Methodology

Rating Companies in the Consumer Products 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.)
Consumer Products Industry

- The consumer products industry encompasses companies that produce and sell non-durable consumer products to retailers for resale, including producers of packaged foods, personal and household care products, brewers, distillers as well as beverage and tobacco companies.
- Per the three-tier IRR system described on the previous page, the consumer products IRR is BBB.
- The consumer products industry is characterized by: (1) better-than-average industry stability, given that many consumer products are inexpensive and non-discretionary items, such as foodstuffs; (2) relatively high barriers to entry in the form of investment in brand development, operating efficiencies and access to distribution channels, particularly retailers; (3) intense competition at the product level, mitigated by a high degree of geographic and product diversification of the dominant firms in the industry; (4) significant innovation risks as the development of successful new products is often critical in preserving or growing market share; and (5) relatively light regulation focused primarily on product safety.
- Brand strength and market share are important factors in driving the industry’s profitability, each of which require large investments in advertising and promotion if any meaningful market share is to be obtained. Products ranked number one and number two in their respective categories are more likely to gain access to retailers. Large global players with strong brand recognition and financial resources have a distinct advantage and dominate specific product categories.
- Necessities display less price elasticity of demand than do luxury items; price increases on consumer necessities will therefore have less of a negative effect on sales relative to the effect of price increases on luxury items.
- Private label brands often compete purely on price, but rarely obtain any significant level of market share.
- Operating margins are greatly affected by economies of scale and operational efficiency. Operating profit margins are sensitive to commodity and other input cost increases and only the better brands are likely able to increase prices in a way that preserves margins.
- Capital expenditures are relatively low and consistently high free cash flow generation through the cycle is possible.
- Typical regulatory or legal concerns, such as product recalls and lawsuits, can have harmful and long-lasting effects on a company’s brand, profitability and cash flow.
Consumer Products Business Risk Rating

PRIMAR Y 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>Consumer Products — Primary BRR Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rating</td>
</tr>
<tr>
<td>Brand Strength</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Overall Market Position/Share</td>
</tr>
<tr>
<td></td>
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</tbody>
</table>
## Consumer Products — Primary BRR Factors

<table>
<thead>
<tr>
<th>Rating</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Diversification</strong></td>
<td>Highly diversified product selection across a number of product types.</td>
<td>Diversified product selection across a number of product types.</td>
<td>Some product diversification across product types.</td>
<td>Limited product diversification.</td>
<td>Very limited to no product diversification.</td>
</tr>
<tr>
<td></td>
<td>Significant exposure to different countries, regions and localities.</td>
<td>Exposure to different countries, regions and localities.</td>
<td>Some exposure to different countries, regions and localities.</td>
<td>Limited exposure to different countries, regions and localities.</td>
<td>Very little geographical diversification, increasing risks related to reliance on an individual area.</td>
</tr>
<tr>
<td></td>
<td>Excellent mix of access and controls to developed and developing markets ensuring very positive growth opportunities.</td>
<td>Mix of access and controls to developed and developing markets, ensuring growth opportunities.</td>
<td>Reasonable diversification across developed and developing markets.</td>
<td>Below-satisfactory growth opportunities resulting from exposure to developing markets.</td>
<td>Very limited to no exposure to different market types; greatly limited future growth opportunities.</td>
</tr>
</tbody>
</table>

| **Economies of Scale/Relative Size** | Large comparative size, offering strong input purchasing power. | Moderate to large size, offering influence on input purchase prices. | Reasonable comparative size, offering some purchasing power. | Below-reasonable relative size, offering limited purchasing power. | Poor size, with no purchasing power benefits. |
| | Scale that allows for significantly larger promotional and advertising campaigns. | Sufficiently large scale to allow for substantial promotional and advertising campaigns. | Scale that allows for reasonably sized promotional and advertising campaigns. | Less than satisfactory scale, thereby limiting opportunities for large promotional campaigns. | Poor scale makes it difficult to undertake significant promotional or advertising campaigns. |
| | Price leader, capable of increasing prices without suffering a substantial decline in volumes. | Influences market pricing, where increases in price have a moderate to small effect on volume declines. | Some influence on pricing. Changes in pricing have some effect on volumes. | Limited influence on pricing, resulting in high volume to price volatility. | Limited influence on pricing combined with significant volume impact of price changes. |
| | Large scale, allowing for investment in and use of newer technologies to improve logistics and increase efficiency. | Scale allows for the investment in and use of newer technologies. | Satisfactory size allows for some use of newer technologies that help improve logistics and increase efficiency. | Less-than-adquent capability to implement and benefit from newer technologies. | Limited use of newer technologies to improve efficiency and logistics. |
| | Very well established, robust, broad and diverse distribution channels. | Good to very well-established distribution channels ensuring timely access to the market. | Satisfactory distribution channel portfolio. | Less-than-adquent portfolio of distribution channels. | Poor distribution channels, elevating uncertainty and business risk. |

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.

Innovation/Responsiveness to Consumer Trends

• An important factor in growing sales and keeping product portfolios healthy is the existence of successful research and development programs to complement, renew or replace existing products in the portfolio.
• An indicator of a successful and innovative company is typically the maintenance of a high proportion of sales from products introduced within the previous five years.

Distribution Channels

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

Procurement/Supplier Relationships

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

Product Liability and Safety

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

### Consumer Products — Primary FRR Metrics

<table>
<thead>
<tr>
<th>Primary Metric</th>
<th>AA</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; 60%</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>&lt; 1.0x</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>&gt; 10.0x</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>&lt; 20%</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.
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 (Excluding Financial Institutions).
- 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 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 DBRS Criteria: Guarantees and Other Forms of Explicit Support.
- Potential indenture and legal considerations are discussed under DBRS 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.