Methodology

Rating Companies in the Transportation Industry

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DBRS

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 on 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. 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

Where an industry is regulated, 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 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 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 that 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 and are noted in Section IV: Industry-Specific Factors.

A. 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., 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 the following:
• Gross margin.
• Return on common equity.
• Return on capital.
• EBIT margin and EBITDA margin.

B. 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 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 the following:
• EBIT interest coverage and EBITDA interest coverage.
• EBIT fixed charges coverage.
• Cash flow-to-total debt and cash flow-to-adjusted total debt.
• Cash flow-to-capital expenditures.
• Capital expenditures-to-depreciation.
• Debt-to-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 the following:
• 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 R&D is critical for the pharmaceutical industry, and seasonality has a significant impact on 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.

KEY CONSIDERATIONS IN EVALUATING A COMPANY WITHIN THE TRANSPORTATION INDUSTRY

The transportation industry encompasses companies principally engaged in the transportation of merchandise and bulk commodities by train and truck. The methodology is broadly applied to all railway companies in North America, despite specific differences between regional and long-haul rail carriers, as well as to trucking companies in view of similar key rating drivers.

Below is a summary of the key considerations and drivers behind DBRS ratings for railway and trucking companies. The summary is segmented into primary and secondary factors to reflect the relative importance of each when reviewing a particular company. The following considerations supplement the macro business and financial considerations in Sections II and III of this methodology, respectively.

PRIMARY FACTORS

Financial Volatility

Railway and trucking companies are exposed to cyclical changes in demand related to economic conditions and commodity-price fluctuations, which can lead to volatility in financial performance. The extent of the impact is assessed primarily based on a company's mix of shipment revenue and volumes, which often include a wide variety of bulk commodities, merchandise and intermodal traffic. Companies with the greatest proportion of merchandise and intermodal-related volumes are typically most sensitive to prevailing economic conditions because demand is most affected by industrial production levels and GDP. However, demand for bulk commodities such as thermal coal and grain, which account for a material share of rail shipments, is generally less cyclical and these shipments tend to add a degree of stability to earnings. That said, both rail and truck shipments can be disrupted by other factors, particularly weather-related issues. As supply-demand fundamentals largely dictate pricing, DBRS also assesses prevailing industry supply conditions: for the railroad companies, network and port capacity, and for trucking companies, the number of competing available trucks on the road. For example, strong demand for rail transportation throughout much of the past decade (mainly caused by rising Asian trade) combined with tight industry capacity contributed to steadily rising rail industry prices. Companies that exhibit the highest degree of stability, particularly where margins and cash flow generation are concerned, are typically viewed most favourably from a ratings perspective.

Network Fluidity

DBRS views railway companies with fluid networks favourably as congestion and bottlenecks on certain routes can constrain overall volume growth and impair earnings as a result of inefficiencies and sharply higher costs. In the case of railways, large networks can provide significant benefits in terms of economies of scale, customer reach and market position (see Secondary Factors below), but capacity constraints would undermine many of these benefits. Network fluidity is much less of an issue during periods of weak or slowing demand, and much less of a consideration (not a primary factor) for trucks. Rail companies with a history of bottlenecks/congestion during periods of strong demand are viewed more cautiously with respect to their ability to achieve earnings growth and/or debt repayment targets (as a higher-than-expected amount of funds may be required for future network investments).

Diversification
DBRS takes into consideration the extent to which transportation companies' shipments and revenues are diversified by end-market and region. Most companies serve a well-diversified mix of end-markets, which adds earnings stability, mainly due to reduced reliance on a particular commodity or customer. However, there are often measurable differences between the end-markets served by both railway and trucking companies and DBRS assesses the exposure to a particular segment or region to help gauge future financial stability.

Geographic Diversification
The extent to which sales are diversified among domestic, trans-border (U.S.-Canadian) and international customers is taken into consideration, as is the geographic location of the network (DBRS only rates railway and trucking companies based in North America). Revenues and earnings distributed among different regional segments reduce exposure to changing business conditions in a particular market. The impact of foreign exchange volatility is also often reduced with diversification, although this is modest for U.S.-based railway companies, which have a limited presence in Canada. Weather is also taken into account; Canadian-based railways and truck companies, for example, are more exposed to weather-related issues and difficult terrain, which have a greater potential to disrupt normal operations. The Canadian railway companies have gradually increased their exposure to U.S. and international customers over the past decade, which has benefited their business risk profiles.

Customer and Business Diversification
DBRS assesses the mix of shipment volumes and revenues by end-market as a gauge of financial risk, given the inherent volatility of certain sectors. Revenues are generally well diversified by customer and end-market, which contributes to the relatively favourable business risk profile of the transportation industry. However, companies with above-average exposure to a specific segment relative to those with more balanced end-market exposures may experience pronounced fluctuations in financial results. The industry fundamentals and outlook of the larger revenue segments are investigated in greater detail when evaluating a company's credit profile. In addition, the composition of customer contracts (e.g., short- versus longer-term contracts and pricing terms) and the history of customer relationships are also reviewed as a means of assessing revenue stability. Transportation companies with a relatively balanced mix of revenues (i.e., each end-market accounting for less than 25% of annual revenue) through a cycle are generally viewed most favourably, given the increased likelihood of stability in operating results.

Cost Position
Operating efficiency and the state of capital assets are key considerations in rating transportation companies. DBRS typically views a rail company's operating ratio (operating expenses as a share of operating revenues) and a trucking company's EBITDA margin or utilization rate as the primary measures of efficiency. High competition and maturity in certain markets requires companies to continue to improve service levels and reduce expenses. DBRS reviews all larger-scale efficiency programs, which include train and truck-scheduling initiatives, information technology investments and yard enhancements. Efficiency programs and capital investments to upgrade and/or expand network assets (i.e., terminals, trucks/rolling stock, track) contributed to the gradual improvement in transportation industry profitability prior to materially weaker demand conditions in 2009. DBRS assesses the average age of a company's locomotive/truck fleet and the funds invested in network capacity and upgrades; on a relative basis, younger locomotive/truck fleets, which boast increased fuel efficiency, and (for the rails) modernized network infrastructure, which requires less maintenance, generally correlate with higher relative operating efficiency.

Labour accounts for the largest share of transportation industry operating expenses. For the Class 1 railway companies, the majority of labour is unionized; contracts (and national bargaining in the United States) limit the ability of railway companies to reduce wages and staff levels. However, DBRS does consider trends in employment, which can be managed via attrition (given an aging workforce within the industry), partly as a gauge of labour productivity and efficiency. In addition, legacy costs for pension and health-care benefits (notably for companies with large, underfunded pensions) add to expenses and increase the potential for large operating cash outflows. Companies with the largest pension/post-retirement benefit liabilities are generally viewed less favourably due to the potential for large cash outflows for underfunded plans (but the underfunded portion is not included in debt-related credit ratios due to their highly variable nature).

Energy Intensity

Rail and truck transportation is a highly energy-intensive business, and fuel costs are a significant component of operating expenses. The management of fuel expenses is a key consideration in reviewing railway company efficiency. Fuel has come to account for an increasingly large share of operating costs, mainly due to the sharp increase in the price of diesel since the mid-2000s. The nature of the surcharge (e.g., the benchmark used and the lag between cost and recovery) and the extent to which customer contracts include fuel surcharges are duly noted in DBRS's assessment. Companies with the lowest exposure to fuel price volatility are viewed most favourably from a ratings perspective as this adds stability to operating results.

SECONDARY FACTORS

Competition

DBRS assesses the competitive position of railway and trucking companies in their respective core markets. Class 1 railway companies typically compete with one primary railway competitor for the majority of longer-haul routes and with a variety of trucking companies for regional, shorter-haul routes. Companies operating on complex, shorter-haul networks generally face a higher degree of competition, which can limit margin upside, mainly as a result of increased price sensitivity and lower relative efficiency. Generally, competition is based on price, but service and reliability have become increasingly important as many product shipments are time-sensitive. Trends in the various service and productivity-related metrics (as well as safety records) are reviewed to help assess service levels and stability in financial performance. Trucks are a much more expensive option for shippers (partly because of fuel costs) and are unable to transport certain bulk commodities effectively, but are generally more reliable and flexible, and dominate shorter-haul routes (roughly within 400 miles). Improving railway reliability and service, combined with lower relative prices, and trucking industry issues (e.g., labour shortages, road congestion and stricter regulations) have enabled railway companies to gain market share from trucking companies in recent years, especially on longer-haul routes.

Size

The scale of a company, particularly with respect to annual sales and shipment capacity, often provides added support for the rating. High relative sales provide an indication of market position and of a company's ability to compete. Larger sales can translate into a greater market advantage, opportunities for efficiency gains and the ability to offset competitive threats. In addition, larger networks typically provide more opportunities for point-to-point shipments, which, with respect to railways, reduces the potential for delays and the costs associated with using a competing railway company's lines (e.g., access fees) and enables companies to service a larger number of prospective customers. Companies that are materially larger than competitors with similar financial and business risk profiles may be rated more favourably.

Barriers to Entry

Barriers to entry in the transportation industry – particularly for railway companies – are high and contribute to the sector's relatively favourable business risk profile. Barriers to entry are mainly related to the significant financial requirements involved. For railways, this includes laying new track, which requires rights of way and land, and acquiring locomotives and rolling stock. The capital expenditures needed to maintain network infrastructures are also significant. For trucking companies, the cost of trucks and trailers can also be substantial and have high ongoing maintenance requirements, particularly when equipment is highly specialized. High barriers to entry generally increase the competitive position of transportation companies, which adds a degree of sales stability.

Technology

The pace of technological change in the transportation industry is modest. However, the importance of innovation and information technology has risen over the years, mainly in terms of expense control and service improvement. Examples include significant and ongoing investments in logistics for scheduling, tracking shipments and billing, which helps to improve working capital efficiency. The ability to offer more favourable service relative to key competitors can be a competitive advantage and provide opportunities for higher relative prices, volumes and margins.

Legislation

Railway activity in the United States is regulated by the Surface Transportation Board (STB), which oversees mergers and acquisitions and has the authority to investigate railway pricing activity. Several regional acquisitions by the Class 1 railway companies have taken place in recent years, with no approval issues. However, the STB implemented new and more stringent rules in 2001 for evaluating mergers, which make large-scale mergers more difficult to complete (in fact, none have been proposed since the new rules came into effect). Other railway legislation is monitored for potential changes, including those relating to freight-rate regulation (e.g., the Western Canadian grain revenue cap) and open access. For trucks, the industry is highly regulated, particularly with respect to driving hours, and in many cases this has constituted a competitive disadvantage for trucking companies relative to their railway peers.

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