



Methodology
Rating Automotive Suppliers

MAY 2008



Insight beyond the rating.

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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 interrelated. 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 that are based upon all relevant information and factors, incorporate both global and local considerations, apply DBRS-approved methodologies and reflect the opinion of DBRS.

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 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 Cyclicalilty

Cyclicalilty is influenced by factors such as levels of consumer spending, consumer confidence and the strength of the economy. The degree of cyclicalilty 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 to 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.



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 interrelationship 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* at www.dbrs.com.

(1) *Earnings*

DBRS 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., the 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

(2) *Cash Flow/Coverage*

DBRS 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

(3) 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.

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 research and development (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 SUPPLIERS GROUP

The automotive suppliers group consists of companies that supply parts and components to automotive original equipment manufacturers (OEMs). Automotive suppliers are categorized into three tiers. Tier 1 suppliers are generally classified as companies that directly supply the OEMs and as such are deemed integral to the OEM supply chain, with the capability of producing complex parts or large-scale module assemblies (i.e., cockpits, chassis, etc.). Tier 2 suppliers, on the other hand, generally manufacture less complex parts and directly supply Tier 1 suppliers (i.e., not the OEMs). Tier 3 suppliers are further down the complexity scale and generally supply simple commodity-like parts, usually to Tier 2 suppliers.

A summary of the key considerations and drivers of DBRS ratings for companies principally operating within the automotive parts industry are listed below. The following considerations supplement the macro business and financial considerations, respectively, in Sections II and III of this DBRS methodology. All three sections, Sections II, III and IV, should be considered together. (Note: These considerations are most applicable to Tier I suppliers, as these are most often rated by DBRS.)

PRIMARY FACTORS

Technology Level/Product Complexity

The technological level is a key consideration with respect to the business risk profile of an automotive supplier. Tier 1 suppliers are generally assessed positively, given their ability to produce complex parts and module assemblies. The increased product complexity helps reduce the risk of substitution by another competitor. In certain cases, a supplier can form a technological partnership with an OEM and solidify its position as a sole or preferred supplier. Higher pricing power and increased margins are therefore effectively defended by high technological levels. Similarly, suppliers that possess a specialized niche technology derive similar benefits. In contrast, Tier 2 and Tier 3 manufacturers that produce less complex components face increased business risk, given the higher likelihood of being substituted by another manufacturer. Tier 3 suppliers in particular have little pricing power and tend to generate significantly lower margins vis-à-vis Tier 1 manufacturers.

In light of the above, suppliers need to defend their technological competitive position with significant R&D programs. The R&D commitment must also be continuous (i.e., consistently maintained at high levels), with the stronger suppliers having sufficient financial resources to fund R&D expenditures through the business cycle.

Diversification

Product: If a supplier has a relatively high dependence on a small number of components or on a particular platform of an OEM, the company could face difficulty in the event of production declines of the affected platform stemming from potential poor market demand or transition to a newer platform. As such, increased product diversity is vital in enabling parts companies to absorb fluctuations in production volumes of OEM platforms.

Geography: While automotive sales and production continue to increase globally, there can be significant deviations across various markets with respect to sales/production trends at a given point in time. Accordingly, establishing a significant presence across global markets alleviates concerns with respect to markedly lower volumes in a particular region. The impact of foreign exchange volatility can also often be reduced through diversification, depending on the location of production facilities. Potentially offsetting such benefits is the increased political risk that may result from a supplier's expansion in an emerging market where the political track record is uncertain.

Customer: Many Tier 1 suppliers are spin-offs of OEMs. As a result, in certain instances, revenues of such companies are highly dependent on their former parent companies. While it remains important to maintain positive relations with the former parent to generate consistent sales, when a supplier demonstrates progress in generating significant revenues from alternative OEMs it is viewed positively. Conversely, negative rating implications result when a supplier is deemed to have a highly concentrated proportion of sales to a few OEMs, particularly those exhibiting deteriorating market shares.

Cost Position/Manufacturing Footprint

Given the intensely competitive environment of the automotive industry, OEMs are avid in their quest to continuously reduce costs. Apart from the spin-offs of many parts companies, these efforts have also included the transfer of significant R&D programs to Tier 1 suppliers. Furthermore, OEMs are constantly demanding price reductions in components sourced from the suppliers.

In view of the above, the relative cost position of parts companies is critical, with cost improvements/efficiency gains representing the primary manner by which to offset the ongoing OEM pricing demands. Apart from right-sizing their operations through labour reductions to effectively compete against their peers, suppliers are looking to establish and/or increase their presence in low-cost countries (LCCs), many of which feature highly educated and motivated workforces.

Financial Position

Given the high incidence of bankruptcies among automotive suppliers, greater emphasis is placed on the financial strength of a given parts manufacturer. OEMs are more likely to award contracts to financially sound companies to reduce the likelihood of a supply interruption attributable to financial distress. Companies with a strong balance sheet are therefore also well positioned to win takeover business from financially distressed competitors.

Additionally, as previously discussed, a strong balance sheet is essential in enabling Tier 1 suppliers to consistently maintain their significant R&D programs through business cycles.



SECONDARY FACTORS

Labour

The characteristics of a company's labour force and its track record 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, particularly for companies with high leverage and modest cash flow.

Supply Chain Management

The relationship between Tier 1 companies and their suppliers (e.g., degree of ownership, collaborative or adversarial) is also a rating consideration. As parts companies are being increasingly relied upon to design and produce complex modules and assemblies for OEMs, the more vital outsourced components become to Tier 1 suppliers. Sub-optimal supplier relations can impact the quality of components, which can ultimately influence product cost and hence, profitability. Other areas assessed include the relative dependence on 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.

Raw Materials Cost Management

Supply chain management with respect to raw materials is yet another important consideration. Automotive production is highly energy- and raw material-intensive, and parts suppliers 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 OEM customers 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.

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