Methodology

Rating Companies in the Capital Goods Dealership Industry

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Introduction to DBRS Methodologies

- DBRS publishes rating methodologies to give issuers and investors insight into the rationale behind DBRS’s rating opinions.
- In general terms, DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. DBRS ratings assess an issuer’s ability to make timely payments on outstanding obligations (whether principal, interest, preferred share dividends or distributions) with respect to the terms of an obligation. In some cases (e.g., non-investment grade corporate issuers), DBRS ratings may also address recovery prospects for a specific instrument given the assumption of an issuer default.
- DBRS rating methodologies include consideration of historical and expected business and financial risk factors as well as industry-specific issues, regional nuances and other subjective factors and intangible considerations. Our approach incorporates a combination of both quantitative and qualitative factors.
- The considerations outlined in DBRS methodologies are not exhaustive and the relative importance of any specific consideration can vary by issuer. In certain cases, a major strength can compensate for a weakness and, conversely, a single weakness can override major strengths of the issuer in other areas. DBRS may use, and appropriately weight, several methodologies when rating issuers that are involved in multiple business lines.
- DBRS operates with a stable rating philosophy; in other words, DBRS strives to factor the impact of a cyclical economic environment into its ratings wherever possible, which minimizes rating changes due to economic cycles. Rating revisions do occur, however, when more structural changes, either positive or negative, have occurred, or appear likely to occur in the near future.
- DBRS also publishes criteria which are an important part of the rating process. Criteria typically cover areas that apply to more than one industry. Both methodologies and criteria are publicly available on the DBRS website and many criteria are listed below under “Rating the Specific Instrument and Other Criteria.”
Overview of the DBRS Rating Process

- There are generally three components to the DBRS corporate rating process: (1) an industry risk rating (IRR); (2) an issuer rating; and (3) considerations for specific securities. The figure below outlines this process.

- An IRR is a relative ranking of most industries that have a DBRS methodology, typically using just three ranges of the DBRS long-term debt rating scale (i.e., “A”, BBB and BB), without making use of the “high” or “low” descriptors. The IRR is a general indication of credit risk in an industry and considers, among other things, an industry’s: (1) profitability and cash flow; (2) competitive landscape; (3) stability; (4) regulation; and (5) other factors. An “industry,” for the purposes of the IRR, is defined as those firms that are generally the larger, more established firms within the countries where the majority of DBRS’s rated issuers are based; this remains true for DBRS methodologies that are more global in nature. The industry risk rating helps DBRS set the BRR grid (see below) in that it positions, in an approximate way, an average firm in the industry onto the BRR grid. For firms in industries with low IRRs, the IRR can, in effect, act as a constraint or “cap” on the issuer’s rating.

- The issuer rating is DBRS’s assessment of the probability of default of a specific issuer. It is a function of: (1) the business risk rating (BRR), determined by assessing each of the primary and (where relevant) additional BRR factors in the BRR grid for a specific issuer; and (2) the financial risk rating (FRR), determined by assessing each of the primary and (where relevant) additional FRR metrics. The two components, BRR and FRR, are combined to determine the issuer rating; in most cases the BRR will have greater weight than the FRR in determining the issuer rating. Throughout the BRR and FRR determination process, DBRS performs a consistency check of the issuer on these factors against the issuer’s peers in the same industry.

- The issuer rating is then used as a basis for specific instrument ratings. DBRS assigns, for example, a recovery rating and notches up or down from the issuer rating to determine a specific instrument rating for instruments of non-investment grade corporate issuers. (See “Rating the Specific Instrument and Other Criteria” below.)

DBRS Rating Analysis Process

- Depending on the instrument, “other criteria” may include the recovery methodology for non-investment grade issuers or the preferred share and hybrid criteria, for example. Please refer to the section below entitled “Rating the Specific Instrument and Other Criteria” for a list of these criteria, as well as other criteria that may be applicable at any stage of the rating process.
Capital Goods Dealership Industry

- The capital goods dealership industry includes both single brand and multi-brand dealers that sell capital goods equipment (both new and used) to end-users in various industry segments including construction, mining, forestry and energy, among others. These companies also supply parts and services and may rent or lease equipment. Some large dealers may also offer sales financing.
- Per the three-tier industry risk rating system described on the previous page, the capital goods dealership industry IRR is BBB.
- The capital goods dealership industry is characterized by: (1) Greater than average stability that arises from the parts and service business which generally benefits from exclusivity in a certain jurisdiction as well as manufacturer support generally; (2) competition that is high for new product sales, but is much less for parts and service; (3) growth that is strongly influenced by the competitiveness of the manufacturer’s product; (4) modest capital requirements; and (5) nominal regulations that are oriented toward safety and environmental issues.
- The capital goods dealership industry is closely aligned to the original equipment manufacturer’s (OEM’s) business. There is little a dealer can do to improve on the OEM’s brand, breadth of product offerings or competitiveness. A financially strong OEM has the capability to protect its market position and brand equity with ongoing new product development as well as extending support to dealers when required.
- New equipment sales are volatile and closely correlate with the economic cycles of the end-use markets and customer’s financial position. New equipment sales also face fierce competition from other brands. This contrasts severely with the parts and service business for which the dealer typically has exclusive rights in a given sales territory. Parts and service can be a long term annuity like business which develops a customer relationship more deeply than the original sales transaction.
- The capital goods dealership industry is working capital oriented and has countercyclical cash needs. The capital goods dealership operations usually generate cash in a down cycle as the dealer reduces inventory, easing financial pressure.
- Regulation is minimal, mostly focused on workplace safety and environmental (hazardous waste handling) issues.
### Capital Goods Dealership Business Risk Rating

**PRIME BRR FACTORS**
- The BRR grid below shows the primary factors used by DBRS in determining the BRR. While these primary factors are shown in general order of importance, depending on a specific issuer’s business activities, this ranking can vary by issuer.

### Capital Goods Dealership - Primary BRR Factors

<table>
<thead>
<tr>
<th>Rating</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strength of Underlying OEM and Brand</strong></td>
<td>The leading brand globally for the equipment category.</td>
<td>A leading brand globally for the equipment category.</td>
<td>Well-known brand for the equipment category.</td>
<td>Known brand for the equipment category.</td>
</tr>
<tr>
<td></td>
<td>Strong support from the OEM in marketing, product training, finance and other services.</td>
<td>Above-average support from OEM in marketing, product training, finance and other services.</td>
<td>Some support from OEM.</td>
<td>Limited support from OEM.</td>
</tr>
<tr>
<td></td>
<td>OEM has superior market position and financial strength.</td>
<td>OEM has above-average market position and financial strength.</td>
<td>OEM has average market position and average financial strength.</td>
<td>OEM has below average market position and at or below average financial strength.</td>
</tr>
<tr>
<td><strong>Business Mix</strong></td>
<td>A full-service dealer.</td>
<td>A full-service dealer.</td>
<td>A full-service dealer.</td>
<td>Not a full-service dealer.</td>
</tr>
<tr>
<td></td>
<td>Significant portion of revenue from parts and service.</td>
<td>Meaningful portion of revenue from parts and service.</td>
<td>Some revenue from parts and service.</td>
<td>Limited revenue from parts and service.</td>
</tr>
<tr>
<td></td>
<td>Low revenue volatility due to offsetting economic cycles among the sales territories.</td>
<td>Average to slightly below average revenue volatility due to offsetting economic cycles among sales territories.</td>
<td>Above-average revenue volatility.</td>
<td>Above-average volatility.</td>
</tr>
<tr>
<td></td>
<td>Strong growth potential in territories.</td>
<td>Good growth potential in territories.</td>
<td>Territory with some growth potential.</td>
<td>Territory with very limited growth potential.</td>
</tr>
<tr>
<td><strong>Product Diversification</strong></td>
<td>Very well diversified mix of products and end-use markets (e.g., mining, forestry and construction).</td>
<td>Well-diversified mix of products and end-use markets (e.g., mining, forestry and construction).</td>
<td>Limited end-use markets (e.g., mining, forestry and construction).</td>
<td>One end use-market (e.g., mining, forestry or construction).</td>
</tr>
<tr>
<td></td>
<td>Strong complementary products from other non-competing OEMs.</td>
<td>Some complementary products from other non-competing OEMs.</td>
<td>Insignificant complementary products from other non-competing OEMs.</td>
<td>No complementary non-competing third party products</td>
</tr>
<tr>
<td><strong>Market Position</strong></td>
<td>Leader in all its territories and/or end-use markets.</td>
<td>Leader or among the leaders in most of its territories and/or end-use markets.</td>
<td>Adequate market position in its territory and/or end-use market but not one of the leaders.</td>
<td>Weak market position.</td>
</tr>
</tbody>
</table>

The following BRR risk factors are relevant to issuers in all industries (although the relevance of sovereign risk can vary considerably):

- **Sovereign Risk**: The issuer rating may, in some cases, be constrained by the credit risk of the sovereign; in other words, the rating of the country in which the issuer operates generally sets a maximum rating for the issuer. If the issuer operates in multiple countries and a material amount of its business is conducted in a lower-rated country, DBRS may reflect this risk by downwardly adjusting its issuer rating.

- **Corporate Governance**: Please refer to [DBRS Criteria: Evaluating Corporate Governance](#) for further information on how DBRS evaluates corporate governance and management.
ADDITIONAL BRR FACTORS

- The additional BRR factors discussed below may be very important for certain issuers, depending upon their activities, but they do not necessarily apply to all issuers in the industry.

**Size and Scale**
- Larger dealers benefit from economies of scale and are more likely to have the resources to expand services or increase product offerings from other non-competing OEMs. Larger dealers may also be able to extract closer attention from OEMs and are less likely to find it difficult to attract and retain skilled labour (such as repair technicians) during times of strong general employment.
- Larger dealers have the resources to attract, retain or develop skilled labour in-house, an important consideration because dealers rely on such resources to support a continuous stream of parts and service revenues, which are often less volatile and generate higher profit margins. Conversely, shortage of skilled labour could affect the firm’s ability to effectively deliver parts and services to customers and could cause reputation and business loss.
- Smaller dealers, particularly private firms, may be more reliant upon the OEM for capital and business support than in comparison with larger publicly traded companies.

**Supply Chain Management**
- Strong inventory management capabilities influence the dealer’s revenues, costs and reputation. For example, if a dealer has the needed inventory to complete a repair job or to deliver equipment to a customer, the dealer would generate revenues and reduce the customer’s downtime, increasing customer satisfaction and creating loyalty.
- A robust information system improves inventory control with up-to-date status of the availability of products and parts and reducing inventory investment. This is particularly important to allow firms to reduce its equipment and parts ordering during periods of slow demand to conserve cash flows to supplement lower operating earnings and cash flows during such periods.
- Parts and equipment management is also critical to a dealer’s profitability, as poor inventory management can entail additional costs associated with financing and storing inventory, or inventory obsolescence.
- The proximity of dealer distribution centres and repair facilities relative to the main distribution centres of the OEM can also impact customer service levels and costs.

**Currency**
- Exposure to the relative value of the U.S. dollar for non-U.S.-based dealers as most equipment are priced in U.S. dollars.
Capital Goods Dealership Financial Risk Rating

PRIMARY FRR METRICS
• The FRR grid below shows the primary FRR metrics used by DBRS to determine the FRR. While these primary FRR metrics are shown in general order of importance, depending upon an issuer’s activities, the ranking can vary by issuer.
• DBRS ratings are primarily based 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 not unusual for a company’s metrics to move in and out of the ranges noted in the grid below, particularly for cyclical industries. In the application of this matrix, DBRS looks beyond the point-in-time ratio.
• Financial metrics depend on accounting data whose governing principles vary by jurisdiction and, in some cases, industry. DBRS may adjust financial statements to permit comparisons with issuers using different accounting principles.
• Please refer to DBRS Criteria: Financial Ratios and Accounting Treatments – Non Financial Companies for definitions of, and common adjustments to, these ratios in the FRR grid below.
• Liquidity can be a material risk factor, especially for lower-rated non-investment grade issuers. DBRS will consider available sources of liquidity including cash on hand, cash flow, access to bank lines, etc., as well as uses of liquidity such as operations, capital expenditures, share buybacks and dividends for every issuer.
• DBRS considers an issuer’s financial policy including factors such as its targeted financial leverage, its dividend policy and the likelihood of share buybacks or other management actions that may favour equity holders over bondholders.
• While market pricing information (such as market capitalization or credit spreads) may on occasion be of interest to DBRS, particularly where it suggests that an issuer may have difficulty in raising capital, this information does not usually play a material role in DBRS’s more fundamental approach to assessing credit risk.

Capital Goods Dealership - Primary FRR Metrics

<table>
<thead>
<tr>
<th>Primary Metric</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flow-to-debt</td>
<td>30% to 60%</td>
<td>20% to 30%</td>
<td>10% to 20%</td>
<td>&lt; 10%</td>
</tr>
<tr>
<td>Debt-to-EBITDA</td>
<td>1.0x to 2.0x</td>
<td>2.0x to 3.5x</td>
<td>3.5x to 5.0x</td>
<td>&gt; 5.0x</td>
</tr>
<tr>
<td>EBITDA-to-interest</td>
<td>7.0x to 10.0x</td>
<td>4.0x to 7.0x</td>
<td>2.0x to 4.0x</td>
<td>&lt; 2.0x</td>
</tr>
<tr>
<td>Debt-to-capital</td>
<td>20% to 30%</td>
<td>30% to 45%</td>
<td>45% to 60%</td>
<td>&gt; 60%</td>
</tr>
</tbody>
</table>

ADDITIONAL FRR METRICS
• While the primary FRR metrics above will be the most important metrics that DBRS will use in determining the FRR of an issuer, other metrics may be used, depending upon an issuer’s activities, capital structure, pension liabilities and off-balance sheet obligations.
• Profitability, particularly in the medium term, can be an important differentiator of credit risk. DBRS may assess profitability through a variety of metrics, including return on capital.
• While free cash flow (i.e., net of changes in working capital, dividends and capital expenditures, etc.) can be volatile and, on occasion, negative, DBRS may use this and/or other cash flow metrics to assess a company’s ability to generate cash to repay debt.
• Because certain dealers may have the ability to sell back equipment to the OEM and may also have very conservative working capital policies, DBRS may on occasion permit higher debt levels for a given rating than would otherwise be permitted by the primary FRR factors in the table above.
Blending the BRR and FRR into an Issuer Rating

• The final issuer rating is a blend of the BRR and FRR. In most cases, the BRR will have greater weight than the FRR in determining the issuer rating.
• At the low end of the rating scale, however, particularly in the B range and below, the FRR and liquidity factors play a much larger role and the BRR would, therefore, typically receive a lower weighting than it would at higher rating levels.

Rating the Specific Instrument and Other Criteria

• For non-investment grade corporate issuers, DBRS assigns a recovery rating and reflects the seniority and the expected recovery of a specific instrument, under an assumed event of default scenario, by notching up or down from the issuer rating in accordance with the principles outlined in the criteria DBRS Recovery Ratings for Non-Investment Grade Corporate Issuers.
• Preferred share and hybrid considerations are discussed under Preferred Share and Hybrid Criteria for Corporate Issuers.
• The issuer rating (which is an indicator of the probability of default of an issuer’s debt) is the basis for rating specific instruments of an issuer, where applicable. 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 the general rating information contained in the DBRS rating policy Underlying Principles.
• For a discussion on the relationship between short- and long-term ratings and more detail on liquidity factors, please refer to the DBRS policy Short-Term and Long-Term Rating Relationships and the criteria Commercial Paper Liquidity Support Criteria for Corporate Non-Bank Issuers.
• 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 Holding Companies and Their Subsidiaries.
• Guarantees and other types of support are discussed in Guarantees and Other Forms of Explicit Support.
• For further information on how DBRS evaluates corporate governance, please refer to DBRS Criteria: Evaluating Corporate Governance.
• Please refer to DBRS Criteria: Financial Ratios and Accounting Treatments – Non Financial Companies for definitions of, and common adjustments to, these ratios.