



Methodology
*Rating Companies
in the Merchandising Industry*

MAY 2011



Insight beyond the rating.

CONTACT INFORMATION

Anil Passi, CA, CFA

Senior Vice President
Consumer, Retail and Real Estate
+1 416 597 7322
apassi@dbrs.com

Kent Wideman

Chief Credit Officer
+1 416 597 7535
kwideman@dbrs.com

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Rating Companies in the Merchandising 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.

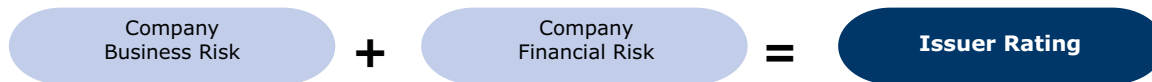


Stage 2: Issuer Rating

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 Merchandising Industry

- The merchandising industry is defined to include companies principally involved in the selling of any number and type of products and services to the retail consumer. This methodology is broadly applied to all merchandisers, despite significant differences between store and product types.
- DBRS views the BRR for the merchandising industry as being BBB. The general BRR is the result of a qualitative assessment that serves as a backdrop for the analysis of the company's financial risk profile, as well as other qualitative factors that are particularly unique to the company. DBRS considers the BRR to represent the rating of an average company within the industry. Based on the five major categories used by DBRS in assessing industry BRRs, the rationale for this assessment is as follows:

INDUSTRY PROFITABILITY AND CASH FLOW

- Profitability and cash flow are average relative to other industries, as merchandising is generally highly competitive and capital-intensive. Companies aim to leverage any strengths (brand name, nature of product offering, relative size and geographic diversification) to drive turnover and maximize margins.
- Working capital management, investment in new and existing stores, and adapting to changing consumer trends are all critical to achieving and maintaining profitability and long-term success in the merchandising industry.

INDUSTRY COMPETITIVE LANDSCAPE

- The retailing industry is more competitive than many other industries as barriers to entry are reasonably low. This results in high levels of competition within and across different product segments. Competing companies often range from regional and specialized to international and broadly diversified in scope.
- Common among all product segments is the fact that larger-volume companies can take advantage of purchasing power to lower the cost of products or gain more favourable lease terms.

INDUSTRY STABILITY

- In terms of cyclicity, the merchandising industry can be wide ranging, but is generally seen as being more cyclical than the average industry. Economic cycles have a more pronounced and significant impact on hard-line retailers (sellers of furniture, appliances, building supplies, hardware, etc.), where the effects can be seen with a decline in volume.
- Cyclicity generally has less of an impact on the top line of soft-line retailers (i.e., discounters or supermarkets) but is often visible in contraction of margins and earnings. Thus, while the effects of economic cyclicity can differ greatly depending on the nature of the product offering, it is clear that virtually all merchandisers are affected to some extent by economic cycles.

INDUSTRY REGULATION

- Regulation across the industry is minimal, which greatly limits any risks associated with a changing regulatory environment, both in North America and internationally.

OTHER INHERENT INDUSTRY CONSIDERATIONS

- Overall, other inherent merchandising industry risks and opportunities are in line with those experienced by other industries.
- Real estate is often a significant consideration, as the lease-versus-buy debate carries numerous potential benefits and risks. Many retailers have also started to offer their customers credit cards and other financial services, which can bolster performance but adds another element of risk.
- Finally, private label/store brands can be a notable strength as they offer both higher margins and enhanced customer loyalty through lower prices.



RESTAURANTS

- DBRS also rates restaurants; this includes a wide range of food-service formats and banners. The following factors are considered:
 - Nature of product offering, types of restaurants and markets served and potential susceptibility to economic cycles.
 - Position in the market served, strength of the brand name and customer loyalty.
 - Operational efficiency and relative scale.
 - Location, including geographic diversification and ownership of restaurant locations.

WHOLESALE/DISTRIBUTORS

- DBRS also rates wholesalers and distributors, this includes companies that act as a middleman and provide all types of food-service industry products, as well as pharmaceuticals. The following additional factors are considered:
 - Nature of product offering and market served.
 - Scale, efficiency and distribution network.
 - Diversification of customer base.

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.

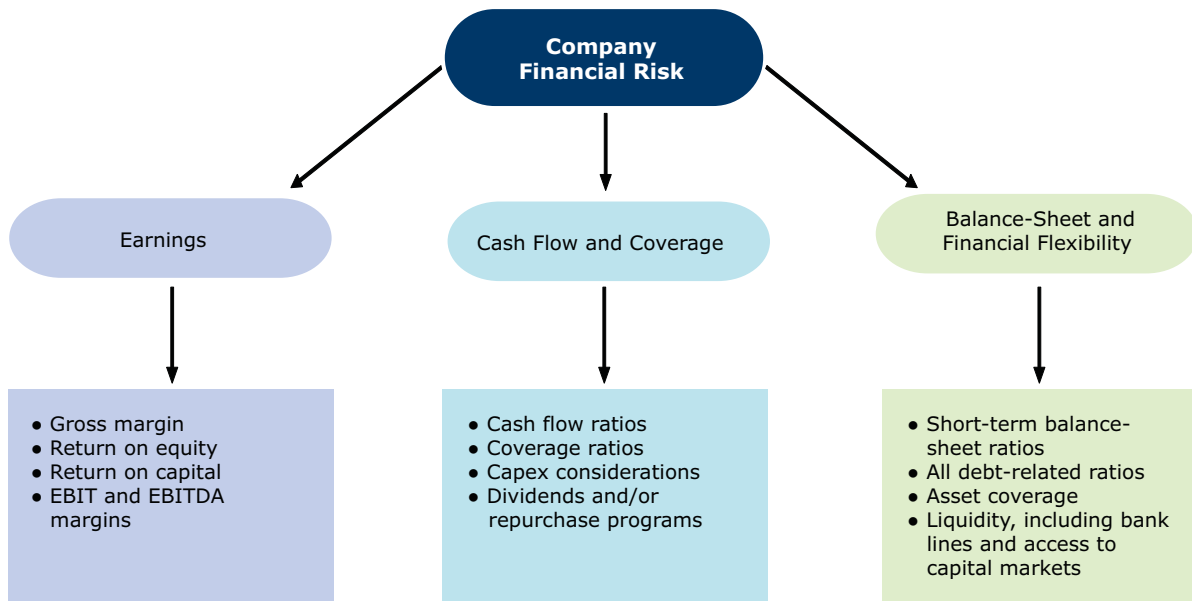
BUSINESS RISK PROFILE

- 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 merchandising 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
Nature of Product Offering	<ul style="list-style-type: none"> Soft-line retailer with primarily non-discretionary and very diverse product offering. Limited effects of seasonality and economic cycles, ensuring consistent cash flow. Minimal risk associated with fashion and changing consumer trends. 	<ul style="list-style-type: none"> Retailer offering primarily non-discretionary products with some diversity or primarily discretionary products with significant diversity. Low to moderate relative risks related to seasonality or economic cycles. Changing fashions and consumer trends offer minor challenges in forecasting. 	<ul style="list-style-type: none"> Soft-line retailer offering limited product diversity or hard-line retailer offering some product diversity. Moderate risks related to relative seasonality of demand and economic cyclicality. Risks related to changing fashion and consumer trends offer challenges in matching offerings to customer preferences. 	<ul style="list-style-type: none"> Retailer offering primarily discretionary products with limited diversity or non-discretionary products with very limited diversity. Significant relative risks from seasonality of demand and economic cyclicality. High risks related to changing fashions and consumer trends raise the need for accurate forecasting. 	<ul style="list-style-type: none"> Hard-line retailer, specializing in specific non-discretionary products, with very limited diversification. Very high risks exist as demand is highly dependent on economic cycles. Very high risks related to seasonality of cash flows, relying heavily on small time periods.
Brand Name	<ul style="list-style-type: none"> Well-known brand name with significant levels of customer loyalty. Relatively high market share. Diverse selections and perception of high levels of quality, service and value. Consistent improvement in levels of same-store sales growth. Consistent Capex investment in store appearance to remain fashionable and attractive to customers. 	<ul style="list-style-type: none"> Known brand name, with some customer loyalty and an acceptable market share. Wide selection of products and solid overall perception of quality and value. Long-term positive growth in same-store sales growth. Moderate capex investment in store appearance and design. 	<ul style="list-style-type: none"> Regionally known brand name, with limited customer loyalty. Adequate selection of products and moderate levels of perceived quality and value. Moderate or flat same-store sales growth. Average investment in store quality and appearance. 	<ul style="list-style-type: none"> Brand name that has failed to establish a reputation. Small to moderate levels of market share. Limited selection and only moderate perception of quality and value. Inconsistent same-store sales growth featuring minor ups and downs. Limited capex investment in improving store quality and appearance. 	<ul style="list-style-type: none"> Brand name offers no benefits or has developed a negative or harmful reputation. Very limited selection of items and poor public perception of quality, value and service. Shrinking same-store sales growth and an erosion of market share. Very limited to no capex investment in store quality and appearance resulting in deterioration of customer perception.

Company-Specific Business Risks – Critical Factors

Rating	AA	A	BBB	BB	B
Business Strength	Exceptional	Superior	Adequate	Weak	Poor
Operational Efficiency	<ul style="list-style-type: none"> • Strong inventory management, with high product turnover and limited need for discounting and markdowns. • High margins, relative to similar product types. • Relatively high levels of sales per square foot. • High levels of return on capital. 	<ul style="list-style-type: none"> • Moderate to strong inventory management. Occasional use of discounting and markdowns to help turnover. • Moderate to high margins relative to similar products. • Relatively moderate to high levels of sales per square foot. 	<ul style="list-style-type: none"> • Average inventory turnover with necessary use of discounts and markdowns. • Overall margins remain adequate. • Moderate levels of sales per square foot, relative to similar product categories. • Comparatively moderate return on invested capital. 	<ul style="list-style-type: none"> • Low to moderate inventory turnover, requiring consistent use of discounting and markdowns, negatively affecting margins. • Low to moderate comparative sales per square foot. • Low to moderate comparative returns on invested capital. 	<ul style="list-style-type: none"> • Consistently low levels of inventory turnover requiring heavy discounts and markdowns. • Extremely small margins comparative to merchandisers with similar product offerings. • Consistently low comparative sales per square foot and return on invested capital.
Relative Scale	<ul style="list-style-type: none"> • Large comparative size, offering strong purchasing power. • Economies of scale sufficient to allow larger advertising and promotional campaigns, and the investment in and use of newer technologies to improve logistics, processes and efficiency. • Price leader, which can be used to drive revenue or act as a barrier to new entrants. 	<ul style="list-style-type: none"> • Moderately large comparative size, offering some influence over purchasing prices. • Size offers some economies of scale, offering certain benefits in advertising and promotion, and/or the investment in newer technologies. • One of few companies that can display some influence on prices. 	<ul style="list-style-type: none"> • Average size and therefore significant limitations on purchasing power influence. • Average economies of scale, limiting advertising and promotional benefits, and potential beneficial investment in newer advantageous technologies. • Moderate influence on product pricing, often simply a reaction to competitors and market conditions. 	<ul style="list-style-type: none"> • Small to moderate-sized organization that has no influence on pricing and can only react to price changes on both the input and output sides. • Use of only older technologies, with no economies of scale, affecting overall efficiency. 	<ul style="list-style-type: none"> • Small scale increases risks from pricing changes by larger competitors. • Drastically behind on new and beneficial technologies that can provide larger competitors with enhanced margins and therefore the capability to lower prices and increase competitive pressures.

Company-Specific Business Risks – Critical Factors

Rating Business Strength	AA Exceptional	A Superior	BBB Adequate	BB Weak	B Poor
Geographic Diversification	<ul style="list-style-type: none"> Significant exposure to different countries, regions and localities as compared with competitors. Efficient use of strategic locations allowing access to more people per store. Excellent mix of access to developed and developing markets, offering continued growth opportunities. 	<ul style="list-style-type: none"> Limited geographic diversification, intensely accessing a limited number of different countries, regions, or localities. Adequate location selection offering decent exposure to significant markets. Adequate mix of developed and developing markets, offering some continued growth potential. 	<ul style="list-style-type: none"> Average geographic spread, providing some performance risk based on regional conditions. Average locations that provide only adequate access to surrounding markets. Limited exposure to developing markets, potentially limiting future growth potential. 	<ul style="list-style-type: none"> Reliance on only a few geographic regions, further enhancing risks. Location selection offers no beneficial access to surrounding markets. Risk of market saturation is high. 	<ul style="list-style-type: none"> Very heavy reliance on only a few geographic regions. Poor choice of locations for accessing surrounding markets. Very high levels of competition and limited potential for market development in the area. General economic performance in the region is highly volatile.
Real Estate	<ul style="list-style-type: none"> Excellent relative locations in prime spaces offering direct access to target markets. Low rents in prime locations locked in with long-term leases. Desirable portfolio of properties offering stability and flexibility in relation to volatile market conditions. 	<ul style="list-style-type: none"> Moderate to good selection of locations, appropriate to the target market. Positive rent pricing locked in long-term leases or low rents that are not locked up long term. Limited ownership of property to help stabilize business or undesirable portfolio of properties. Overall real estate portfolio provides sufficient flexibility for future store closures and changes. 	<ul style="list-style-type: none"> Average relative locations, with limitations related to market access or size or available space. Average or market-rate rents locked in for long periods of time. Limited to no real estate property ownership. Limited long-term flexibility with respect to store changes and closures. 	<ul style="list-style-type: none"> Below-average locations relative to competitors, presenting challenges related to target market access or with respect to the physical property. Below-average or above-market rents locked in long term, creating an unfavourable liability. Inflexible real estate lease portfolio makes store closures very expensive. 	<ul style="list-style-type: none"> Very questionable store locations, offering numerous challenges related to market access and physical storefronts. Poorly negotiated lease agreements create rents locked in well above market values. Poor portfolio limits organizational changes due to high penalties related to lease terminations.

- The merchandising industry includes companies principally engaged in retail-level sales to final end-users, as well as certain wholesalers and quick-serve restaurants or food retailers. Increasingly, these companies are beginning to develop minor complementary businesses, typically relating to credit card offerings or other financial services. DBRS evaluates these key rating drivers for all merchandising companies, despite significant differences between retailer types and product offerings.



PRIMARY FACTORS

Nature of Product Offering

- DBRS understands that sales and earnings tend to be cyclical for most merchandisers and are influenced by consumer spending levels, the strength of the economy, consumer confidence, personal debt levels, savings rates, unemployment and interest rates.
- The degree of cyclicality is dependent upon the type of market segment in which the retailer specializes.
- Hard-line retailers tend to experience high cyclicality since they are influenced by the level of housing starts, which are often volatile.
- Soft-line retailers like big box stores or supermarkets, which typically sell everyday, non-discretionary items, tend to experience less cyclicality.
- DBRS takes into consideration the nature and diversity of a merchandiser's product offering, its exposure to cyclical and seasonal risks and how these factors affect the stability of the company's earnings and cash flow.

Brand Name

- The strength of a merchandiser's brand often differentiates retailers and is instrumental in developing customer loyalty and driving sales growth. Brand strength is typically established on a combination of quality, value, selection, service, consistency, convenience and store environment.
- DBRS evaluates a company's brand strength on a relative basis to its peers. Quantitatively, as indicators of brand strength DBRS considers same-store sales growth, changes in market share and capex investments in store quality and appearance.
- In addition, DBRS examines the existence and strength of a merchandiser's private label/store brands, as these can provide retailers with higher margins and enhanced customer loyalty through lower prices.

Operational Efficiency

- Inventory management and logistics capabilities driven by technology are key considerations in rating merchandising companies.
- DBRS typically views the strength of a merchandiser as evidenced by its ability to maximize inventory turnover while minimizing discounting or markdown activity. The effects of different market segments on operational performance are taken into consideration and evaluated on a relative basis.
- DBRS analyzes sales per square foot, working capital deployment, operating margins and return on invested capital to assess the quality and sustainability of a company's earnings.

Relative Scale

- Larger operations allow for more competitive purchasing power and economies of scale with respect to logistics, administrative costs, advertising and technology systems. Cost savings on a relative basis in each of these areas will help reduce overall margins and improve the bottom line.
- In addition, larger organizations have the capability to invest in newer, cutting-edge technologies that further improve efficiency of operations.
- Finally, companies that are dominant in their respective market segment have the ability to be price leaders, allowing them to exert power over market pricing to either increase revenues or serve as a barrier to new entrants in the marketplace.
- DBRS recognizes that along with the numerous strengths of larger merchandisers, come certain risks. Larger stores face significantly greater effort and cost when undertaking a conversion or restructuring. In addition, large, well-known companies have difficulty changing an already established image, making it difficult to attract new customer segments.



Geographic Diversification

- DBRS recognizes the benefits of geographic diversification and seeks to consider the benefits of such in relation to its cost. Spreading risk among diverse countries, regions and localities generally helps smooth out potential market trends.
- Certain market segments may experience even greater benefits from this diversification, where seasonal cash flows in different regions may help even earnings throughout the course of a year and eliminate heavy reliance on small revenue-generating windows.
- Diversification into other regions and countries will also aid in providing growth opportunities for companies that would otherwise be operating in saturated, mature markets.
- DBRS considers the benefits of geographic diversification in relation to the risks and added complexity associated with a diversified operation. DBRS evaluates a company's diversification strategy to determine the level of risk and potential benefit; for example, in a case where a particular expansion may seem risky, appropriate location choice offering access to a high number of shoppers from a single store may offset some of that risk.

Real Estate

- DBRS considers store locations, which can be a significant factor in determining the success of a chain.
- Retailers with prime urban real estate in formats that match demand of the target demographic have a significant competitive advantage.
- In addition, DBRS evaluates the structure of the real estate portfolio relative to a company's geographic footprint, competitive environment and financial position. Ownership of stores typically provides greater operating flexibility, ensuring the ability to expand or contract stores without significant cash expense to terminate a lease. Furthermore, ownership can provide greater stability, boost assets and also provide a good alternate source of capital (e.g., sale-leaseback).
- Leases, on the other hand, can be extremely advantageous in the case of low-rent, long-term leases, but do entail a number of risks, as they can lack flexibility and significantly increase the cost of potential store closures. DBRS adjusts leverage ratios by capitalizing operating leases by a factor of six times to reflect off-balance sheet financing.

ADDITIONAL FACTORS

Format/Banners

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

Understanding/Adapting to Consumer Trends

- Consumer preferences are constantly evolving, requiring retailers to adapt their product offerings.
- DBRS assesses the ability of retailers, particularly within riskier market segments, to predict and cater to changing demand, which is the key factor in remaining competitive over the long term. Riskier market segments are those most susceptible to changes in consumer trends (such as those that sell fashion-oriented apparel or merchandise).

Labour

- Non-unionized retailers generally have a significant advantage over unionized competitors due to the potential impact of work stoppages, higher labour costs, and the general lack of flexibility in collective bargaining agreements.
- DBRS evaluates the historical relationship between management and labour in both environments and examines whether any labour issues are expected to arise. The impact of unsuccessful collective bargaining, potential labour disruptions and potential negative publicity is considered by DBRS.



Credit Cards and other Complementary Financial Businesses

- It is increasingly common for retailers to operate a proprietary credit card program which can contribute significantly to profits and add stability to company earnings. Store credit cards are typically linked to loyalty programs, providing retailers with closer relationships with their customer base.
- Credit card and financial business operations carry risks (such as underwriting and collection risks), and if not managed properly, such operations can lead to higher bad debt expense. DBRS assesses the positive impact of credit card programs on a retailer's earnings profile, in relation to the risks posed.
- Securitized credit card receivables can provide added liquidity; however, DBRS adjusts leverage ratios to include these potential off-balance sheet liabilities.
- In general, where such a business exists, DBRS will treat it as a deconsolidated entity and use the appropriate methodology to examine each business segment in order to ensure the appropriate rating is assigned.

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 merchandising 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.

Merchandising Industry Financial Metrics

Key Ratio	AA	A	BBB	BB	B
% Debt in the Capital Structure ¹	< 25%	25% to 40%	40% to 60%	60% to 75%	> 75%
EBIT Coverage ¹	> 10.0x	6.0x to 10.0x	3.0x to 6.0x	1.5x to 3.0x	< 1.5x
Cash Flow-to-Debt ¹	> 60%	30% to 60%	20% to 30%	10% to 20%	< 10%
EBITDA-to-Interest ¹	> 12.0x	8.0x to 12.0x	5.0x to 8.0x	3.0x to 5.0x	< 3.0x
Debt-to-EBITDAR ¹	< 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%

(1) Adjusted for operating leases capitalized at 6.0 times.

- Companies in the merchandising industry have a high level of operating leases versus most other industries. The ratios above have included DBRS adjustments and experience for this factor as deemed appropriate for assessing the financial strength of merchandising entities.
- 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 merchandising 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 merchandising 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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www.dbrs.com

Corporate Headquarters

DBRS Tower
181 University Avenue
Suite 700
Toronto, ON M5H 3M7
TEL +1 416 593 5577