Methodology

Rating Automotive

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Insight beyond the rating.

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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.

I. Overview

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

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.

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Industry Cyclicality

Cyclicality is influenced by factors such as levels of consumer spending, consumer confidence and the strength of the economy. The degree of cyclicality 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

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.

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 much 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

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 and 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.

KEY CONSIDERATIONS IN EVALUATING A COMPANY WITHIN THE AUTOMOTIVE GROUP

The automotive group includes automotive original equipment manufacturers (OEMs) that are principally engaged in the production and distribution of light vehicles. DBRS rates automotive OEMs that are based throughout the world, with most conducting operations on a global scale.

A summary of the key considerations and drivers of DBRS ratings for companies principally operating within the automotive industry are listed below. The following considerations supplement the macro business and financial considerations, respectively, in Sections II and III of DBRS methodology. All three sections, Sections II, III and IV, should be considered together.

PRIMARY FACTORS

Market Position/Share

The competitive landscape is a key consideration with respect to the business risk profile of automotive OEMs. Competition is based largely on price, quality, style, safety and reliability, with market concentration and product differentiation having an important influence. Pricing is of key importance due to a high degree of fragmentation in most regions, which tends to add volatility to sales and earnings. However, a degree of stability is afforded to companies with well-established brand images and a strong market position in a particular region. This is particularly evident for niche producers of premium vehicles, which generate above-average margins partly from strong brand equity and product excellence. Sustainability of sales provides support for ongoing investments in research and development, as well as new plants and equipment. While strong market positions in a particular product group and region are viewed favourably, market share trends (particularly declining share) are also taken into consideration.

Diversification & Product Cadence

Sales diversification should provide increased earnings stability, mainly in the form of reduced reliance on a particular market and business.

Geographic: Revenues and earnings distributed between several regions in measurable proportions reduces exposure to changing business conditions in a particular market, including fluctuating supply and demand and pricing and input costs. The impact of foreign exchange volatility can also often be reduced with diversification; depending on the location of production facilities (significant deviations herein could lead to exposure to currency fluctuations and even political backlash in areas where a given OEM is deemed to have an unduly low regional manufacturing presence).

Product: If there is a strong dependence on a single product and a competitor introduces an attractive competing product, the company could face difficulty. As such, the degree of reliance on one or two core products or broad diversification among various product lines (i.e., cars and light trucks) is examined.

An additional factor is the general product cadence of the OEM. Typically, there is a significant correlation between the relative age of an OEM's product range, market share and profitability.

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Production Efficiency
This area assesses the cost structure, the level of capacity utilization, the integration and co-operation of global design and manufacturing functions, the flexibility of production facilities (multiple models and the use of common platforms or modules), and the use of joint-venturing to supplement production capacity.

Financial Volatility
Automotive companies are generally impacted by cyclical changes in the economy, which can lead to significant volatility in financial performance. DBRS takes into account the sensitivity of automotive companies' financial profiles to changes in economic demand (i.e., GDP growth rates) and supply (i.e., inventory, imports). Companies with a larger share of higher value-added premium models are generally less affected by change in supply and demand fundamentals (given reduced price sensitivity) than are predominantly mass market model producers.

With the exception of some emerging markets, the automotive industry is in a state of considerable overcapacity. This creates the need for significant incentive spending to help generate sales sufficient to maintain production volumes. As such, the end result is an extremely competitive landscape for the automotive OEMs.

SECONDARY FACTORS

Barriers to Entry
The development costs associated with light vehicle production have risen sharply as much more discerning and sophisticated consumers generally demand an extremely refined product. Additionally, elevated levels of regulation, primarily regarding matters such as safety and emissions standards, impose very high development costs. When one also considers costs associated with the high capital intensity of production, and the extensive distribution and servicing networks required to remain competitive in these markets, then the effective barriers to entry become quite high.

In emerging automotive markets, such as Eastern Europe, China and India, barriers to entry for prospective automotive producers are relatively low, reflecting the open competitive landscape of these markets combined with sparse regulation. Furthermore, it is typically the very inexpensive mini-cars that are gaining prominence in emerging markets, with such vehicles being much less costly to design and produce.

Maturity of Markets
Traditional domestic markets, including North America, Europe and Japan, are very mature, with demand growth generally in line with GDP growth and excess capacity. As a result, new emerging markets have become increasingly important to generate measurable earnings growth. Increased international sales also provide increased stability via earnings diversification, although expansion risks exist. Emerging markets such as Eastern Europe, China and India have very low vehicle penetration levels and are exhibiting strong economic growth.

Product Quality/Warranty Cost
The product quality of an OEM is an important factor in determining product acceptance and, ultimately, market share. It is important to note that this is a long-term indicator, as perceived product attributes and quality can often significantly lag actual product quality.
Product quality can, however, impact OEM performance in the short-term as well through product warranty costs, which can significantly affect profitability.

Finance Subsidiaries
The role of the finance subsidiary as a marketing tool and the diversities of businesses (captive versus multi-businesses), geography and services mix are all evaluated by DBRS. Subsidiaries that have expanded their financing activities well beyond their parent's products are viewed with caution. In addition, the finance subsidiary's penetration of the parent OEM's sales, financial profile (e.g., financial structure), sources of funding, matching of assets and liabilities, and portfolio credit profile are also reviewed. In evaluating the

financial profile of the automotive operations, the finance subsidiary is treated as an equity investment to remove the influence of high leverage associated with the finance operations.

Research and Development

Technological capabilities and strengths are assessed, including in-house technological expertise; technology sharing through the use of joint-venturing to develop product and to share development costs; purchase of technology; product development track record; and the ability to meet safety and fuel consumption standards.

Labour

The characteristics of a company's labour force and the track record of the OEMs with respect to labour relations (e.g., strike history, staffing levels) are also taken into consideration. Highly unionized workforces are less flexible, which, in particular, reduces the ability to adjust quickly to changing market conditions, and increases the risk of work stoppages in the event of a strike. In addition, legacy costs for pension and healthcare benefits (notably for companies with large under-funded pensions) add to expenses and increase the potential for large operating cash outflows. The ability to control these costs has become critical for U.S. firms relative to most Asian-based competitors that do not face the same burden, notably for companies with high leverage and modest cash flow. The migration of production facilities to regions with significantly lower employment costs and outsourcing have continued over the past several years as a means to control costs.

Supply Chain Management

The relationship between automotive OEMs and their suppliers (e.g., degree of ownership, collaborative or adversarial) is a key rating consideration. Historically, many OEMs have spun off their suppliers in an effort to reduce fixed costs. Suppliers are in turn being increasingly relied upon to design and produce complex components and modules. The more vital these outsourced components become to the OEM, the more important the relationship with suppliers becomes. Sub-optimal supplier relations can impact the quality of components, which can ultimately influence product and warranty cost and hence, profitability. Other areas assessed include the relative dependence on parts suppliers (i.e., single source suppliers), the participation of local suppliers in each market, the procurement function and contract bidding process, and the financial health of suppliers.

Supply chain management with respect to raw materials is yet another important consideration. Automotive production is highly energy- and raw material-intensive, and producers are exposed to often volatile commodity costs. A company's ability to manage such costs (notably steel, aluminum, resin and precious metals) is taken into account, given the potentially significant impact on earnings. The ability to pass on rising costs to consumers and the nature of contracts (i.e., short- or long-term versus spot exposure) are all considered as part of a company's ability to moderate input cost volatility. Maintaining relationships with multiple suppliers typically improves bargaining power and reduces the risks associated with potential supply disruptions.

Dealer Network

The assessment of an automotive OEM's dealer network includes its size and strength in each market, the quality and location of the dealers, the services offered to customers, the support provided by auto manufacturers regarding training, finance, and so on, and the degree of ownership by auto manufacturers. Strong dealer networks can lead to increased barriers to entry for competitors. Conversely, inflated dealer networks can compromise distribution efficiency while increasing costs and undermining profitability.

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