



Methodology

Rating the Consumer Products Industry

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Insight beyond the rating.

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Rating the Consumer Products Industry

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Introduction to DBRS Methodologies

- In general terms, DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. They are opinions based on an analysis of historic trends and forward-looking measurements that assess an issuer's ability and willingness to make timely payments on outstanding obligations (whether principal, interest, dividend or distributions) with respect to the terms of an obligation.
- 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 and, 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 methodologies are underpinned by a stable rating philosophy, which means that in order to minimize the rating changes due primarily to economic changes, DBRS strives to factor the impact of a cyclical economic environment into its rating as applicable. 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.
- As a framework, DBRS rating methodologies consist of several components that together form the basis of the ultimate ratings assigned to individual securities. Assessments typically include the industry's business risk profile, the company's general business risk profile, the company's financial risk profile and considerations related to the specific security.
- To some extent, the business risk and financial risk profiles are interrelated. The financial risk for a company must be considered along with the business risks that it faces. In most cases, an entity's business risk will carry more weight in the final issuer rating than will its financial risk.

Business and Financial Risk Overview

- On a high-level macro basis, DBRS has a consistent approach to determining the issuer rating of an entity that is common across many industries. (See the appendix for the definition of "issuer rating.") Our high-level approach can be broken into three stages, as shown on the opposite page.
- Where applicable, DBRS uses the concept of business risk ratings (BRRs) as a tool in assessing the business strength of both industries and individual companies within many methodologies across the corporate finance area. DBRS typically assesses five areas to establish the overall BRR for an industry:
 - Profitability and cash flow.
 - Competitive landscape.
 - Stability.
 - Regulation.
 - Other inherent industry considerations.
- Although there is an overlap in some instances (to some degree, in the long term, all five factors tend to relate to profitability and stability), DBRS has found that considering these five measures in a separate fashion is a useful way of approaching this analysis.
- Using the same factors across different industries provides a common base with which to compare the business risks of various industries, even when they are distinctly different. In all cases, DBRS uses historic performance and our experience to determine an opinion on the future, which is the primary focus. For additional discussion on industry BRRs, please refer to the Industry Business Risk Ratings and Industry Business Risk Rating Definitions sections in the appendix.



- It is important to note that the ratings for company-specific business and financial risks as provided under Stage 2 of this document should not be taken as final issuer ratings. For example, an individual company may fit into the “A” range with respect to the analysis of its business risk, but its financial metrics could be more in the BB category. It would be incorrect to believe that the final issuer rating in this case would be either “A” or BB. In determining the final issuer rating, both of these two major areas must be considered. For additional discussion on this topic, please refer to the Interrelationship between Business and Financial Risk section in the appendix.

Three Stages of DBRS Rating Analysis

Stage 1: Industry Business Risk Rating

Consider the overall business risk rating (BRR) for the industry.

Industry Business Risk Rating

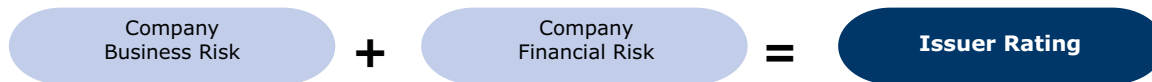


Stage 2: Issuer Rating

Consider the strength of the individual issuer:

- (a) First assessing how the company’s BRR compares with the industry BRR.
- (b) Then assessing the company’s financial risk.

Taken together, these factors will determine the company’s issuer rating.



The **long-term rating** puts more emphasis on business risk than the short-term rating does.



The **short-term rating** stresses financial risk as well as business risk, but places more emphasis on financial risk and liquidity than the long-term rating does.

Stage 3: Rating the Security

Consider covenant and ranking issues that exist for specific securities, using the issuer rating to determine specific security ratings.



Stage 1: Industry Business Risk Rating for the Consumer Products Industry

- The consumer products industry encompasses companies principally involved in the production and sale of various types of non-durable products to retailers for resale. Companies to which this methodology is applicable include (but are not limited to) producers of packaged foods and personal and household care products, brewers and makers of other alcoholic beverages, and beverage and tobacco companies. This methodology is broadly applied to all consumer products companies, despite significant differences between product types, diversity and geographic reach.
- This methodology is not applicable to retailers, agribusiness operators or grain producers, which are covered in other DBRS rating methodologies.
- DBRS views the BRR for the consumer products industry as being A (low). Based on the five major factors used by DBRS in assessing industry BRRs, the rationale for this assessment is as follows.

INDUSTRY PROFITABILITY AND CASH FLOW

- Profitability and cash flow for the consumer products industry is generally considered to be better relative to the average of other industries. Brand strength and market share are the key drivers for consistent revenues, while growth is highly dependent on innovative product development and marketing. As such, advertising and promotion expenses are typically higher than in other industries in order to enhance brand strength, which affects top-line sales growth. Product and geographic diversification can also influence the stability of revenues and growth potential.
- Operating margins in the consumer products industry are greatly affected by economies of scale and operational efficiency (procurement, manufacturing and logistics). Risks related to increases in commodity and input costs often emerge and companies are pressed to at least partially offset this challenge by way of price increases in order to preserve margins.
- In general, strong operating income combines with comparatively low maintenance capital expenditure requirements to result in high free cash flow generation.

INDUSTRY COMPETITIVE LANDSCAPE

- The competitive landscape in the consumer products industry is normal relative to levels seen across other industries. Challenges exist for new entrants as consumer products companies benefit from broad, well-developed and efficient distribution networks.
- Large global players with strong brand recognition and financial resources have a distinct advantage and dominate specific product categories.
- Another layer of competition based on price is introduced by producers of private-label brands, yet there still exists a divide between the market share and penetration levels of market leaders and smaller competitors.

INDUSTRY STABILITY

- The consumer products industry is less cyclical than most other industries. Certain segments of the industry, in particular food products, are neither expensive nor discretionary and as such are less affected by economic cycles. More expensive premium products will experience pricing and demand pressures during a downturn as overall stability is tied to consumer spending habits.
- In general, the consumer products industry is very diverse both geographically and with respect to product offerings, which helps to stabilize performance during downward cycles.

INDUSTRY REGULATION

- Regulation across the consumer products industry is limited and considered average relative to the level of regulation in other industries. Most regulation in the consumer products industry is focused on product safety.



- Typical regulatory or legal concerns such as product recalls and lawsuits can have harmful and long-lasting effects on a company’s brand, profitability and cash flow. In general, however, the overall impact of regulation on the industry does not raise any specific concerns with regard to rating assessment.

OTHER INHERENT INDUSTRY CONSIDERATIONS

- Other inherent risks and considerations examined by DBRS in the consumer products industry can be considered average relative to those seen in other industries. Risks and factors considered in determining the long-term viability of consumer products companies include established research and development pipelines, marketing and advertising campaigns, and logistics planning.

Stage 2: Issuer Rating

To move from the generic industry BRR toward the issuer rating for a specific company, two tasks must be performed. Specifically, we must determine the business risk and the financial risk for the individual company.

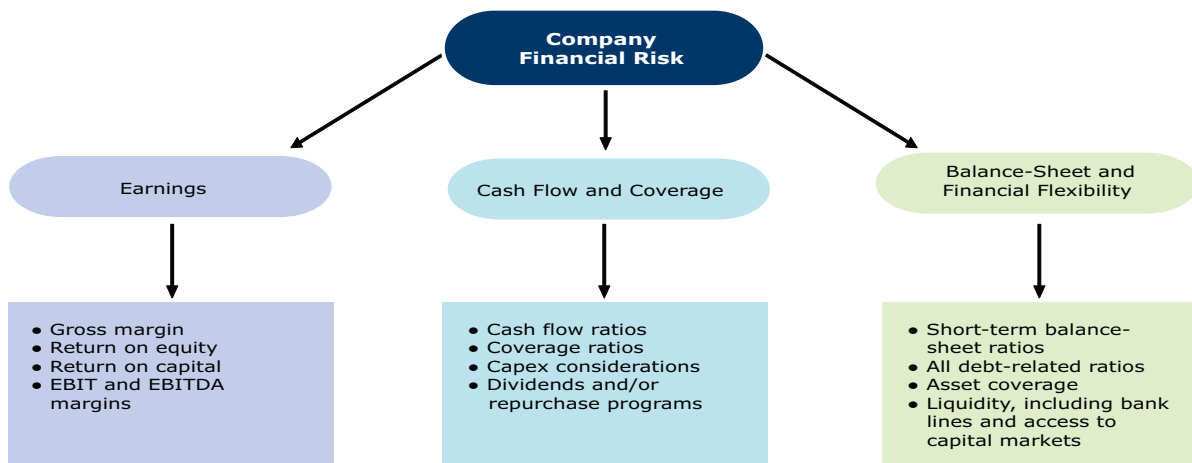
BUSINESS RISK PROFILE

- The business risk profile of the issuer may be better or worse than the industry average due to the presence of unique attributes or challenges that exist at the issuing entity. While not exhaustive, the list of critical factors outlined in the previous section could result in a specific issuer rating being different from the industry BRR.
- This methodology also provides some guidance on which factors are considered the most critical for the industry in question. Issuers may also have meaningful business lines in addition to the base business that extend beyond their most prominent industry, which could add significant attributes or challenges.

FINANCIAL RISK PROFILE

- The graphic below is a visual display of the key financial risk profile considerations that are discussed in the Company-Specific Financial Risk Factors section of this methodology, although even the detail provided there is not meant to be exhaustive.
- The discussion will note that DBRS often makes calculation adjustments in key ratios for risks related to a variety of areas. In some cases, a relationship with a parent or associated company will also be important.

Key Financial Risk Metrics





Company-Specific Business Risk Factors

- We now consider if an individual company in the consumer products industry would be better, worse or the same as the industry BRR. Our focus here is on the critical business risk factors that relate to this industry in particular. The five critical factors used to determine the industry BRR are applied by DBRS to compare numerous industries and are thus more general in nature.
- By analyzing these key drivers (which will vary on an industry-by-industry basis), the essential strengths and challenges of each industry are captured in an accurate fashion, and transparency is provided. The analysis below is connected to the industry BRR in that the industry BRR establishes where an average company would be considered to score on the matrix. For example, an industry with a BRR of BBB would mean that the following matrix describes the scoring of an average company within the BBB column.

Company-Specific Business Risks – Critical Factors

Rating	AA	A	BBB	BB	B
Business Strength	Exceptional	Superior	Adequate	Weak	Poor
Brand Strength	<ul style="list-style-type: none"> • Very well-known brand names, with significant levels of customer loyalty. • All brands have high levels of perceived quality and value, even despite premium pricing. • Consistent, strong improvement in year-over-year sales of existing products. • High levels of investment in marketing and advertising, bolstering the strength of brand names. 	<ul style="list-style-type: none"> • Moderate to well-known portfolio of brand names, with above-average levels of customer loyalty. • Solid levels of perceived quality and value. • Moderate to strong improvements in year-over-year sales of existing products. • Significant levels of investment in marketing and advertising to help strengthen brand names. 	<ul style="list-style-type: none"> • Moderately known portfolio of brand names, with average levels of customer loyalty. • Satisfactory levels of perceived quality and value. • Moderate year-over-year performance in sales of existing products. • Reasonable investment in marketing and advertising. 	<ul style="list-style-type: none"> • Moderately to lesser-known portfolio of brand names, with limited customer loyalty. • Below-satisfactory levels of perceived quality and value. • Moderate to poor year-over-year performance in sales of existing products. • Less-than-reasonable investment in marketing and advertising, no real focus on strengthening brand. 	<ul style="list-style-type: none"> • Portfolio of unknown brand names, with no established customer loyalty. • Poor levels of perceived quality and value. • Poor performance of existing products year-over-year. • No substantial investment in developing brand strength through marketing and advertising.
Overall Market Position/Share	<ul style="list-style-type: none"> • High relative market share, ranking number 1 or number 2 in virtually all respective product categories. • Very diverse product selection, spreading any risks associated with an individual product line. 	<ul style="list-style-type: none"> • Moderate to high relative market share. High number 1 and number 2 products only in certain product categories. • Relatively diverse product selection. 	<ul style="list-style-type: none"> • Adequate market share, with solid rankings in each respective product category but no individual segments ranking number 1 or 2. • Reasonable product diversity, limiting some risk across categories. 	<ul style="list-style-type: none"> • Below-satisfactory to satisfactory market shares, with no particularly strong product categories. • Limited product diversity, relying heavily on one particular product or type. 	<ul style="list-style-type: none"> • Poor overall market share, ranking poorly in each respective product category. • Very limited diversity, with very heavy reliance on a single product category.

Company-Specific Business Risks – Critical Factors

Rating	AA	A	BBB	BB	B
Business Strength	Exceptional	Superior	Adequate	Weak	Poor
Diversification	<ul style="list-style-type: none"> Highly diversified product selection across a number of product types. Favourable mix of discretionary and non-discretionary products. Significant exposure to different countries, regions and localities. Excellent mix of access and controls to developed and developing markets ensuring very positive growth opportunities. 	<ul style="list-style-type: none"> Diversified product selection across a number of product types. Less favourable mix of discretionary and non-discretionary products. Exposure to different countries, regions and localities. Mix of access and controls to developed and developing markets, ensuring growth opportunities. 	<ul style="list-style-type: none"> Some product diversification across product types. Reasonable mix of discretionary and non-discretionary products. Some exposure to different countries, regions and localities. Reasonable diversification across developed and developing markets. 	<ul style="list-style-type: none"> Limited product diversification. Less-than-adequate mix of discretionary and non-discretionary products. Limited exposure to different countries, regions and localities. Below-satisfactory growth opportunities resulting from exposure to developing markets. 	<ul style="list-style-type: none"> Very limited to no product diversification. Poor mix of discretionary and non-discretionary products. Very little geographical diversification, increasing risks related to reliance on an individual area. Very limited to no exposure to different market types, greatly limited future growth opportunities.
Economies of Scale/Relative Size	<ul style="list-style-type: none"> Large comparative size, offering strong input purchasing power. Scale that allows for significantly larger promotional and advertising campaigns. Price leader, capable of increasing prices without suffering a substantial decline in volumes. Large scale, allowing for investment in and use of newer technologies to improve logistics and increase efficiency. Very well established, robust, broad and diverse distribution channels. 	<ul style="list-style-type: none"> Moderate to large size, offering influence on input purchase prices. Sufficiently large scale to allow for substantial promotional and advertising campaigns. Influences market pricing, where increases in price have a moderate to small effect on volume declines. Scale allows for the investment in and use of newer technologies. Good to very well established distribution channels ensuring timely access to the market. 	<ul style="list-style-type: none"> Reasonable comparative size, offering some purchasing power. Scale that allows for reasonably sized promotional and advertising campaigns. Some influence on pricing. Changes in pricing have some effect on volumes. Satisfactory size allows for some use of newer technologies that help improve logistics and increase efficiency. Satisfactory distribution channel portfolio. 	<ul style="list-style-type: none"> Below reasonable relative size, offering limited purchasing power. Below satisfactory scale, which limits opportunities for large promotional campaigns. Limited influence on pricing, resulting in high volume to price volatility. Less-than-adequate capability to implement and benefit from newer technologies. Less-than-adequate portfolio of distribution channels. 	<ul style="list-style-type: none"> Poor size, with no purchasing power benefits. Poor scale makes it difficult to undertake significant promotional or advertising campaigns. Limited to no influence on pricing combined with significant volume impact of price changes. Limited use of newer technologies to improve efficiency and logistics. Poor distribution channels, elevating uncertainty and business risk.

- The consumer products industry comprises companies that are engaged principally in the production and selling of goods, including both packaged foods and non-food goods. The evaluation of these key ratings drivers is undertaken for all consumer products companies despite significant differences in the range of product offerings and in the size and scale of operations.

PRIMARY FACTORS

Brand Strength

- Strong brand names are typically the result of years of effective marketing and operational execution. Well-established brands are generally associated with a certain level of quality and/or value by consumers. Successful brands may be the most considerable asset for many consumer product companies. Consumer perception and loyalty is fundamental in assessing the overall business risk profile of companies in this sector.

Overall Market Position/Share

- A portfolio of strong brands benefits a company's overall position and influence in the marketplace. Products ranked number-one and number-two in their respective categories are generally favoured and more likely to be stocked by retailers. It is important to view market share with an emphasis on long-term trend, as changes are generally gradual.

Diversification

- DBRS evaluates the type of products offered by the company, as well as their level of diversification. Products classified as necessities will experience less sensitivity to economic cyclicality and be less affected by changes in consumer confidence and spending than luxury items. In addition, necessities display less price elasticity than do luxury items, indicating that as a general rule, price increases will have less of an overall effect on sales.
- DBRS considers the nature of the markets within which the company operates as these may have a significant influence on long-term profitability and growth. Markets can range from mature markets with limited growth potential to emerging markets that offer significant opportunities for growth, typically with inherent risks.
- International consumer product companies may cover the full range of market types, greatly diversifying their geographic risks.

Economies of Scale/Relative Size

- Larger companies can benefit from increased efficiencies in a number of areas. The ability to absorb larger costs allows greater efficiencies to be gained through the use of newer technologies for manufacturing and distribution. In addition, economies of scale can have significant impacts on marketing and advertising, as well as purchasing power.

ADDITIONAL FACTORS

Innovation/Responsiveness to Consumer Trends

- A very important factor in growing sales and keeping product portfolios healthy is the existence of successful research and development programs to complement, renew or replace existing products in the portfolio.
- Marketing programs are also essential, to introduce new products, gain market share and ensure high demand and proper distribution channels. An indicator of a successful and innovative company is the maintenance of a high proportion of sales from products introduced within the previous five years.

Distribution Channels

- Distribution channels and logistics capabilities are analyzed as they often differentiate companies, indicating better efficiency and/or other operational advantages. Distribution channels are important to consumer products companies, as product placement and convenience for the consumer provide the tools necessary for growth. Strong relationships with wholesalers and retailers, along with the appropriate tools and technology to efficiently manage inventories, will be good indicators of positive performance and/or growth prospects.

Procurement/Supplier Relationships

- The size and scale of a company will have some impact on the influence it can have in supplier relationships and its ability to negotiate discounts with its supplier base. Supplier diversity often provides added flexibility in materials sourcing, as well as leverage in price negotiations. A supportive supplier relationship may have a dramatically positive effect on company success, while confrontational relationships may have a negative impact on company performance.

Product Liability and Safety

- Product recalls and lawsuits can have long-lasting and harmful effects on a company's brands and profitability. Strong quality controls may increase short-term costs but can be instrumental in ensuring long-term profitability and customer loyalty.

COMMON BUSINESS CONSIDERATIONS

- There are two major considerations that were not included with the prior analysis but can have a meaningful impact on an individual company in any industry: country risk and corporate governance (which includes management). These areas tend to be regarded more as potential negative issues that could result in a lower rating than otherwise would be the case, although DBRS would certainly consider exceptional strength in corporate governance as a rating attribute.
- In most cases, our focus on the two areas is to ensure that the company in question does not have any meaningful challenges that are not readily identifiable when reviewing the other business risk considerations and financial metrics outlined in this methodology.

Country Risk

- Governments often intervene in their economies and occasionally make substantial changes that can significantly affect a company's ability to meet its financial obligations; 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.
- As such, the sovereign rating itself may in some cases become a limiting factor in an entity's rating, particularly when the sovereign has a lower rating and the entity does not have meaningful diversification outside its domestic economy.

Corporate Governance

- Effective corporate governance requires a healthy tension between management, the board of directors and the public. There is no single approach that will be optimal for all companies.
- A good board will have a profound impact on a company, particularly when there are significant changes, challenges or major decisions facing the company. DBRS will typically assess factors such as the appropriateness of board composition and structure, opportunities for management self-interest, the extent of financial and non-financial disclosure and the strength or weakness of control functions. For more detail on this subject, please refer to the DBRS criteria *Evaluating Corporate Governance*.
- With respect to the pivotal area of management, an objective profile can be obtained by assessing the following: the appropriateness of core strategies; the rigour of key policies, processes and practices; management's reaction to problem situations; the integrity of company business and regulatory dealings; the entity's 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 can also be considerations.



Company-Specific Financial Risk Factors

KEY METRICS

- Recognizing that any analysis of financial metrics may be prone to misplaced precision, we have limited our key metrics to a small universe of critical ratios. For each of these ratios, DBRS provides a range within which the issuer's financial strength would be considered as supportive for the same level of business risk as the consumer products industry. For example, a company where the outlook for both business risk and financial risk metrics falls within the BBB category would, all else being equal, be expected to have an issuer rating in the BBB range.
- To be clear, the ratings in the matrix below should not be understood as the final rating for an entity with matching metrics. This would only be the case to the extent that the business risk of the company and a wide range of other financial metrics were also supportive. The final rating is a blend of both the business risk and financial risk considerations in their entirety.

Consumer Products Industry Financial Metrics

Key Ratio	AA	A	BBB	BB	B
% debt in the capital structure	<20%	20% to 30%	30% to 45%	45% to 60%	>60%
EBIT coverage	>8.0x	5.0x to 8.0x	3.0x to 5.0x	1.5x to 3.0x	<1.5x
Cash Flow-to-debt	>60%	30% to 60%	20% to 30%	10% to 20%	<10%
EBITDA-to-interest	>10.0x	7.0x to 10.0x	4.0x to 7.0x	2.0x to 4.0x	<2.0x
Debt-to-EBITDA	<1.0x	1.0x to 2.0x	2.0x to 3.5x	3.5x to 5.0x	>5.0x
Return on equity	>14%	9% to 14%	7% to 9%	5% to 7%	<5.0%

- While the data in the above table are recognized as key factors, they should not be expected to be fully adequate to provide a final financial risk rating for any company. The nature of credit analysis is such that it must incorporate a broad range of financial considerations, and this cannot be limited to a finite number of metrics, regardless of how critical these may be.
- DBRS ratings are based heavily on future performance expectations, so while past metrics are important, any final rating will incorporate DBRS's opinion on future metrics, a subjective but critical consideration.
- It is also not uncommon for a company's key ratios to move in and out of the ranges noted in the ratio matrix above, particularly for cyclical industries. In the application of this matrix, however, DBRS is typically focusing on multi-year ratio averages.
- Notwithstanding these potential limitations, the key ratios are very useful in providing a good starting point in assessing a company's financial risk.
- It is important to note that actual financial ratios for an entity can and will be influenced by both accounting and accounting choices. In Canada, this will include the shift to International Financial Reporting Standards (IFRS). DBRS acknowledges that IFRS and other accounting choices will have an impact on the financial metrics of the companies that it covers. The financial risk factors include ratios based on data from company financial statements that are based on Canadian Generally Accepted Accounting Principles (GAAP) and U.S. GAAP, for the most part. When company financial statements are based on GAAP in other countries, including IFRS, the ratios and ranges may need to be redefined.
- Recognizing that the metrics in the table above do not represent the entire universe of considerations that DBRS examines when evaluating the financial risk profile of a company, the following provides a general overview that encompasses a broader range of metrics and considerations that could be meaningful in some cases.



Overall Considerations in Evaluating a Company's Financial Risk Profile

In addition to the information already provided with respect to key financial metrics, the following financial considerations and ratios are typically part of the analysis for the Consumer Products industry. As it is not possible to completely separate business and financial risks, note that many of the following ratios will relate to both areas.

EARNINGS

- DBRS earnings analysis focuses on core earnings or earnings before non-recurring items 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 analysis. Notwithstanding the focus on core earnings, note that actual net earnings is also a consideration in our analysis given the direct impact that this has on the capital structure.

Typical Earnings Ratios

- EBITDA interest coverage.
- EBIT interest coverage.
- EBITDA margin.
- EBIT margin.
- Net margin.
- Return on equity.
- Return on capital.

CASH FLOW AND COVERAGE

- DBRS cash flow analysis focuses on the core ability of the company to generate cash flow to service current debt obligations and other cash requirements as well as on 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 relevant. As with earnings, the impact that non-core factors have on cash flow may also be an important reality.
- 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, future capital expenditures and dividend and/or stock repurchase programs, as applicable.

Typical Cash Flow Ratios

- Cash flow-to-debt.
- Adjusted cash flow-to-adjusted debt (DBRS-adjusted ratios for operating leases, which are capitalized and included as debt).
- Cash flow-to-net debt.
- Adjusted cash flow-to-adjusted net debt (DBRS-adjusted ratios for operating leases, which are capitalized and included as debt).



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 considerations such as 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 and plans for maintenance or expansion, and the expected source of funding for these requirements, including bank lines and related covenants. Where the numbers are considered significant and the adjustments would meaningfully affect 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

- Current ratio.
- Debt-to-EBITDA.
- Net debt-to-EBITDA.
- Adjusted debt-to-EBITDA (DBRS-adjusted ratios for operating leases, which are capitalized and included as debt).
- Debt-to-capital.
- Net debt-to-capital.
- Adjusted debt-to-capital (DBRS-adjusted ratios for operating leases, which are capitalized and included as debt).

Stage 3: Rating the Security

With respect to Stage 3, the following comments describe how the issuer rating is used to determine ratings on individual securities:

- DBRS uses a hierarchy in rating long-term debt that affects issuers that have classes of debt that do not rank equally. In most cases, lower-ranking classes would receive a lower DBRS rating. For more detail on this subject, please refer to DBRS rating policy entitled "[Underlying Principles](#)."
- In some cases, issued debt is secured by collateral. This is more typical in the non-investment-grade spectrum. For more detail on this subject, please refer to [DBRS Rating Methodology for Leveraged Finance](#).
- The existence of holding companies can have a meaningful impact on individual security ratings. For more detail on this subject, please refer to the criteria [Rating Parent/Holding Companies and Their Subsidiaries](#).

Appendix

INDUSTRY BUSINESS RISK RATINGS

- DBRS uses the concept of business risk ratings (BRRs) as a tool in assessing the business strength of both industries and individual companies within many methodologies across the corporate finance area. (DBRS does not typically use this approach for most financial, government and public finance sectors, where the industry is more challenging to define and this approach is not as useful.)
- The BRR is assessed independently of financial risk, although in some cases there are subtle but important links. As an example, the very low business risk profile of many regulated utilities has historically allowed this sector to operate with debt levels that would not be acceptable for most other industry sectors. Given this reality, it is difficult to consider the utility industry's BRR without acknowledging to some degree that the industry operates with sizable debt levels. This type of relationship exists with many industries, although typically to a much lesser degree.
- When a BRR is applied to an industry, there is an acknowledgment that this is a general assessment and there may in fact be a wide disbursement in the business strength of individual entities within the industry. Nonetheless, this assessment is beneficial to enabling DBRS to clearly delineate our industry opinion and is a useful tool when comparing different industries. An industry BRR is defined as being representative of those entities that the market would consider as "established," meaning that the group of companies being considered would have at least reasonable critical mass and track records. As such, the BRR for an industry does not consider very small players, start-up operations or entities that have unusual strengths or weaknesses relative to the base industry.
- DBRS methodologies note whether they apply to global industries or more specific countries or regions. When analyzing individual credits, DBRS considers the degree to which regional considerations may differ from the geographic area applicable within the industry methodology. Many entities have business units that transcend industries and in these cases, more than one BRR would be considered, including the possible benefits or challenges that may exist when all businesses are analyzed as part of a combined group.
- The BRR is a tool that provides additional clarity regarding the business risk of the industry overall, but it should be viewed as just one aspect in the complex analysis of setting ratings and should by no means be seen as either a floor or ceiling for issuers within a given industry. Although DBRS does not anticipate volatility in an industry's BRR, changes are possible over time if there are meaningful structural developments in the industry. When such a change does occur, DBRS will make this clear and note any impact on related individual ratings within the industry as applicable.
- DBRS assesses five areas to establish the overall BRR for an industry. Although there is an overlap in some instances (to some degree, in the long term, all five factors tend to relate to profitability and stability), DBRS has found that considering these five measures in a separate fashion is a useful way of approaching its analysis. In all cases, DBRS uses historic performance and our experience to determine an opinion on the future, which is the primary focus.

Industry Profitability and Cash Flow

- When ratios such as return on equity, return on capital and a variety of cash flow metrics are considered, some industries are simply more profitable than others. While standard economics would suggest a reversion to the mean through new competitors, this often occurs at a very slow pace over a long time horizon and in some cases may not occur at all because of barriers to entry.
- The benefits from above-average profits and/or cash flow are substantial and include internal capital growth, easier access to external capital and an additional buffer to unexpected adversity from both liquidity and capital perspectives.
- Some industries and their participants have challenges or strengths in areas such as research and development (R&D), brand recognition, marketing, distribution, cost levels and a potentially wide variety of other tangibles and intangibles that affect their ability in the area of profitability.

Industry Competitive Landscape

- The competitive landscape provides information regarding future profitability for the industry and thus somewhat crosses over into the profitability and cash flow assessment, but competition is deemed worthy of separate consideration because of its critical nature.
- Participants in industries that lack discipline, produce commodity-like products or services, have low barriers to entry and exhibit ongoing pricing war strategies generally have difficulty attaining high profitability levels in the longer term. Certain industries benefit from a monopoly or oligopoly situation, which may relate to regulation.

Industry Stability

- This factor relates primarily to the degree of stability in cash flow and earnings, measuring the degree to which the industry and its participants are affected by economic or industry cycles. Stability is considered critical as industries with high peaks and troughs have to deal with higher risk at the bottom of a cycle. As such, to some degree, industries with lower but stable profitability are considered more highly than industries with higher average profitability that is more cyclical.
- Some of the key factors in considering stability include the nature of the cost structure (fixed or variable), diversification that provides counter-cyclical and the degree to which the industry interrelates with the overall economy. Depending on the industry, economic factors could include inflation or deflation, supply and demand, interest rates, currency swings and future demographics.

Industry Regulation

- Where applicable, regulation can provide support through stability and a barrier to entry, but it can also cause challenges and change the risk profile of an industry and its participants in a negative way, including the reality of additional costs and complications in enacting new strategies or other changes.
- As part of its analysis of regulation, DBRS also considers the likelihood of deregulation for a regulated industry, noting the many examples where this transition has proven to be a major challenge in the past.

Other Inherent Industry Considerations

- Each industry has its own set of unique potential risks that, even if managed well, cannot be totally eliminated. Specific risks, the ability to manage them and the range of potential outcomes vary industry by industry. Two of the most common risks are changing technology and operational risks.
- Some of the other more common risks are in the areas of legal, product tampering, weather, natural disasters, labour relations, currency, energy prices, emerging markets and pensions.



INDUSTRY BUSINESS RISK RATING DEFINITIONS

DBRS specifies the BRR for an industry in terms of our **Long-Term Obligations** rating scale. When discussing industry BRRs for an industry, DBRS typically provides either one specific rating or a limited range (such as BBB (high)/BBB). Using a range recognizes the fact that, by their nature, industry BRRs are less precise than a specific corporate or security rating as they represent an overall industry. In addition to relating to the industry level, these definitions also apply to the business risk of individual companies, which will fall more often in the very high and low categories (AA/AAA and B) than would be the case for an entire industry.

Industry Business Risk Ratings (BRRs)

Rating	Business Strength	Comment
AA/AAA	Exceptional	An industry BRR of AA/AAA is considered unusually strong, with no meaningful weakness in any individual area. It may include pure monopolies that are deemed essential (the primary case being regulated utilities, where the risk of deregulation is believed to be very low). Common attributes include product differentiation, high barriers to entry and meaningful cost advantages over other industries or entities. These and other strengths provide exceptional stability and high profitability. It would be quite rare for an industry to have a BRR in this category.
A	Superior	Industry BRRs at the "A" level are considered well above average in terms of stability and profitability and typically have some barriers to entry related to capital, technology or scale. Industries that have, by their nature, inherent challenges in terms of cyclicity, a high degree of competition and technology risks would be unlikely to attain this rating category.
BBB	Adequate	Industry BRRs at the BBB level include many cyclical industries where other positive considerations are somewhat offset by challenges related to areas such as commodity products, labour issues, low barriers to entry, high fixed costs and exposure to energy costs. This rating category is considered average and many industries fall within it, with key considerations such as overall profitability and stability typically considered as neither above or below average.
BB	Weak	An industry at the BB level has some meaningful challenges. In addition to high cyclicity, challenges could include the existence of high technology or other risks. Long-standing industries that may have lost their key strengths through factors such as new competition, obsolescence or the inability to meet changing purchaser demands may fit here. The culmination of such factors results in an industry that does not generally score well in terms of stability and profitability. For an entire industry, this is typically the lowest BRR level.
B	Poor	While not common, there are cases where an industry can have a BRR of B. Such industries would typically be characterized by below-average strength in all or virtually all major areas.



INTERRELATIONSHIP BETWEEN FINANCIAL AND BUSINESS RISK

Having in mind the prior discussion on the typical importance that DBRS places on certain financial metrics and business strengths for the consumer products industry, we provide some guiding principles pertaining to the application of DBRS methodologies, the first one being that, in most cases, an entity's business risk will carry more weight in the final rating than its financial risk.

Based on this underlying concept, we provide the additional guidance for individual companies with varying business risks:

- **For an Entity with a Business Risk of AA (Exceptional):** A company with a business risk of AA will almost always be able to obtain an investment-grade issuer rating. When financial metrics are in the BBB range, an entity with a business risk of AA would typically be able to attain an "A"-range issuer rating.
- **For an Entity with a Business Risk of "A" (Superior):** Unless financial strength fails to exceed the B range, superior business strength will typically allow the final issuer rating to be investment grade. Very conservative financial risk may in some cases allow the final issuer rating to be within the AA range, but this should not be considered the norm.
- **For an Entity with a Business Risk of BBB (Adequate):** At this average level of business risk, the level of financial risk typically has the ability to result in a final issuer rating from as high as "A" to as low as B.
- **For an Entity with a Business Risk of BB (Weak):** At this weak level of business risk, conservative financial risk can, in some cases, take the final issuer rating into the BBB investment-grade range.
- **For an Entity with a Business Risk of B (Poor):** It is not typically possible for a company with a business risk of B to achieve a final investment-grade issuer rating.

DEFINITION OF ISSUER RATING

- DBRS Corporate rating analysis begins with an evaluation of the fundamental creditworthiness of the issuer, which is reflected in an "issuer rating". Issuer ratings address the overall credit strength of the issuer. Unlike ratings on individual securities or classes of securities, issuer ratings are based on the entity itself and do not include consideration for security or ranking. Ratings that apply to actual securities (secured or unsecured) may be higher, lower or equal to the issuer rating for a given entity.
- Given the lack of impact from security or ranking considerations, issuer ratings generally provide an opinion of default risk for all industry sectors. As such, issuer ratings in the banking sector relate to the final credit opinion on a bank that incorporates both the intrinsic rating and support considerations, if any.
- DBRS typically assigns issuer ratings on a long-term basis using its **Long Term Obligations** Rating Scale; however, on occasion, DBRS may assign a "short-term issuer rating" using its **Commercial Paper and Short Term Debt** Rating Scale to reflect the issuer's overall creditworthiness over a short-term time horizon.

SHORT-TERM AND LONG-TERM RATINGS

- For a discussion on the relationship between short- and long-term ratings and more detail on liquidity factors, please refer to the DBRS policy entitled "**Short-Term and Long-Term Rating Relationships**" and the criteria *DBRS Commercial Paper Liquidity Support Criteria for Corporate Non-Bank Issuers*.

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