Methodology

*Rating Companies in the Services Industry*

*July 2014*

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# Rating Companies in the Services 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” below.)
Services Industry

- DBRS defines the services industry as those firms which provide services to either industrial companies or to consumers. Industrial services include engineering services (excluding construction companies), architecture and design, research and development, logistics, operational management and other services provided to a wide range of sectors, including manufacturing, facility and waste management, chemicals, IT and infrastructure design. Consumer services can include private health care and tax or other advisory services, provided directly to consumers, other than banking or other financial services. Where discussions in this methodology are specific to only one of either industrial or consumer services, this will be highlighted. (Note that issuers in the oil and gas drilling sector, financial services, and engineering and construction companies are each covered in separate DBRS methodologies.)
- Per the three-tier IRR system described on the previous page, the services IRR is BB.
- The services industry is characterized by: (1) profitability and competition that vary with the degree of technical expertise required and the importance of the service to the customer; (2) generally low barriers to entry, resulting in higher-than-average industry competition; (3) reasonable stability that is somewhat isolated from general economic conditions, particularly for industrial services provided under longer-term contracts; (4) limited regulation that typically only monitors the education standards of employees and/or environmental or licensing issues; and (5) fragmentation in certain sectors, which can lead to the consolidating firms having large amounts of goodwill and other intangible assets on their balance sheets.
- Labour costs are often a substantial portion of total costs. When demand is strong, it may be difficult for firms to find the requisite skilled workforce, which can increase labour costs. Intellectual capital is important to these firms and investment in training and education must be ongoing. Their ability to recruit and retain quality staff is a significant challenge.
- Acquisitions to expand a company’s geographic reach or scale, or to acquire technological or delivery capability, are common, which could lead to an elevated debt level and material goodwill and intangible assets, when compared to its equity base. In times of weak demand and business conditions, the company may have to make significant provisions against impairment of such intangible assets, resulting in possible depletion of equity base.

**For Industrial Services Providers (to Public or Private Sectors) Only**
- Firms providing industrial services can be dependent upon the cyclical nature of the customers’ industry and vagaries of the customers’ businesses, which may be on a cycle that is different from general economic growth. Engineering firms supplying infrastructure projects, for example, may be more vulnerable to political issues rather than economic issues. While the presence of long-term contracts provides stability and probably increases profitability, the need to arrange for subcontractors can diminish this profitability. Diversification of customers and a flexible labour force can reduce the risk of declines in profitability from the loss of any given customer.
- Demand for industrial services could also depend on the preferences of customers (be they in the public or private sector) toward outsourcing, as opposed to conducting the operations themselves. Factors affecting the economic benefits and risks of outsourced operations (including savings of labour costs, IT and data costs and risk of business disruption) will also be important determinants of such demand.
- Especially for more technologically oriented or complex industrial services that are critical to a customer’s operations, a firm’s reputation and franchise can command higher pricing and repeat business, particularly if services represent a critical but small component of a customer’s overall costs.
For Consumer Services Providers Only

- Brand management and advertising can be important for consumer service providers and, in this respect, these companies are more akin to consumer product companies, although this is less important for more local service providers, such as private health care or related consumer services.
- Consumer services are much more standardized and consumers may be much more price-sensitive than their industrial equivalents. Competition in the consumer space, therefore, is generally more intense than it is in the industrial services space.
- Fixed assets tend to be limited, with the firm’s intellectual capital being more important than any hard assets. Debt tends to finance working capital rather than plant and equipment. For some firms, a substantial portion of earnings may be paid out as dividends, since the need for capital to support future capital expenditures is relatively low.
Services Business Risk Rating

PRIMARY 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.

<table>
<thead>
<tr>
<th>Rating</th>
<th>Market Position and Range of Services</th>
<th>Franchise/Brand Strength (Including Execution Capability and Reputation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>• Ranks number one or two in major lines of service, where it has a niche and a strong competitive position. • Significant size and critical mass in several major lines of service in several countries.</td>
<td>• Possesses industry-leading in-house expertise and execution capability in key lines of service. • Clear leader in service quality, staff training and customer relations. • Very strong credibility and reputation. • Very strong ability to maintain its expertise and attract and retain talent.</td>
</tr>
<tr>
<td>BBB</td>
<td>• Ranks in the top three as one of the industry leaders in several major lines of service. • Moderate size and critical mass in only a few countries.</td>
<td>• Possesses strong in-house expertise and execution capability in most lines of service. • Above-average service quality, training and relations. Strong in credibility and good reputation. Strong ability to maintain its expertise and attract and retain talent.</td>
</tr>
<tr>
<td>BB</td>
<td>• Has one or two lines of service in which it is strong and above average. • Small size, limited critical mass in mainly one country, partly mitigated by good competitive position in one or more niche markets.</td>
<td>• Possesses strong in-house expertise and execution capability in some lines of service and average in others. • Average service quality, training and relations for the sector. • Sector average in credibility and reputation. • Average ability to maintain its expertise and attract and retain talent. History of occasional loss of key staff.</td>
</tr>
<tr>
<td>B</td>
<td>• Is not considered a leader in most lines of service it offers. • Small size and limited dominance in any one line of service and located mainly in one country.</td>
<td>• Processes average to below-average expertise and execution capability in most lines of service. • Material reliance on subcontracted expertise to perform. • Some concerns with credibility and reputation in certain lines of service, with recent execution problems. • Has difficulty attracting and retaining key staff.</td>
</tr>
</tbody>
</table>


## Services – 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>Customer Relationships (for Industrial Services only)</strong></td>
<td>Majority of business supported by medium-to-long-term contracts.</td>
<td>High proportion of medium- to long-term contracts.</td>
<td>Some but moderate proportion of medium- to long-term contracts.</td>
<td>Limited revenue from medium- to long-term contracts.</td>
</tr>
<tr>
<td></td>
<td>Established long-term customer relationships with uninterrupted repeat engagements for more than ten years.</td>
<td>Good customer relationships with uninterrupted repeat engagements for more than five years.</td>
<td>Some customer relationships with repeat engagements for more than three years.</td>
<td>Some customer relationships with repeat engagements for less than three years, but customer attrition is an issue.</td>
</tr>
<tr>
<td></td>
<td>Demonstrated capability to service customers’ global operating needs.</td>
<td>Demonstrated capability to service customers’ operating needs in two or more geographic regions.</td>
<td>Demonstrated capability to service customers’ operating needs in local markets.</td>
<td>Limited demonstrated capability to service customers’ operating needs in any significant markets.</td>
</tr>
<tr>
<td></td>
<td>Switching costs for the customer are high.</td>
<td>Moderately high switching costs.</td>
<td>Average switching costs.</td>
<td>Low switching costs.</td>
</tr>
<tr>
<td></td>
<td>Typically services provided are essential to the customers’ operations, especially where such services make up a very small (&lt;5%) proportion of customers’ operating costs.</td>
<td>Services provided are somewhat essential to the customers’ operations, especially where services make up a moderate proportion (5%-10%) of customers’ operating costs.</td>
<td>Services provided are of limited essentiality but make up a material proportion (about 20%) of customers’ operating costs, suggesting vulnerability to customer attrition during cost-cutting exercises by the customer.</td>
<td>Services provided are not essential and they make up a significant proportion (&gt;20%) of customers’ operating costs and therefore are very vulnerable to cancellation if the customer is looking for ways to cut costs.</td>
</tr>
<tr>
<td><strong>Elasticity of Demand (for Consumer Services only)</strong></td>
<td>Higher pricing does not cause a large fall-off in demand.</td>
<td>Less flexibility in pricing but demand still relatively inelastic, so price increases only slightly affect volumes sold.</td>
<td>Flexibility in pricing is modest at best, although inconvenience of switching suppliers adds to stability.</td>
<td>Low pricing power as raising prices causes a sharp decline in demand for services.</td>
</tr>
<tr>
<td><strong>Cost Structure</strong></td>
<td>Very low cost structure allows for superior and steady profit margins.</td>
<td>Attractive cost structure, with normal and steady margins.</td>
<td>Average cost structure, which often leads to weaker and inconsistent margins.</td>
<td>A high cost structure in lines of service where it has no competitive advantage.</td>
</tr>
<tr>
<td></td>
<td>Strong control over all major cost items, technologies and processes required to provide its services.</td>
<td>Good control over some major cost items, technologies and processes required to provide its services.</td>
<td>Some control over only certain cost items. Limited control over technologies and processes required to provide its services.</td>
<td>Limited control over most cost items. Rely on purchase of technologies and processes required to provide its services.</td>
</tr>
<tr>
<td></td>
<td>Strong ability to pass on most increased costs to customers.</td>
<td>Some ability to pass on some increased costs to customers.</td>
<td>Limited ability to pass on increased costs to customers.</td>
<td>Reliance on subcontracted expertise with limited control in costs.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Average cost structure, which often leads to weaker and inconsistent margins.</td>
<td></td>
<td>No ability to pass on increased costs to customers.</td>
</tr>
</tbody>
</table>
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Services – 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>Diversification</td>
<td>• Large number of lines of service where company has strong competitive position.</td>
<td>• Major strength in a few lines of service.</td>
<td>• Concentrated in a few lines of service with no apparent competitive advantage.</td>
<td>• Limited to one or two lines of service with no apparent competitive advantage.</td>
</tr>
<tr>
<td></td>
<td>• Well-diversified by customers and geographic regions.</td>
<td>• Moderate diversification by customers or geographic regions.</td>
<td>• A service provider with meaningful customer or geographic concentration.</td>
<td>• A service provider with high customer or geographic concentration.</td>
</tr>
<tr>
<td></td>
<td>• No material exposure to any significant customer’s highly cyclical industry segment.</td>
<td>• Exposure to a few customers’ industry segments, one of which is considered cyclical.</td>
<td>• Many of customers’ industry segments are cyclical.</td>
<td>• Most customers’ industry segments are cyclical.</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.

**Order Intake and Backlog (for Industrial Services)**

• The ability of a company to obtain business orders and grow its backlog is important to future growth prospects and future resource planning. Backlog-to-annual revenue or book-to-bill ratios (defined as orders received divided by services delivered) are two commonly used indicators of order replenishments. While industry benchmarks could be different depending on the types or services provided and the end-user segments, comparison with peers providing similar services and historic trends of the company could give useful insight into the company’s business. A declining ratio could signal weak demand or business conditions of the end-user industries, or the company’s loss of competitiveness.

**Strategy of Growth by Acquisition**

• A strategy of continual acquisitions may be followed by larger firms in the industry acting as consolidators. Acquisitions pose a risk of overpayment and integration failure, although companies could develop a systematic and vigorous approach over time in establishing acquisition target selection criteria, conducting due diligence and executing business integration to mitigate these risks. Growth by acquisition can be a viable strategy, although the outcome may be large amounts of goodwill and intangibles in relation to the equity base of the company and expose it to possible impairment charges in the future.

**Regulations**

• Certain sectors may require specialized qualifications and permits. For these sectors, a record of past regulatory violations or sanctions may put downward pressure on a rating where these violations have been material as they relate to material parts of the business.
Services 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 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 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.

Services – 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>&gt; 30%</td>
<td>20% to 30%</td>
<td>10% to 20%</td>
<td>&lt; 10%</td>
</tr>
<tr>
<td>Debt-to-EBITDA</td>
<td>&lt; 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>&gt; 7.0x</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>&lt; 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.
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 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 (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.
- Potential indenture and legal considerations are discussed under the criteria Trust Indentures – Representations and Warranties, Covenants and Events of Default.
- 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.