for corporate ratings. A country ceiling is assigned to corporate foreign currency ratings based on the country's susceptibility to systemic shocks and the private sector's ability to maintain its foreign currency debt payments when shocks occur.



### *Industry Cyclical*

Cyclical is influenced by factors such as levels of consumer spending, consumer confidence and the strength of the economy. The degree of cyclical is influenced by the market segment in which a company specializes. Non-cyclical industries are better able to withstand dramatic economic changes, as are companies with more predictable cycles, than those with significant peaks and troughs. It is important to examine a company's strategies and performance over the longer term and understand them in cyclical highs and lows.

### *Management*

The capability and strength of management is a pivotal factor in company success. An objective profile of management can be obtained by assessing the following: the appropriateness of core strategies; rigour of key policies, processes and practices; management's reaction to problem situations; its appetite for growth, either organically by adding new segments or through acquisition; its ability to smoothly integrate acquisitions without business disruption; and its track record in achieving financial results. Retention strategies and succession planning for senior roles are also critical considerations.

### *Corporate Governance*

Effective corporate governance requires a healthy tension between management, the board of directors and the public. There is no one "right" approach for all companies. A good board can have a profound impact on growing companies, those in fragile financial states, or those undergoing significant change. Beyond a review of management, assessment should focus on the appropriateness of board composition and structure (including the independence and expertise of the audit committee) to approve executive compensation and corporate strategy, and to oversee execution and opportunities for management self-interest. Other important areas include the extent of disclosure of financial and non-financial information (including aggressiveness of accounting practices and control weaknesses), share ownership (including director's) and shareholder rights.

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## III. General Financial Risk Profile

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The financial risk profile is largely a quantitative assessment of the company's financial strength and an estimation of its future performance and financial profile. DBRS reviews three key areas: earnings, cash flow, and additional measures for balance sheet and financial flexibility. Within each area, DBRS focuses on key metrics and considerations which are assessed over time, noting that the trend in the ratios is also important to the rating. However, ratios alone cannot be used as an absolute test of financial strength. With a focus on future expectations, the primary goal of financial risk assessment is to understand the inter-relationship between the numbers, interpret what they mean, and determine what they indicate about the company's ability to service and repay debt on a timely basis given the industry background.

### **KEY CONSIDERATIONS IN EVALUATING A COMPANY'S FINANCIAL RISK PROFILE**

The following financial considerations and ratios tend to be analyzed for the majority of industries in the corporate sector. There may be additional quantitative factors and ratios that are considered on an industry-specific basis which are noted under Section IV – Industry-Specific Factors.

Also refer to the *Corporate Sector – Glossary of Ratio Definitions* on [www.dbrs.com](http://www.dbrs.com).



### *(A) Earnings*

DBRS's earnings analysis focuses on core or normalized earnings and in doing so considers issues such as: the sources, mix and quality of revenue; the volatility or stability of revenue; the underlying cost base (e.g., company is a low-cost producer); optimal product pricing; and potential growth opportunities. Accordingly, earnings as presented in the financial statements are often adjusted for non-recurring items or items not considered part of ongoing operations. DBRS generally reviews company budgets and forecasts for future periods. Segmented breakdowns by division are also typically part of DBRS's analysis.

Typical earnings ratios include:

- Gross margin
- Return on common equity
- Return on capital
- EBIT margin and EBITDA margin

### *(B) Cash Flow/Coverage*

DBRS's cash flow analysis focuses on the core cash flow generating ability of the company to service current debt obligations and other cash requirements as well as the future direction of cash flow. From a credit analysis perspective, insufficient cash sources can create financial flexibility problems even though net income metrics may be favourable. DBRS evaluates the sustainability and quality of a company's core cash flow by focusing on cash flow from operations and free cash flow before and after working capital changes. Using core or normalized earnings as a base, DBRS adjusts cash flow from operations for as many non-recurring items as possible. In terms of outlook, DBRS focuses on the projected direction of free cash flow, the liquidity and coverage ratios, and the company's ability to internally versus externally fund debt reduction and future capital expenditure and dividend/stock repurchase programs, as applicable.

Typical cash flow ratios include:

- EBIT interest coverage and EBITDA interest coverage
- EBIT fixed charges coverage
- Cash flow/total debt and cash flow/adjusted total debt
- Cash flow/capital expenditures
- Capital expenditures/depreciation
- Debt/EBITDA
- Dividend payout ratio

### *(C) Balance Sheet and Financial Flexibility Considerations*

As part of determining the overall financial risk profile, DBRS evaluates various other factors to measure the strength and quality of the company's assets and its financial flexibility.

From a balance sheet perspective, DBRS focuses on the quality and composition of assets including goodwill and other intangibles, off-balance sheet risk, and capital strength including the quality of capital, appropriateness of leverage to asset quality, and the ability to raise new capital. DBRS also reviews the company's strategies for growth including capital expenditures, plans for maintenance or expansion, and the expected source for funding these requirements. Where the numbers are considered significant and the adjustments would meaningfully impact the credit analysis, DBRS adjusts certain ratios for items such as operating leases, derivatives, securitizations, hybrid issues, off-balance sheet liabilities and various other accounting issues.

Typical balance sheet ratios include:

- Current ratio
- Turnover – Receivables and inventory
- Asset coverage (times)
- Per cent total debt to capital and per cent adjusted total debt to capital
- Per cent adjusted net debt to capital



The following factors focus on the company's liquidity:

- Maintaining sufficient bank-lines or cash balances
- Prudent use of cash balances for dividends or stock repurchases
- Terms and conditions of credit facilities including unique terms and/or financial covenants
- Debt management approach including dependence on short-term versus long-term debt, fixed versus variable rate debt, and debt maturity schedule
- Interest rate and/or foreign exchange exposure
- Relationship and strength or weakness of a parent holding company or associated companies, if applicable

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## IV. Industry-Specific Factors

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Each industry within the corporate sector has unique features that cannot be broadly applied across all industries. For example, capital spending is a key area in the utilities industry, reserves are particular to the mining industry, adequate R&D is critical for the pharmaceutical industry, and seasonality significantly impacts merchandisers. Against the backdrop of the general business and financial risk profiles, a company's unique strengths, weaknesses and industry-specific issues need to be factored into the credit analysis to form an appropriate rating. These particular business and financial issues and measures also help to shape the company's status relative to its peers.

### EVALUATING A COMPANY WITHIN THE MERCHANDISING GROUP

The following considerations more specifically characterize the Merchandising group, and supplement the macro business and financial considerations, respectively, in Sections II and III of DBRS's methodology. All three sections, Sections II, III and IV, should be considered together.

#### *Key Considerations*

##### **Nature of Product Offering**

Sales and earnings tend to be cyclical for most merchandisers and are influenced by the level of consumer spending; the strength of the economy; consumer confidence; personal debt levels; savings rates; unemployment; and interest rates. The degree of cyclicality is dependent upon which market segment the retailer specializes in. Hard-line retailers (furniture, appliances, building supplies, hardware, etc.) experience high cyclicality since they are influenced by the level of housing starts, which can swing significantly. Soft-line retailers selling everyday, non-discretionary items experience less cyclicality (e.g., discounters and warehouse format retailers). DBRS's ratings consider the nature and diversity of a merchandiser's product offering and how it affects the stability of a company's earnings profile.

##### **Brand Name**

The strength of a merchandiser's brand differentiates retailers and is instrumental in developing customer loyalty and driving sales growth. Brand strength is established based on a combination of quality, value, selection, service, consistency, convenience and store environment. DBRS evaluates a company's brand strength on a relative basis to its peers. Quantitatively, DBRS considers same-store sales growth as an indirect indicator of brand strength.

##### **Operational Efficiency**

Profitability in retailing largely depends on strong inventory management and logistics capabilities driven by technology. These capabilities allow for the maximization of inventory turnover while minimizing discounting or markdown activity. DBRS analyzes sales per square foot, working capital deployment, operating margins and return on invested capital when evaluating operational efficiency, which ultimately reflects the quality and sustainability of a company's earnings.



### **Relative Size**

A larger operation allows for competitive purchasing power and economies of scale with respect to logistics, administrative costs, advertising, systems, and so on. Large-scale operations face a greater challenge, however, when undertaking store conversions or restructurings. When determining ratings, DBRS considers the benefits of a company's larger size relative to risks stemming from scale (potential for operational inefficiency, higher restructuring costs, etc.).

### ***Other Considerations***

#### **Formats/Banners**

Retail formats vary in terms of product positioning, physical size, location and level of service. Discounters tend to favour large-scale, no frills, low-service "big box" formats, while higher-end retailers generally have smaller, more refined spaces offering higher levels of service. DBRS assesses a company's banner portfolio and format diversity in order to determine the level of competition the company faces; the nature of its cost structure; level of profitability; and the extent to which it depends on certain market segments or demographics.

#### **Understanding/Adapting to Consumer Trends**

Consumer preferences are constantly evolving, requiring retailers to adapt their product offerings. DBRS assesses the ability of a retailer to predict and cater to changing demand, as this is a key factor in remaining competitive over the long term. Retailers most susceptible to changes in consumer trends are those that sell fashion-oriented apparel or merchandise.

#### **Diversification**

Geographic diversification provides insulation against region-specific economic conditions and seasonality. Nationally diversified retailers can lower costs by using national advertising campaigns. Diversification by store format can also allow a retailer to sell to different consumer groups (e.g., different income levels). DBRS's evaluation considers the benefits diversification provides relative to the added complexity of a diversified operation.

#### **Private Label Brands**

DBRS assesses the strength of a company's private label/store brands, as these can provide retailers with higher margins, enhanced customer loyalty (through lower prices), and increased bargaining power with suppliers.

#### **Real Estate – Owned versus Leased**

Ownership of stores provides greater operating flexibility (to expand/close a store), as well as an alternate source of capital (e.g., sale-leaseback). Leases can be either an advantage (in the case of low-rate long-term leases) or a disadvantage (if they reduce operating flexibility and add to the cost of closing stores). DBRS considers the structure of the real estate portfolio relative to a company's geographic footprint, competitive environment and financial position. Leverage ratios are adjusted by capitalizing operating leases by a factor of six times to reflect off-balance sheet financing.

#### **Locations**

DBRS assesses store locations, as this can be a significant factor in determining the success of a chain. Retailers with prime urban real estate in formats that match demand of the target demographic have a competitive advantage.



### **Labour**

Non-unionized retailers have a significant advantage over unionized competitors due to the impact of strikes, higher labour costs and the inflexibility of labour contracts. DBRS assesses management's history in successfully negotiating collective agreements and the potential impact labour actions can have on the operation.

### **Credit Cards**

Many retailers operate a proprietary credit card program which can contribute a significant portion of profit and add stability to earnings. Store credit cards are normally tied into loyalty programs, providing retailers with closer ties to customers. However, credit card operations carry their own risks (such as underwriting or collection risks), and if not managed properly, these can lead to high bad debt expense. DBRS assesses the positive or negative impact of credit card programs on a retailer's earnings profile. Securitized credit card receivables can also provide liquidity, however DBRS adjusts leverage ratios to include these potential off-balance sheet liabilities.

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